



Ministry of Housing,
Communities &
Local Government

The decapitalisation rates for the 2021 business rates revaluation

A technical consultation paper and call for evidence on the decapitalisation rates for properties assessed on the contractor's basis of valuation.



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Scope of the consultation

Topic of this consultation:	This technical consultation seeks views on the decapitalisation rates to be adopted for the 2021 business rates revaluation in England.
Scope of this consultation:	The consultation concerns whether the Government should prescribe decapitalisation rates for 2021 and, if so, how the rates should be prescribed.
Geographical scope:	These proposals relate to England only.
Impact Assessment:	An impact assessment has not been prepared for this consultation as it is concerned with amendments to a local taxation regime.

Basic Information

To:	Business ratepayers, local government and their representative bodies.
Body/bodies responsible for the consultation:	Ministry of Housing, Communities and Local Government
Duration:	This consultation will last for 11 weeks from Thursday 14 March.
Enquiries:	For any enquiries about the consultation please contact nick.cooper@communities.gov.uk
How to respond:	<p>You can email your response to the questions in this consultation to ndr@communities.gov.uk clearly marking your email and response “Decap consultation response”</p> <p>If you are responding in writing, please make it clear to which questions you are responding. Written responses should be sent to:</p> <p>Non-Domestic Rates Team LGF – Local Taxation, SE Quarter - 2nd Floor Fry Building, 2 Marsham Street, London SW1P 4DF</p> <p>When you reply it would be very useful if you confirm whether you are replying as an individual or submitting an official response on behalf of an organisation and include:</p> <ul style="list-style-type: none"> - your name, - your position (if applicable), - the name of organisation (if applicable), - an address (including post-code), - an email address, and - a contact telephone number

Introduction

1. The Government is committed to supporting business with their rates bill and has introduced reforms in England worth over £13 billion by 2023. This includes providing eligible retailers with a third off their bills for two years from April 2019 and doubling Small Business Rate Relief from 50% to 100% for eligible businesses and raising the threshold for relief from £6,000 to £12,000. As a result, over 655,000 small businesses – occupiers of a third of all properties – pay no business rates at all.
2. As part of these reforms the Government has committed to introduce more frequent business rates revaluations and will bring forward the date of the next revaluation from 2022 to 2021. Thereafter the Government will move to 3 yearly revaluations ensuring rating assessments are more up to date.
3. In order to deliver upon this commitment, the Valuation Office Agency (VOA) has already started work on the 2021 revaluation which will be based on market rental values at 1 April 2019. For most properties the VOA will use evidence of actual rents to set rateable values but where market rents do not exist, they may use the “contractor’s basis” of valuation. But before the VOA can complete this task, the Government must first consider the decapitalisation rates to be used in contractor’s valuations. The decapitalisation rates are a technical part of the contractor’s basis of valuation without which the valuation cannot be finalised.
4. Since 1990 the Government has prescribed the decapitalisation rates to be adopted as part of contractor’s basis valuations. This technical consultation document considers whether the Government should again prescribe decapitalisation rates, discusses the methodological options for setting the rates and invites views and calls for evidence. Decisions will be taken in light of responses to this consultation after which the VOA will proceed to finish the revaluation.
5. Business rates policy is devolved and, therefore, this consultation applies to England only.

Background

6. Rateable values are set independently of Ministers by the VOA. 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 2019 for the 2021 revaluation)¹, if it was being offered on the open market. For most properties the VOA will use evidence of actual rents to prepare valuations. But for some specialist properties where rents do not exist they may use the contractor’s basis of valuation.
7. 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

¹ This date was set by regulation 2 of the Rating Lists (Valuation Date) (England) Order 2018 (S.I. 2018/553).

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.

8. 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),
- 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).

9. The decapitalisation rate (stage 4) may be prescribed by the Secretary of State in regulations. It is currently prescribed at:

- 2.6% for educational, healthcare and defence properties, and
- 4.4% for all other properties assessed on the contractor’s basis (such as specialist local government properties and heavy industry properties).²

10. It is estimated that about £3.5 billion of rates bills are currently valued under the contractor’s basis (and are therefore based on the decapitalisation rates). See table 1 below³.

Table 1: Estimate of current rates bills for properties assessed on the contractor's basis of valuation	
Sector	Rates Bill £m (2019/20 terms) before reliefs
Education	1,430
Health	570
Industry	260
Utilities and transport	500
MOD	130
Other public sector	520
Other non-public sector	90
Total	3,490

11. 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.

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

³ Notes: Based on estimates provided by the Valuation Office Agency as at 30 November 2018. Rates bill are based on the national non-domestic multiplier of 50.4p. Actual bills may be less especially in the education sector where many properties will qualify for 80% charity relief. Total may not sum due to rounding.

Whether to prescribe decapitalisation rates

12. Decapitalisation rates have been prescribed by the Government at every revaluation since 1990 and the Government is minded to prescribe them again for 2021.
13. Ending prescription and leaving the VOA to determine decapitalisation rates would have some advantages. It would allow the VOA 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.
14. 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.
15. 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. Ending prescription would also put additional burdens on the VOA (both in terms of setting rates and then defending those rates under challenge) and would not, therefore, support them in moving to more frequent revaluations.
16. The Government currently considers the factors supporting continued prescription are strong and is, therefore, minded to continue to prescribe the decapitalisation rates.

Question 1: Do you agree that the Government should prescribe the decapitalisation rates for the 2021 revaluation? And if not why not?

Prescribing the decapitalisation rates

17. If the Government decided to prescribe decapitalisation rates, it would have regard to all methodologies and factors which it considered relevant. Annex B describes the factors which the Government currently considers relevant in setting the decapitalisation rates. In summary the methods which have traditionally been considered in setting the decapitalisation rates are:
 - a. Method 1: The cost of securing capital to build the alternative property from borrowing. This was the method used by the courts prior to 1990 and the approach commonly supported by rating practitioners. However, it is less likely to reflect the cost of borrowing in the private sector,
 - b. Method 2: The cost of securing capital to build the alternative property from debt and equity. This method is more likely to reflect how capital is secured in the

private sector. However, the results can be very sensitive to small changes in inputs and it has limited relevance to public sector bodies, and

- c. Method 3: property investment yields. This provides direct evidence of yields in the market (showing the relationship between capital and rental values) but was rejected by the courts prior to 1990 and is not generally favoured by practitioners as valuations conducted on the contractor's basis have little connection to property yields or other rents.

18. The figures produced by the application of these methodologies are traditionally subject to an adjustment (called the "Denning Discount") to reflect the advantages and disadvantages of renting a property compared to owning a property.

Question 2. What are your views on the methodologies set out at Annex B for setting prescribed decapitalisation rates?

Question 3. Can you provide evidence in relation to the methodologies set out at Annex B for 2021 based on the valuation date of 1 April 2019?

19. Since 1990, the Government has prescribed 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 basis⁴. As a result, a wide range of different sectors and types of properties are assessed on the same rates. Adjusting the types of properties in each rate or even introducing new groups might allow the Government to adopt rates more specific to the circumstances of the properties concerned.

20. However, prescribing only 2 rates has provided certainty for ratepayers and has avoided the large changes in rate bills unconnected to the revaluation which would follow if sectors were moved between the rates. To create new groups would add 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.

Question 4. 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? If not, how should different properties be grouped and defined?

⁴ Prior to the ending of the Crown Immunity from rates in 2000, the MOD were assessed on the lower rate on the Crown list.

About this consultation

This consultation document and consultation process have been planned to adhere to the Consultation Principles issued by the Cabinet Office.

Representative groups are asked to give a summary of the people and organisations they represent, and where relevant who else they have consulted in reaching their conclusions when they respond.

Information provided in response to this consultation, including personal data, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 2018 (DPA), the General Data Protection Regulation, and the Environmental Information Regulations 2004).

If you want the information that you provide to be treated as confidential, please be aware that, as a public authority, the Department is bound by the Freedom of Information Act and may therefore be obliged to disclose all or some of the information you provide. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

The Ministry of Housing, Communities and Local Government will process your personal data in accordance with the law and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties. A full privacy notice is included at Annex A.

Individual responses will not be acknowledged unless specifically requested.

Your opinions are valuable to us. Thank you for taking the time to read this document and respond.

Are you satisfied that this consultation has followed the Consultation Principles? If not or you have any other observations about how we can improve the process please contact us via the [complaints procedure](#).

Annex A

Personal data

The following is to explain your rights and give you the information you are be entitled to under the Data Protection Act 2018.

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the data controller and contact details of our Data Protection Officer

The Ministry of Housing, Communities and Local Government (MHCLG) is the data controller. The Data Protection Officer can be contacted at dataprotection@communities.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

The Data Protection Act 2018 states that, as a government department, MHCLG may process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

3. With whom we will be sharing your personal data

As part of this consultation exercise, MHCLG may share your personal data with the Valuation Office Agency and HM Treasury.

4. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for two years from the closure of the consultation

5. Your rights, e.g. access, rectification, erasure

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right:

- a. to see what data we have about you
- b. to ask us to stop using your data, but keep it on record
- c. to ask to have all or some of your data deleted or corrected
- d. to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

- 6. Your personal data will not be sent overseas.**
- 7. Your personal data will not be used for any automated decision making.**
- 8. Your personal data will be stored in a secure government IT system**

Annex B

SETTING AN APPROPRIATE DECAPITALISATION RATE

1. If the Government decides to prescribe decapitalisation rates for the 2021 revaluation then it will consider the circumstances at 1 April 2019 (the valuation date for the 2021 revaluation). These rates would then apply for the 3 years of the 2021 rating list.

Broad principles in determining the decapitalisation rate

2. Prior to the rates in England and Wales being prescribed in 1990, the courts⁵ 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. Since 1990 the Government has had regard to these approaches when setting the decapitalisation rates and they are examined below for the 2021 revaluation.

The Denning Discount

4. 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 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 does not suffer from capital loss on the asset,
 - 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

⁵ The principle case being *Williams v Cardiff City Council* (VO) 1973 RA 46

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.

5. The first four of these factors increase the discount and the last four reduce the discount. Whilst some of these factors are capable of being analysed, all of them are, to a degree, a matter of professional judgement and may also vary by the type of property, the type of hypothetical tenant and the method adopted below. 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.
6. As a result, a wide range of outcomes is possible from the Denning Discount. At the previous revaluation in 2017 the Government concluded that the Denning discount could vary from a 4% point discount to a 2% point increase in the decapitalisation rate.

Method 1: The cost of securing capital to build the alternative property from borrowing

7. Prior to 1990, the courts looked towards debt as the principle means of finance. Therefore, whilst the leading case (*the Imperial College case*)⁶ 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). For 2021 the appropriate rate would, therefore, be the official bank rate as at 1 April 2019 to which it would be necessary to apply adjustment for inflation and a borrower's premium in reaching a cost of securing capital.
8. In the public sector, debt may also be secured from the Public Loans and Works Board and, therefore, in considering Method 1 regard is also had to the cost of borrowing from the PLWB again as at 1 April 2019.
9. To both of these sources of evidence, it would be necessary to apply the Denning discount. With historically low interest rates, the application of the Denning Discount could, at the lower end of the range, give rise to a negative outcome of Method 1. 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 command a rent. This is not realistic and suggests that the range of possible decapitalisation rates should have a minimum value.
10. Nor is it feasible that consideration of Method 1 would result in a single answer. A range of answers is more likely reflecting the different sources of debt and premium likely to be attached to different sectors and tenants for those properties assessed on the contractor's basis.

⁶ Imperial College of Science and Technology v Ebdon (VO) and Westminster City Council 1986 RA 233

11. The merits of Method 1 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 the construction of property (although not always exclusively).

12. The drawbacks of Method 1 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.

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

13. In the private sector capital may be 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).

14. The WACCs on relatively secure industries such as price controlled utilities will be low end compared to other more risky commercial occupations assessed on the contractor's basis. As a result the range of WACCs under consideration is likely to be wide. 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 range of outcomes from Method 2 is expected to be wide.

15. The merits of Method 2 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.

16. The drawbacks of Method 2 are that:

- the cost of equity and the balance between debt and equity can vary significantly between sectors and over time. This suggests the range for those ratepayers which use debt and equity will 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

17. 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.

18. Nevertheless, there is an argument for the use of industrial yields.

19. The merits of Method 3 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 reliant on professional judgement than other methods as it is based around observation of the market.

20. The drawbacks of Method 3 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, there may be little or no evidence of yields, and
- it is unlikely to have any relevance for the education, healthcare and Ministry of Defence rate.

Relative movement in rents between the valuation dates

21. 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. Central to the contractor's basis is the assumption that cost equates to value but that link is not always strong. In practice the value of existing properties will be driven by many other factors affecting supply and demand and not just the cost of constructing an alternative property. The strength or otherwise of those other factors would influence the decapitalisation rate used to reach the rental value.

22. A wider view of the relative movement in rents between the valuation dates for revaluations could, therefore, assist with the consideration of the decapitalisation rates. In principle, if movements of rateable values on the contractor's basis were significantly out of line with movements for other properties more generally then this could 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 could be argued that relative movements in rents should have some relevance in setting the decapitalisation rates.

23. However, it is unlikely that consideration of relative movement in rents would provide anything more than just 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 and any consideration of rental movements in setting the decapitalisation rate should be done with caution.

Consultation and call for evidence

24. At questions 2 and 3 in the consultation document the Government is seeking views on these factors and calling for evidence of them at the valuation date of 1 April 2019.
25. In providing evidence, respondents should state clearly whether their evidence is nominal or real. 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 Government expects that its starting point for the decapitalisation rate will be a nominal rate of interest (unless otherwise stated) in considering Options 1 or 2 above. To the extent that the effects of inflation should be adjusted or ignored in reaching a decapitalisation rate, this will be reflected in the Denning Discount (explained above).

⁷ See *Imperial College of Science and Technology v Ebdon (VO) and Westminster City Council* 1986 RA 233