

Explanatory Memorandum to the Non-Domestic Rating (Miscellaneous Provisions) (Amendment) (Wales) Regulations 2015

This Explanatory Memorandum has been prepared by the Local Government and Communities Department and is laid before the National Assembly for Wales in conjunction with the above subordinate legislation and in accordance with Standing Order 27.1.

Minister's Declaration

In my view, this Explanatory Memorandum gives a fair and reasonable view of the expected impact of the Non-Domestic Rating (Miscellaneous Provisions) (Amendment) (Wales) Regulations 2015. I am satisfied the benefits outweigh any costs.

**MINISTER FOR PUBLIC SERVICES
8 OCTOBER 2015**

Description

1. Non-domestic rates are a tax on properties which are not used for domestic purposes, such as shops, factories, offices, schools and hospitals. In 2015-16 non-domestic rates revenues in Wales are estimated to total £1.05 billion. The revenues contribute to the funding of local services in Wales.
2. On 1 April 2017 a new rating list will come into force and all non-domestic properties (known as hereditaments) in Wales will be assigned new rateable values for the purposes of calculating the non-domestic rates liability of these properties. Preparations are currently underway by the Valuation Office Agency (the “VOA”) to ensure that all non-domestic properties in Wales are revalued based on the value assigned to them as at the Antecedent Valuation Date (AVD) 1 April 2015.
3. This statutory instrument will set the decapitalisation rates which will be used when Valuation Officers calculate the rateable value of a property using the Contractor’s Method of Valuation – this is one of the three main valuation methods of calculating rateable value used by the VOA. The decapitalisation rates (along with a number of other factors) will therefore directly affect the rateable value of properties assessed according to the Contractor’s Method of Valuation and hence the non-domestic rates (“NDR”) liability attributed to them. The decapitalisation rates will also have a minor indirect effect on the NDR liability of all properties in Wales following revaluation.
4. This statutory instrument amends the Non-Domestic Rating (Miscellaneous Provisions) (No 2) Regulations 1989 (“the 1989 regulations”) in relation to properties valued on the Contractor’s Basis to be set out in the Non-Domestic Rating list to be compiled on or after 1 April 2017. It sets a lower decapitalisation rate of 2.1% for educational, healthcare, defence and public convenience properties and a standard rate of 3.8% for all other properties.

Legislative background

5. Paragraph 2(1) of Schedule 6 to the Local Government Finance Act 1988 (“the 1988 Act”) provides that the rateable value of a non-domestic hereditament is taken to be an amount equal to the rent at which it is estimated the hereditament might reasonably be expected to be let from year to year (subject to specified assumptions). In those cases where there is no available information on the general rental market and profit and loss cannot be used as an indication of rental value, the rateable value of a non-domestic hereditament is instead ascertained by ‘decapitalising’ the estimated total capital value of the hereditament to turn it into an annual rental equivalent. (This is known as “the Contractor’s Basis of valuation”).

6. The decapitalisation rates are prescribed by regulations made by the Welsh Ministers under paragraph 2(8) of Schedule 6 to the 1988 Act. This paragraph states that the Secretary of State (the power is now vested in the Welsh Ministers – see paragraph 6 below) may make regulations which provide that in determining the rateable value of a non-domestic hereditament (including a prescribed class of hereditaments), prescribed assumptions (as to the hereditament or otherwise) are to be made. The decapitalisation rates are one such prescribed assumption. The decapitalisation rates are prescribed in Regulation 2 of the 1989 regulations (as amended).
7. The powers of the Secretary of State in paragraph 2(8) of Schedule 6 to the 1988 Act were transferred, in relation to Wales, to the National Assembly for Wales by the National Assembly for Wales (Transfer of Functions) Order 1999. The Local Government Finance Act 1988 is referred to in Schedule 1 of that Order. The functions of the National Assembly for Wales were subsequently transferred to the Welsh Ministers under section 162 and paragraph 30 of Schedule 11 to the Government of Wales Act 2006.
8. The Regulations will follow the negative resolution procedure and will not be brought into force until 21 days from the date they are laid before the Assembly.

Purpose and intended effect of the legislation

Primary purpose of the legislation

9. Preparations are currently underway to ensure that all non-domestic properties in Wales are revalued and given new rateable values so that their non-domestic rate liability can be calculated for the purposes of compiling a new rating list. The new list will come into force on 1 April 2017 and will be based on values as at the AVD, 1 April 2015.
10. The primary purpose of revaluation is to ensure that the credibility of the ratings system is maintained and that the rates burden is fairly distributed based on relative changes in rental values in Wales.
11. Valuation works hand-in-hand with the multiplier. At each revaluation, the multiplier is reset to ensure the NDR tax-base can broadly generate the same level of funding after revaluation as before. This is because NDR needs to generate funding for the provision of local services at a level consistent with spending plans. As such, the combined effect 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 that rates liability is spread fairly between ratepayers and is based on up-to-date rental values.

12. Approximately 20% of non-domestic properties in Wales are valued using the Contractor's Basis of valuation. The proposed legislation will set the decapitalisation rates, which are a key component of this valuation method.

13. The primary purpose of this statutory instrument is to revise the decapitalisation rates to reflect market conditions as at the AVD.

The valuation process

14. The VOA is an executive agency of HM Revenue and Customs and is responsible for determining the rateable value of all non-domestic properties for the purpose of calculating NDR liability.

15. At the last revaluation in 2010, the total rateable value for all non-domestic hereditaments in Wales was approximately £2 billion. This comprised:

Sector	% Total Rateable Value
Commercial	59%
Education, Training and Cultural	6%
Utilities	11%
Industry	15%
Leisure	3%
Miscellaneous	6%

16. At every revaluation, the VOA calculates the new rateable value of a property based on the estimate of the rental value of the property on the open market. To ensure that rateable values keep pace with changes in the property market non-domestic properties are usually revalued every five years by the VOA. However the 2015 revaluation exercise was postponed until 2017.

17. The VOA uses three main 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. 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.

18. The Contractor's Basis is used when no such evidence exists. It is generally applied to 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 estimated construction costs. At the last revaluation in 2010, about 22% of all non-domestic properties in Wales were valued using the Contractor's Method of Valuation.

The Contractor's Basis

19. The Contractor's Basis involves the VOA estimating the cost of replacing the buildings and any other rateable items for example plant and machinery and then adjusting this estimate to reflect any obsolescence in the actual property. The resulting figure represents an estimate of the capital value of the site. This capital value is then "decapitalised" using the decapitalisation rate to give an annual equivalent which is taken to be the rateable value.
20. 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 could purchase land and build a similar hereditament.
21. Rating Case Law has established six principal 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 and adjust it 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 result of the application of the first four stages and make any adjustment required to reflect any factors 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 (v)).
22. The decapitalisation rate is required at stage (iv) of the Contractor's Basis of assessment. The rate is a percentage figure which is used to convert capital value into an annual rental value. It ensures that 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 rates, the higher the resultant rateable value will be.
23. Before 1990, valuation assessors and the Courts had a great deal of difficulty in deciding on the appropriate decapitalisation rate to be used in non domestic valuations. As a result there was extensive litigation on this issue following each revaluation exercise. Therefore, since 1990,

Ministers have prescribed the appropriate decapitalisation rate to be used in Contractor's Basis valuations.

Setting Decapitalisation rates

24. 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. For example, if at stage 3 of the Contractor's Basis, the capital value of a hereditament is calculated at £500k, if the decapitalisation rate is 4.5% (as is currently) the annual rateable value at stage 4 would be £22,500.
25. In turn, therefore, the decapitalisation rates will have an impact (albeit minor) on the total rateable value of hereditaments in Wales. It will also, therefore have an indirect effect on how the rating burden is distributed across other non-domestic properties by exerting pressure on the multiplier. If the decapitalisation rate increases, it exerts a downward pressure (albeit minor) on the multiplier, and vice versa.
26. Setting the decapitalisation rate is only one part of the revaluation process and impacts will be dependent on other factors such as market conditions, changes in rental values and the multiplier. These will be analysed as the revaluation progresses.
27. Determining appropriate decapitalisation rates is a complex matter and is not an exact science. There are a number of different academic 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 construction costs to be taken into account. In setting the rates, the Welsh Government has had due regard to all of the methods and factors which it considers to be relevant.
28. As the primary function of the decapitalisation rate is to translate cost into value, relative movements in rents between the valuation dates for the 2010 Revaluation and the 2017 Revaluation also needs to be taken into consideration. This acts as a check upon the results of the academic methods and will ensure valuations take into account the changes in the property market in Wales.
29. 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. 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 and grants. As a result, the decapitalisation rate (which in part reflects the cost of financing) should be lower compared with those hereditaments on the standard rate.

30. This statutory instrument will set the decapitalisation rates for the 2017 Revaluation:

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

PART 2 – REGULATORY IMPACT ASSESSMENT

Options

Option 1 – Do nothing – decapitalisation rates set for the 2010 Non-Domestic Rate Revaluation will remain in place

If no changes are made to legislation, the decapitalisation rates introduced following the 2010 Revaluation would continue to apply.

The Non-Domestic Rating (Miscellaneous Provisions) (Amendment) (Wales) Regulations 2008 apply to properties valued on the Contractor's Basis recorded in the Non-Domestic Rating list compiled on or after 1 April 2010.

The lower rate (2.97%) would continue to apply to educational, healthcare, defence and public convenience properties and the standard rate (4.5%) would continue apply to all other properties. These percentages reflect the market conditions on the AVD for the 2010 Revaluation which was 1 April 2008.

If decapitalisation rate(s) are not revised the credibility of the 2017 revaluation and the ratings system would be damaged. The primary purpose of the revaluation is to ensure occupiers of all non-domestic properties are subject to NDR liability based on up-to-date rental values.

Option 2 – Make legislation revoking previous legislation prescribing decapitalisation rates

No decapitalisation rates would be prescribed in relation to properties on any Non-Domestic Rating list compiled on or after 1 April 2017.

For the 2017 Revaluation the decapitalisation rates applied in the valuation process would instead be decided by the valuation assessors in each category of valuation.

This would have a number of adverse impacts for ratepayers, the Welsh Government and public services.

Option 3 – Prescribe decapitalisation rates for the 2017 Revaluation

Revised decapitalisation rates would be prescribed in relation to properties valued by the Contractor's Basis shown in the Non-Domestic Rating list compiled on or after 1 April 2017.

A lower rate (2.1%) will apply to educational, healthcare, defence and public convenience hereditaments. A standard rate (3.8%) will apply to all other properties.

Revising the decapitalisation rates to reflect the market conditions as at the AVD for the 2017 Revaluation (1 April 2015) will ensure the credibility of the

ratings system is maintained by ensuring occupiers of all non-domestic properties are subject to NDR liability based on up-to-date rental values.

Costs and benefits

Option 1 – Do nothing

Costs

The decapitalisation rates (prescribed by the Non-Domestic Rating (Miscellaneous Provisions) (Amendment) (Wales) Regulations 2008) which reflect market conditions as at 1 April 2008 are higher than the rates which would have been prescribed had they been revised to reflect the current market conditions on AVD for the 2017 Revaluation (1 April 2015).

As a result properties valued by the Contractor's Basis would have a higher rateable value and therefore non-domestic ratepayers would receive higher rates bills than they would otherwise.

An increase in the rateable value of a non-domestic property valued by the Contractor's Basis, would also have an indirect effect on the distribution of the rating burden by exerting a downward pressure (albeit minor) on the multiplier. This would lead to those non-domestic properties not valued by the Contractor's Basis having a lower rates bill than would otherwise be the case.

The primary reason for revaluation and reviewing the decapitalisation rates is to maintain the credibility of the rating system by ensuring occupiers of all non-domestic properties are subject to NDR liability based on up-to-date rental values.

Not revising the decapitalisation rates to reflect the market conditions at the AVD for the 2017 Revaluation, could damage the credibility of the rating system and the revaluation process. It could also lead to a higher number of appeals in respect of properties valued via the Contractor's Basis.

Benefits

Other than no amending legislation being required, the benefits of doing nothing are very limited.

The primary reason for revaluation and reviewing the decapitalisation rates is to maintain the credibility of the ratings system by ensuring occupiers of all non-domestic properties are subject to NDR liability based on up-to-date rental values.

Option 2 – Make legislation revoking previous legislation prescribing decapitalisation rates

Costs

Revoking the prescription of the decapitalisation rates would increase the scope for a large number of appeals and litigation in respect of properties valued via the Contractor's Basis.

It is likely ratepayers affected by the Courts' decisions in relation to decapitalisation rates would wait many years before their rateable values, and therefore, their rates bills could be confirmed. This would create unnecessary uncertainty and the potential for large backdated liabilities.

It is now around 25 years since appeals against prescribed decapitalisation rates were last considered. Before 1990, the following issues were considered to be central to the setting of the rate:

- The cost of finance that would be required by the range of likely tenants who, under the assumptions of the Contractor's Basis of valuations, would be considering building their property; and
- How the cost of that finance should be adjusted in recognition of the fact that the tenant would decide to rent the property rather than build an alternative property.

It is likely that these issues would arise again and lead to continuous appeal. There is no evidence to suggest that, since 1990 uncertainty surrounding rates would have reduced had they not been prescribed. In fact because financing theory has developed considerably since 1990 and there are now many more sophisticated academic models available, this would almost certainly give rise to even greater uncertainty and resulting extensive litigation.

If decapitalisation rates are not prescribed by the Welsh Ministers, the following difficulties are likely:

- some ratepayers would be unable to predict their rates liability with a reasonable degree of certainty;
- the Valuation Office Agency (VOA) would struggle to make accurate predictions about the overall Rateable Values of property and likely number of appeals; and therefore
- it would be more problematic for the Welsh Ministers to set the multiplier whilst ensuring that no more tax is raised from rates in real terms after the revaluation than was raised before the revaluation; and
- there would be uncertainty as to the total expected non-domestic rates yield and hence as to funding for public services

An increase in appeals would also lead to increased legal, consultancy and staff costs. As there would be a high level of uncertainty around the number of appeals and the associated costs, it is not possible to provide an accurate estimate of such costs.

Benefits

There are limited benefits of not prescribing the decapitalisation rates. It could be argued that in the long term, uncertainty over the rates should be settled by allowing the appeals courts to determine the right rate for different classes of property. However it is far from clear that the courts could deliver long term stability, consistency and a thorough consideration of individual cases.

Option 3 – Prescribe Decapitalisation Rates for the 2017 Revaluation

Costs

The decapitalisation rates prescribed within this statutory instrument are lower than the rates which were applied for the 2010 revaluation, reflecting relevant changes in the costs of construction and current market conditions. This will exert a slight downward pressure on the total rateable value of property in Wales which in turn will exert an upward pressure (albeit minor) on the multiplier and the ratings bill of properties which are not valued by the Contractor's Basis. It is not possible to quantify this impact as it will also depend on the relative changes since the last revaluation of rateable values for properties not valued on the Contractor's Basis.

Benefits

The primary reason for a revaluation is to ensure occupiers of all non-domestic properties are subject to NDR liability based on up-to-date rental values.

Revising the decapitalisation rates to reflect the market conditions, as at the AVD for the 2017 Revaluation (1 April 2015) will ensure the credibility of the ratings system is maintained and that the rates burden is fairly distributed based on relative changes in values.

Maintaining the current groupings of properties which are subject to the lower and standard rate will avoid any big increases in rates liability and provide a degree of stability for all ratepayers.

Consultation

A public consultation sought views on setting the decapitalisation rates for the Non-Domestic Revaluation 2017. The six-week technical consultation was launched on 14 August 2015 and closed on 25 September 2015. The full consultation can be found at **Annex A**.

It asked stakeholders for views on the proposal to continue to prescribe a standard and lower decapitalisation rate, as well as the available methodology and the preferred approach for calculating the rates.

The consultation was sent to the following organisations:

- All Local Authorities
- Welsh Local Government Association
- Valuation Tribunal Wales
- Valuation Office Agency
- Institute of Revenues, Rating and Valuation
- Royal Institute of Chartered Surveyors

11 consultation responses were received.

The breakdown of responses is as follows:

- 4 Property consultancy/real estate firms
- 3 Rating/Taxation Professional Associations
- 2 Local Authorities
- Welsh Local Government Association
- 1 Police Force

All responses generally agreed that Welsh Government should continue to prescribe decapitalisation rates, as long as it is set fairly and is set within the confines and precedents of existing case law. There was a general consensus that on balance the advantages of prescribing decapitalisation rates outweighed the disadvantages.

The majority of responses agreed that the Welsh Government should continue to prescribe two decapitalisation rates. The general consensus was that on balance the advantages of maintaining the status quo and continuing to prescribe two decapitalisation rates outweighed the disadvantages. While many different alternative proposals were put forward, it was acknowledged in most responses that, the current system worked and was well understood.

Competition Assessment

In drafting this Statutory Instrument we have applied the Office of Fair Trading's competition filter test.

The purpose of revaluation is to adjust the liability of properties *relative* to others within the NDR tax-base whilst ensuring the NDR tax-base can broadly generate the same level of revenue after revaluation as before.

The purpose of setting the decapitalisation rates is to ensure the rateable values (and therefore the rates bills) of those properties valued via the Contractor's Basis reflect market conditions as at the AVD date 1 April 2015.

While this Statutory Instrument will impact upon all sectors, no competition impacts have been identified as arising from these proposals. However, if the Regulations were not made, the credibility of the ratings system would be damaged and the rates burden would not reflect current market conditions.

Equality Impact Assessment

In drafting these Regulations, consideration has been given to the duty on Welsh Ministers' to promote equality and eliminate discrimination.

No impact on protected groups has been identified.