

NON DOMESTIC RATING REVALUATION 2010 DECAPITALISATION RATE FOR SPECIALISED PROPERTIES

A brief explanation

There is to be another rating revaluation of all non domestic properties, in 2010. The last one in NI occurred in 2003 and before that, 1997.

All properties are valued for rates by reference to an estimate of rental value (net annual value or NAV). However, some properties are rarely let and therefore have to be valued with reference to construction costs.

This amounts to about 17% of the total value attributable to non domestic properties, including hospitals, schools, airports, shipyards, some sport and leisure facilities, churches* and halls*.

A conversion factor (the decapitalisation rate) is needed to derive an annual equivalent or rental value from the depreciated construction cost estimate and is loosely based on the cost of borrowing.

Small changes in the decapitalisation rate can have a big effect on rate bills.

Up until 1997 (and 1990 in GB) this factor was determined by valuers but its uncertainty led to expensive and prolonged litigation which served neither government nor ratepayers well.

Since then decapitalisation rates have been prescribed in legislation and this can only be set at revaluations.

There are two decapitalisation rates, a lower one for healthcare, education and Ministry of Defence property and a standard one for all other specialized properties.

* These types of properties are mainly exempt or have substantial relief and therefore pay little or no rates but until there is universal metering of non domestic properties, occupiers may be paying an unmetered water and sewerage charge to NI Water calculated with reference to NAV.

What is this consultation about?

1. The purpose of this short paper is to inform relevant non domestic ratepayers at an early stage about plans for the treatment of properties that are assessed with reference to construction costs and afford them the opportunity to express their views and make representation about:
 - the continuing need for prescription; and
 - the proposal to follow the English decapitalisation rates for the Revaluation in 2010.

What impact will these proposals have?

2. It is appreciated that views are being sought before the decapitalisation rates are set for England, Scotland and Wales and before impacts can be fully assessed. We do not know the results of those consultation exercises yet. However, it is our assessment that England and Scotland will adopt decapitalisation rates that are no higher than the current ones (5% and 3.33%), which at the very least will mean a small but significant reduction for NI in the decapitalisation rate.
3. It is too early in the revaluation process to say what the precise impact will be in money terms because a variety of other factors come into play, such as cost inflation since the last revaluation, rental growth of other sectors and rates in the pound. It is clear, however, that harmonisation with England and other parts of the UK will help moderate all cost based assessments in NI, compared to what they would have been at current decapitalisation rates.

Why not consult later, when these matters are more certain?

4. The position regarding decapitalisation has to be established in advance to allow time for the legislation and valuations to be prepared and to provide certainty for ratepayers.
5. The matter has been out for consultation in England, Scotland and Wales. For this reason, undertakings and organisations which operate on a UK wide basis, may find that their head offices have responded to the more extensive consultation undertaken in England. **This consultation is targeted at undertakings and organisations that are solely based in NI** though it is not confined in this way and views are welcome from interested ratepayers who do not fall into this category.

6. It is worth noting that the English consultation exercise was completed in mid September this year and Ministerial decisions for England have still to be made. An announcement is expected before the end of this year, 2008.

Why consult at all?

7. The Department is reasonably satisfied that the proposed approach, which has been adopted for the last two revaluations here, is the best one for both government (regional and local) and ratepayers. Although this may appear to be a rather obscure and technical matter, it is important that ratepayers who are affected by this gain an understanding of the issue and are afforded an opportunity to comment. It is not expected that there will be a high response rate, however, consultation is all about discovering unforeseen consequences and for this reason (as well as the need for openness and transparency) the Department considers the exercise to be a worthwhile one.

Why revalue?

8. Last year the NI Executive authorised a revaluation of non domestic property. This will come into effect in April 2010 and will be based on values pertaining at April 2008. Revaluation is a natural part of the property taxation system and this one builds on the recent non domestic revaluations in 2003 and 1997.
9. The purpose of the exercise is to ensure fairness by redistributing the commercial rating burden amongst businesses in line with current rental values. The aim is to reflect the social, economic and environmental changes that have taken place since the last revaluation. It is not an exercise in raising more revenue from the system, it simply redistributes the rating burden in a different way.
10. Some of the new rateable values will, as before, be derived from the contractor's basis of valuation and this consultation paper contains proposals for prescribing the decapitalisation rate to be used by valuers in such cases.
11. For the first time, NI's non domestic revaluation is taking place at the same time as the rest of the UK.

Why use costs to value?

12. Broadly speaking, the rateable value of a property is taken to be its market rental value at the valuation date. For the 2010 valuation list, the valuation date is 1 April 2008. In most cases, valuers will use evidence of actual

rents to determine rateable values but that is not always possible.

13. Where there is insufficient rental evidence available, valuers may use the receipts and expenditure method of valuation to ascertain the rateable value of a property. Where there is insufficient rental evidence available and the property is of a type which is not considered suitable for valuation by the receipts and expenditure method, valuers may have to resort to a valuation using costs, commonly known as the contractors' method of valuation.
14. This method requires a valuer to estimate the cost of replacing the buildings and any other rateable items such as plant and machinery. This cost is then adjusted to reflect any obsolescence in the actual property, and the figure arrived at added to the capital value of the site. The total capital sum is then decapitalised by using a "decapitalisation rate" to give an annual equivalent which is taken to be the rateable value.
15. The contractors' method is used in the main to value specialised public sector buildings but it also includes some large industrial and commercial properties. Examples include airports, shipyards, community halls, sporting leisure facilities hospital and schools. It is also used to value churches and halls, though these are usually exempt from rates.

The Decapitalisation Rate

16. Before 1990, the decapitalisation rate had to be assessed for each property that was subject to a contractors' method of valuation. Valuers and the courts had experienced great difficulties in deciding the appropriate decapitalisation rate. This resulted in extensive litigation which would have recurred with the introduction of each new valuation list.
17. To eliminate the risk of appeals and remove uncertainty about rateable values it was decided to prescribe[†] the decapitalisation rate in the UK for each revaluation, as they occur. Broadly speaking, the rates are set having regard to various interest rates and property yield rates, reflecting the cost of borrowing that a tenant occupying the property might incur if rebuilding.
18. For the NI 1997 valuation list, the rate was set at 5.5%, except for education and health care properties which had a lower rate of 3.67% which at that time was in line with the rest of the UK. For the NI 2003 valuation list the decapitalisation rates remained unchanged and at that time matched the rates used for the GB revaluation on 2000. MOD property was added to education and healthcare on the lower rate in line with the rest of the UK.
19. The Northern Ireland rates are however now out of line with those applying in the rest of the UK. This is because the revaluation dates in NI and GB are

[†] In Northern Ireland this was achieved using powers in the Rates (Northern Ireland) Order 1977

out of sequence, with the last revaluation in GB being carried out in 2005. This introduced a decapitalisation rate of 5% with a lower rate of 3.33% for GB.

20. Therefore, taking the most likely scenario where, Northern Ireland at the Revaluation in 2010 reduces its decapitalisation rates to the current GB level of 5% and 3.33%, it is expected that this will help moderate assessments for these properties. It is not possible to be precise about the impact because of other factors, such as above trend increases in construction costs over the past couple of years. Much will depend on the regional cost variations that are applied.

Whether To Prescribe The Decapitalisation Rate

21. The scope for excessive litigation on decapitalisation rates remains as significant now as it was in 1990. It could be argued that because the courts have not considered decapitalisation rates since 1990, the scope for argument in appeals over the appropriate rate is greater than it has ever been. Furthermore, the Department is unaware of any pressure to change prescription from non-domestic ratepayers or their advisors. Therefore, the Department proposes to continue to prescribe the decapitalisation rates to be used in the contractors' method of valuation.
22. The Department will prescribe parts of the rating valuation process only for those industries or occupiers where it is not possible to use the normal rental approach but instead using the actual or notional cost of construction. These are:
 - educational or health care properties,
 - local government properties,
 - Crown properties,
 - large industrial properties,
 - conference and exhibition centres,
 - Community halls,
 - airports and airfields, and
 - some sport and recreational facilities.

The Department welcomes comments on its plans to continue to prescribe the decapitalisation rates used in contractor's basis valuations.

Setting the Rate

23. The Department is merely suggesting that we follow the decapitalisation rates that will be fixed for England. Although Scotland has followed the

English levels since 1990 no decisions have yet been made by Scottish Ministers for the next revaluation.

24. Were the Department to prescribe a different rate or allow valuers to assess the rate, it is generally accepted that there are 3 main methods which can be used to set one.
25. The traditional approach involves estimating the cost of borrowing allowing for deductions which take account of the effects of inflation over time and real costs of appreciation or depreciation. This would produce a decapitalisation rate between 6% and 8.5%.
26. Yields from property investment which examine rates of return on capital investments. Average yields on industrial investments as at April 2008 (the valuation date for the 2010 rating list) suggest a rate of not less than 8%.
27. The money market approach which analyses the factors which determine yields in the investment market. This method indicates a rate of between 6.5% and 10%.
28. The evidence from these methods suggests that the main decapitalisation rate could fall within a wide range of 6% to 10%. Two of the three methods suggest that a more appropriate range would lie between 6% and 8% (though practice in the past was to cast it at the low end of the range to reflect what prospective tenants would be willing and able to pay).
29. Setting the rate at these sorts of levels could result in an increase of up to 3 times the average increase in rateable values for other types of property in Northern Ireland, though (as explained below) this will not mean rate bills will increase proportionately.
30. **The Department considers that the best approach to take is to set decapitalisation rates in line with what is agreed for England and other parts of GB provided that is consistent with the principles set out above.**
31. Furthermore, to do otherwise (i.e. strike a lower rate for NI) carries a risk that it would contravene European Union regulations on State Aid. The Department also has to consider the interests of the majority of non-domestic ratepayers that are valued by conventional methods to ensure that the rate bills applying to the specialised properties assessed with reference to costs are not being cross subsidized.
32. Another consequence of following the preferred options in the English consultation paper, assuming they are adopted, is that two decapitalisation rates are used, a standard one and a lower one for the educational, health

care and other institutional properties. The Department considers this to be desirable.

33. In relation to education and healthcare properties, the rationale for putting them on the lower rate when it was introduced in 1995 in GB (and 1997 in NI) was that these types of occupiers were, in theory, deemed to be able to fund building from cheaper sources of finance, particularly so in the charitable sector, with funding available from donations. There may be sufficient grounds, therefore, for continuing this treatment, particularly in the context of both these sectors being spending priorities for the NI Assembly.
34. Until 2000, MOD properties came under Crown exemption, which meant that the Crown paid a contribution in lieu of rates which is equivalent to the full bill had they been liable. In 2000, when MOD sites became liable for rates on the same basis as other non-domestic properties, it was agreed to adopt the lower decapitalisation rate, given the very specialised nature of MOD property and also the substantial increase in rates that would occur through placing the defence estate on the standard decapitalisation rate.
35. Moving these properties to the standard decapitalisation rate could substantially increase their rates bills and, in the case of education and health estates, would be counter to the Assembly's priorities in these key policy areas. It would also make little sense given that they are ultimately funded by the Assembly. Similar grounds exist for retaining MOD on the lower rate, though the issue is one of national interest, as defence is not a devolved matter.

The Department welcomes views on whether the decapitalisation rates should follow those which will be set by England

Financial Implications

36. We estimate that moving the current rates of 5.5% and 3.67% to 5% and 3.33% would lead to average valuation decreases (not rate bills) of around 9%. A summary analysis is attached at **Annex 1** for your information. This does not necessarily mean a 9% decrease in rates bills as there are various other factors to consider. A key one is the multiplier (or poundage) for 2010-11 which will be set by the Assembly in 2010 when full information on the effect of the revaluation is available. The legislation requires that the multiplier is set so that, following the revaluation, broadly the same level of rates is raised as before. This is so that revaluation does not result in an overall increase in yield from business rates, but redistributes rates paid more fairly by reflecting current prices and relative rateable values.

37. The decapitalisation rate is only one of several factors which could affect the outcome of a contractor's basis valuation. Rateable values for 2010 may vary from the rateable values in the 2003 valuation list because of, for instance, changes in the value of land or changes in building costs. Whatever the Assembly decides to do, rateable values and rates bills may still change due to other factors.
38. The higher the decapitalisation rate set, the higher the overall relative increase in rates payable by businesses that it applies to. This in turn increases the overall yield across Northern Ireland from rates as a result of the revaluation and therefore reduces the multiplier, so that the additional income from business that the decapitalisation rate applies to is effectively redistributed amongst all rate payers by reducing their rates bills.
39. Attached at **Annex 2** are references to the English, Scottish and Welsh Consultation Papers, which provide more detailed technical and background information. The English and Scottish papers do not seek views on the actual rates themselves but rather on the need for prescription and the methodology used to set the rates. The Welsh Paper does seek views on the level of the higher and lower rates.

If you have any comments they should be sent by 16 January 2009 to;

Department of Finance and Personnel
Rating Policy Division
Room D12, Rathgael House
Balloo Road
BANGOR
BT19 7NA

or you may wish to fax your comments to 028 9185 8008.

or e-mail your response to:

ratingpolicy.cfg@dfpni.gov.uk

Decapitalisation Analysis

This note records a summary of the analysis which was carried out to look at the impact of altering the decapitalisation rate. The list of property types which were included in the analysis is identified in the table below

CLASS	DESCRIPTION	DECAP RATE
299	Airfield, Airport	5.5
831	Court, Police Station, Custodial Centre	5.5
841	Barracks, Military Camp, Airfield, Misc. Defence	3.67
851	Fire Station	5.5
321	Community Hall, Ballroom, Bandroom, Misc.	5.5
811	Hospital	3.67
321	Youth Hostel	5.5
511	Libraries, Museums, Art Galleries	5.5
521	Day Nurseries	3.67
851	Public Conveniences	5.5
521	Schools, Colleges, Universities	3.67
821	Religious Establishments (other than places of worship)	5.5
311	Sporting and Recreational (driving ranges, leisure centres, swimming pools, playing fields, race track)	5.5
321	Theatre	5.5
299	Bus station, Bus depot	5.5

Results

- The total (non-exempt) NAV of the properties which were valued using this method was £170,319,822.
- This represents 16.7% of the total non domestic tax base.
- There were some 4,996 properties from a total of 69,480 (only 7.2%).
- The total rate revenue generated based on 08/09 poundages from these properties is £87,546,307 which is 18.36% of the overall non domestic revenue for 08/09.

Setting Decap rates at current England and Scotland Levels

- Reducing the decap rates to 5% and 3.33% respectively reduces the overall value of these properties in NAV terms to £154,633,076 (a drop of 9.21%).
- It has the effect of reducing the NAV of properties by 9%.
- The revenue from these properties would fall to £79,483,018 – again a 9.21% drop.

Setting Decap rates 1% lower

- Reducing the decap rates by 1% compared to current levels would reduce the overall tax base by £41,587,806 (a fall of 24%).
- The non domestic regional rate would have to be increased by 1.19p to generate the same revenue.

The English Consultation Paper -

<http://www.communities.gov.uk/publications/localgovernment/decapitalisationrate>

The Scottish Consultation Paper –

www.scotland.gov.uk/Publications/2008/06/decapitalisation

The Welsh Consultation Paper -

<http://new.wales.gov.uk/consultation/dsjlg/2008/decapitalisation/consultation.doc?lang-en>