Explanatory Memorandum to the Non-Domestic Rating (Miscellaneous Provisions) (No.2) (Amendment) (Wales) Regulations 2019

This Explanatory Memorandum has been prepared by Local Government Strategic Finance Division 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) (No.2) (Amendment) (Wales) Regulations 2019. I am satisfied the benefits justify the likely costs.

Rebecca Evans AM
Minister for Finance and Trefnydd
25 November 2019

PART 1 – EXPLANATORY MEMORANDUM

Description

1. Non-domestic rates (NDR) are a local tax which raise revenue on properties that are used for non-domestic purposes, for example public buildings, shops, factories, offices, schools and hospitals. In 2019-20, non-domestic rates in Wales are estimated to generate over £1 billion (net). All the revenue is distributed to local government to help fund local services in Wales.

2. On 1 April 2021, depending on the passage of primary legislation in Parliament, 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 their rates liability. The Valuation Office Agency (VOA) is already engaged in the work to ensure that all non-domestic properties in Wales are assigned new rateable values as at the Antecedent Valuation Date (AVD) of 1 April 2019.

3. This statutory instrument sets 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 methods the VOA uses for calculating rateable values. Decapitalisation rates are used to convert the capital value of properties to an equivalent rental value where no rental comparison or receipts and expenditure evidence exists. The decapitalisation rates (along with a number of other factors) therefore directly affect the rateable value of properties assessed according to the Contractor's Method of Valuation and the rates liability attributed to them. The decapitalisation rates will also have a minor indirect effect on the liability of other 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 in the rating list to be compiled on or after 1 April 2021. It sets a lower decapitalisation rate of 1.9% for educational, healthcare, public conveniences and defence properties and a standard rate of 3.5% for all other properties.

Matters of special interest to the Constitutional and Legislative Affairs Committee

5. No matters of special interest to the Constitutional and Legislative Affairs Committee have been identified.

Legislative background

6. 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 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 determined 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).

7. The decapitalisation rates are prescribed by Regulations made by the Welsh Ministers under paragraph 2(8) of Schedule 6 to the 1988 Act. The paragraph states that the Secretary of State (the power is now vested in the Welsh Ministers) 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).

8. 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 an enactment referred to in Schedule 1 and transferred by Article 2 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.

9. The Regulations will follow the negative resolution procedure.

Purpose and intended effect of the legislation

Primary purpose of the legislation

10. Preparations are currently being made to ensure that all non-domestic properties in Wales are revalued and given new rateable values so that their non-domestic rates liability can be calculated for the purposes of compiling a new rating list. The new list will come into force on or after 1 April 2021 and will be based on values as at the AVD, 1 April 2019.

11. The primary purpose of revaluation is to ensure that the credibility of the rating system is maintained and that the rates liability is fairly distributed between properties based on relative changes in rental values in Wales.

12. Valuation works hand-in-hand with the multiplier. At each revaluation, the multiplier is reset to ensure the tax-base can broadly generate the same level of funding after revaluation as before. This is because the rates system 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 non-domestic tax-base. This ensures that rates liability is spread fairly between ratepayers and is based on up-to-date rental values.

13. Approximately 14% of the non-domestic tax-base in Wales is 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.

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

The valuation process

15. 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 their rates liability.

16. At every revaluation, the VOA calculates the new rateable value of a property based on an 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 next revaluation is planned to be moved forward from 2022 to 2021. The 2019 Regulations have been drafted to allow the rates to be applied to a list compiled on or after 1 April 2021 to accommodate both dates.

17. The VOA uses three main methods for calculating the rateable value of a property depending on the available evidence. Rental Comparison where there are sufficient numbers of comparable properties to provide reliable evidence on rental values: this method is the most commonly used. 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 by the business occupying the property, for example pubs and hotels.

The Contractor's Basis

18. The Contractor's Basis is used when no rental comparison or receipts and expenditure 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.

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 the 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.

    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 point following each revaluation. Therefore, since 1990, Ministers have prescribed the appropriate decapitalisation rate to be used in Contractor's Basis valuations.

24. In the 2017 revaluation, around 6,000 non-domestic properties in Wales were valued using the Contractor's Basis. These properties had a total rateable value of approximately £365m as summarised in the following table.

Sector	**Rateable value (£m)**
Utilities	39
Education	133
Industry	55
Local Government	42
Health	56
Other Government	22
Defence	8
Other	10
Total	**365**

Setting Decapitalisation rates

25. If the decapitalisation rate is prescribed in legislation, it has a fixed value and therefore has a demonstrable effect on the rateable value of 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 £500,000 and the decapitalisation rate is 3.8% (the current higher rate), the annual rateable value at Stage 4 would be £19,000.

26. In turn, therefore, the decapitalisation rates have an impact (albeit minor) on the total rateable value of hereditaments in Wales. It also has an indirect effect on how rates liability is distributed between other non-domestic properties by exerting pressure on the multiplier. If the decapitalisation rate increases, it exerts a small downward pressure on the multiplier, and vice versa.

27. Setting the decapitalisation rate is only one part of the revaluation process and the impacts will depend on other factors such as market conditions, changes in rental values and the multiplier. These will be analysed as the revaluation progresses.

28. Determining appropriate decapitalisation rates is a complex matter and is not an exact science. There are a number of different academic methodologies (and each has 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.

29. As the primary function of the decapitalisation rate is to translate cost into value, relative movements in rents between the valuation dates for the 2017 Revaluation and the 2021 Revaluation also need to be taken into consideration. This acts as a check on the results of the academic methods and ensure valuations take account of changes in the property market in Wales.

30. Since 1990, two decapitalisation rates have been prescribed in legislation – a standard and a lower rate. At the 2017 revaluation, the lower rate applied to educational, healthcare, defence and public convenience hereditaments, while the standard rate applied to all other properties. A lower rate is applied to certain public sector properties to reflect the fact that the occupiers have access to cheaper forms of financing such as public loans and grants.

31. This statutory instrument will set the decapitalisation rates for the non-domestic rating list in Wales compiled on or after 1 April 2021.

    - The lower decapitalisation rate which applies to education, healthcare, defence and public convenience hereditaments is set at **1.9%**.

    - The standard decapitalisation for all other properties is set at **3.5%**.

Consultation

32. A public consultation sought views on setting the decapitalisation rates for the 2021 Non-Domestic Rates Revaluation. The 12-week technical consultation was launched on 8 March 2019 and closed on 30 May 2019.

33. 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.

34. The consultation was published on the Welsh Government website and was sent to the following organisations:

    - All local authorities
    - Welsh Local Government Association
    - Valuation Tribunal for Wales
    - Valuation Office Agency
    - Institute of Revenues, Rating and Valuation
    - Members of the Welsh Ratepayers Forum

35. Nine consultation responses were received. The breakdown of responses is as follows.

    - Four associations
    - Four professional representative financial or advisory bodies
    - One software company

36. The use of prescribed decapitalisation rates for the Contractor's Basis of Valuation was the preferred method for most respondents. Respondents expressed the view that rates should be set fairly in context of existing case law and that there should be greater harmonisation across the UK.

37. The majority of responses agreed that the Welsh Government should continue to prescribe two decapitalisation rates. Respondents thought the current system was well understood.

38. Most respondents agreed with the Welsh Government's proposed approach for setting decapitalisation rates in Wales with the proviso that that it did not unfairly affect particular sectors.

Regulatory Impact Assessment

39. The Welsh Ministers' Code of Practice on the carrying out of Regulatory Impact Assessments was considered in relation to these amendments.

40. A Regulatory Impact Assessment has been conducted and is included in Part 2 of this document.

PART 2 – REGULATORY IMPACT ASSESSMENT

Options

Option 1 – Prescribe decapitalisation rates using the latest market information making no adjustments

Decapitalisation rates would be prescribed using the latest market information.

A lower rate (2.1%) would apply to educational, healthcare, and defence hereditaments and a standard rate (3.8%) would apply to all other properties. These percentages reflect the market conditions on the AVD for the 2021 Revaluation which was 1 April 2019.

This would provide the most straightforward approach but would have large adverse impacts on properties valued using the Contractor's Basis.

Option 2 – Prescribe decapitalisation rates which limit the increases for properties valued using the Contractor's Basis

Decapitalisation rates would be prescribed which limit the increases for properties valued using the Contractor's Basis so they are in line with the wider tax-base.

A lower rate (1.8%) would apply to educational, healthcare, and defence hereditaments and a standard rate (3.2%) would apply to all other properties.

This approach would increase the multiplier for all ratepayers in Wales.

Option 3 – Prescribe decapitalisation rates which moderate the increases for properties valued using the Contractor's Basis but do not substantially increase the multiplier

Decapitalisation rates would be prescribed to strike a balance between the increase for properties valued using the Contractor's Basis and an increase in the multiplier.

A lower rate (1.9%) would apply to educational, healthcare, defence hereditaments and a standard rate (3.5%) would apply to all other properties.

This approach would moderate to impact on properties valued using the Contractor's Basis while limiting the impact on the multiplier.

Costs and benefits

All the options are designed to be cost neutral in terms of the total revenue raised through non-domestic rates. Each of the options maintains the overall revenue generated by adjusting the balance between the decapitalisation rates and the multiplier.

Option 1 – Prescribe decapitalisation rates using the latest market information making no adjustments

Costs

If the decapitalisation rates are set using the latest market information and no adjustment is made to limit the impact of any changes, bills would increase for properties valued using the Contractor's Basis by an estimated 21%. This would create a significant liability for these ratepayers.

The impact on properties using the Contractor's Basis compared to other ratepayers would be that their bills would be 16% higher, assuming other factors remain the same.

Benefits

The main reason for a revaluation is to ensure the liability for occupiers of non-domestic properties are based on up-to-date rental values and market conditions. Revising the decapitalisation rates to reflect conditions as at the AVD of 1 April 2019, would be the simplest approach and would ensure that rates liability is distributed solely on the basis of relative values.

Option 2 – Prescribe decapitalisation rates which limit the increases for properties valued using the Contractor's Basis

Costs

This would increase the multiplier above inflation in order to distribute the rise in liability for Contractor's Basis valued properties. The increased multiplier would see rates bills for properties valued using methods other than the Contractor's Basis increase by an estimated £30 million a year. All properties would be impacted equally, this would lead to an increase in rates bills of around 4%, this is 2% above the assumed CPI inflation measure.

Benefits

The relative impact on properties valued using the Contractor's Basis would be reduced to zero, avoiding significant increases in liability for the relevant sectors.

Option 3 – Prescribe decapitalisation rates which moderate the increases for properties valued using the Contractor's Basis but do not substantially increase the multiplier

Costs

Option 3 would split the increase between both properties valued using the Contractor's Basis and those valued using other methods. The impact on properties using the Contractor's Basis would be limited compared to Option 1.

The multiplier would increase to a lesser extent than under Option 2. The estimated overall increase for properties valued using methods other than the Contractor's Basis would be £15 million a year. This equates to an increase of around 2.7% on all bills that are not valued using the Contractor's Basis, this is 0.7% higher than the assumed CPI inflation measure.

Benefits

Setting the decapitalisation rates at a level between Options 1 and 2 would moderate the increase in liability for properties valued using the Contractor's Basis and limit the impact on the multiplier.

While the main reason for revaluation is to base liability on up-to-date conditions, consideration needs to be given to the impact on specific sectors. Option 3 modifies the potential impact for properties valued using the Contractor's Basis and those valued using other methods.

Analysis of other effects and impacts

Programme for Government / Prosperity for All / Taking Wales Forward
Revaluations help to meet the Prosperous and Secure objective of delivering the right support for people and businesses. Setting appropriate decapitalisation rates helps to ensure that rates liability is distributed equitably between ratepayers.

Promoting Economic Opportunity for All (Tackling Poverty)
Revaluations, with appropriate decapitalisation rates, adjust rateable values to reflect economic conditions. This may enable the creation of employment opportunities and the development of skills.

UNCRC
No impact on the rights of children has been identified.

Welsh language
No effect on the opportunities to use the Welsh language or on the equal treatment of the language has been identified.

Equalities
No specific impact, positive or negative, has been identified for people who share a protected characteristic under Section 149(1) of the Equality Act 2010.

Well-being of Future Generations (Wales) Act 2015

Revaluations contribute towards the wellbeing goals of a prosperous Wales and a more equal Wales and also to long-term, integrated economic growth. The use of decapitalisation rates helps to ensure that liability is shared appropriately between ratepayers.

Competition Assessment

In drafting this Statutory Instrument, we have applied the competition filter test.

The purpose of revaluation is to adjust the liability of non-domestic properties *relative* to others within the tax-base whilst ensuring the 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 the rates bills) of properties valued using the Contractor's Basis reflect market conditions as at the AVD of 1 April 2019 and taken account of the potential impacts of significant changes.

This Statutory Instrument will affect the multiplier for all ratepayers in a consistent way and no competition impacts have been identified as a result of the approach. However, if the Regulations are not made, properties valued on the Contractor's Basis would be disproportionately affected.