



SCOTTISH EXECUTIVE

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Your ref:
Our ref:

20 January 2004

Dear Sir/Madam

SETTING THE DECAPITALISATION RATES FOR THE 2005 REVALUATION - A CONSULTATION PAPER

I attach a short consultation paper and an associated partial regulatory assessment document setting out our proposals and invite your views. If you have any questions about the consultation paper, please contact Billy McKenzie on 0131 244 7051.

Comments including the attached *Respondee Information Form* should be submitted by **Tuesday 13 April 2004**. Electronic comments can be sent via e-mail to stuart.blackie@scotland.gsi.gov.uk and postal comments should be sent to Stuart Blackie, Decapitalisation Rate Consultation, Local Government Finance and Constitution Division, Area 3-J (North), Victoria Quay, Edinburgh EH6 6QQ.

We would be grateful if you could clearly indicate in your response which questions or parts of the consultation paper you are responding to as this will aid our analysis of the responses received. We will make all responses available to the public in the Scottish Executive library by Tuesday 27 April 2004, unless confidentiality is requested. All responses not marked confidential will be checked for any potentially defamatory material before being logged in the library.

You may be interested to know that a new e-mail alert system for Scottish Executive consultations (<http://www.scotland.gov.uk/consultations/>) was launched in December 2003. This system will allow stakeholder individuals and organisations to register and receive a weekly email containing details of all new Scottish Executive consultations (including web links). "SEconsult" is designed to allow stakeholders to "keep an eye" on all Scottish Executive consultation activity, and therefore be alerted at the earliest opportunity to those of most interest.

Yours faithfully

Carol Sibbald
CAROL SIBBALD



RESPONDEE INFORMATION FORM

Please complete the details below and attach it with your response. This will help ensure we handle your response appropriately:

Name:

Postal Address:

Consultation title:

1. Are you responding as: (please tick one box)

- (a) an individual (go to 2a/b)
(b) **on behalf of** a group or organisation (go to 2c)

2a. INDIVIDUALS:

Do you agree to your response being made available to the public (in SE library and/or on SE website)?

- Yes (go to 2b below)
No, not at all

2b. **Where confidentiality is not requested**, we will make your response available to the public on the following basis (**please tick one** of the following boxes)

- Yes, make my response, name and address all available
Yes, make my response available, but not my name or address
Yes, make my response and name available, but not my address

2c ON BEHALF OF GROUPS OR ORGANISATIONS:

Your name and address as respondees **will be** made available to the public (in the SE library and/or on SE website). Are you content for your response to be made available also?

- Yes
No

3. We will share your response internally with other SE policy teams who may be addressing the issues you discuss. They may wish to contact you again in the future, but we require your permission to do so.

Are you content for the Scottish Executive to contact you again in the future for consultation or research purposes?

- Yes
No



Non-domestic rates: Setting the Decapitalisation Rates for the 2005 Revaluation - A consultation paper

Introduction

1. The next revaluation of non-domestic property in Scotland will take effect from 1 April 2005. A revaluation results in the introduction of new valuation rolls which will contain revised rateable values for all non domestic properties in Scotland. Some 20% of the new rateable values will be derived using the contractor's principle method of valuation.

2. This consultation paper contains proposals for prescribing the decapitalisation rates to be used when subjects are valued using the contractor's principle method of valuation. This consultation paper applies to Scotland only. Similar consultation exercises covering England and Wales have been undertaken by the Office of the Deputy Prime Minister and the Welsh Assembly Government respectively.

Sending us your views:

3. We invite responses by **Tuesday 13 April 2004**. E-mail responses should be sent to: stuart.blackie@scotland.gsi.gov.uk and paper responses to: Stuart Blackie, Decapitalisation Rate Consultation, Finance and Constitution Division, Area 3J (North), Victoria Quay, Edinburgh, EH6 6QQ.

4. Further copies of this consultation paper can be obtained from the Scottish Executive website www.scotland.gov.uk; by post from Stuart Blackie, Decapitalisation Rate Consultation, Finance and Constitution Division Area 3J (North), Victoria Quay, Edinburgh, EH6 6QQ or by e-mail from stuart.blackie@scotland.gsi.gov.uk.

5. We would be grateful if you can clearly indicate in your response which questions or parts of the consultation paper you are responding to as this will aid our analysis of responses received. We will make all responses available to the public in the Scottish Executive Library by Tuesday 27th April 2004, unless confidentiality is requested. All responses not marked confidential will be checked for any defamatory material before being logged in the library.

Background

- non domestic rating revaluation

6. Occupiers of non-domestic subjects in Scotland pay non-domestic rates. Non-domestic rates are levied on the basis of a national poundage rate multiplied by the rateable value of each non-domestic subject in the valuation roll. Adjustments are made to take account of any rate relief a subject may be entitled to before arriving at the rates liability for the forthcoming financial year. The rateable values for most non-domestic subjects are set by the Scottish Assessors. The rateable value is the Assessor's estimate of the annual rent which that property would command on the open market.

7. To ensure that rateable values keep pace with changes in the property market all non-domestic subjects are re-valued every five years by the Assessors. The non-domestic rate income raised from ratepayers after revaluation remains constant in real terms. The Scottish Executive will reduce the rate poundage if necessary to ensure this. The principal purpose of a revaluation is to ensure that the distribution of the rates burden between ratepayers remains equitable.

- contractor's principle

8. Rateable value broadly represents rental value and in most cases the Assessors use evidence of actual rents to estimate rateable value. However for some properties (oil refineries, hospitals, schools etc) there is no direct evidence of actual rents and in these circumstances the Assessors may use an alternative method of valuation called the contractor's principle.

9. A summary of the steps the Assessors take in arriving at a rateable value under the contractor's principle valuation method is given below:

- ⇒ an estimate is made of the cost of replacing the building and any rateable items such as certain types of plant and machinery;
- ⇒ this cost is adjusted to reflect any obsolescence in the actual property;
- ⇒ this sum is then added to the capital value of the site; and
- ⇒ the total capital sum is then “decapitalised” by using the decapitalisation rate to give an annual equivalent that is taken to be the rateable value.

- decapitalisation rate

10. Prior to the creation of the 1990 valuation roll, Assessors and the courts experienced considerable difficulties in determining how the decapitalisation rate should be derived and at what level it should be set. This gave rise to a series of appeals which created uncertainty as to the rates liability of a whole class of ratepayers, and ultimately the level of non-domestic rates income.

11. For the last three revaluations - 1990, 1995 and 2000 - Ministers have prescribed the decapitalisation rates using regulation making powers in the Valuation and Rating (Scotland) Act 1956 as amended. For the 1990¹ revaluation, the decapitalisation rate was set at 6% except for educational and healthcare properties which had a lower rate of 4%. For the 1995² and 2000³ revaluations, the higher rate was set at 5.5% and the lower rate at 3.67%. Broadly speaking the rates were set having regard to various interest and property yield rates.

¹ Valuation for Rating (Decapitalisation Rate) (Scotland) Regulations 1990 (1990 No.505 (S.63) as amended by The Designation of Institutions of Higher Education (Scotland) Order 1992 (1992 No. 1025 (S.99))

² Valuation for Rating (Decapitalisation Rate) (Scotland) Regulations 1994 (1994 No.3256 (S.184))

³ Valuation for Rating (Decapitalisation Rate) (Scotland) Amendment Regulations 2000 (SSI 2000 No.56)

The 2005 Valuation Roll

- whether to prescribe the decapitalisation rates

12. If the decapitalisation rates to be used at the 2005 Revaluation were not prescribed by Ministers then they would be decided by Assessors in each category of valuation. This would increase the scope for unnecessary appeals and litigation. As it is around 15 years since the Courts have considered appeals against the decapitalisation rate to be used the scope for appeals is greater than ever. The Scottish Executive therefore proposes to continue to prescribe both the higher and the lower decapitalisation rate to be used in relation to properties valued using the contractor's principle method of valuation.

Q.1 Do you agree that the Scottish Ministers should continue to prescribe the decapitalisation rates to be used in the contractor's principle method of valuation at the 2005 revaluation?

13. As with the 2000 Valuation Roll, the Scottish Executive proposes only to prescribe a decapitalisation rate for those industries or occupiers for application within the contractor's principle method of valuation. A prescribed decapitalisation rate does not mean that the contractor's principle method of valuation is preferred by the Scottish Executive to any other method of valuation. Assessors and the Courts will be free to choose the most appropriate method of valuation for the property concerned.

14. Reference should only be made to the prescribed decapitalisation rates where the contractor's principle method of valuation is used. The use of decapitalisation rates in other circumstances should not be considered to be prescribed by the Scottish Ministers.

- education, healthcare and defence properties

15. When Ministers first prescribed decapitalisation rates at the time of the 1990 Revaluation, a lower rate was set for lands and heritages consisting of any church property, an educational establishment or a hospital (as defined in the regulations).⁴ Educational establishments-generally independent schools and universities-formed a distinct and self-contained set of properties. They were owner-occupied and there was no rental evidence for them. Occupiers of this type of property raised much of the capital required to build, not from borrowing but by way of grants and charitable donations. It was considered that a lower decapitalisation rate should be applied in these cases to reflect the lesser extent to which the occupier may be expected to borrow to fund these works. The same rationale was applied to church property and hospitals.

16. In 1992 there was a minor change made to the definition of what qualified as an educational establishment to reflect changes made in education legislation. At the 1995 Revaluation, the definition of a "hospital" was widened to "healthcare property". This meant that the lower decapitalisation rate would now apply to subjects such as doctors' surgeries and physiotherapy units.

⁴ Valuation for Rating (Decapitalisation Rate) (Scotland) Regulations 1990 (1990 No.505 (S.63))

17. Prior to 1 April 2000, all Crown properties were exempt from non-domestic rates although Crown occupiers were expected to make equivalent payments – contributions in lieu of rates (CILOR). CILOR was abolished with effect from the 2000 Revaluation (1 April 2000). From this date, educational, healthcare and Ministry of Defence properties which had previously benefited from CILOR were assessed on the lower decapitalisation rate.

18. The Scottish Executive proposes to continue to set a lower decapitalisation rate in the case of any lands and heritages consisting of any:

- ⇒ church property
- ⇒ healthcare property
- ⇒ educational establishment
- ⇒ day nurseries
- ⇒ Ministry of Defence properties

Setting the decapitalisation rate at the higher rate for these properties would result in a *significant* rise in rateable values. Such a rise in rateable value would be out of line with any increase in rental value which could be expected for similar properties overall. Education and healthcare are key priorities for the Scottish Executive and defence is a key priority for the Westminster Government. A significant increase in rates bills-due to a change in the decapitalisation rate-for these categories of properties would be unacceptable. The Scottish Executive therefore proposes that education, healthcare and defence properties continue to benefit from a lower decapitalisation rate.

Q.2 Do you agree that there should continue to be a lower decapitalisation rate for those categories listed at paragraph 18 above?

Q.3 Do you consider that the lower decapitalisation rate should apply to categories of properties other than those listed at paragraph 18 above? For each additional category of property you list, please explain why you consider it should benefit from the lower decapitalisation rate?

- setting the decapitalisation rate for the 2005 Revaluation

19. The Scottish Executive proposes that the higher decapitalisation rate should be prescribed at 5% for the 2005 Valuation Roll in Scotland. Annex A to this paper explains how the Scottish Executive arrived at this figure. The Annex is a technical document.

20. The Scottish Executive proposes to reduce the lower decapitalisation rate for education, healthcare and defence properties broadly in line with the reduction in the higher decapitalisation rate to 3.33%.

Q.4 Do you agree with the Scottish Executive proposal to set a higher decapitalisation rate of 5% and a lower decapitalisation rate of 3.33%?

- costs

21. The decapitalisation rates are only one of several factors which will affect the outcome of a valuation made under the contractor's principle method of valuation. Rateable

values for the 2005 valuation roll may vary from the rateable values in the 2000 valuation roll because of changes in the value of land or changes in building costs. Although the Scottish Executive proposes to reduce the decapitalisation rates, rateable values are likely to increase due to other factors.

Summary of questions on which views are sought

- Q.1 Do you agree that the Scottish Ministers should continue to prescribe the decapitalisation rates to be used in the contractor's principle method of valuation at the 2005 revaluation?**
- Q.2 Do you agree that there should be a lower decapitalisation rate for those categories listed at paragraph 18 above?**
- Q.3 Do you consider that there should be a lower decapitalisation rate for categories of properties other than those listed at paragraph 18 above? For each additional category of property you list, please explain why you consider it should benefit from the lower decapitalisation rate.**
- Q.4 Do you agree with the Scottish Executive proposal to set a higher decapitalisation rate of 5% and a lower decapitalisation rate of 3.33%?**

SETTING AN APPROPRIATE DECAPITALISATION RATE

The Scottish Executive has reviewed the existing prescribed decapitalisation rates. It has looked at the methods that are generally accepted as appropriate for setting the decapitalisation rate. Consideration of these methods is set out below.

MONEY MARKET INTEREST RATES AND THE ECONOMIST'S APPROACH BASED ON "REAL" RATES OF INTEREST

This route to the decapitalisation rate is based on the rate at which money can be borrowed in the market to construct a building or structure.

A range of sources of finance is available in the market. However, we begin traditionally with the bank base rate on the antecedent valuation date (AVD). For the 2005 valuation roll the AVD is 1st April 2003 and the base rate on that day was 3.75%.

To this a borrower's premium is added. Previously it has generally been considered that it should not exceed 2%. For this Revaluation we have added 1.5%.

Following case law precedent on this approach a discount is then made to take account of the benefits of ownership. The discount can be said to have two components: inflation, and real growth. It is in principle an adjustment that addresses the differences between owning and renting. An owner will receive the advantage of both inflationary and real increases in the value of a property; the tenant will not. However, the owner of a property is also vulnerable to negative change in value i.e. depreciation. The discount therefore reflects both inflation and real growth or the depreciation of a property.

The current target rate of inflation is 2.5%. Having regard to scales of obsolescence which have been used by the Scottish Assessors (particularly for the 2000 Valuation Rolls) and which have gained a wide measure of acceptance, it may be estimated that the average owner of a property valued under the contractor's principle would experience a decline in value of their property by about 0.8% per annum. The total discount reduces the rate from 5.25% to 3.48%.

This must then be grossed up to reflect a landlord's management expenses and the risk of voids. This results in a higher decapitalisation rate of approximately 3.88%.

However, this approach ignores the fact that the cost of capital (other than for the public sector) is partly that of equity and only partly of debt. In the paper "A Study into Certain Aspects of the Cost of Capital for Regulated Utilities in the UK" published on 13th February 2003 a qualified estimate of the cost of equity for all companies is given as 5.5% (geometric average). This is a conservative estimate, since arithmetic averaging indicates a higher range.

This is a real cost of equity capital and does not need to be adjusted for the rate of inflation but it does need to be adjusted for tax. However, before making this adjustment we must add in the cost of debt.

Assuming a gearing ratio of 33.33%, if a debt premium of 1.5% were added to the risk free rate of 2% (adopting the current yields on medium to long index linked gilts) a post tax weighted cost of capital would be 4.83%. Pre tax, this will be higher, at 5.36%.

In this context the discount for the benefits of ownership can ignore inflation since the calculations have been expressed in real rather than nominal terms. It only remains to eliminate the real price changes, and as set out above, these are likely to be negative, in the region of -0.8% per annum. Even if we assume an offsetting real positive depreciation of 1.5% per annum, we are left with a decapitalisation rate of 4.6%.

This must be adjusted to reflect a landlord's management expenses and the risk of voids. This brings the decapitalisation rate up to at least **5.00%**.

YIELDS FROM PROPERTY INVESTMENT

Prior to prescription of the decapitalisation rate Scottish precedent placed greater reliance on investment yields derived from those properties for which both a rental and capital market value exists. The closest available evidence for specialised industrial property valued on the contractors' principle is found in the general industrial market. It is questionable whether this evidence is particularly helpful for the non-industrial classes valued on the contractor's principle, the most important of which are educational and hospital properties.

There has been no significant change in prime industrial yields since the last revaluation. At first quarter 1988 the CB Hillier Parker average industrial yield stood at 8%, and at first quarter 2003, 7.9%. On the evidence of market yields the decapitalisation rate should not be less than 7.25%. However, as yields in industrial property investment have remained static since the last revaluation, it could be argued that the decapitalisation rate should remain static at 5.5%.

CONCLUSION

While industrial property yields have remained static since the last Revaluation which indicates that the decapitalisation rate should remain the same, the decline in interest rates suggests that the higher rate should be reduced. The Economist's approach to the decapitalisation rate suggests that the rate should be set at around 5%. The Scottish Executive is therefore consulting on a rate of 5% for the 2005 Valuation Roll.

The Scottish Executive Consultation Process

Consultation is an essential and important aspect of Scottish Executive working methods. Given the wide-ranging areas of work of the Scottish Executive, there are many varied types of consultation. However, in general Scottish Executive consultation exercises aim to provide opportunities for all those who wish to express their opinions on a proposed area of work to do so in ways which will inform and enhance that work.

While details of particular circumstances described in a response to a consultation exercise may usefully inform the policy process, consultation exercises cannot address individual concerns and comments, which should be directed to the relevant public body. Consultation exercises may involve seeking views in a number of different ways, such as public meetings, focus groups or questionnaire exercises.

Typically, Scottish Executive consultations involve a written paper inviting answers to specific questions or more general views about the material presented. Written papers are distributed to organisations and individuals with an interest in the area of consultation, and they are also placed on the Scottish Executive web site enabling a wider audience to access the paper and submit their responses¹. Copies of all the responses received to consultation exercises (except those where the individual or organisation requested confidentiality) are placed in the Scottish Executive library at Saughton House, Edinburgh (K Spur, Saughton House, Broomhouse Drive, Edinburgh, EH11 3XD, telephone 0131 244 4552).

The views and suggestions detailed in consultation responses are analysed and used as part of the decision making process. Depending on the nature of the consultation exercise the responses received may:

- indicate the need for policy development or review
- inform the development of a particular policy
- help decisions to be made between alternative policy proposals
- be used to finalise legislation before it is implemented

If you have any comment about how this consultation exercise has been conducted, please send them to:

Name: Stuart Blackie
Address: Decapitalisation Rate Consultation
Finance and Constitution Division
Area 3 J (North)
Victoria Quay
Edinburgh
EH6 6QQ

E-mail: stuart.blackie@scotland.gsi.gov.uk

¹ www.scotland.gov.uk

PARTIAL REGULATORY IMPACT ASSESSMENT

Non-Domestic Rates: Setting the Decapitalisation Rates for the 2005 Revaluation-A consultation paper.

1. Purpose and intended effect

Background

The occupiers of non-domestic property in Scotland pay non-domestic rates. Individual rate bills are based upon rateable values of each non-domestic property. In most cases, rateable values are set by the Assessors and are based on the rental values of these properties on the open market. To ensure that rateable values reflect changes in the property market, all non-domestic properties are re-valued every five years by the Assessors. The next revaluation will take effect on 1 April 2005. The purpose of the revaluation is to ensure that the distribution of the rates burden between ratepayers remains equitable.

For most valuations, the Assessors will use evidence of the actual rental value of the property to calculate its rateable value. However, this is not always possible. Where there is no rental evidence the Assessor will have to find an alternative method to calculate an appropriate rateable value for the property concerned. In such cases the Assessor will use the contractor's principle method of valuation.

To arrive at a rateable value under the contractor's principle method of valuation an estimate is made of the cost of replacing the building and any rateable items such as certain types of plant and machinery. This cost is then adjusted to reflect any obsolescence in the actual property and the resultant sum is then added to the capital value of the site. 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 of the capital value which is taken to be the rateable value. Around 20% of non-domestic properties in Scotland are valued using the contractor's principle method of valuation.

Objective in setting the decapitalisation rate

The decapitalisation rate is generally used to value large industrial property and specialised public sector properties. For example oil refineries, chemical process plants, hospitals, schools are all valued using the contractor's principle method of valuation.

Prior to 1990, rating valuers and the courts had a great deal of difficulty in deciding on the appropriate decapitalisation rate to be used in non-domestic rating valuations. This resulted in extensive litigation through the appeal process following each revaluation. This created uncertainty as to the rating liability of a whole class of ratepayers until the appeals were resolved.

Since 1990, Ministers have prescribed the decapitalisation rates to be used under the contractor's principle method of valuation. The powers which allow the Scottish Ministers to prescribe the decapitalisation rate are contained in the Valuation and Rating (Scotland) Act 1956 as amended.

For the 1990, 1995 and 2000 Revaluations two decapitalisation rates were set. A lower rate was set for church property, educational establishments and healthcare properties at the 1990 and 1995 Revaluations. Educational establishments-generally independent schools and universities-formed a distinct and self-contained set of properties. They were generally owner-occupied and there was no rental evidence for them. Occupiers of this type of property raised much of the capital required to build, not from borrowing but by way of grants and charitable donations.

It was considered that a lower decapitalisation rate (set at two thirds of the higher rate) should be applied in these cases to reflect the lesser extent to which the occupier may be expected to borrow to fund these works. The same rationale was applied to church property and hospitals.

CILOR (Contribution in lieu of rates) was a scheme whereby the occupiers of Crown properties made a contribution in lieu of rates rather than receiving a rates bill. CILOR was abolished with effect from the 2000 Revaluation (1 April 2000). From this date, educational, healthcare and Ministry of Defence properties which had previously benefited from CILOR were assessed on the lower decapitalisation rate.

The Scottish Executive proposes to continue to prescribe a higher and lower decapitalisation rate for the 2005 Revaluation. At the 2000 Revaluation the decapitalisation rates were set at 5.5% and 3.67% respectively. For the 2005 Revaluation, the Scottish Executive proposes to reduce the decapitalisation rates to 5% and 3.33% respectively.

This should mean that the aggregate increase in rateable value of those properties valued under the contractor's principle method of valuation should be no more than the increase faced by other properties valued by other valuation methods.

2. Risk Assessment

Decapitalisation rates are already prescribed. This proposal will facilitate the revaluation of properties valued under the contractor's principle. If the decapitalisation rates are not prescribed then as discussed above this will result in extensive litigation through the appeal process following the 2005 Revaluation. This will create uncertainty as to the liability of a whole class of ratepayers until the appeals are resolved.

If the decapitalisation rates remain at the current levels then the rateable value of the properties valued by the contractor's principle could rise by up to an estimated 24 %. The Scottish Executive is proposing to lower the current decapitalisation rates so that the aggregate increase in rateable value of those properties valued under the contractor's principle is no more than the aggregate increase likely to be experienced by properties valued by other methods.

3. Options

Prior to consulting on the Scottish Executive's proposal to set the decapitalisation rates for the 2005 Revaluation at 5% and 3.33%, several options were considered.

Option 1: No prescription of higher and lower decapitalisation rates

Decapitalisation rates have been prescribed since 1990. Prior to 1990 there was no uniformity in the way in which these rates were applied and this resulted in a large number of appeals and subsequent court cases after each revaluation. Prescribing the decapitalisation rates provided stability for ratepayers and increased confidence in the contractor's principle as a method of valuation. Decapitalisation rates were prescribed at the 1990, 1995, and 2000 Revaluations. There has been no call from ratepayers to review this element of the valuation process. The Scottish Executive therefore proposes to continue to prescribe the decapitalisation rates for the 2005 Revaluation.

Option 2: No change to the current higher and lower decapitalisation rates

The current higher and lower decapitalisation rates of 5.5% and 3.67% were set at the 2000 Revaluation (1 April 2000). If these rates remained unchanged for the 2005 Revaluation, then rateable values for properties valued by the contractor's principle method of valuation could rise by up to an estimated 24%. We currently expect that increases in rateable values generally, at the revaluation, will be in the region of 11-13%. The Scottish Executive therefore proposes to adjust the decapitalisation rates to avoid such an inequitable increase for properties valued by the contractor's principle method of valuation.

Option 3: Reduce the higher and lower decapitalisation rates for Revaluation 2005

The Scottish Executive is proposing to set the higher and lower decapitalisation rate at 5% and 3.33% respectively. Broadly speaking the decapitalisation rate is calculated by making an estimate of how much it would cost to borrow the money necessary to build a property valued under the contractor's principle method of valuation. The lower decapitalisation rate is set at two thirds of the higher decapitalisation rate. The detailed calculations of the way in which the decapitalisation rate is calculated for the 2005 Revaluation are set out in the annex to the consultation document.

Option 4: Prescribing only one decapitalisation rate at Revaluation 2005

Currently there are two decapitalisation rates prescribed by the Scottish Ministers at a revaluation. The lower decapitalisation rate applies to all church property, education, healthcare and defence lands and heritages. The higher decapitalisation rate applies to all other lands and heritages valued under the contractor's principle method of valuation. One option for the 2005 Revaluation would be to prescribe one decapitalisation rate.

This option would mean that occupiers of church property, education, healthcare and defence lands and heritages would see a substantial increase in their rates bills. The effect of this option would be to shift the burden of rates from businesses onto schools, hospitals and defence properties. The Scottish Executive therefore proposes to retain a lower decapitalisation rate at the 2005 Revaluation. This will mean that the rates bills for schools, hospitals and defence properties should not increase by more than the national average.

4. Costs

Option 1: No prescription of higher and lower decapitalisation rates

This would mean a return to the pre 1990 scenario of debate about how the decapitalisation rate should be derived and at what level it should be set at. This is likely to result in a series of appeals which will be costly for ratepayers and Assessors both in terms of time and money.

Option 2: No change to the current higher and lower decapitalisation rates

If, as discussed above, the higher and lower decapitalisation rates remain at 5.5% and 3.67% respectively for the 2005 Revaluation, then rateable values for the properties valued by the contractor's principle could increase by an estimated 24%. This is a significant increase and would result in placing the burden of business rate increases on those properties valued by the contractor's principle method of valuation. This would undermine the contractor's method of valuation.

Option 3: Reduce the higher and lower decapitalisation rates for Revaluation 2005

The Scottish Executive is proposing to set a prescribed decapitalisation rate of 5% for the higher rate and 3.33% for the lower rate. This is expected to result in an increase in rateable values of no more than an estimated 11-13% at the 2005 Revaluation. We currently expect that increases in rateable values generally, at the revaluation, will be in the region of 11-13%. This means that those properties valued under the contractor's principle should face increases in rateable value that are broadly similar to those we expect those properties valued by conventional methods to face. However, it is impossible to anticipate exact increases in rateable values until the Assessors have completed all valuations of non-domestic property in late 2004.

In addition, the decapitalisation rates are only one of several factors which could affect the outcome of a valuation made under the contractor's principle. Rateable values for 2005 may vary from the rateable values in the 2000 valuation roll because of the changes in the value of land or changes in building costs. Although the Scottish Executive proposes to reduce the decapitalisation rates, rateable values may still increase due to other factors, such as changes in the value of land or changes in building costs.

In addition, whilst the amount that a property pays in rates is based on its rateable value, there are other factors that affect an individual rate bill. A rates bill is calculated by taking a property's rateable value and multiplying it by the national rate poundage –which is set annually by the Scottish Ministers. This figure is then adjusted to take account of any rate reliefs the ratepayer might be entitled to – e.g. transitional arrangements. It is too early in the revaluation process to say what the 2005-06 poundage rate will be set at, or whether there will be a transitional rate relief scheme in operation. This information will not be available until late 2004.

Option 4: Prescribing only one decapitalisation rate at Revaluation 2005

If education, healthcare and defence subjects which currently benefit from the lower decapitalisation rate were required to pay a decapitalisation rate of 5% from 2005 onwards, then as discussed above these ratepayers would face a significantly above average increase in their rateable values. This would in effect, be shifting the burden of rates from businesses and onto schools, hospitals and defence establishments.

5. Benefits

Option 1: No prescription of higher and lower decapitalisation rates

Given that it is over 15 years since the Courts have considered appeals against decapitalisation rates, it is difficult to quantify what the benefits of this option might be. This would depend on how successful ratepayers were with their appeals but any reduction in rateable value would be offset by the costs of the appeal litigation.

Option 2: No change to the current higher and lower decapitalisation rates

There are no benefits for this option. As discussed above ratepayers whose properties are valued using the contractor's principle method would face a significantly above average increase in their rateable values. This would in effect, be shifting the burden of rates to non-domestic properties valued under the contractor's principle method from all other non-domestic properties.

Option 3: Reduce the higher and lower decapitalisation rates for Revaluation 2005

Reducing the decapitalisation rates in the way the Scottish Executive is proposing to do maintains a balance between non-domestic properties valued under the contractor's principle and all other non-domestic properties. Setting a decapitalisation rate of 5% should also mean that the change in rateable values for properties to which the prescribed decapitalisation rate applies should be no greater than the changes faced by properties valued by other methods.

Option 4: Prescribing only one decapitalisation rate at Revaluation 2005

The only benefit of this option would be that all non-domestic properties valued under the contractor's principle method of valuation would be subject to the same decapitalisation rate.

6. Equity and Fairness

Setting higher and lower decapitalisation rates is the fairest option as it means that all properties valued under the contractor's principle will face a similar increase in their rate bills at the 2005 Revaluation.

7. Compliance costs

There are no additional compliance costs for businesses.

8. Enforcement and sanctions

Non-domestic rates are collected and enforced by the 32 local authorities in Scotland. There is no evidence to suggest that collection rates have been affected by a change in the decapitalisation rate at each revaluation.

9. Impact on Small & Macro Businesses

The vast majority of small businesses are assessed by conventional valuation methods and are therefore not subject to the decapitalisation rates. The decapitalisation rates will therefore have no direct effect on small businesses.

Small businesses would be affected by the decapitalisation rates if the rates were set at levels which gave disproportionate benefit to those properties which are valued by the contractor's principle method of valuation.

However, the Scottish Executive has attempted to set the decapitalisation rates at a level which ensures that the increase in the aggregate rateable values of those properties valued on the contractor's principle is no more than the increase in the aggregate rateable value of those properties assessed by other valuation methods.

10. Consultation

The Scottish Executive is holding a 12-week public consultation on its proposals to prescribe the decapitalisation rate for the 2005 non-domestic rates revaluation. The Scottish Executive will use the responses to the attached consultation document to finalise proposals for the decapitalisation rates which will subsequently be set out in a Statutory Instrument and laid before the Scottish Parliament.

11. Monitoring & Evaluation

The Assessors who are responsible for carrying out all non-domestic rating valuations in Scotland will be able to monitor the effect that the decapitalisation rate has on any changes taking place during the revaluation. Once the new rateable values for properties are available we will be able to see the effect that the decapitalisation rate has had on rateable values. The Assessors will be able to relay any lessons to the Scottish Executive from the 2005 revaluation which can be taken on board when setting the decapitalisation rates for the next revaluation in 2010.