

# Non-domestic rates: Setting the decapitalisation rates for the 2010 Revaluation – a consultation paper

## Introduction

1. The next Revaluation of non-domestic property in Scotland will take effect from 1 April 2010. 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 rate to be used when subjects are valued using the contractor's principle method of valuation. As regards the decapitalisation rates themselves, this consultation paper examines the methodologies available to reach the rates but does not suggest a preferred option. Ministerial decisions on the decapitalisation rates will take into account responses to the consultation.

3. This consultation paper applies to Scotland only. Similar consultation exercises covering England, Wales and Northern Ireland are being undertaken by the Department for Communities and Local Government, the Welsh Assembly Government and the Northern Ireland Department of Finance and Personnel.

## Sending us your views:

4. We invite responses by Friday 26 September 2008. E-mail responses should be sent to: [jim.gilmour@scotland.gsi.gov.uk](mailto:jim.gilmour@scotland.gsi.gov.uk) and paper responses to: Jim Gilmour, Decapitalisation Rate Consultation, Local Government Division, Area 3-J (North), Victoria Quay, Edinburgh EH6 6QQ. To ensure that we handle your response appropriately, all responses must be accompanied by a Respondent Information Form (reproduced as [Annex C](#)). The Scottish Government consultation process is described in [Annex D](#).

5. We should be grateful if you could indicate clearly 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 Government Library by 24 October 2008 and on the Scottish Government consultation web pages by 31 October 2008, unless confidentiality is requested. All responses not marked confidential will be checked for any defamatory material before being logged in the Library.

6. Further copies of this consultation paper can be obtained from: the Scottish Government website: [www.scotland.gov.uk/consultations](http://www.scotland.gov.uk/consultations); by post from Jim Gilmour, Local Government Division, Area 3J (North), Victoria Quay, Edinburgh EH6 6QQ; or by e-mail from: [jim.gilmour@scotland.gsi.gov.uk](mailto:jim.gilmour@scotland.gsi.gov.uk).

## **Background**

### **Non-Domestic Rating Revaluation**

7. 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 to which a subject may be entitled before arriving at the rates liability for the forthcoming financial year. The rateable values for 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.

8. 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 principal purpose of a Revaluation is to ensure that the distribution of the rates burden between ratepayers remains equitable.

### **Contractor's principle**

9. 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 (such as oil refineries, hospitals, schools, *etc.*) there is little or no direct evidence of actual rents, and in these circumstances the Assessors may use an alternative method of valuation called the contractor's principle.

10. 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 rates**

11. 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.

12. For the last four Revaluations – 1990, 1995, 2000 and 2005 – the decapitalisation rates have been subject to Ministerial prescription using regulation-making powers contained in the Valuation and Rating (Scotland) Act 1956<sup>1</sup> as amended. For the 1990<sup>2</sup> Revaluation, the decapitalisation rate was set at 6%, except for educational and healthcare properties which had a lower rate of 4%. For the 1995<sup>3</sup> and 2000<sup>4</sup> Revaluations, the higher rate was set at 5.5% and the lower rate at 3.67%. For the 2005<sup>5</sup> Revaluation, the higher rate was set at 5% and the lower rate 3.33%. Broadly speaking, the rates were set having regard to various interest and property yield rates.

## The 2010 Valuation Roll

### Whether to prescribe the decapitalisation rates?

13. If the decapitalisation rates to be used at the 2010 Revaluation were not prescribed by Scottish Ministers, then they would be decided by the Scottish Assessors in each category of valuation. This would increase the scope for unnecessary appeals and litigation, as it is now around 20 years since the Courts last considered appeals against the decapitalisation rate to be used. The Scottish Government therefore proposes to continue to prescribe both the higher and the lower decapitalisation rates to be used in relation to properties valued using the contractor's principle method of valuation.

**Q.1 Do you agree that Scottish Ministers should continue to prescribe the decapitalisation rates to be used in the contractor's principle method of valuation at the 2010 Revaluation?**

14. As with the 2005 Valuation Roll, the Scottish Government proposes only to prescribe a decapitalisation rate for those industries or occupiers for application within the contractor's principle method of valuation, taking into account the established basis for granting obsolescence allowances. A prescribed decapitalisation rate does not mean that the contractor's principle method of valuation is preferred by the Scottish Government to any other method of valuation. The Scottish Assessors and the Courts will be free to choose the most appropriate method of valuation for the property concerned.

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<sup>1</sup> [The Valuation and Rating \(Scotland\) Act 1956](#) (c.60)

<sup>2</sup> [The 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))

<sup>3</sup> [The Valuation for Rating \(Decapitalisation Rate\) \(Scotland\) Regulations 1994](#) (1994 No.3256 (S.184))

<sup>4</sup> [The Valuation for Rating \(Decapitalisation Rate\) \(Scotland\) Amendment Regulations 2000](#) (SSI 2000 No.56)

<sup>5</sup> [The Valuation for Rating \(Decapitalisation Rate\) \(Scotland\) Regulations 2005](#) (SSI 2005 No.41)

15. 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 (such as in the case of relatively minor additions made to lands and heritages otherwise valued on the comparative principle).

## **Education, healthcare, day nursery, church and Ministry of Defence properties**

16. 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).<sup>6</sup> Educational establishments – generally universities and independent schools – 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 might be expected to borrow to fund these works. The same rationale was applied to church property and hospitals.

17. 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 where the contractor’s principle is used.

18. 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. From 1 April 2000, educational, healthcare and Ministry of Defence properties which had previously benefited from CILOR were assessed on the lower decapitalisation rate.

19. The Scottish Government 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.

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<sup>6</sup> [The 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))

20. It is proposed to continue to prescribe a separate rate for these groups because they have special characteristics which merit separate consideration – for example, they may be funded from cheaper sources of public sector finance and, in the charitable sector, partly from donations. Among the benefits of retaining the current groupings are that this would continue to provide certainty for ratepayers assessed on the contractor’s principle valuation method and that it would preserve a system which has worked well and is widely understood.

21. Maintaining the current groupings would also ensure that no ratepayer faced a significant change in their bill for reasons unconnected with the Revaluation. Any class of properties which moved between the two decapitalisation rates would be likely to see large swings in rateable value, significantly out of line with the general movement of rateable value at the Revaluation and with the change in value which could otherwise be expected for the properties concerned.

22. In the light of the factors summarised above, the Scottish Government proposes to continue to prescribe two decapitalisation rates and to maintain the current groupings of properties in each rate.

**Q.2 Do you agree that the Scottish Government should continue to prescribe two decapitalisation rates and to maintain the current groupings of properties in each rate?**

## **The appropriate rates for the 2010 Revaluation**

23. In setting the decapitalisation rates, the Scottish Government will have regard to all methodologies and factors which it considers relevant. However, this is a very complex matter and it is likely that a wide range of views exist upon the subject. The Scottish Government would like to ensure that in reaching its decision it has regard to all such methodologies and, to the extent they are open to a reasonable decision maker, all views upon those methodologies.

24. In light of this, while this consultation paper examines the methodologies available to reach the rates, it does not suggest a preferred option. Ministerial decisions on the decapitalisation rates will take into account responses to the consultation. Parallel consultation exercises are being undertaken in England, Wales and Northern Ireland as part of the preparations for the 2010 Revaluation.

25. **Annex A** sets out the broad principles behind the decapitalisation rates, the methods available for determining the rates and the range of values which could flow from each method. It identifies three methods for reaching a rate:

- the cost of securing capital to build the alternative property from borrowing;
- the cost of securing capital to build the alternative property from debt and equity, and
- property investment yields.

**Q.3 What are your views on the methods for setting the rate (including any suggestions for alternative methods) and the range of values generated by each method, and the merits or otherwise of each method?**

## Costs

26. The decapitalisation rate is 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 2010 valuation roll may vary from the rateable values in the 2005 valuation roll because of changes in the value of land or changes in building costs.

### 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 2010 Revaluation?
- Q.2** Do you agree that the Scottish Government should continue to prescribe two decapitalisation rates and to maintain the current groupings of properties in each rate?
- Q.3** What are your views on the methods for setting the rate (including any suggestions for alternative methods) and the range of values generated by each method, and the merits or otherwise of each method?

Scottish Government  
June 2008

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## **SETTING AN APPROPRIATE DECAPITALISATION RATE**

1. The Scottish Government has looked at the methods that have, in the past, been generally accepted as providing an appropriate basis for setting the decapitalisation rates. Consideration of each is set out below, together with a brief summary of the broad principles used in determining decapitalisation rates.

### **Broad principles in determining decapitalisation rates**

#### **Approaches adopted prior to prescription in 1990**

2. Prior to prescription in 1990, a number of methods were adopted for setting decapitalisation rates, and some were tested through the courts.

3. In Scotland, the courts tended to look towards yields and rent-to-cost relationships on property investment as an appropriate basis for setting a decapitalisation rate. This was based on the principle that a yield (the amount in rent in relation to the capital value or cost of the property) provides a more direct evidence of the rental value of a property, set against its capital value or cost, than other valuation methods.

4. In England and Wales, the courts tended to examine the cost of securing the capital to build an alternative property. The resulting figure was then adjusted to reflect the difference between ownership and renting.

#### **Should the decapitalisation rate be based upon real or nominal rates?**

5. A real rate of interest ignores the element in the rate for inflation. In the past, there has been some discussion as to whether the decapitalisation rate should be based upon a real or a nominal rate (which includes inflation). A rate of interest to be paid on a long-term loan is, in theory, made up from several elements. The first is the lender's return on investment. Secondly, the lender will add an element to take account of the risk of default or late repayment. Thirdly, in times of continuing inflation, the lender expects that capital will depreciate in value over time and will therefore add an element to the rate of interest as a safeguard against future inflation.

6. In the rating world, the hypothetical tenant would have to pay a nominal rate of interest (assuming that the capital sum they repaid remained the same). For the purposes of this paper, the starting point for the decapitalisation rate is a nominal rate of interest (unless otherwise stated). To the extent that the effects of inflation should be adjusted or ignored in reaching a decapitalisation rate, this is reflected in a discount to reflect the benefits of ownership.

## Discount to reflect the benefits of ownership

7. Precedent suggests that a discount should be made to the nominal rate of interest 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 which is intended to address the differences between owning and renting.

8. This adjustment could reflect a number of factors, such as that the tenant:
- does not benefit from capital growth on rented assets (real or inflationary);
  - does not have full flexibility to adapt the building to changing circumstances;
  - does not have title to the land (a non-wasting asset);
  - is not able to sell the lands and heritages;
  - is largely unaffected by additional obsolescence arising during the tenancy;
  - does not have to manage rent collection, including risk of default; and
  - does not run the risk of void periods.

9. The last three factors would reduce the discount. Whilst some of these factors are capable of being analysed, the value effects of all of them will vary by the type of property, the type of hypothetical tenant and the method adopted below. Furthermore, the absolute discount will vary depending upon the percentage to which it is being applied. In general, the discount under this method could vary from a 3.5% discount to a 0.5% increase. For simplicity, this range is adopted for each of the three methods described below.

## Methods for determining decapitalisation rates

10. Three generally accepted methods for setting the decapitalisation rate are described below, together with a brief consideration of the effect of the relative movement in rents between the valuation dates. The methods considered are as follows:

- **Method 1:** The cost of securing capital to build the alternative property from borrowing;
- **Method 2:** The cost of securing capital to build the alternative property from debt and equity; and
- **Method 3:** Property investment yields.

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

11. All methods for arriving at a decapitalisation rate based on money market interest rates are based, to some extent, upon the minimum lending rate of the Bank of England (now the official bank rate), with an adjustment for inflation and a borrower's premium.

12. The Bank of England base rate on 1 April 2008 was 5.25%, to which can be added a borrower's premium of between 1% and 2.5%. (This wide range reflects the different premium likely to be attached to different sectors and tenants.) This approach gives an initial range of 6.25% to 7.75%. After allowing for the effect of the discount to reflect the benefits of ownership (described above), the resulting range of outcomes from this method is 2.75% to 8.25%. This range would apply for debt borrowed in the commercial market.

13. In the public sector, debt may be secured from the Public Works Loan Board (PWLB). The PWLB borrowing rate at 1 April 2008 was 4.51% for the longest periods. After taking into account the effect of the discount to reflect the benefits of ownership, this gives a range of 1.01% to 5.01% for the public sector.

14. Much public expenditure is, however, funded by receipts or by Government grants, so this is not necessarily a true reflection for the cost of whole projects. The Treasury Green Book<sup>7</sup> provides binding guidance for Government Departments and Executive Agencies throughout the UK on the appraisal and evaluation of projects. It includes a discount rate to be used in evaluating public sector projects of 3.5% in real terms, which suggests the underlying cost of capital in the public sector is higher than that implied by the PWLB rates. However, the Green Book rate is not derived from any market – it is simply a rate used by the public sector for ranking and evaluating projects.

15. Having regard to the mix of public sector and private sector properties in each group, this suggests a range of 1% to 5% for education, healthcare and Ministry of Defence properties and 2.3% and 7.4% for all other properties.<sup>8</sup>

16. The merit of this approach is that:

- it reflects the fact that, in the public and private sector, debt is used to fund property (although not always exclusively).

17. The drawbacks of this approach are that:

- in the private sector, it is unlikely that a project would be funded entirely from debt; and
- in the public sector, borrowing from the PWLB may only constitute part of the cost. Other sources could include receipts or Government grant.

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<sup>7</sup> [\*The Green Book: Appraisal and Evaluation in Central Government\*](#), HM Treasury

<sup>8</sup> This is based on the assumption that, within the group of properties on the higher rate, around 25% are in the public sector.

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

18. Methods adopted prior to 1990 tended to look at only one source of finance – debt. In fact, capital may be raised from a balance of equity and debt. The common method of determining the cost of finance from equity and debt is to use a Weighted Average Cost of Capital (WACC).

19. A recent study (2006) by Smithers & Co for Ofgem<sup>9</sup> indicates a cost of equity range of 6.5% to 7.5% (arithmetical average) for utilities. This cost is likely to increase, for higher-risk industries to, perhaps, as high as 9% or more. The cost of debt for the utilities found by the same study was 3% to 4% but, again, this could be more for other industries. Adopting a balance of 1/3 debt and 2/3 equity gives a WACC range of 5.6% to 7.3%.

20. This is in real terms, and so the resulting figure does not require to be adjusted for inflation, although it does require some adjustment for the other aspects of the discount to reflect the benefits of ownership, i.e. real growth, depreciation, management expenses and the risk of voids. It is unlikely that, without the need to adjust for inflation, this discount would in fact reduce the rate; rather, it could increase it by as much as 3%. This suggests a range of, say, 5.6% to 10.3% on the above assumptions.

21. The merits of this approach are that:

- it reflects the true picture of how property is funded in large industry; and
- it reflects modern theory on cost of capital.

22. The drawbacks of this approach are that:

- the cost of equity and the balance between debt and equity can vary significantly between sectors. This suggests the range for those ratepayers which use debt and equity could be wide;
- a significant proportion of the rateable value in the wider rate is public sector, for which equity is not relevant. This suggests a further weighting is needed which changes the debt to equity ratio nearer to 50% (assuming that 25% of the relevant rateable value is in the public sector and that this is entirely financed by debt). This suggests a range of 4.75% to 8.75%; and
- it has no direct application to the educational, healthcare, day nursery, church and Ministry of Defence rate.

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<sup>9</sup> [Report on the Cost of Capital provided to Ofgem](#), 1 September 2006, Smithers and Co. Ltd.

### Method 3: Property investment yields

23. Established case law in Scotland has favoured the use of rental yields and rent-to-cost relationships in preference to an approach based on the components of interest rates. Although it is not possible to draw a precise analogy between those classes of property valued using the contractor's principle valuation method and other sectors for which market rental yields are available, there is sufficient similarity for market transactions to play their part in narrowing the range of possible decapitalisation rates.

24. 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 existed. The closest available evidence for specialised industrial property valued on the contractor's principle is found in the general industrial market. Consideration of prime yields for commercial property also points the way to the sorts of minimum return that should be taken into account in setting an appropriate rate. Essentially, these two approaches – industrial and prime commercial property – should lead to similar results and, taken together, can therefore be taken as representing a valid indicator of real-world outcomes.

25. Industrial yields reported by CB Richard Ellis for the first quarter of 2008 were 6.8%.<sup>10</sup> The IPD Monthly Property Index reports an average equivalent yield for industrial property of 7.18% in February 2008.<sup>11</sup> No further adjustment is required, as the yield establishes a direct relationship between capital value and rental value. These studies therefore suggest that the range from this method lies between 6.25% and 7.75%. For groupings of properties subject to the lower decapitalisation rate, an adjustment could be made to reflect the cheaper sources of finance available to these groupings, and the resulting differential may be similar to that arrived at using Methods 1 and 2 above.

26. The merits of this approach are that:

- it uses evidence from the market of what is, in effect, the decapitalisation rate, *i.e.* the relationship between annual value and capital value; and
- it is less subjective than some other methods, as it is based around observation of the market.

27. The drawbacks of this approach are that:

- by definition, yields are only available on classes in which there is rental evidence and, therefore, not valued on the contractor's basis. For classes assessed on the contractor's basis, little or no evidence of actual yields exists; and
- it is unlikely to have specific relevance for the education, healthcare, day nursery, church and Ministry of Defence rate, although an adjustment could be applied to take into account the particular circumstances of these groupings, as outlined above.

<sup>10</sup> CBRE UK Prime Rent and Yield Monitor, Quarter 1 2008, [www.cbre.com](http://www.cbre.com)

<sup>11</sup> IPD UK Monthly Property Index, February 2008, [www.ipd.com](http://www.ipd.com)

## Relative movement in rents between the valuation dates

28. The contractor's principle method of valuation is used where there is little or no evidence of rental value and, generally speaking, where the receipts and expenditure method is not available. It is used because it is the best method available, but it is acknowledged that, in common with most other valuation methods, it is far from perfect.

29. Central to the contractor's basis is the assumption that cost equates to value, but that is not always the case. For example, there may be instances in some sectors where construction costs have increased but returns have fallen, and the decapitalisation rate is the central part of the valuation which translates cost into value.

30. In the light of this, in coming to a conclusion on the appropriate decapitalisation rate to adopt, there will also be a need to take a wider view of the relative movement in rents between the valuation dates for the 2005 and 2010 revaluations. In principle, the movement in rateable values for properties assessed on the contractor's basis should not, overall, be significantly out of line with the general movement in rental values. If it were the case that movements in rateable values on the contractor's basis were significantly out of line with movements for other properties, then this might indicate that the results of the method had departed, to some extent, from the value of the properties. Since the decapitalisation rate is a principal tool in the contractor's basis for translating cost into value, then it follows that it should be set having some regard to those relative movements in rents.

31. It is nevertheless unlikely that consideration of relative movement in rents alone would provide anything more than a general indication of the decapitalisation rate. By their nature, properties valued on the contractor's basis are unlike other properties. The main groups of properties valued on the contractor's basis such as schools, hospitals, Ministry of Defence bases and large industrial complexes have no comparative properties which are rented. Furthermore, the majority of rental information published in rental indices is only available on prime properties and not on lower-value properties. Therefore, it is not possible to draw any direct conclusions on the decapitalisation rate from analysing rental movements. Instead, it is proposed to examine the relative movement in rents as a check upon the methods described above.

Scottish Government  
June 2008

## **PARTIAL REGULATORY IMPACT ASSESSMENT**

### **Non-Domestic Rates: Setting the Decapitalisation Rates for the 2010 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 Scottish 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 2010. 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 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 rates and rationale for government intervention**

The decapitalisation rate is generally used in valuing large industrial property and specialised public sector properties. For example, oil refineries, chemical process plants, hospitals and 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 appeals 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, the decapitalisation rates to be used as part of the contractor's principle method of valuation have been subject to Ministerial prescription. 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, 2000 and 2005 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 universities and independent schools – 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 Government proposes to continue to prescribe a higher and lower decapitalisation rate for the 2010 Revaluation. At the 2005 Revaluation the decapitalisation rates were set at 5% and 3.33% respectively. Advice on setting the decapitalisation rates will be collected from as wide a perspective as possible.

As regards the decapitalisation rates themselves, while this consultation paper examines the methodologies available to reach the rates, it does not suggest a preferred option. Ministerial decisions on the decapitalisation rates will take into account responses to the consultation. Parallel consultation exercises are being undertaken in England, Wales and Northern Ireland as part of the preparations for the 2010 Revaluation.

## **2. Risk Assessment**

Decapitalisation rates are already prescribed. This proposal will facilitate the revaluation of properties valued under the contractor's principle method of valuation. If the decapitalisation rates were not prescribed then, as discussed above, this would result in extensive litigation through the appeals process following the 2010 Revaluation. This would create uncertainty as to the liability of a whole class of ratepayers until the appeals were resolved.

### 3. Options

There are three possible options for the 2010 Revaluation:

- Option 1: not prescribing the decapitalisation rate;
- Option 2: prescribing only one decapitalisation rate; and
- Option 3: continuing to prescribe higher and lower decapitalisation rates.

For the consultation exercise, the Scottish Government has stated that its preferred option is Option 3.

#### **Option 1: Not prescribing the decapitalisation rate**

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, 2000, and 2005 Revaluations. There has been no call from ratepayers to review this element of the valuation process. The Scottish Government therefore proposes to continue to prescribe the decapitalisation rates for the 2010 Revaluation.

#### **Option 2: Prescribing only one decapitalisation rate**

Currently there are two decapitalisation rates prescribed by the Scottish Ministers at Revaluation. The lower decapitalisation rate applies to all education, healthcare, day nursery, church and Ministry of Defence subjects. The higher decapitalisation rate applies to all other lands and heritages valued under the contractor's principle method of valuation. One option for the 2010 Revaluation would be to prescribe a single decapitalisation rate.

Prescribing a single decapitalisation rate would mean that occupiers of education, healthcare, day nursery, church and Ministry of Defence subjects would be likely to see large swings in rateable value, which could be significantly out of line with the general movement of rateable value at the Revaluation and with the change in value which could otherwise be expected for the properties concerned. The Scottish Government therefore proposes to retain a lower decapitalisation rate at the 2010 Revaluation and to maintain the current groupings of properties.

#### **Option 3: Continuing to prescribe higher and lower decapitalisation rates**

If the decapitalisation rates to be used at the 2010 Revaluation were not prescribed by Scottish Ministers, then they would be decided by the Scottish Assessors in each category of valuation. This would increase the scope for unnecessary appeals and litigation. As it is now around 20 years since the courts have considered appeals against the decapitalisation rate, the scope for appeals would be greater than ever. The Scottish Government therefore proposes to continue to prescribe both the higher and the lower decapitalisation rates to be used in relation to properties valued using the contractor's principle method of valuation.

## 4. Costs

### Option 1: Not prescribing the decapitalisation rate

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

### Option 2: Prescribing only one decapitalisation rate

If education, healthcare, day nursery, church and Ministry of Defence subjects which are currently subject to the lower decapitalisation rate were required to pay the higher decapitalisation rate from 2010 onwards, then these ratepayers could face large swings in rateable value, significantly out of line with the general movement of rateable value at the Revaluation and with the change in value which could otherwise be expected for the properties concerned.

### Option 3: Continuing to prescribe higher and lower decapitalisation rates

It is not possible at this early stage of the Revaluation to estimate with any degree of accuracy the rateable values for the properties valued by the contractor's principle. The reason for this is that 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 2010 may vary from the rateable values in the 2005 valuation roll because of the changes in the value of land or changes in building costs. Exact increases in rateable values will not be available until the Assessors have completed all valuations of non-domestic property in late 2009.

In addition, it should be noted that, whilst the amount that a property pays in rates is based on its rateable value, there are other factors which affect an individual rates 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 Scottish Ministers. This figure is then adjusted to take account of any rate reliefs to which a ratepayer might be entitled. It is too early in the Revaluation process to say at what level the poundage rate will be set for 2010-11. This information will not be available until late 2009.

## 5. Benefits

### Option 1: Not prescribing the decapitalisation rate

Given that it is over 20 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 in challenging their rateable values at appeal, although any reduction in rateable value would be offset by the costs of the appeal litigation.

### **Option 2: Prescribing only one decapitalisation rate**

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.

### **Option 3: Continuing to prescribe higher and lower decapitalisation rates**

As discussed above, it is too early to say with any degree of accuracy what the effect of retaining higher and lower decapitalisation rates might be. In setting the decapitalisation rates for 2010, the Scottish Government will aim to maintain a balance between non-domestic properties valued under the contractor's principle and all other non-domestic properties.

## **6. Equity and fairness**

Continuing to prescribe 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 2010 Revaluation.

## **7. Compliance costs**

No additional compliance costs for businesses have been identified as arising from these proposals.

## **8. Legal Aid impact test**

No Legal Aid impacts have been identified as arising from these proposals.

## **9. 'Test run' of business forms**

No impacts on business forms have been identified as arising from these proposals.

## **10. Competition assessment**

No competition impacts have been identified as arising from these proposals.

## **11. 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.

## **12. Impact on small and micro businesses**

The contractor's principle valuation method is generally used for large specialist properties. In contrast, the vast majority of small businesses are assessed by conventional valuation methods. It is therefore unlikely that the decapitalisation rates will have a direct effect on small businesses.

## **13. Consultation**

The Scottish Government is holding a 12-week public consultation to seek views on its proposals to prescribe the decapitalisation rates for the purposes of the 2010 Revaluation. The Scottish Government will use the responses to the attached consultation document to finalise proposals for the decapitalisation rates. If the Scottish Ministers decide to change the rates, the revised arrangements would be set out in a Statutory Instrument and laid before the Scottish Parliament. If the rates remain unchanged, the existing legislation would remain in force for the 2010 Revaluation.

## **14. Monitoring and evaluation**

The Scottish 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, it will be possible 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 Government from the 2010 Revaluation which can be taken into account when setting the decapitalisation rates for the subsequent Revaluation, which is planned for 2015.

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## THE SCOTTISH GOVERNMENT CONSULTATION PROCESS

Consultation is an essential and important aspect of Scottish Government working methods. Given the wide-ranging areas of work of the Scottish Government, there are many varied types of consultation. However, in general, Scottish Government 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.

The Scottish Government encourages consultation that is thorough, effective and appropriate to the issue under consideration and the nature of the target audience. Consultation exercises take account of a wide range of factors and no two exercises are likely to be the same.

Typically, Scottish Government 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 issue, and they are also placed on the Scottish Government website enabling a wider audience to access the paper and submit their responses. Consultation exercises may also involve seeking views in a number of different ways, such as through public meetings, focus groups or questionnaire exercises. Copies of all the written responses received to a consultation exercise (except those where the individual or organisation requested confidentiality) are placed in the Scottish Government Library at Saughton House, Edinburgh (K Spur, Saughton House, Broomhouse Drive, Edinburgh EH11 3XD, telephone 0131 244 4565).

All Scottish Government consultation papers and related publications (e.g. analysis of response reports) can be accessed at: Scottish Government consultations:

[www.scotland.gov.uk/consultations](http://www.scotland.gov.uk/consultations)

The views and suggestions detailed in consultation responses are analysed and used as part of the decision-making process, along with a range of other available information and evidence. 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; or
- be used to finalise legislation before it is implemented.

Final decisions on the issues under consideration will also take account of a range of other factors, including other available information and research evidence.

**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.**

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## LIST OF CONSULTEES

The following is a primary distribution list of the initial circulation of this consultation paper. The paper is also publicly available on the consultation pages on the Scottish Government website: [www.scotland.gov.uk/consultations](http://www.scotland.gov.uk/consultations). If respondents are aware of any other organisations who they consider should be consulted, please contact Jim Gilmour at the address shown on page 1 of this paper.

Association of Directors of Education in Scotland  
 Brewers Association of Scotland  
 British Energy  
 British Federation of Care Home Proprietors  
 British Ports Federation  
 British Waterways  
 Caledonian MacBrayne  
 Chemical Industries Association  
 Clydeport  
 Committee of Scottish Clearing Bankers  
 Confederation of British Industry (Scotland)  
 Convention of Scottish Local Authorities  
 Corus  
 Crown Estate  
 DM Hall Chartered Surveyors  
 Department for Communities & Local Government  
 Dundee Energy Recycling  
 Electricity Association Services  
 English, Welsh & Scottish Railways  
 Federation of Small Businesses (Scotland)  
 Forth Ports  
 Forum for Private Business in Scotland  
 Gerald Eve Chartered Surveyors  
 Grangemouth Combined Heat & Power  
 Health Care International  
 Highlands and Islands Enterprise  
 Institute of Chartered Accountants in Scotland  
 Institute of Directors (Scotland)  
 Joint Committee of Colleges of Education in Scotland  
 Network Rail  
 National Express  
 Northern Ireland Executive  
 OFGEM  
 OFWAT  
 Institute of Revenues, Rating & Valuation (Scotland)  
 Registered Nursing Homes Association  
 Royal Institute of Chartered Surveyors (Scotland)  
 Ryden (Chartered Surveyors)  
 Scotch Whisky Association  
 Scottish & Southern Energy  
 Scottish Assessors Association  
 Scottish Chambers of Commerce  
 Scottish Civic Forum

Scottish Council for Development & Industry  
Scottish Council of Independent Schools  
Scottish Council of Voluntary Organisations  
Scottish Enterprise  
Scottish Football Association  
Scottish Local Authorities (Chief Executives, Directors of Finance, Heads of Revenue)  
Scottish Parliament Local Government & Communities Committee  
Scottish Power  
Scottish Renewables  
Scottish Rugby Union  
Scottish Water  
Sport Scotland  
Standing Committee of the Scottish Universities  
Strathclyde Partnership for Transport  
The Chartered Association of Certified Accountants  
The Law Society of Scotland  
The Rating Surveyors' Association (Scotland)  
Transco  
Transport Scotland  
UK Petroleum Industry Association  
Valuation Joint Boards  
Virgin Trains  
Welsh Assembly Government  
Wind Energy Group

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