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Rebalancing business rates



Annex A

Methodology for Calculating Decapitalisation Rates

Broad principles in determining the decapitalisation rate

The 'Contractor's Basis' is one of three recognised methods for valuing hereditaments for rating purposes. It is used for specialised properties when there is little or no rental evidence available on the general market. It is based on the premise that the hypothetical tenant has an alternative to renting and they could purchase land and build a similar hereditament.

Therefore, they will not pay more in rent than the annualised cost of buying the land and building a similar property nearby.

Using this method, after the capital value has been derived (taking into account construction costs, the age of the property and the land value), the decapitalisation rate is applied. The function of the decapitalisation rate is to convert capital value into an annual rental value. Therefore, the decapitalisation has a direct bearing on the final valuation of a property.

Prior to the prescription of decapitalisation rates in Northern Ireland in 1997, a number of methods were adopted and tested through the courts.

In the UK, apart from Scotland, the courts tended to examine the cost of securing the capital to build an alternative property and then adjusted this figure to take into account the benefits of owning a property as opposed to renting a property, this adjustment has become known as the 'Denning Discount'.

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

These approaches have been considered when setting the decapitalisation rates across the UK since 1997 and they are examined below for the 2023 revaluation having regard to the economic circumstances at the Antecedent Valuation Date (AVD) for the revaluation, 1st October 2021.

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. (See *Imperial College of Science and Technology v Edbon (VO)* and *Westminster City Council 1986 RA 233*). Therefore, the starting point for the decapitalisation rates 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 the Denning Discount.

Discount to reflect the benefits of ownership (The Denning Discount)

A discount may be applied to the nominal rate of interest to take account of the difference between owning and renting a property (See *Dawkins (VO) v Royal Lemington Spa Corporation* (1961) 8 RRC 241 and *Cardiff City Council v Williams (VO)* [1973] RA 46). This can reflect a number of factors which influence the costs and benefits for the owner of the property, for example the tenant:

- does not benefit from capital growth (or loss) on the asset which is capable of being realised at any time;
- does not have title to the land (a non-wasting asset);
- is not able to sell the asset at the time of their choosing;
- is largely unaffected by the costs of obsolescence of the property (for example technological change may lead to a fall in capital value);
- does not incur the cost of rent collection, or run the risk of void periods or the tenant defaulting on their rent; and
- does not have full freedom to adapt the property to changing circumstances.

While some of these factors are capable of being analysed, the effects are to some extent subjective and may vary by type of property, by type of hypothetical tenant and by the method adopted. More recently, the returns from owning property have become less certain and the risk of losses has risen in some sectors. This has increased the uncertainty over the Denning Discount and could also reduce the discount compared to previous revaluations.

After allowing for a range of outcomes on the various indicators used, it has been calculated that the Denning Discount could vary from a 4% discount to a 2% increase. This range has been adopted for the methods set out below.

The Department is also aware, in this context, of the historic low level of the Bank of England Bank Rate:

<https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp>

Methods for determining decapitalisation rates

There are three generally accepted methods for determining the decapitalisation rate.

These are:

- A. The cost of securing capital from borrowing to build the alternative property**
- B. The cost of securing capital from debt and equity to build the alternative property**
- C. Property investment yields**

Each method for calculating the decapitalisation rates is outlined below, along with its strengths and weaknesses. Each method uses an array of indicators, and therefore a range of possible values will be derived, within which a final figure could be used for the decapitalisation rates.

A. The cost of securing capital from borrowing to build the alternative property

This method is based on predicting the Bank of England base interest rate for the medium-long term with adjustments made for inflation and a borrower's premium.

Strengths of this method include:

- it reflects the fact that in the public and private sector, debt is used to fund property (although not always exclusively);
- the economic variables which underpin the result are relevant to the economic climate at the time, giving the approach simplicity and transparency; and
- its development evolved from case law prior to statutory prescription of the decapitalisation rate.

Weaknesses of this method include:

- it includes a number of variables which require assumptions to be made and which are sensitive to small changes in economic circumstances. This may make the method less reliable in times of economic change; and
- the method assumes that capital is funded only from borrowing when in fact there may be a number of other sources available.

B. The cost of securing capital from debt and equity to build the alternative property

This approach develops the traditional route by taking a more sophisticated look at the cost of capital and recognises that capital may be raised not just from debt, but a combination of debt and equity.

The common method of determining the cost of finance from debt and equity is the Weighted Average Cost of Capital (WACC). This combines the cost of debt with the cost of equity to arrive at a weighted average between the two. Such an approach is commonly adopted by regulators assessing returns allowed on capital for regulated industries such as utilities.

Strengths of this method include:

- it recognises that capital may be funded by equity as well as debt, thereby offering a more sophisticated approach; and
- it reflects how property is funded in large industry.

Weaknesses of this method include:

- it does not apply to public sector bodies as they seldom fund capital through equity;
- slight changes to any of the inputs can produce significant variations in the final answer, calling into question its accuracy; and
- the cost of equity and the balance between debt and equity can vary significantly between sectors and over time resulting in a wider range of possible rates.

C. Property investment yields

This approach is predicated on the basis that yields from property investment provide a measure of the relationship between capital and rental value.

Industrial property yields are considered to be a useful indicator for this purpose, as these are the only class of property which, in part, is valued on the Contractor's Basis and for which evidence of yields is available. They can also be a useful indicator as they are likely to be fairly stable in periods of economic change, unlike other sectors such as the retail sector which tends to fluctuate according to market conditions.

Strengths of this method include:

- it is simple and transparent, drawing on actual market evidence, which makes it less subjective than other methods; and

- it focuses on the relationship between capital and rental values which is what a decapitalisation rate ultimately tries to achieve.

Weaknesses of this method include:

- prior to prescription in 1997, the use of investment yields as a means of determining the decapitalisation rate was generally rejected by the courts (it stems from Scottish case law);
- it is questionable whether the industrial evidence base has relevance to the majority of Contractor's Basis hereditaments such as schools, hospitals and defence properties; and
- decapitalisation rates are meant to represent the cost of obtaining capital, property investment yields do not do this.

The fall in the overall cost of borrowing in recent years has created a large separation between the results of this method and the traditional route, highlighting its limitations.