

Explanatory Memorandum to the Non-Domestic Rating (Miscellaneous Provisions) (Amendment) (No.2) (Wales) Regulations 2021

This Explanatory Memorandum has been prepared by the Local Government Finance Reform Division and is laid before Senedd Cymru in conjunction with the above subordinate legislation and in accordance with Standing Order 27.1.

Minister's Declaration

In my view, this Explanatory Memorandum gives a fair and reasonable view of the expected impact of the Non-Domestic Rating (Miscellaneous Provisions) (No.2) (Wales) (Amendment) Regulations 2021. I am satisfied that the benefits justify the likely costs.

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Minister for Finance and Local Government
13 October 2021

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PART 1: EXPLANATORY MEMORANDUM

Description

1. Non-domestic rates (NDR) are a local tax which raise revenue on properties that are used for non-domestic purposes, for example public buildings, shops, factories, offices, leisure facilities, schools and hospitals. In 2021-22, it is estimated that NDR in Wales will generate over £1.1 billion (net). All the revenue is distributed to local government to help fund local services in Wales.
2. On 1 April 2023, a new rating list will come into force and all non-domestic properties (known as hereditaments) in Wales will be assigned new rateable values for the purposes of calculating their rates liability. The Valuation Office Agency (VOA) is already engaged in the work to ensure that all non-domestic properties in Wales are assigned new rateable values as at the Antecedent Valuation Date (AVD) of 1 April 2021.
3. This statutory instrument sets the decapitalisation rates which will be used when Valuation Officers calculate the rateable value of properties using the Contractor's Basis of Valuation. The Contractor's Basis is one of the three main methods the VOA uses for calculating rateable values. Decapitalisation rates are used to convert the capital value of properties to an equivalent rental value where no rental comparison or receipts and expenditure evidence exists. The decapitalisation rates (along with a number of other factors) therefore directly affect the rateable value of properties assessed according to the Contractor's Basis and the rates liability attributed to them. The decapitalisation rates will also have a minor indirect effect on the liability of other properties in Wales following revaluation.
4. The *Non-Domestic Rating (Miscellaneous Provisions) (No.2) (Amendment) (Wales) Regulations 2021* (the Regulations) amend the *Non-Domestic Rating (Miscellaneous Provisions) (No 2) Regulations 1989* (the 1989 Regulations) in relation to properties valued on the Contractor's Basis in the rating list to be compiled on or after 1 April 2023. It sets a lower decapitalisation rate of 1.9% for educational, healthcare, public conveniences and defence properties and a standard rate of 3.4% for all other properties.

Matters of Special Interest to the Legislation, Justice and Constitution Committee

5. None.

Legislative background

6. Paragraph 2(1) of Schedule 6 to the Local Government Finance Act 1988 (the 1988 Act) provides that the rateable value of a non-domestic hereditament is taken to be an amount equal to the rent at which it is estimated the hereditament might reasonably be expected to be let from year to year (subject to specified assumptions). In cases where there is no available information on the general rental market and where profit and loss cannot be used as an

indication of rental value, the rateable value of a non-domestic hereditament is determined by 'decapitalising' the estimated total capital value of the hereditament to turn it into an annual rental equivalent (this is known as the Contractor's Basis of Valuation).

7. The decapitalisation rates are prescribed by regulations made by the Welsh Ministers under paragraph 2(8) of Schedule 6 to the 1988 Act. The paragraph states that the Secretary of State (the power is now vested in the Welsh Ministers) may make regulations which provide that in determining the rateable value of a non-domestic hereditament (including a prescribed class of hereditaments), prescribed assumptions (as to the hereditament or otherwise) are to be made. The decapitalisation rates are one such prescribed assumption. The decapitalisation rates are prescribed in Regulation 2 of the 1989 Regulations (as amended).
8. The powers of the Secretary of State in paragraph 2(8) of Schedule 6 to the 1988 Act were transferred, in relation to Wales, to the National Assembly for Wales by the National Assembly for Wales (Transfer of Functions) Order 1999. The Local Government Finance Act 1988 is an enactment referred to in Schedule 1 and transferred by Article 2 of that Order. The functions of the National Assembly for Wales were subsequently transferred to the Welsh Ministers under section 162 and paragraph 30 of Schedule 11 to the Government of Wales Act 2006.
9. The Regulations will follow the negative procedure.

Purpose and Intended Effect of the Legislation

Primary purpose of the legislation

10. Work is in hand to ensure that all non-domestic properties in Wales are revalued and given new rateable values so that their NDR liability can be calculated for the purposes of compiling a new rating list. The new list will come into force on or after 1 April 2023 and will be based on values as at the AVD, 1 April 2021.
11. The primary purpose of revaluation is to ensure that the credibility of the rating system is maintained and that the rates liability is fairly distributed between properties based on relative changes in rental values in Wales.
12. Valuation works hand-in-hand with the multiplier. At each revaluation, the multiplier is reset to ensure the tax-base can broadly generate the same level of funding after revaluation as before. This is because the rates system needs to generate funding for the provision of local services at a level consistent with spending plans. As such, the combined effect of revaluation and the setting of the multiplier is to adjust the liability of properties relative to others within the non-domestic tax-base. This ensures that rates liability is spread fairly between ratepayers and is based on up-to-date rental values.

13. Approximately 14% of the non-domestic tax-base in Wales is valued using the Contractor's Basis of Valuation. The Regulations set the decapitalisation rates, which are a key component of this valuation method.
14. The primary purpose of this statutory instrument is to revise the decapitalisation rates to reflect market conditions as at the AVD.

The valuation process

15. The VOA is an executive agency of HM Revenue and Customs and is responsible for determining the rateable value of all non-domestic properties for the purpose of calculating their rates liability.
16. At every revaluation, the VOA calculates the new rateable value of a property based on an estimate of the rental value of the property on the open market. To ensure that rateable values keep pace with changes in the property market, non-domestic properties are usually revalued every five years by the VOA. The next revaluation is scheduled to take effect on 1 April 2023 having been deferred in response to the Covid-19 pandemic.
17. The VOA uses three main methods for calculating the rateable value of a property depending on the available evidence. Rental Comparison is used when there are sufficient numbers of comparable properties to provide reliable evidence on rental values: this method is the most commonly used. The Receipts and Expenditure method is used when there is insufficient information to compare rental values and when rent is likely to be based on the profits made by the business occupying the property, for example pubs and hotels. The third method is the Contractor's Basis.

The Contractor's Basis

18. The Contractor's Basis is used when no rental comparison or receipts and expenditure evidence exists. It is generally applied to specialised properties, for example large industrial buildings, schools and hospitals. Properties such as these are rarely let and therefore their rental values are determined by reference to estimated construction costs.
19. The Contractor's Basis involves the VOA estimating the cost of replacing the buildings and any other rateable items, for example plant and machinery, and then adjusting the estimate to reflect any obsolescence in the actual property. The resulting figure represents an estimate of the capital value of the site. This capital value is then 'decapitalised' using the decapitalisation rate to give an annual equivalent which is taken to be the rateable value.
20. The Contractor's Basis has evolved through rating case law over some 200 years. It is based on the premise that the hypothetical tenant has an alternative to renting and could purchase land and build a similar hereditament.
21. Rating case law has established six principal stages for the Contractor's Basis of valuation.

- i. Estimate the cost of replacing the building and any rateable items such as certain types of plant and machinery.
- ii. Make deductions to reflect the actual property being valued and adjust it for age and obsolescence.
- iii. Add the land value to arrive at the total capital sum.
- iv. Decapitalise the total capital sum at the appropriate decapitalisation rate (or interest on capital rate). This converts capital value into an annual equivalent, or rental value.
- v. Stand back and look at the result of the application of the first four stages and make any adjustment required to reflect any factors which would affect the rental value, as opposed to the capital cost.
- vi. Consider the differences between the landlord's and tenant's viewpoints (in practice this stage is often combined with stage (v)).

22. The decapitalisation rate is required at stage (iv) of the Contractor's Basis. The rate is a percentage figure which is used to convert capital value into an annual rental value. It ensures that the costs and benefits of owning a property, compared to renting a property, are taken into account when calculating the rateable value of a property. The higher the decapitalisation rates, the higher the resultant rateable value will be.

23. Before 1990, valuation assessors and the courts had great difficulty in deciding on the appropriate decapitalisation rate to be used in non-domestic valuations. As a result, there was extensive litigation on this point following each revaluation. Therefore, since 1990, Ministers have prescribed the appropriate decapitalisation rates to be used in Contractor's Basis valuations.

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

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

Setting Decapitalisation rates

25. If the decapitalisation rate is prescribed in legislation, it has a fixed value and has a demonstrable effect on the rateable value of properties valued by the Contractor's Basis – the higher the decapitalisation rate, the higher the rateable value of these properties. For example, if at Stage 3 of the Contractor's Basis, the capital value of a hereditament is calculated at £500,000 and the decapitalisation rate is 3.8% (the higher rate applicable to the current 2017 rating list) the annual rateable value at Stage 4 would be £19,000.
26. The decapitalisation rates therefore have an impact (albeit minor) on the total rateable value of hereditaments in Wales. It also has an indirect effect on how rates liability is distributed between other non-domestic properties by exerting pressure on the multiplier. If the decapitalisation rate increases, it exerts a small downward pressure on the multiplier, and vice versa.
27. Setting the decapitalisation rate is only one part of the revaluation process and the impacts will depend on other factors such as market conditions, changes in rental values and the multiplier. These will be analysed as the revaluation progresses.
28. Determining appropriate decapitalisation rates is a complex matter and is not an exact science. There are a number of different academic methodologies (and each has its own advantages and disadvantages) as well as a number of other factors, such as changes in the value of land or in construction costs, to be taken into account. In setting the rates, the Welsh Government has taken account of all the methods and factors which it considers to be relevant.
29. As the primary function of the decapitalisation rate is to translate cost into value, relative movements in rents between the valuation dates for the 2017 Revaluation and the 2023 Revaluation also need to be taken into consideration. This acts as a check on the results of the academic methods and ensures valuations take account of changes in the property market in Wales.
30. Since 1990, two decapitalisation rates have been prescribed in legislation for each revaluation – a standard and a lower rate. At the 2017 revaluation, the lower rate applied to educational, healthcare, defence and public convenience hereditaments, while the standard rate applied to all other properties. A lower rate is applied to certain public sector properties to reflect the fact that the occupiers have access to cheaper forms of financing such as public loans and grants.
31. This statutory instrument will set the following decapitalisation rates for the non-domestic rating list in Wales compiled on or after 1 April 2023.
- The lower decapitalisation rate which applies to education, healthcare, defence and public convenience hereditaments is set at **1.9%**.
 - The standard decapitalisation for all other properties is set at **3.4%**.

Consultation

32. A public consultation sought views on setting the decapitalisation rates for the 2023 Non-Domestic Rates Revaluation. The 12-week technical consultation was launched on 24 March 2021 and closed on 16 June 2021. A summary of responses was published on 25 August 2021 and is available [here](#).
33. It asked stakeholders for views on the proposal to continue to prescribe a standard and lower decapitalisation rate, as well as the available methodology and the preferred approach for calculating the rates. It also sought views on the adoption of a general policy where changes to the decapitalisation rate did not occur at each revaluation, subject to market conditions.
34. The consultation was published on the Welsh Government website and was also sent to the following organisations:
- All local authorities in Wales
 - Welsh Local Government Association
 - Valuation Tribunal for Wales
 - VOA
 - Institute of Revenues, Rating and Valuation
 - Members of the Welsh Ratepayers Forum.
35. Six consultation responses were received. The breakdown of responses received is as follows:
- One individual
 - Five professional representative financial or advisory bodies.
36. The use of prescribed decapitalisation rates for the Contractor's Basis of Valuation was the preferred method for most respondents. Respondents expressed the view that rates should be set fairly in context of existing case law and that there should be greater harmonisation across the UK.
37. The majority of responses agreed that the Welsh Government should continue to prescribe two decapitalisation rates. Respondents thought the current system was well understood.
38. Most respondents agreed with the Welsh Government's proposed approach for setting decapitalisation rates in Wales with the proviso that that it did not unfairly affect particular sectors.
39. Views were generally against the notion of adopting a general policy for future revaluations.

PART 2: REGULATORY IMPACT ASSESSMENT

Options

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

Decapitalisation rates would be prescribed using the latest market information.

A lower rate (2.1%) would apply to educational, healthcare, and defence hereditaments and a standard rate (3.8%) would apply to all other properties. These percentages reflect the market conditions on the AVD for the 2023 Revaluation which is 1 April 2021.

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

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

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

A lower rate (1.7%) would apply to educational, healthcare, and defence hereditaments and a standard rate (3.1%) would apply to all other properties.

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

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

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

A lower rate (1.9%) would apply to educational, healthcare, defence hereditaments and a standard rate (3.4%) would apply to all other properties.

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

Costs and benefits

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

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

Costs

If the decapitalisation rates are set using the latest market information and no adjustment is made to limit the impact of any changes, bills would increase for properties valued using the Contractor's Basis by an estimated 24.6%. This would create a significant liability for these ratepayers.

Properties using the Contractor's Basis would see an increase in their bills 23.9 percentage points higher than other ratepayers. Other ratepayers would see an increase of 0.7% (assuming that other factors remain the same), which is lower than the assumed CPI inflation of 1.9%.

Benefits

The main reason for a revaluation is to ensure the liability for occupiers of non-domestic properties is based on up-to-date rental values and market conditions. Revising the decapitalisation rates to reflect conditions as at the AVD of 1 April 2021 would be the simplest approach and would ensure that rates liability is distributed solely on the basis of relative values.

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

Costs

This would increase the multiplier above inflation in order to distribute the rise in liability for properties valued on the Contractor's Basis. All properties would be affected equally, with properties using the Contractor's Basis and other ratepayers all seeing an increase in rates bills of around 4%. This increase is around 2.1 percentage points above assumed CPI inflation of 1.9%. As a result, rates bills for properties valued using methods other than the Contractor's Basis would increase by an estimated £39.5 million a year.

Benefits

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

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

Costs

Option 3 would split the increase between properties valued using the Contractor’s Basis and properties valued using other methods. The impact on properties using the Contractor’s Basis would be limited compared to Option 1, with an estimated increase in bills of 13.9%.

The multiplier would increase to a lesser extent than under Option 2. Properties valued using methods other than the Contractor’s Basis would see an increase in bills of around 2.4%, which is 0.5 percentage points above assumed CPI inflation of 1.9%. As a result, rates bills for properties valued using methods other than the Contractor’s Basis would increase by an estimated £19.8 million a year.

Benefits

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

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

Option selection

The effects outlined for Option 1 would present substantial risk to the public purse, with bills for public sector buildings increasing substantially relative to the rest of the tax-base. Option 2 would have a substantial impact on other ratepayers who would otherwise expect lower bills.

Option 3 provides a balance, limiting the impacts presented by Options 1 and 2.

Option 3 is the Welsh Government’s preferred option.

Analysis of other effects and impacts

Promoting Economic Opportunity for All (Tackling Poverty)

Revaluations, with appropriate decapitalisation rates, adjust rateable values to reflect economic conditions. Setting appropriate decapitalisation rates helps to ensure that rates liability is distributed equitably between ratepayers.

UNCRC

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

Welsh language

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

Equalities

No specific impacts, positive or negative, on persons who share a protected characteristic (as determined by the Equality Act 2010) have been identified.

Well-being of Future Generations (Wales) Act 2015

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

Impact on the voluntary sector

No specific negative impacts on the voluntary sector have been identified. Setting decapitalisation rates enables a more robust revaluation process which is to the benefit of all sectors.

Competition assessment

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

The purpose of revaluation is to adjust the liability of non-domestic properties *relative* to others within the tax-base whilst ensuring the tax-base can broadly generate the same level of revenue after revaluation as before.

The purpose of setting the decapitalisation rates is to ensure the rateable values (and the rates bills) of properties valued using the Contractor's Basis reflect market conditions as at the AVD of 1 April 2021 and take account of the potential impacts of significant changes.

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

Post-implementation review

The Welsh Government will continue to monitor the impact of the non-domestic rates revaluation on different sectors and will consider the overall outcome and effect of the revaluation once the finalised draft rating list becomes available.