Annex A: Methodological approaches for calculating decapitalisation rates

Introduction

1. The Welsh Government set the decapitalisation rates for Wales for the 2010 Revaluation having regard to circumstances as at 1 April 2008. For the 2017 Revaluation, the Welsh Government will consider the circumstances at 1 April 2015 (the Antecedent Valuation Date for the 2017 Revaluation).

Broad principles in determining the decapitalisation rate

2. 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 no information on the general rental market available. 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 some land and building a similar property nearby.

3. 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.

4. Prior to the prescription of decapitalisation rates in 1990, a number of methods were adopted and tested through the Courts.

5. In England and Wales, 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'.

6. 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 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.

7. These approaches have been considered when setting the decapitalisation rates since 1990 and they are examined below for the 2017 revaluation having regard to the economic circumstances at the antecedent valuation date for the revaluation – 1 April 2015.

8. 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) [1]. 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)

9. As detailed above, a discount may be made to the nominal rate of interest to take account of the difference between owning and renting a property[2]. This can reflect a number of factors which influence the costs and benefits for the owner of the property, such as, that 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); and
    - 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 the full to adapt the property to changing circumstances.

10. Whilst 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 in some sectors has risen. This has increased the uncertainty over the Denning Discount and could also reduce the discount compared to previous revaluations.

11. 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.

Methods for determining decapitalisation rates

12. There are three generally accepted methods for determining the decapitalisation rate, these are:

    i. The cost of securing capital to build the alternative property from borrowing;
    ii. The cost of securing capital to build the alternative property from debt and equity; and
    iii. Property Investment Yields.

[1] See Imperial College of Science and Technology v Edbon (VO) and Westminster City Council 1986 RA 233

[2] See Dawkins (VO) v Royal Lemington Spa Corporation (1961) 8 RRC 241 and Cardiff City Council v Williams (VO) [1973} RA 46

13. Each method for calculating the decapitalisation rates is outlined below, along with their particular strengths and weaknesses. Each uses an array of indicators and therefore a range of possible values are suggested within which a final figure could be selected for the decapitalisation rates.

The Cost of Securing Capital to build the alternative property from borrowing

14. 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.

15. 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.

16. 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 debt when in fact there may be a number of other sources available.

17. The Bank of England base rate on 1 April 2015 was 0.5% but this is a historically low level. Looking at the medium to longer term, it is reasonable to expect a base rate rise at some point and therefore adopting a range of 0.5% to 1.5% for the purposes of the calculation would be reasonable. Bearing in mind the current state of the economy, and the generally more restrictive lending policies now in place, a borrower's premium of between 2% to 4% has been also been applied**.** This range is then adjusted for the Denning Discount which produces a range of minus 1.5% to plus 7.5%. This range would apply for debt borrowed in the commercial market.

18. In the public sector, debt may be secured from the Public Works Loans Board. At 1 April 2015, the fixed rate standard loan transaction for five years had a maturity rate of 2.15%. After allowing for the range of outcomes on the Denning Discount, the resulting range for the public sector is minus 1.86% to plus 4.14%.

19. It is not considered reasonable to set a decapitalisation rate at nil or close to nil as this would imply that a large group of properties providing public and commercial services would command a negligible rent. Taking this into account, this suggests a range of **1% to 4%** for properties on the lower rate, and a range of **1% to 7.5%** for all other properties.

The Cost of securing Capital to build the Alternative Property from Debt and Equity

20. 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.

21. The common method of determining the cost of finance from equity and debt 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.

22. 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;

23. 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.

24. Since the 2010 Revaluation, the WACCs adopted for utilities have fallen. For example, the regulator of water and sewage companies (Ofwat) adopted a range of 3.6% to 3.9%[3], whilst the Civil Aviation Authority adopted WACCs for Heathrow of 4.85% and Gatwick 5.1%[4]. In more risky sectors, such as energy, higher WACCs will be adopted, for example the Competition and Markets Authority has estimated that WACCs in the electricity generation and supply market range from 7.7% to 11%[5].

[3] OFWAT (2014) Setting Price Controls for 2015-20 – Risk and Reward Guidance: http://www.ofwat.gov.uk/pricereview/pr14/gud_tec20140127riskreward.pdf

[4] The Civil Aviation Authority (2014) Estimating the cost of capital: a technical appendix for the economic regulation of Heathrow and Gatwick from April 2014: Notices of the proposed licences http://www.caa.co.uk/docs/33/CAP%201140.pdf

[5] Competition and Markets Authority (2015) Energy Market Investigation: Analysis of cost of capital of energy firms

25. Again, this approach requires adjustments to be made for some aspects of the Denning Discount, such as real growth, depreciation and risk of voids. After these are taken into account, this approach suggests a range of **4% to 11%**.

Property Investment Yields

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

27. Industrial property yields are considered to be a useful indicator for this purpose, as these are the only class of property which 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 stay fairly stable under periods of economic change, unlike other sectors such as the retail sector which tends to fluctuate according to market conditions.

28. 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.

29. Weaknesses of this method include:

- Prior to prescription in 1990, the use of investment yields as a means of determining the decapitalisation rate was generally rejected by the Courts in England and Wales (it stems from Scottish case law):
- It is questionable whether the industrial evidence base has any 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.

30. There is a range of evidence on the industrial and logistics UK sector, surveyors have reported industrial yields for the first quarter ranging from 4.75% for prime sites to over 14% for secondary and tertiary locations[6]. Therefore the evidence suggests that the range of values from this approach is somewhere between **5% to 15%.**

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

[6] Cushman E.G and Wakefield (2015) Industrial Snapshot – Quarter 1 http://www.cushmanwakefield.com/~/media/marketbeat/2015/05/uk_ind_1q15.pdf
Knight Frank (2015) Yield Guide – May 2015 http://content.knightfrank.com/research/522/documents/en/may-2015-2885.pdf
Lambert Smith Hampton (2015) Yield and Void Matrix: Quarter 1 2015 http://www.lsh.co.uk/commercial-property-research/2015/05/yield-and-void-matrix-q1-2015