

VALUATION FOR RATING

The Contractor's Basis

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The Court of Appeal in the case of the China Light and Power Co Ltd and the Commissioner for Rating and Valuation (Hong Kong) began its judgement with a quotation from Lord Pearce in the case of Dawkins v Ash Brothers & Heaton Ltd:

“The world of rating appears, to one unfamiliar with the arcane, to be cloud-cuckoo land, a world of virtual unreality from which real cuckoos are excluded (although it seems that permission to land will be granted to a cuckoo flying in from the real world if it can demonstrate that its presence in cloud-cuckoo land is essential, not merely accidental).”

Not a flattering comment on the rating system or its practitioners but is this correct? Are valuations for rating purposes carried out in cloud-cuckoo land? I think not because valuations for rating are based on reality in that as far as possible we are looking either at market evidence, or at evidence of accounts or evidence of construction costs. The latter of course concerns us tonight.

Before we go further I think that it is worth reminding ourselves of what we are trying to do. In short we are attempting to establish a rental value for a hereditament that corresponds to the definition in Para 1 of Schedule 12 to the Rates (NI) Order 1977.

“Subject to the provisions of this Schedule, for the purposes of this Order the net annual value of a hereditament shall be the rent for which, one year with another, the hereditament might, in its actual state, be reasonably expected to let from year to year, the probable average annual cost of repairs, insurance and other expenses (if any) necessary to maintain the hereditament in its actual state, and all rates, taxes or public charges (if any), being paid by the tenant.”

In simple terms rent on an FRI basis.

To establish rental value we use three main methods:

- The analysis of actual rents passing;

- The revenue principle [receipts and expenditure method / profits method] which looks at accounts; and
- The subject of tonight's talk i.e. the Contractor's Basis.

Of the three methods the Contractor's Basis has been the subject of much criticism and debate indeed it has been dubbed by some commentators as the "Method of last resort". Be that as it may the reality is as expressed by Lord Avonside in the Scottish Case of the Post Office v Assessor for Fife Region when he said:

"I would only add that in a case such as the present one, where no proper comparisons and values are available, and the Revenue Principle is plainly inapplicable, resort must be had to the Contractors Principle. That principle has been criticised decade after decade but I have yet to see any critic suggesting a method of valuation which could take its place".

In short the Contractors Basis is the "only show in town" for the valuation of properties which are not let and which are not run for profit. Examples are – public buildings such as schools, hospitals, libraries, fire stations, prisons, specialist industrial undertakings such as oil terminals, pipelines, distilleries and so on.

The use of the method is then not in doubt and in an attempt to deal with some of the problems with its application a forum was established in the early 1990s. Such a body had been suggested by the Wood Committee who carried out research into the valuation for rating of plant and machinery following the 1990 revaluation and the suggestion by the Committee was implemented because as well as dealing with some of the issues of concern it was an opportunity to harmonise the approach of the VOA and the Scottish Assessors. There had been criticism following the 1990 GB revaluations that similar properties were being valued at different levels north and south of the border. The Joint Professional Institute and Rating Valuation Forum (known as the Joint Rating Forum) had representatives of the Assessors; VOA; IRRV, ISVA and the VLA. It produced a Practice Note that was published by the RICS in November 1995. This does not have mandatory status but it does try to set out what is

generally accepted to be good practice in the United Kingdom and I would commend it to you.

Turning them to the method itself. The “traditional” explanation of the theory underlying its use is that the hypothetical tenant, instead of taking the subject property at a rent, has the option of building a precisely similar property for his own occupation, and that his rental bid for the property will be related to the annual equivalent of the cost of building such a property. Whilst this “classic” explanation may have received approval in case law, closer examination reveals that it is unrealistic since the hypothesis underlying the concept of rateable value means that the tenant does not actually have the choice between renting the property and building for himself. The objective of a rating valuation is to ascertain the rent that would be paid for a property in accordance with the statutory definition of rateable value, no more – no less. It has to be assumed that the property is owned by a hypothetical landlord who wishes to let it and that there is a hypothetical tenant who is willing to pay a rent in order to occupy it. Although the parties to this transaction are hypothetical the property is real and the valuer’s concern is therefore with ascertaining the rental value of the actual property. Given that this is the case the justification for adopting a cost based approach is that – when property applied – it provides a guide to the rent that may be paid where no other, more direct, valuation method can be used.

Turning then to the method in more detail. The recommended approach to a valuation comprises five stages:

Stage 1 - Estimate the replacement cost of the site works, buildings, rateable structures and rateable P&M. [ERC]

Stage 2 - Adjust the replacement cost to reflect any deficiencies in the buildings etc. [ARC]

Stage 3 - Value the land.

Stage 4 - Decapitalise the sum of Stage 2 and Stage 3 by the appropriate interest rate.

Stage 5 - Stand back and look at the result of Stage 4 and make any further adjustments considered appropriate.

Some would argue for a sixth stage i.e. a further adjustment to reflect the “negotiations” which take place between landlord and tenant. However if stages 1 to 5 have been properly applied it is normally not necessary to have a stage 6.

I would like then to go through the various stages in some more detail and the first is:

Stage 1 – Estimate the replacement cost (ERC)

In applying the Contractor’s Basis, the valuer is concerned with ascertaining the cost of building the subject property but it should be made clear that the valuer is costing a **notional** building of the property. There will be no **actual** building of the property either on its present site or elsewhere, either immediately or in the future. The costing exercise that underlies the Contractors Basis merely provides the basis from which a rental value can ultimately be derived by the careful application of the subsequent stages in the valuation method. That is not to say that some departure from what is “on the ground” cannot be allowed. Clearly, even a notional building involves a costing exercise based upon the provision of a new replacement; such a new property would be built with modern materials to present – day standards and may not, in every case, be identical to the actual hereditament. It is the Rating Forum’s view however that where possible the costing exercise should be related to the notional reinstatement of the actual property that is the subject of the valuation exercise.

What then needs to be included?

- In broad terms the valuer has to estimate what it would cost to construct the property, including all the buildings, site works and all rateable plant and machinery within the property on an undeveloped site.

- The estimated cost of replacement should include all the elements that would go to make up actual costs. Design costs, site works, provision of services and supervision costs (including fees) must all be included.
- The valuer has to estimate replacement cost and this is done either by: -
 - (a) Reference to unit costs derived from an analysis of actual costs – in other words instead of valuing say every hospital a representative sample are valued and the costs derived from the valuation of these “beacon” properties are used to value all other similar hospitals; or
 - (b) By reference to the actual costs of building the property.
- The Rating Forum considers that unit costs should be the primary method adopted in order to achieve consistency of approach but actual costs may be used where full information is available, the costs are incurred close to the valuation date and the property is unique in nature and not suitable for valuation on a unit cost approach.
- Any cost information used will need to be adjusted to correspond with the date of valuation and reference should be made to building tender indices although the older the cost the less reliable this method will be. The cost of plant and machinery will of course be updated by reference to a plant index.
- Total costs to be taken at Stage 1 must include professional fees and be exclusive of VAT.

Turning then to:

Stage 2 – Adjusted Replacement Cost (ARC)

- The replacement costs estimated at Stage 1 relates to the provision of new buildings, plant and machinery etc. As it is the actual property which has to be valued, in its existing physical state, adjustments may properly be considered at this stage to reflect certain deficiencies in comparing the actual property with the “new” property costed at Stage 1.
- The deficiencies can be grouped under the general heading of obsolescence and can usefully be sub divided into:
 - (a) Physical **obsolescence** which relates to “wear and tear” of the building due to its age. Although age itself is not a justification for an allowance, the tenant will reflect on the prospect of increased maintenance costs in his rental bid;
 - (b) **Functional obsolescence** which relates to the problems which may be present in the design of the property by comparison with current requirements e.g. poor layout, inferior heating and lighting, poor ventilation, poor car parking, vehicular access etc, and lastly
 - (c) **Technical obsolescence** which may be regarded as an extension of functional obsolescence and which arises where current technology has changed so radically that the actual plant to be valued or the building’s housing the equipment have become redundant e.g. coal fired boilers being replaced by modern gas or oil boilers.

The next stage is:

Stage 3 - Value the land.

- The “cost” of the site is the open market capital value of the land adjusted if necessary for any disadvantageous effects that the actual buildings or rateable structures may have on the value of the site.
- The value adopted for the land should be on the basis that the site is undeveloped, with such services as existed at the relevant date available for connection and with planning permission for development of the property.
- Evidence of value should be obtained from market transactions in sites of a comparable size for use within the same mode or category as the subject property. Any price paid for the site itself may require to be adjusted to bring it into line with the date of valuation.
- Surplus land within the boundaries of the hereditament that is reserved for future expansion should be valued as it stands and this may result in only a nominal value being applied. Care however should be exercised in distinguishing undeveloped land from open amenity or safety buffer zones that should be valued at the proper level.
- Having established the value of the land it is necessary at this stage to consider whether that value needs to be adjusted to reflect the fact that the site is to be viewed as one encumbered by the buildings. In practice the value of the site is often depreciated by the same percentage as that used for the buildings.

Stage 4 - Decapitalisation Rate

- The sum of the figures arrived at in Stages 2 and 3 is then converted into an annual equivalent by the application of the appropriate decapitalisation rate.

- For the purposes of the 4th General Revaluation in Northern Ireland the appropriate rates were specified by the Valuation for Rating (Decapitalisation Rate) Regulations (Northern Ireland) 1997
- The current rate is:
 - (a) 3.67% in the case of any hereditaments consisting of any church property, healthcare property or an educational establishment; and
 - (b) 5.5% in any other case.

The last stage is:

Stage 5 – Review (stand back and look)

- This stage involves the valuer taking an overview of the value that results after the completion of Stage 4. It should be noted that adjustments must be for specific reasons and cannot be used to circumvent the prescribed decapitalisation rate.
- Adjustments at this stage should reflect the nature of the property as a whole, including such factors as poor access, cramped site conditions, poor layout etc.
- It may be appropriate to take account of grants at this stage and the extent of the allowance will be entirely dependant on the facts and circumstances relating to particular hereditaments. It is also possible to consider if the property falls into a class considered to be a “new venture” where demand has still to be established and where the uncertainties have to be faced by the hypothetical tenant.
- It may also be appropriate at this final stage to reflect the economic state of the subject industry or business. Specialised buildings and/or plant will be costly

to provide but if there is little or no demand for the produce that they are designed to produce (and no alternative use exists for the property within the same mode or category of use), this is likely to have an effect on the value of the property.

- While the adjustments noted normally only apply in the more extreme situations, it does underline the need for the valuer to keep in mind that cost does not necessarily equate with value and to be aware of the state of the particular business or industry concerned so that, where appropriate, adjustments can be made.

To conclude with two final items:

(1) I have included a worked example.

(2) Cases of interest are:

(a) Monsanto PLC & D & M Farris (VO)

RA/356 – 362/1993

RA/373 – 375/1993

(b) Plymouth City Council and Hoare (VO)

VT/1995

(c) Eastborne BC & Wealden DC v Allen (VO)

RA/16 – 17/1999

