

Agriculture, Food and Rural Communities Directorate  
Land Reform and Tenancy Unit

T: 0131-244 - 9254  
E: [billy.mckenzie@gov.scot](mailto:billy.mckenzie@gov.scot)

Rob Gibson MSP  
Convenor  
Rural Affairs, Climate Change and Environment Committee  
C/O Clerk to the Committee  
Room T3.40  
The Scottish Parliament  
EDINBURGH EH99 1SP

12 November 2015

Dear Mr Gibson

### **Land Reform (Scotland) Bill – Update on Rent Review modelling work**

Thank you for your e-mail of 04 November 2015 in which you requested further information on the progress made to date on the agricultural holdings rent-review modelling work.

The attached document represents the most up to date position on the new rental model, and includes the following items:

- Agreed paper on productive capacity and other elements of the new rental process
- Summary note on conclusions from testing the model in practice
- Agreed minutes of 29 October stakeholder meeting
- Agreed minutes of 01 October stakeholder meeting

The work has been taken as far as we can in order to fit within Stage 1 of the Bill. We hope that the attached papers serve to inform your deliberations, while making you aware of the issues which require further consideration moving forward.

**Billy McKenzie**

# DEFINITION OF PRODUCTIVE CAPACITY AND OTHER ELEMENTS OF NEW RENTAL PROCESS

## Introduction

1. The purpose of this paper is to:
  - Set out a draft definition of Productive Capacity (PC) (**see paragraph 1**)
  - Set out the draft non-exhaustive list of other factors to take account of when setting productive capacity (**see paragraph 13**)
  - Set out a draft proposals on how land Court should address the issue of fair rent (**see paragraph 14**)
  - Provide a statement on relevant price data to use when assessing potential output (**see paragraph 15**)
  - Discuss outstanding issues related to rental assessments (**see paragraph 16**)
2. The draft provisions contained at paragraph 12 onwards are intended as a starting point for further exploration with stakeholders following clarity on what the Bill will require. They are not intended as specific legislative drafting as more time will be required to undertake this process in full consultation with stakeholders, allowing them to consult internally.
3. The intention now is to await clarity on the Agricultural Holdings Provisions within the land Reform Scotland Bill, prior to taking forward more detailed drafting of provisions and testing of the new system in the early part of 2016.

## Background

4. Following the Court of Session's (CofS) decision in the Moonzie case in February 2012, the case was sent back to the Scottish Land Court (SLC) for that court to revise their valuation in light of the CofS guidance that was contained within their decision. The CofS also stated at that time that in determining any rent case in the future the SLC had to follow their guidance.
5. The Moonzie case decision was significant, as this was the only case at that point in which the SLC had determined the appropriate rent level for a holding since the Agricultural Holdings (Scotland) Act 2003 came into force. The CofS decision highlighted that the SLC had placed too much emphasis on a budget approach and in doing so had lost sight of the hypothetical open market evidence. The SLC was wrong to assume that the rent level should not exceed the economic capacity of the holding. The essential question should have been what was a prospective tenant farmer likely to offer for the holding on the open market. The best evidence of this would, in practice, be the rent level paid for a Limited Duration Tenancy (LDT). Another, more direct, indicator of open market value would be evidence of the rent reviews agreed between landlords and their sitting tenant farmers. Valuation based on a budget approach was a method of last resort.
6. This led to allegations that there was too much uncertainty in the sector, which may have damaging impacts on tenants and the sector as a whole.

7. The second agricultural rent review decision made by the SLC was in June 2014 re Capital Investment Corporation of Montreal v Elliot (Roxburgh Mains Farm). In their decision, the SLC concluded that the rent from Whitsunday 2009 should be £48,982 which was an increase of £21,482 from the previous agreed rent of £27,500. Whilst the revised rent payable of £77/a was consistent with rents in the area the increase awarded caused concern to some.

8. Key points to arise from the SLC's decision in this case are:

- following the CofS guidance in the Moonzie case, the SLC fixed the rent by reference to open market of a comparable farm on the Roxburghe Estate that was suitably adjusted and cross-checked against a number of agreed sitting tenant rents
- the SLC held that the rent for the comparable farm had been distorted by scarcity, but, was not persuaded that the extent of the distortion could be measured by a formula that had no statutory foundation. Instead, the SLC made broad judgements based on their expertise as a specialist court and hypothesised what rent the comparable farm would have made in a reasonably balanced market
- on the other hand, the SLC made no deduction for 'marriage value' as most of the offers treated the comparable farm as a standalone holding. They did, however, apply agreed adjustments to reflect the different repairing and replacing obligations for the two holdings, and certain fixed equipment provided by the tenant farmer at the comparable farm
- although the SLC in principle, agreed that a secure 1991 Act tenancy arrangement should be more valuable than a LDT, based on the offers received for the LDT (the comparable farm) the SLC did not find scope for a premium as the majority of bidders had made their best possible offers for the LDT
- the SLC was satisfied that an upward adjustment for SFP was appropriate, on the grounds that, had the Moonzie case been decided when rents of comparables had been negotiated then higher rents would have been obtained.

9. On rents, the AHLRG's recommended the following:

Legislative provisions on rents for secure 1991 Act agricultural tenancies should be amended so that rents are determined on: the basis of the productive capacity of the holding; farmed by a hypothetical tenant (who is an efficient and experienced farmer of adequate resources who will make best use of the land); using the fixed equipment provided by the landlord; taking account of the budget for the holding; and including the contribution from non-agricultural diversified activity

10. Following on from this the Scottish Government have proposed the following in the Land Reform Bill:

In determining the fair rent for the holding, the Land Court must have regard, in particular, to -

- (a) the productive capacity of the holding,
- (b) the open market rent of any surplus residential accommodation on the holding provided by the landlord, and

- (c) the open market rent of—
  - (i) any fixed equipment on the holding provided by the landlord, or
  - (ii) any land forming part of the holding,used for a purpose that is not an agricultural purpose.

The Scottish Ministers may by regulations make provision for the purposes of paragraph 7(4)(a) about the productive capacity of agricultural holdings, including -  
(a) how the productive capacity of an agricultural holding is to be determined,  
(b) the information to be provided by the landlord and the tenant of a holding to the Land Court to enable the court to have regard to the productive capacity of the holding.

11. Following on from above the Group have been working on a draft definition of productive capacity, and other elements that require some form of statement/guidance to provide increased clarity to the sector where that is possible.

12. Below are set out proposals on how to address the definition of productive capacity, and other factors to take account of.

### **Proposed legislative provisions for Productive Capacity**

13. The provisions developed by the Group, which can be developed further into the required secondary legislation for more detailed consultation, is:

#### Definition

(1) For the purposes of paragraph 7 of Schedule 1A of the Agricultural Holdings (Scotland) Act 1991 (“the Act”) the “productive capacity of the holding” means the sustainable yield of agricultural products that would reasonably be expected from the holding under a system of farming suitable to it when farmed by a competent, efficient and experienced tenant with adequate resources for that system with such assessment being made as at the effective date and taking account of any factors that might reasonably be thought to vary it before the next rent review.

#### Determination of the Productive Capacity

(2) The productive capacity of the holding is to be determined:

- (a) taking account of the physical character of the holding relevant to its use for agriculture as a trade or business, including but not limited to those factors detailed in the non-exhaustive list below,
- (b) having disregarded the presence of fixed equipment and any tenant’s improvement so far as **(CAVEAT: the majority of the group agreed that we should develop a system which removes tenants improvements at the outset, rather than working back to remove their effect once the output had been calculated. However some view this as being overly complex and risked unintended and damaging outcomes. It was agreed this would be looked at in detail via the testing process but we would**

**progress by removing tenants improvements at the beginning. Referred to as the “black patch” approach):**

- (i) it has been provided wholly or partly at the expense of the tenant (whether or not that expense has been or will be reimbursed by any grant) without equivalent allowance or benefit having been made by the landlord in consideration of its provision
  - (ii) it has not been provided under an obligation imposed on the tenant by the terms of the lease unless it was an item that the landlord was obliged to provide when the lease commenced in the circumstances holding at that date
- (c) taking account of the fixed equipment provided by the landlord but disregarding such proportion of its cost represented by any grant that the landlord has received or will receive in respect of his providing it
- CAVEAT: paragraph (2)(c) reflects the currently understood position, however views were mixed with some in the group pointing out that it could be seen as unfair to allow a tenant to be compensated for all improvements they made whether grant aided or not, but not the landlord. Many were of the view that both should be treated in the same way. This issue will need further discussion and exploration, and certainly needs to be considered alongside waygo procedures.**
- (d) allowing for any land and fixed equipment provided by the landlord that is accepted as being used for a purpose that is not an agricultural purpose relevant to paragraph 7(4) of Schedule 1A
  - (e) having disregarded any dilapidation to or deterioration of or damage to fixed equipment or land caused or permitted by the tenant
  - (f) taking account of the extent to which the holding may reasonably be farmed with other land
  - (g) taking account of the terms of the lease by which the holding is let to the tenant
  - (h) taking account of the terms of any other legally enforceable agreement or restriction affecting the use of the holding
  - (i) using the yields that would reasonably be expected from the holding for that system of farming conducted by such a tenant.

Information to be provided to Land Court as to Productive Capacity

- (3) The landlord and tenant are to provide the Land Court with the information necessary to that determination of the productive capacity of the holding including but not limited to:
- (i) the factors affecting the selection of the system of farming suitable to the holding
  - (ii) the land use stocking rotation of crops and other details of that system
  - (iii) the yields of agricultural products that would be expected from that system
- with any other information and factors that may assist the Land Court in assessing the productive capacity of the holding.

**Proposed non-exhaustive list of other factors that may be taken into account when determining the farming system and productive capacity of the holding**

14. The non-exhaustive list is proposed as:

- Locality (including proximity to or remoteness from markets and other factors based on general location)
- Topography (including altitude, aspect, inland, coastal, exposed, sheltered, etc)
- Geology and soil types, depth and nature (acid, alkaline, stony, heavy clay, organic content, light sand, free- or slow-draining, etc)
- Climate
- Vulnerability of land to flood, drought, wind blow or erosion
- Presence of contamination, disease infestation, pollution and other limiting factors
- Quality, quantity and compliance with standards of landlord's fixed equipment – not only buildings but also including drainage, fencing, field water supplies, reservoirs and other items
- Services and permissions benefiting the holding
- Quality and suitability of land parcels and their relative mix
- Macaulay land classification
- Layout of the holding
- Field sizes, slopes and shapes, sizes of headlands and margins, ease of working, neighbouring woodland
- Access to holding and fields
- Damage risk by rabbits, game and other animals
- Field drainage and ditches
- Water supply to the holding, including private water supplies, abstraction licences on the land
- Designations including SPAs, SACs, SSSIs, NNRs, National Parks, Scheduled Monuments, Listed Buildings, Battlefields and items listed on the Inventory of Gardens and Designed Landscapes.
- Site specific statutory regulations (eg NVZs)
- Servitudes and wayleaves affecting the holding (including pylons, poles, cables, mobile phone masts and pipes)
- Core paths and rights of way affecting the farm
- Existing uses of the holding for non-agricultural purposes
- Any long term use established on the land that could limit choice or offer opportunities
- The terms of the lease
- Past, current and available future prices of inputs and agricultural products relevant to the holding
- Availability of labour for the holding

**Fixed Equipment Provided by the Tenant – Section inserted to provide further clarification on how to take account of tenants improvements.**

*Potentially a new Paragraph 7(5) or a rider to paragraph 10 but here drafted as freestanding while recognising the potential overlap with 2(b) above in the definition of productive capacity.*

- (1) In determining the fair rent for the holding [assessing the productive capacity under paragraph 8 and the open market rent for paragraph 10] the Land Court shall subject to sub-paragraph (2) disregard the presence of fixed equipment and any tenant's improvement so far as:
  - (i) it has been provided wholly or partly at the expense of the tenant (whether or not that expense has been or will be reimbursed by any grant) without equivalent allowance or benefit having been made by the landlord in consideration of its provision
  - (ii) it has not been provided under an obligation imposed on the tenant by the terms of the lease unless it was an item that the landlord was obliged to provide when the lease commenced in the circumstances holding at that date
- (2) The Land Court may have regard to any item of fixed equipment or tenant's improvements to the extent to which it considers that a tenant could reasonably be expected to have provided it either
  - (a) to meet statutory requirements for a use of the holding permitted by the lease or
  - (b) to secure a beneficial economic return from a use of the holding permitted by the lease that would not be available without that provision.

Where the Land Court takes such account of an item of fixed equipment or a tenant's improvement it shall make allowance for the current cost of providing that item and such other factors as it considers relevant.

### **Proposal on fair rent**

15. The following provisions set out proposals on how the Land Court should address the issue of setting a fair rent for both parties.

- (1) The principles which the Land Court shall apply in deciding the fair rent for the holding are that –
  - (a) the economic outcome that is reasonably to be expected to be derived from the productive capacity of the holding should be shared fairly between tenant and landlord;
  - (b) it should then take account of the open market rental value of:
    - (i) the right to sub-let surplus residential accommodation
    - (ii) the land and buildings provided by the landlord which are used for purposes other than agriculture
  - (c) it should take account of such other factors as it considers necessary to determine a rent for the holding that would be reasonably seen as fair between a landlord and a tenant
- (2) The economic outcome that is reasonably to be expected to be derived from the productive capacity of the holding is to be determined by reference to:

- (a) the value of the output from that productive capacity together with all other relevant income and subsidies arising from the occupation and use of the holding
- (b) the costs of producing that output and income and of complying with the rules of those subsidies including overhead costs but excluding rent and any return for tenant's own labour and management taking into account as appropriate the extent to which the holding might reasonably be expected to be farmed in conjunction with other land. **CAVEAT: Some members of group believe it would be appropriate for some consideration to be given for the tenants own labour and management, however as this is not a cost to the tenant, rather a result of them choosing to farm, the text has been drafted to exclude this. The group can return to this issue in due course.**

(3) In determining the fair division under sub-paragraph 1(a), taking account of the values under sub-paragraph 1(b) and the factors identified under sub-paragraph 1(c) the Land Court shall not take account of the personal circumstances of either landlord or tenant but shall have regard to all relevant factors including:

- (a) any other income available to and costs that would be the liability of a tenant by virtue of occupying the holding under the terms of the lease which the Land Court considers relevant but excluding those that accrue from activity not on the holding solely because the tenant is resident in a dwelling on the holding **CAVEAT – wording added to make clear that the income a tenant secures outwith the holding (e.g. through part-time work elsewhere) is not relevant to the rental calculation, as it is the productive capacity of the farm in question that is relevant (taking account of any diversification income using the land and assets provided by the landlord).**
- (b) the tenant's investment in the fixed equipment of the holding
- (c) the working capital reasonably required by a tenant of the holding
- (d) the land provided by the landlord
- (e) the investment by the landlord in the fixed equipment of the holding
- (f) the needs of the landlord to fund his obligations to the holding under the law and the lease
- (g) the terms of the lease more generally.

(4) The landlord and tenant are to provide the Land Court with the information that each considers necessary or that the Land Court may require to assist it in determining the fair rent in accordance with this paragraph.

**DECISION REQUIRED:** The group is invited to agree these provisions, in order for them to be shared with the Scottish Parliament and other interests to aid parliamentary scrutiny and debate.

### **Statement on price data**

16. The statement developed by the Group is:



- The appropriate price data to use is often specific to the farm itself, and based on individual business choices. However, future prices are the most appropriate starting point to consider potential financial outputs from the products produced.

### **Other elements of rent process to resolve**

17. The issues below have all been raised by stakeholders during discussions within the group (and in other places such as AHLRG and Scottish Parliament). They may also in some way fall within the remit of the TFC and the codes of practice they will develop, depending on decisions taken by the TFC. One of the overarching purposes of the work being taken forward is to increase clarity within the tenancing sector regarding rental negotiations. Given this, the group were asked to consider whether an appropriate level of guidance should be drafted to address the issues below; and whether this guidance should be placed on a statutory basis. Further consideration would need to be given regarding the relationship with the work of the TFC to ensure there is an effective and appropriate balance between issues addressed in legislation, and issues best left to TFC codes of practice.

18. There are clear risks arising from putting guidance into legislation regarding future lack of flexibility, and unintended consequences on individual businesses. However, there is the benefit of providing certainty to those operating within the sector regarding the elements that should or should not be taken account off when setting rents, and how to go about addressing these.

19. Below, each of the issues raised by the group and others is briefly explored. Further discussion will need to be held in the New year on these issues, based on findings from the pilot work that will be undertaken to test the proposals from the group, and taking account of the Stage 1 report from the Rural Affairs, Climate Change and Environment Committee.

### **Tenants Improvements**

19.1 The group has agreed as a starting point that tenants improvements should be removed from the calculation of productive capacity. This will see any improvements made by the tenant that impact on productive capacity requiring an adjustment of the productive capacity to remove the output generated by the tenants improvements. This will be a complex system to develop, and guidance on how to do this would be beneficial to remove inconsistency in approach. Work will be undertaken by group members to test the process to ensure any challenges are identified and resolved. This can then inform wider consideration of the issue, potentially to aid drafting of some form of guidance. Attention will have to be given to the issue caveated at 13(2)(b) to consider the potential situation whereby a minor improvement is made, that any tenant would reasonably be expected to make, and the asset is disregarded as a result. An example of a smoke alarm was given. Without it the house may be technically uninhabitable; so if it was provided by the tenant, but all the rest of the property by the landlord, then the complete exclusion of the asset from the assessment of productive capacity would be considered disproportionate

## Surplus accommodation

19.2 The SG has legislated to state that when determining the rent and taking account of surplus accommodation, the Land Court must disregard any accommodation all or part of which is occupied by the tenant of the holding. It has been suggested by some members of the group that the tenants accommodation is taken account of in the productive capacity/fair rent calculation instead, as part of the assets provided by the landlord. This would see an allowance applied to reflect the rental saving to the tenant of having a dwelling (or dwellings) made available on the holding for their use (or for the use of any workers they require). Having a dwelling on the holding allows the tenant to be more efficient through having immediate access, and negates the need to find housing elsewhere. There are questions about whether the size of the dwelling, or the quality of the dwelling would make a difference. Opinion is relatively divided and further work will need to be done in the development of guidance.

19.3 There is debate over the rental charge in the Productive Capacity calculation, regarding the assessment of an appropriate rent. Reference to the local housing market is felt to be appropriate, however discussion centred around the size of the house and holding and whether it could be farmed part time or not. Some (numbers unclear) tenant farms will be supplied with a dwelling that is no longer an ideal fit for the size of the farm (due to decisions to reduce the original size, or because modern farming methods no longer require a large workforce). Given this results in a tenant being given a house that is too large for their purposes, but with no other option available to them (beyond moving into a house off-farm which may not be practical), further consideration has to be given to the principle of charging rent for farmhouses and other dwellings on-farm to house the tenant and his family and any workers required for the holding. There are also a substantial number of holdings which have a SLR of less than 1, that is they are part time. Some members of the group are concerned that these holdings will have high fixed costs per acre and are likely to present negligible, or no, divisible surplus under a productive capacity test. Yet they may be providing a dwelling for the part time farmer to earn a living elsewhere. A concern has been expressed by some that the landlord, who still faces the same obligations, will be unfairly affected in these circumstances. A potential solution presented was for an allowance based on the local housing market (adjusted for the different repairing obligations) to be provided for. By way of example if the unit were a 0.5 SLR unit then it would be assumed 50% of the adjusted residential rental value could be allowed against the property. There is disagreement over this approach. Another option is to leave this to discussion and negotiation, although there are clear risks this will result in inconsistency of approach and uncertainty within the sector.

19.4 It is unclear what the impact of this would be across all scenarios and it will be important to ensure the system is fair to both the tenant and the landlord.

19.5 If the tenants accommodation is to be taken account of in the productive capacity calculation, thought will have to be given as to how to take account of tenants improvements and the minimum standards that the majority of dwellings in Scotland must meet. It can be argued that if it is the improvements made by the tenant that mean the accommodation meets the minimum standards then no rent should be due as otherwise the accommodation would not be deemed habitable in a

normal rental context - noting the point about proportionality in para 19.1. Conversely if a landlord is required to make improvements to the accommodation to ensure it remains habitable, then some level of rent could be merited (e.g. if those improvements mean the accommodation meets the minimum standards). Consideration also needs to be given to how/whether to compensate a tenant at waygo for any improvements to the dwelling. This is linked to the earlier discussion on tenants improvements, and reasonable investments the tenant could have been expected to make.

19.6 In addition to the tenants accommodation there is general surplus accommodation, which is that beyond the accommodation required to meet the standard labour requirement of the holding. At present the Land Court can take account of this in the rental calculation, with reference to its condition and location (and other factors such as agreements on retired workers). There may be merit in clarifying what is meant by reference to its condition. For instance should surplus accommodation be disregarded if it is not capable of being let on the open market due to it not meeting minimum standards? Or should it be taken account of only where it is agreed in the lease that the accommodation can be rented out, and the tenant takes up this opportunity? If so, how is it taken account of, is it a straight split of the rent secured?

**19.7 The Group has not settled on a definitive view on this issue in the time available, and further discussion and exploration will be required to resolve.**

#### Marriage value

19.8 This arises where the farmer uses machinery and other assets to farm more than one holding thus reducing their fixed costs on a per acre basis across the farmed area. In a productive capacity / budget approach the difference in fixed costs may have a material impact on the divisible margin. Ensuring that the likelihood that the farm would be farmed as part of another holding is considered appropriately will be important in identifying a rent which is fair to both parties. **Further discussion and exploration will be required to set out more detailed thoughts on this issue.**

**Billy McKenzie**  
**Scottish Government**  
November 2015

## **CONCLUSIONS OF HYPOTHETICAL EXERCISE: Potential Issues**

### Agreeing Hypothetical System

This could be a potential problem area, particularly when the hypothetical system deviates away from the practice the actual tenant carries out. Generally speaking this will be the case, due to improvements made and particular preferences of individual tenants. A system also has to disregard all of the tenant's improvements, which is a fundamental part of the review process.

### Current Forward and Past Data

The new rent assessment, as per productive capacity, has the subject to create large differences in the divisible surplus to be divided by virtue of a small movement in commodity prices, ie £10 per tonne.

There is a clear need for fully transparent data on current pricing, recent historical pricing and also for forward pricing. This is not only for commodity sales but also for input such as diesel and fertiliser.

Guidance needs to be produced to educate persons of what actual data is to be used, ie at present wheat is less than £115 per tonne; however a realistic forward budget would be nearer £130 per tonne, bearing in mind past prices and futures markets.

For the modelling exercise we chose to use professional experience and locally available costing data as well as reference to and use of standard cost data as to establish the fixed costs for the hypothetical system. For certain types of farms fixed costs are lower than the standard SRUC costs, even when adjusted for the rent which they include. We therefore concluded that care needs to be taken when using standard costs.

### No Model Fits All Circumstances

It is concluded that it is impossible to produce a single model that would suit all purposes. There are an extremely wide range of farm types, circumstances and farming practices throughout the country. Trying to introduce that into a single model would be far too restrictive and would certainly not be able to incorporate all of the circumstances.

### Divisible Surplus

In this practical testing, the three practitioners arrived at a divisible surplus; however, they did not tackle the issue of how that was to be divided. The AHLRG had recommended that the divisible surplus be split on a 50/50 basis; however, this point is yet to be fully determined.

It was concluded that once the divisible surplus was arrived at, and division agreed, in order to alleviate major fluctuations or volatility it would be important to consider what level of rent other holdings (of the same type, size, nature and, crucially, let on

the same basis - e.g. 1991 Act Tenancies) were let for. Rents for holdings let upon the same basis, of the same type need to be considered to bring things into reality.

**Minutes of Rent Review modelling meeting on Thursday 29 October 2015 at 13:00, in Conference Room 2, SASA, Roddinglaw Road, Edinburgh**

**Attendees**

Billy McKenzie (SG)	Christopher Nicholson (STFA)
Fiona Buchanan (SG)	Angus McCall (STFA)
Angela Morgan (SG)	Tom Oates (Youngs RPS, with STFA)
Alan Barclay (SG)	Jeremy Moody (CAAV with SAAVA)
Laura Merenciano-Sanchis (SG)	Robert Forrest (SAAVA)
Mal Cooke (SG RESAS)	Ken Bowlit (RICS)
Andrew Howard (SLE)	Hew Edgar (RICS)
Roddy Jackson (SLE)	Niall Milner (RICS)
Gemma Thomson (NFUS)	

**i) Welcome and Introduction**

1. Billy McKenzie chaired the meeting.

**ii) Minutes from previous meeting**

2. No comments were made on the minutes of 1<sup>st</sup> October 2015. However, attendees were given the opportunity to provide further comments to these minutes by close on Friday 6<sup>th</sup> November prior to having them considered as cleared by the Group.

**AP1: Group to provide comments to the minutes of 01 October by Friday 6 November 2015.**

**iii) Proposed legislative provisions for Productive Capacity (Paper)**

3. Ken Bowlit expressed his concerns on the agreed approach to disregard tenant's improvements at the beginning of rent review process. He noted that practitioners are always mindful of tenant's improvements and the best place to look at them is once the productive capacity has been established.
4. Jeremy Moody noted that the Group had agreed the approach was towards black patching tenant's improvement at the beginning as the least problematic way of taking tenants' improvements out of account (given the problems of valuing out improvements afterwards) but there were exceptions that should be carefully considered – the example had been given of where a smoke alarm was the only impediment to letting out a surplus cottage.
5. Angus McCall suggested that guidance could help to provide greater clarity on how to proceed in disregarding tenant's improvements.
6. The **Group agreed that** section 12 (2) (b) should include a caveat to account for some of the group members concerns on those situations where disregarding certain tenant's improvements may end up creating distortions to the rent

calculations. The issues around this process would be thoroughly explored through the testing process, that will be taken forward in the early part of next year.

7. The **Group also agreed that** the caveat introduced in section 12 (2) (c) should also make a reference to way-go as the issue of grant funded fixed equipment items is also relevant at that stage.

**iv) Proposed non-exhaustive list of other factors taken into account when determining the farming system and productive capacity (Paper)**

*Damage risk by rabbits, game and other animals*

8. Ken Bowlt commented that there was a need to add a qualification if tenant has the 'right' to control animals on the land.

9. Angus McCall said that the damage risk is always present even in estates where there are factors on the ground. Jeremy Moody noted that rabbit problems might also come from railway embankments.

10. The **Group agreed** to leave the text as it was at this stage.

**v) Fixed equipment provided by tenant**

11. The **Group agreed** that paragraph (1) in page 5 should be amended to reflect that tenant's improvements are disregarded in the whole rent review process.

12. The **Group agreed** that paragraph (2) should have a sentence added about what the purpose of the lease was. This is to account for what the original lease was, for example, a dairy farm, or an arable farm, or mixed farm and the fixed equipment provided at the start of the tenancy was appropriate for that use.

**vi) Proposal on fair rent**

*Section 14 (2) (b)*

13. Christopher Nicholson thought that it was reasonable that the hypothetical tenant's reasonable finance costs were taken into account before calculating the split. This was supported as well by Tom Oates who considered that finance were costs to be considered earlier in the process. It was argued that access to finance and loans was a common practice among tenant farms. In most cases, interest rates represent the bulk of costs and it was normal business practice, and thus a normal business expense, to have an overdraft.

14. Roddy Jackson believed it was more reasonable to consider finance later in the process when calculating the divisible surplus, but stated it was not a substantive issue.

15. Following discussion, the Group agreed that the hypothetical tenant's finance costs were better considered as costs rather than as income. As a result, the **Group agreed** to remove the word 'finance' from section 14 (2) (b). The **Group also agreed**

to remove the word ‘borrowings’ from paragraph 15 (3) (c) as a factor in finding the fair rent.

#### *Section 14 – last paragraph*

16. Christopher Nicholson argued that the last paragraph on Section 14 run counter to the policy objective of retaining a supply of small and part-time holding suitable for new entrants, as supported by the Agricultural Holdings Legislation Review Group. He considered that the sentence opened up uncertainties related to marriage value. It was not justifiable to assume that a tenant farmer is in occupation of another holding.

17. Andrew Howard noted that this is what happens in reality. Costs are very high if a holding is farmed as a single unit. However, it was up to the Scottish Land Court to consider whether the farm was likely to be farmed as part of a wider holding. This was the normal practice and was not controversial.

18. Jeremy Moody argued that you cannot ignore the fact that a holding may be run as part of other units. Any approach had to be able to set a rent for a bare land unit that has no buildings just as well as for an equipped holding.

19. The **Group agreed** that both sides of the argument needed to be flagged up as part of the revised paper, and that the issues around marriage value required further exploration.

#### **vii) Statement on price data**

20. The Group did not make further comments in relation to this section.

#### **viii) Other elements of rent process to resolve**

##### *Surplus accommodation*

21. Andrew Howard took the opportunity to emphasise that the point made on surplus accommodation did not refer to the farmhouse size but the unit’s labour capacity.

22. Jeremy Moody pointed out that the key fact to bear in mind is that a tenant is in occupation of a house which in its absence he would otherwise need to find elsewhere. The key concept is the ‘hypothetical standard accommodation’ instead of capturing the extra number of rooms within the farmhouse.

23. Niall Milner argued that it was also important to bear in mind that farmhouses under agricultural holdings legislation are not subject to repairing standard. He asked how this was to be account as part of the rent calculation.

24. Ken Bowlt asked whether the Scottish Land Court was going to be left with discretion to interpret the surplus accommodation issue.



25. Billy McKenzie emphasised that the intention was to provide as much clarity as possible so there is consistency of approach going forward, where that is appropriate. He noted that this was a topic where agreement had not been reached, so the revised paper will expose both sides of the argument to further explore this issue in the future.

26. With regard to paragraph 18.5, Ken Bowlit noted that he was not aware that tenant's improvements in the farmhouse were taken into account as part of the rent calculation. This factor was more relevant for way-go discussions.

27. Christopher Nicholson mentioned that Lord Gill had pronounced himself on this. This may help to shed some light on the discussion around surplus accommodation and how to treat tenant's improvements in the farmhouse.

**AP2: Billy McKenzie and team to revise paper in line with the key points raised at the meeting.**

**ix) Presentation on lessons learned from testing of provisions on real-life scenarios – Tom Oates**

28. Tom Oates delivered a presentation on the key lessons learned from testing the rent model on three volunteering farms. This testing work had been developed along with Rob Forrest and Roddy Jackson. The presentation first focussed on each of the tested cases, providing an explanation of the different considerations taken at each stage of the review. It then moved on to presenting key lessons learned.

29. Some of the key lessons learned as part of the testing exercise were as follows:

- The testing exercise had revealed that the proposed rent review system works, but those involved need to carefully consider how to go about agreeing and evidencing the hypothetical farming system.
- It is virtually impossible to use a 'standard figure' on issues such as costs and prices that may be applied as reference to all holdings. A combination of local knowledge, practice, and farming accounts books is needed as part of the rent assessment (needs to be 'sense tested'). Farm Accounts Survey figures had been found inappropriate to the specific farms, particularly as regards fixed costs.
- Results showed a significant variability on the divisible surplus available depending on the data used – such as a £10/tonne difference in sale price of grain if actual data was used. If standard averages were used (e.g. from SAC handbook) then the calculated divisible surplus might not be appropriate to the farm, which could lead to significant difficulties in negotiations.
- Tom Oates also presented some sensitivity analysis to illustrate the impact of changes in commodity prices. Even relatively small changes in prices had a

marked effect on the available surplus. This pointed to the potential for significant volatility in rents if the budget process alone was used.

30. Most of the members agreed that a key component to 'sense check' rent reviews would be to refer to rents agreed for other secure 1991 Act tenancies (not LDTs or SLDTs). This will remove or smooth an element of volatility in the rent calculation.

31. Scottish Government officials exposed some of the practical challenges of finding 1991 Act comparables. It was argued that this was one of the reasons for which the AHLRG had recommended to change current statutory formula, that is, the lack of open market rent in secure 1991 Act tenancies and the subsequent need to use as comparators rents obtained through LDTs and associated adjustments. In light of this, Scottish Government officials encouraged attendees to think about how these comparators may be found in practice. This issue will require further investigation, but the principle of allowing some form of comparison to sense test the figures (without being tied to the comparison) was believed to be appropriate.

32. All the professionals indicated that the data was available from any local surveyor. They all felt that a statutory register of rents was unworkable because the bald rent alone does not tell you the full story which is why advice should be sought. However, this advice is available and reasonably priced.

#### **x) Next steps for the Group and close of meeting**

33. Ken Bowlt expressed that the industry may need a long time to transit to the new rent review system. Practitioners will need to work through the new system and reflect on how to implement it.

34. Billy McKenzie provided a summary of the Bill's timetable to explain that the new rent review approach will not apply until the Bill is passed around March 2016. Following this the group will have to undertake further work to finalise the provisions to allow regulations to be drafted. There should be a period of consultation on the proposals that come out of the group, which will allow members to have a thorough debate within their respective organisations. It is possible that guidance will also have to be drafted on the system, and potentially certain aspects of it such as marriage value, tenants improvements and accommodation. Given the need for this work, it is likely that the first rent reviews using the new formula will not be before the Spring of 2017. This was welcomed by the group as it allowed proper development of the new system to take place.

35. The **Group agreed** to share the presentation slides to the RACCE Committee, firstly removing any data that allowed the farms to be identified. The **Group also agreed** to present a note to the RACCE Committee on the key lessons learned in testing the model. Tom Oates agreed to lead on this.

#### **ACTION POINTS**

**AP1: Group to provide comments to the minutes of 01 October by Friday October 2015.**

**AP2: Billy McKenzie and team to revise paper in line with the key points raised at the meeting.**

**AP3: Tom Oates to amend presentation to ensure farms cannot be identified.**

**AP4: Tom Oates agreed to produce a summary of key lessons learned in testing the model with actual farms, to be shared with the RACCE Committee.**

**Minutes of Rent Review modelling meeting on Thursday 1<sup>st</sup> October 2015, at 09:30am, in Conference Room 2, SASA, Roddinglaw Road, Edinburgh**

**Attendees**

Billy McKenzie (SG)  
Fiona Buchanan (SG)  
Alan Barclay (SG)  
Mal Cooke (SG RESAS)  
Julian Bell (SRUC)  
Gillian Reid (SRUC)  
Andrew Howard (SLE)  
Roddy Jackson (SLE)  
Allan Bowie (NFUS)

Christopher Nicholson (STFA)  
Angus McCall (STFA)  
Mike Halliday (STFA)  
Tom Oates (Youngs RPS, with STFA)  
Jeremy Moody (CAAV with SAAVA)  
Robert Forrest (SAAVA)  
Ken Bowlit (RICS)  
Niall Milner (RICS)  
Sarah Speirs (RICS)

**i) Welcome and Introduction**

1. Billy McKenzie chaired the meeting.

**ii) Minutes from meeting of 25<sup>th</sup> August 2015**

2. No amendments were required to the draft minutes of the 25<sup>th</sup> August meeting and these were agreed by the Group.

**iii) Modelling rent – issues on data**

3. Mal Cooke presented the paper prepared by RESAS on modelling rent based on the productive capacity. He noted the modelling work that could feasibly be done based on the current data available. He explained that one of the constraints in the modelling work is that the Scottish Government does not hold data on tenants improvements, therefore, it is not possible to provide an estimate average of output that disregards tenant's improvements. Similar constraints are faced in data regarding housing, marriage value and diversified activity. Mal Cooke also noted that data available for the Scottish Government (Farm Accounts Survey and Cereal Survey) captures output for farms, and the sample includes both owner-occupied and tenanted farms.
4. Mal Cooke also asked the Group how they envisaged the calculation of the estimated average costs for the typical hypothetical farm. He noted that, unlike calculating values for the output, the calculation of costs necessarily involves financial data, consequently bringing an element of volatility to the model.
5. Tom Oates argued that the model should not be seen as a strait jacket. This was corroborated by Jeremy Moody, who said there are not 'arithmetic' answers to different individual circumstances. Allan Bowie noted that model should be regarded as guidance. Christopher Nicholson and Angus McCall agreed with this, although they saw some merit in having data in a form to assist the parties in the calculation of a fair rent. They found it useful to have data on regional

average quantity of output (yields), and average costs for inputs, which would serve as guidance.

6. **The Group agreed** that the model was useful as a an aide during rental discussions, particularly on average yield data. However it could not be used with accuracy, but as a guide only. The development of this data is secondary to the other issues being tackled by the Group and as such can be set aside for now. At a later date the Scottish Government will look to provide as much detail as possible on average yields and costs, heavily caveated to highlight they are a guide for information only.

#### iv) **Definition of productive capacity**

7. Before discussing the definition of productive capacity, Christopher Nicholson stressed that in considering rent modelling it was important to adhere to the principle findings of the AHLRG which had recommended to remove reference to the open market comparisons, scarcity, and marriage value. He noted that, since the Moonzie judgement the industry had not progressed in finding solutions for rent reviews.
8. Andrew Howard also sought clarification from Scottish Government officials on what the purpose of the discussion was. He showed concern that the Group may be making decisions around wording of definition, which should be the task of Scottish Government Legal Directorate and the Parliamentary Counsel drafters. He thought the role of the Group was to agree on the principles which will underpin the new rent model.
9. Billy McKenzie advised the Group that the purpose of their discussion was to discuss and agree (or at least highlight) the detailed issues that need to be addressed in legislation. This will aid the parliamentary process by providing as much detail as possible during Bill scrutiny.
10. Allan Bowie stated for the record that, in agreeing the new rent review model, stakeholder organisations would be allowed to go back to their members and experts to further reflect on the principles and background work supporting the modelling work. Billy McKenzie noted this and assured Allan and the Group that there would be further development work on the new rental system, and a consultation on the draft regulations.
11. The Group then moved into discussing the definition of productive capacity:

#### *Section 11 (1) - Definition*

12. **The Group agreed** that the definition of productive capacity in section 11 (1) should make reference to the *'hypothetical tenant who is an efficient and experienced farmer of adequate resources who will make the best use of the land'*. This was in line with recommendation 3 in the AHLRG's Final Report.

13. **The Group agreed** that it would be helpful to see the definitions of ‘agricultural products’ to ensure that it covers all the required elements.

**AP1: Scottish Government officials to provide the Group with information on these definitions.**

*Section 11(2) – Elements to determine the productive capacity of the holding*

*Section 11 (2) (a)*

14. **The Group agreed** that the elements to determine the productive capacity should only include physical elements, and whether financial elements should be addressed as elements to consider in determining the fair rent for the holding (section 14 in the paper). Following a discussion, Jeremy Moody agreed to reword sub-section for the Group’s agreement at next meeting.

*Section 11 (2) (b) (ii)*

15. **The Group agreed** that the sentence should read as ‘*it has not been provided under an obligation imposed on the tenant by the terms of the lease when the lease commenced*’ to account for the fact that some old leases imposed obligations on tenant’s to provide fixed equipment, and this should be disregarded.

*Section 11 (2) (b) (iii)*

16. Andrew Howard explained that the sentence, as it was drafted, seemed that any grant, regardless of the portion funded by any of the parties, would be disregarded. He explained that this would be unfair, so it should relate only to the portion funded by the grant in order to be fair to the parties. He also pointed out that investments by the tenant that are grant-aided are considered to be an investment by the tenant in its entirety, with no disregard for the grant-aided element. This creates a situation where both parties to the rental system are treated slightly differently. **It was agreed** this issue would need to be considered further.

17. **The Group agreed** on the principle that landlords should, at the least, be able to charge rent on the portion he/she has contributed to a grant funded project. However, there was disagreement within the Group on the practical consequences of how to go about this. Roddy Jackson provided the example of a grant funded drainage system to illustrate how coming to a clear-cut split may be impractical. Furthermore, he stressed that the liability in relation to the grant funded fixed equipment item fell disproportionately on the landlord. Andrew Howard reinforced Roddy Jackson’s point by arguing that the proposed system will not reduce the room for dispute if the consequences of the new rent model were not clearly thought out. This was contested by Tom Oates and Christopher Nicholson who thought that this was not problematic as existing legislation and practice already catered for grant aided investments by disregarding the grant

element. Billy McKenzie accepted that there would remain room for dispute once the new system was fully developed, but the task of the Group was to provide as much clarity on the elements that could be considered (and where possible how they are to be considered) as was possible. This would reduce the room for dispute.

18. Ken Bowlt emphasised that the example provided on how to treat a grant aided fixed equipment item illustrated how the black patch approach could be seen to be disproportionate or have an unequal effect for the parties if certain improvements were disregarded. It was noted that the black patch approach would be tested through the work of Tom Oates and others.

19. Allan Bowie noted that it was important the Scottish Parliament was aware of both sides of the argument; and that the rent model treated both parties fairly so that investment was not discouraged.

**20. The Group agreed the following:**

- Amend section 11 (2) (b) (iii) to acknowledge the fact that contributions made by the landlord to a grant funded item of fixed equipment should be subject to rent. This will allow model provisions to be in line with case law on the treatment of grant aiding.
- Amendment to the paper should present the different arguments and include any caveats to ensure the scrutiny process is aware of all the issues involved.
- Roddy Jackson, Tom Oates and Rob Forrest will test the new approach on some tenanted farms to further reflect on its implications and further tease out the issues that were creating debate within the Group (i.e. grant aiding).

*Section 11 (3) (c)*

21. Following discussion within the Group Fiona Buchanan agreed that the word 'economic' would be better dropped from the working of this subsection.

**AP2: Jeremy Moody to revise paper in line with meetings discussions and return to Scottish Government officials for circulation around the Group.**

**AP3: Christopher Nicholson to share with the Group the section of Fraser R Barraclough's book that provides guidance on the treatment of grant aided improvements for rent review and way-go compensation issues.**

**AP4: Tom Oates, Roddy Jackson and Rob Forrest to test the model on some tenanted farms to further reflect on the model's implications and think of solutions in areas of disagreement (disregarding tenant's improvements, housing provision and marriage value).**

**v) Non-exhaustive list of factors bearing on the productive capacity**

22. Mal Cooke sought clarifications on the purpose of the list. He asked the Group how tenant farmers and their landlords were going to know how they performed in relation to the average for any of the elements included in the list. The Group noted that the list would serve as guidance on the physical factors bearing on the productive capacity.

*Parish/region*

23. The Group discussed the comments made by members of the Group to this list of factors bearing on the productive capacity.

24. **The Group agreed** to substitute '*parish or region*' for '*locality*'.

*Subsidies*

25. The Group also discussed whether decoupled payment was a factor to assess the productive capacity of the holding or rather should it be an element for Scottish Land Court to consider in reaching a view on the fair rent. Jeremy Moody's view was that coupled payments should be part of the non-exhaustive list because the aim of these subsidies was to support production where it would not otherwise happen. However, de-coupled payments fed better into the fair rent test as they provided financial support.

26. Tom Oates thought that this view was problematic as it assumed that an hypothetical tenant would not be making any profit before receiving subsidies.

27. Christopher Nicholson thought that it would be less confusing to include both coupled and decoupled subsidies as part of the elements for the Scottish Land Court in determining the fair rent.

28. **The Group agreed** to include subsidies as part of the fair rent test.

*Housing provision*

29. Christopher Nicholson considered that the list should make reference to the provision of housing as it influenced labour costs and availability. However, the problematic issue here in terms of assessing the fair rent was dealing with the surplus accommodation.

30. The Group did not reach an agreement on this issue. Tom Oates noted that the Roxburgh Mains judgement still was unclear on where the 'housing provision' would sit. Some tenant farmers may decide to live elsewhere, in the village for example.



### *Availability and cost of labour for the holding*

31. Jeremy Moody suggested that the cost of labour for the holding should be moved to the fair rent test and **this was agreed by the Group**.

### **vi) Proposal on fair rent**

#### *Section 14 (1) (a)*

32. The Group agreed that the phrase '*economic benefits*' would be better stated as '*economic outputs*'.

#### *Section 14 (2) (c)*

33. Following discussion Jeremy Moody agreed to reword sub-section to take on board comments made by Christopher Nicholson that tenant's fixed equipment should be disregarded at the first stage.

### **vii) Statement on price data**

34. The Group agreed with Andrew Howard's comment that greater emphasis was to be expected on current and forward prices as part of the decision making. Historic data is helpful in analysing trends but it is where the trend is expected to go which will interest the parties the most. **The Group agreed** that the statement will be revised to reflect this.

### **viii) Outstanding issues that need to be dealt with in the future**

35. Billy McKenzie explained to the Group that there were certain elements within the rent process that needed to be resolved. The purpose was to consider whether it was possible to develop guidance, or some other alternative, to address these issues to provide some clarity and consistency as to how these elements will work in practice. He also confirmed there was a need to consider the interface of the proposed systems with way-go. Particularly around the treatment of issues such as tenant's improvements, grants and housing.

### **ix) Tenant's improvements**

36. The first issues discussed was how to take account of tenant's improvements, based on the agreement of the Group that the black patch approach will be adopted initially and tested for appropriateness/ ease. Christopher Nicholson argued that the black patch approach should establish the productive capacity in the unimproved state.
37. Andrew Howard provided an example where disregarding an improvement provided by the tenant could have an unfair impact for the landlord. For instance,

an item of fixed equipment provided by the landlord being totally disregarded because of a carbon monoxide detector has been installed by the tenant in that particular item. It was agreed that this type of impact was not appropriate, with some stating the system would not disregard a landlord's asset for a minor reason such as installation of a smoke detector. **However the Group agreed** that the system had to be tested to ensure this was the case as this type of impact is not desirable if a fair and robust rental process is to be developed.

38. The Group said that they would find it useful to see the outcomes from the rent test examples undertaken by Roddy Jackson, Tom Oates and Rob Forrest when applying and not applying the black patch approach to rent model calculation.

**AP3 – Tom Oates to provide his early thoughts/ guidance on how to disregard tenant's improvements, and any other lessons learned, following the work he and others will undertake.**

**x) Surplus accommodation**

39. Billy McKenzie explained that the Scottish Government has legislated to ensure that when determining the fair rent the Scottish Land Court must disregard any accommodation all or part of which is occupied by the tenant. The expectation is that the farmhouse is then taken account of in the Productive Capacity/ Fair rent calculations as part of the landlords fixtures and fittings, however this needs to be resolved to ensure clarity. The stated intention is to not permit a system whereby a tenant on a small farm, who lives in a house now too large for that farm, to be charged rent on that large house at a level inappropriate to the farm. The landlord has supplied the house to the tenant for the purpose of running the farm, the size of it is therefore not relevant to the calculation although the fact that a farmhouse has been supplied is relevant to the tenant farmers costs.
40. Andrew Howard argued that some small holdings may require less than one labour unit and are likely to result in part time farming with a material proportion of household income directed off farm. This means that landlords will be subsidising housing to tenant farmers. He also pointed out that some farms will have housing and some will not, and that those without a house will be at a disadvantage in comparison to those who do.
41. Ken Bowlt agreed that under current provisions two holdings with the same characteristics but differing on the provision of housing may end up paying the same rent. He thought that the rent should capture the provision of housing in some way or another. Otherwise, the new rent model will be creating a serious anomaly.
42. Christopher Nicholson and Tom Oates considered that housing could be accounted as part of the productive capacity/fair rent calculation, as the tenant farmers own and labour costs would be higher for those without a house or other surplus accommodation for any workers required. Tom Oates pointed out that it was worth bearing in mind that some holdings have ended up with big homes compared to land size because of resumption by the landlord.

43. Allan Bowie expressed that he struggled with the idea that a tenant farmer should be charged extra rent for a 1 unit farm simply due to there being a house provided by the landlord that is too large for the holding. This did not seem to represent fairness in the system.
44. Fiona Buchanan asked Andrew Howard his view on how rent calculation may account for the fact that tenants have raised housing standards.
45. Andrew Howard recognised that some adjustment would need to be done in order to account for the fact that landlords are exempt from the repairing standard.
46. Jeremy Moody reiterated that the ultimate decision on fair rent would lie in the Scottish Land Court, and that the bottom line of argument was that a holding with a house was not the same as a holding without a house from a rent perspective.
47. Andrew Howard pointed out that the new formula was radically changing landlord/ tenant farmer relationships; with landowners being drawn into the risk taking exercise of being a farmer.
48. The Group did not reach an agreement on how to treat surplus accommodation. **Billy McKenzie advised** that the next rent review paper would reflect positions on each side of the argument to ensure Parliament were aware of the issue and the debate around it. Given the timescales involved, and the need for further discussion in this area based on factual testing, it is not possible to reach a settle view as yet.

#### **xi) Marriage value**

49. From the Group's brief discussion, it was highlighted that the hypothetical tenant should not be assumed to be in occupation of another holding. Although it was recognised that the hypothetical tenant may have assumed to have another holding if that would be the norm in the area. This topic would be discussed further, and tested as part of the work being undertaken by Tom Oates and others.

#### **xii) Next steps**

- The Group agreed to meet again at the end of October, the papers for this meeting will be shared with RACCE to aid their scrutiny of the Bill.
- Jeremy Moody agreed to revise paper in line with the meeting's discussion.
- Tom Oates, Rob Forrest and Roddy Jackson to meet to go through the new draft system using real-life data so as to highlight any further issues to resolve.

#### **xiii) Close**