UPPER TRIBUNAL (LANDS CHAMBER)

UT Neutral citation number: [2010] UKUT 427 (LC)
LT Case Numbers: LRA/76/2007, LRA/145/2007, LRA/129/2008, LRA/60/2008, LRA/128/2007, LRA/17/2008, LRA/56/2007, LRA/68/2007

TRIBUNALS, COURTS AND ENFORCEMENT ACT 2007

LEASEHOLD ENFRANCHISEMENT − collective enfranchisement − deferment rate – leases under 20 years unexpired – prime central London – alternative methods of determination considered – net rental yield and formula based methods rejected – determined by exercise of valuation judgment

IN THE MATTER OF A PRELIMINARY ISSUE ARISING IN EIGHT APPEALS AGAINST THE DECISIONS OF THE LEASEHOLD VALUATION TRIBUNAL FOR THE LONDON RENT ASSESSMENT PANEL

BETWEEN
(1) CADOGAN SQUARE PROPERTIES LIMITED
(2) 31 CADOGAN SQUARE FREEHOLD LIMITED
(3) 37 CADOGAN SQUARE FREEHOLD LIMITED
(4) CADOGAN SQUARE LIMITED
(5) BETUL ERKMAN **Tenants**

and

THE EARL CADOGAN **Landlord**

Re: 23 Cadogan Square, London SW1

and

31 Cadogan Square
(and 130 Pavilion Road)

London SW1

and

37 Cadogan Square, London SW1

and

38 Cadogan Square, London SW1

and

42 Cadogan Square, London SW1

Before: The Honourable Mr Justice Morgan and A J Trott FRICS
Sitting at 43-45 Bedford Square, London WC1B 3AS
on 19 -23 July 2010

Stephen Jourdan QC instructed by Forsters LLP, solicitors, on behalf of the First, Fourth and Fifth Tenants and by Bircham Dyson Bell LLP, solicitors, on behalf of the Third Tenant.
Andrew P D Walker instructed by Bircham Dyson Bell LLP, solicitors, on behalf of the Second Tenant.
K S Munro instructed by Pemberton Greenish LLP, solicitors, on behalf of the Landlord

The following cases are referred to in this decision:

Earl Cadogan v Sportelli [2007] 1 EGLR 153 (Lands Tribunal); [2008] 1 WLR 2142 (Court of Appeal); and [2010] 1 AC 226 (House of Lords)
31 Cadogan Square Freehold Limited and Another v The Earl Cadogan [2010] UKUT 321 (LC)
Earl Cadogan v Erkman [2009] 1 EGLR 87
Arbib v Earl Cadogan [2005] 3 EGLR 139
South Australia Asset Management Corporation v York Montague Ltd [1997] AC 191
Zuckerman and Others v The Trustees of the Calthorpe Estates [2009] UKUT 235 (LC)

The following cases were also referred to in argument:

Lady Fox's Executors v Commissioners of Inland Revenue [1994] 2 EGLR 185
Railtrack plc v Guinness Ltd [2003] 1 EGLR 124
Arrowdell Limited v Coniston Court (North) Hove Limited [2007] RVR 39
Re: Mansal Securities Limited and Others [2009] Lands Tribunal reference LRA/185/2007 (unreported)

DECISION

Introduction

1. This decision concerns a preliminary issue which was directed (on 1 February 2010) to be determined in eight appeals concerning five properties in Cadogan Square, London SW1. The five properties are 23 Cadogan Square, 31 Cadogan Square and 130 Pavilion Road (which will be referred to together as 31 Cadogan Square), 37 Cadogan Square, 38 Cadogan Square and 42 Cadogan Square.

2. In the case of each of the above properties, an application had been made to the LVT for the determination of the premium payable in respect of the freehold of the relevant property pursuant to the provisions of Schedule 6 to the Leasehold Reform, Housing and Urban Development Act 1993 ("the 1993 Act"). The LVT has determined the premium in each case. As part of the process of determining the open market value of a freehold subject to a lease, the LVT was required in each case to determine the deferment rate which should be used to arrive at the value, at the relevant valuation date, of the freehold valued with vacant possession, in circumstances where the purchaser of the freehold would not enjoy such vacant possession, until a future date upon the expiry of the existing leases.

3. The preliminary issue requires us to determine the deferment rate which should be used in the valuations of the five properties.

4. The parties to the applications before the LVT were the freeholder and the nominee purchaser, in accordance with the provisions of the 1993 Act. The parties have found it more convenient to refer to themselves as "the landlord" and "the tenants" respectively and we will refer to them in the same way in this decision. We will not use the terms appellant or respondent.

5. In the case of 23 Cadogan Square, 38 Cadogan Square and 42 Cadogan Square there is an appeal to this Tribunal by both the landlord (LRA/76/2007, LRA/128/2007 and LRA/56/2007 respectively) and the tenants (LRA/145/2007, LRA/17/2008 and LRA/68/2007 respectively). In the case of 31 Cadogan Square (LRA/129/2008) and 37 Cadogan Square (LRA/60/2008) there is an appeal to this Tribunal by the tenants only.

6. For the purpose of determining the preliminary issue, we have the advantage of the guidance given by the Tribunal in *Earl Cadogan v Sportelli* [2007] 1 EGLR 153 (Lands Tribunal) and the comments of the Court of Appeal in the same case, reported at [2008] 1 WLR 2142. That case will be referred to in this decision as "*Sportelli*". The properties in these appeals are plainly all in prime central London ("PCL") which is the subject of that guidance.

7. The guidance in *Sportelli* related to cases where the length of the unexpired term of the relevant leases was 20 years or more. In the present cases, the length of the unexpired terms at the relevant valuation date in every case were less than 20 years, the unexpired terms being:

(1) 23 Cadogan Square – 17.5 years;

(2) 31 Cadogan Square – 15.6 years;

(3) 37 Cadogan Square – 16.1 years;

(4) 38 Cadogan Square – 17.8 years;

(5) 42 Cadogan Square – 17.3 years.

In *Sportelli,* it was stated that with a length of unexpired term of below 20 years, regard would need to be had to the property cycle at the valuation date.

8. The principal question which needs to be addressed in order to determine the appropriate deferment rate is whether the generic rate identified in *Sportelli*, and in particular the generic rate of 5% in relation to flats, should be increased if, and in so far as, the property market would have been perceived to have been at or near the top of the property cycle at the relevant valuation dates.

9. There is a second issue which arises in relation to 31 Cadogan Square and 37 Cadogan Square; the issue is whether the deferment rate should be the appropriate rate for flats or the appropriate rate for houses in view of the landlord's contention that at the valuation date for those properties, they should be regarded as houses in view of the prospect of a development of those properties by way of their reconversion from properties each containing several flats back to single dwelling houses. This issue overlaps, or may overlap, with the issue identified in the next paragraph.

10. In the case of the properties at 31 Cadogan Square and 37 Cadogan Square, a separate issue arising in the appeals in those cases has already been considered and determined by a differently constituted Tribunal (HH Judge Huskinson and A J Trott FRICS: *31 Cadogan Square Freehold Limited and Another v The Earl Cadogan* [2010] UKUT 321 (LC)). The issue was whether the valuation of the freehold of the relevant property should include an additional element to reflect the prospect of a development of that property by way of a reconversion of that property from one containing several flats back to a single dwelling house. The Tribunal concluded that at the relevant valuation dates for those properties, the freehold value should include an element to reflect that prospect. The Tribunal held that the best price which a hypothetical purchaser would pay would be a price calculated by reference to the value of the property as flats plus 15% of the potential development value (i.e. 15% of the difference between the value of the property as flats and the value of the property available for conversion to a house).

11. Mr Stephen Jourdan QC appeared on behalf of the tenants in relation to 23, 37, 38 and 42 Cadogan Square. Mr Andrew Walker appeared on behalf of the tenants in relation to 31 Cadogan Square and 130 Pavilion Road. Mr Kenneth Munro appeared on behalf of the landlord in relation to all of the properties.

Facts

23 Cadogan Square

12. 23 Cadogan Square is a Grade II listed building, divided into five residential units: a caretaker's flat in the front part of the basement, flat A on the ground floor and rear part of the basement, flat B on the first floor, flat C on the second and third floors, and flat D on the fourth and fifth floors.

13. The building is subject to a headlease which expires on 25th March 2023. All of the flats, other than the caretaker's flat in the basement, are held under underleases. The underleases of flats A and C expire on 15 March 2023. The underleases of flats B and D were both granted pursuant to the 1993 Act and expire on 15 March 2113.

14. On 3 October 2005, the underlessees of flats A, C and D served a notice under s.13 of the 1993 Act claiming the freehold. They were, therefore, the participating tenants, and that is the valuation date. The nominee purchaser identified in the notice was Cadogan Square Properties Ltd, which is also the underlessee of flat A.

15. On 21 December 2005, a counter-notice was served admitting the right of the participating tenants to the freehold.

16. On 24 February 2006, an application was made to the LVT by the landlord under s.24 of the 1993 Act, seeking determination of the premium payable in respect of the freehold of the building and the covenants to be contained in the transfer.

31 Cadogan Square

17. 31 Cadogan Square (a Grade II listed building) and 130 Pavilion Road (the adjoining mews house) is a mid-terrace building extending between the east side of Cadogan Square and the west side of Pavilion Road.

18. It comprises the following:

(1) Three flats/maisonettes in 31 Cadogan Square, held on individual long leases and a caretaker's flat;

(2) Flat 1 is the caretaker's living accommodation in the basement of 31 Cadogan Square, owned by the headlessee pursuant to the headlease. Flat 2 is on the ground and first floors, flat 3 is on the second and third floors and flat 4 is on the fourth and fifth floors;

(3) Common areas; and

(4) The attached mews property behind at 130 Pavilion Road also held on an individual long lease.

19. For practical purposes, as currently laid out, the building comprises four flats and an attached mews house.

20. There is a headlease of 31 Cadogan Square, which is owned by 31 Cadogan Square Residents Association Ltd. The reversion on that head lease expires on 25 March 2023, 3 days after the expiry of the original terms of the leases of the individual units (22 March 2023).

21. The lease of the mews property is held directly from the freeholder.

22. The participating tenants are the lessees of flats 3 and 4 and of 130 Pavilion Road.

23. In this case, the caretaker's flat in the basement of the property is to be acquired.

24. The participating tenants served their notice of claim on 29 August 2007 and this is therefore the valuation date.

25. At the valuation date, the property comprised, and was used and arranged as, flats and a mews property.

26. At the valuation date, the lease of flat 2 had already been extended under Chapter II of Part I of the Act.

27. Subsequently, a counter-notice was served admitting the right of the participating tenants to the freehold.

28. On 7 January 2008, an application was made to the LVT by the landlord under s.24 of the 1993 Act, seeking determination of the premium payable in respect of the freehold of the building and the covenants to be contained in the transfer.

37 Cadogan Square

29. 37 Cadogan Square is a Grade II listed building, divided into six residential units: a caretaker’s flat in the front part of the basement, flat 1 on the ground floor and rear part of the basement, flat 2 on the first floor, flat 3 on the second floor, flat 4 on the third floor and flat 5 on the fourth and fifth floors.

30. The building is subject to a headlease which expires on 25th March 2023. All of the flats, other than the caretaker’s flat in the basement, are held under underleases. The underleases of flats

1, 2, 4 and 5 expire on 15 March 2023. The underlease of flat 3 was granted pursuant to the 1993 Act and expires on 15 March 2113.

31. On 19 February 2007, the underlessees of flats 1, 3 and 4 served a notice under s.13 of the 1993 Act claiming the freehold. They were, therefore, the participating tenants, and that is the valuation date. The nominee purchasers identified in the notice were Evangelos Tsiapkinins and John Stephenson. Subsequently, they were replaced as nominee purchaser by the Appellant, 37 Cadogan Square Freehold Limited.

32. Subsequently, a counter-notice was served admitting the right of the participating tenants to the freehold.

33. On 26 July 2007, an application was made to the LVT by the landlord under s.24 of the 1993 Act, seeking determination of the premium payable in respect of the freehold of the building and the covenants to be contained in the transfer.

38 Cadogan Square

34. 38 Cadogan Square is a Grade II listed building, divided into six residential units: a caretaker's flat in the front part of the basement, flat 1 on the ground floor and rear part of the basement, flat 2 on the first floor, flat 3 on the second floor, flat 4 on the third floor and flat 5 on the fourth floor.

35. The building is subject to a headlease which expires on 25th March 2023. All of the flats, other than the caretaker's flat in the basement, are held under underleases. The underleases of flats 1, 2, 3 and 5 expire on 18 March 2023. The underlease of flat 4 was granted pursuant to the 1993 Act and expires on 18 March 2113.

36. On 22 June 2005, the underlessees of flats 1, 2 and 5 served a notice under s.13 of the 1993 Act claiming the freehold. They were, therefore, the participating tenants, and that is the valuation date. The nominee purchaser identified in the notice was Cadogan Square Limited, which is also the underlessee of flat 1.

37. On 6 September 2005, a counter-notice was served admitting the right of the participating tenants to the freehold.

38. On 8 November 2005, an application was made to the LVT by the landlord under s.24 of the 1993 Act, seeking determination of the premium payable in respect of the freehold of the building and the covenants to be contained in the transfer.

42 Cadogan Square

39. 42 Cadogan Square is a Grade II listed building, divided into six residential units: a caretaker's flat in the front part of the basement, the G/LG flat on the ground floor and rear part of the basement, flat 1 on the first floor, flat 2 on the second floor, flat 3 on the third floor and flat 4 on the fourth floor.

40. The building is subject to a headlease which expires on 25th March 2023. All of the flats, other than the caretaker's flat in the basement, are held under underleases. The underleases of the G/LG flat and flats 1, 3 and 4 expire on 15 March 2023. The underlease of flat 2 was granted pursuant to the 1993 Act and expires on 15 March 2113.

41. On 29 November 2005, the underlessee of the G/LG flat together with the persons who, at the time, held both the headlease and the underlease of flat 1, and who were therefore the qualifying tenants of the caretaker's flat and flat 1, served a notice under s.13 of the 1993 Act claiming the freehold. They were, therefore, the participating tenants, and that is the valuation date. The nominee purchaser identified in the notice was Ms. Betul Erkman.

42. On 24 February 2006, a counter-notice was served admitting the right of the participating tenants to the freehold.

43. On 8 August 2006, an application was made to the LVT by Ms. Erkman under s.24 of the 1993 Act, seeking determination of the premium payable in respect of the freehold of the building and the covenants to be contained in the transfer.

An outline of the valuation method

44. Before referring to the decisions made by the LVTs which are under appeal, it will be helpful to describe briefly what is involved in a determination of the open market freehold value on a collective enfranchisement in accordance with the 1993 Act and to understand the part played by the deferment rate. It is not necessary to set out the text of the statutory provisions in full.

The components of the valuation

45. Section 32(1) of the 1993 Act provides that the price payable by the nominee purchaser for the freehold (and also in respect of any other interests to be acquired) is to be calculated in accordance with Schedule 6.

46. Paragraph 2(1) of Schedule 6 stipulates that there are three components to the purchase price. The first is the value of the freeholder's interest in the premises (determined in accordance with paragraph 3). The second is the freeholder's share of the marriage value (determined in accordance with paragraph 4). The third is any amount of additional compensation (determined in accordance with paragraph 5). This third component is not in issue in any of these appeals.

47. Various valuation assumptions are specified in paragraph 3. One which is important for present purposes is the assumption in paragraph 3(1)(b) that "this Chapter and Chapter II confer no right to acquire any interest in the specified premises or to acquire any new lease (except that this shall not preclude the taking into account of a notice given under section 42 with respect to a flat contained in the specified premises where it is given by a person other than a participating tenant)". This is often referred to as a "no-Act world" assumption but it can also be described as a "no-Act building" assumption – an assumption that, for some unspecified reason, the rights under Chapters I and II do not apply to the tenants in the building which is the subject of the collective enfranchisement claim (referred to as "the specified premises" – see s.13).

The value of the freeholder's interest: term and reversion

48. The value of the freeholder's interest is defined in paragraph 3(1) as: "the amount which at the valuation date that interest might be expected to realise if sold on the open market by a willing seller …"

49. In valuation terms, there are three aspects of the freeholder's interest which contribute to the price it would fetch in the open market:

(1) There is the right to receive the rent under the lease(s) to which the freehold is subject, during the term of those lease(s). This is referred to as "the term".

(2) There is the right to possession of the property when the terms of the lease(s) expire. This is referred to as "the reversion".

(3) There is the hope that, in the period before the terms of the lease(s) expire, it may be possible to sell the freehold or an extended lease to the tenant(s), or to buy in the lease(s), so unlocking the marriage value, with a share of the marriage value being payable to the freeholder. This is referred to as "hope value".

50. The term and reversion method of valuation is intended to replicate in a logical way the thinking of a hypothetical purchaser of a freehold reversion.

51. The value of the "term" - the right to receive the rent - is calculated by capitalising the rent. This aspect of the valuation is not in issue in any of these appeals.

52. The value of the "reversion" is normally calculated by taking the estimated vacant possession value of the building and then discounting it at an appropriate rate of interest to arrive at the value today of the freeholder's right to possession at some point in the future. This rate of interest is the deferment rate.

53. In the past, "hope value" was often reflected in the deferment rate. However, in *Sportelli* at [109] – [112], the Tribunal held that it should be calculated separately. For the purposes of determining the preliminary issue before us, hope value can, therefore, be ignored.

The deferment rate

54. How much will someone pay now for the right to receive a sum of money at a future date? This depends on the rate of compound interest that he wants in return for parting with his money now, and only getting it back at a future date. The formula for calculating the present value of a right to receive a future payment, using a given compound interest rate is:

Future payment/$(1+i)^n$

Where i = the compound rate of interest
n = the number of years until deferment

55. So if an investor purchases the right to acquire £1,000,000 in 5 years time, and wants a compound rate of return of 5%, he will pay £783,526, because £1,000,000/$(1 + 0.05)^5$ = £783,526. If he invests that sum at 5% compound interest, then at the end of 5 years he will have £1,000,000:

Year	Amount at start of year	Interest at 5%	Amount at end of year
1	£783,526	£39,176	£822,702
2	£822,702	£41,135	£863,837
3	£863,837	£43,192	£907,029
4	£907,029	£45,351	£952,381
5	£952,381	£47,619	£1,000,000

56. The deferment rate is therefore "the annual discount applied, on a compound basis, to an anticipated future receipt (assessed at current prices) to arrive at its market value at an earlier date" (*Sportelli* at [2]). So, if a freehold worth £1,000,000 with vacant possession were to be sold subject to a lease with five years unexpired, using this formula and a deferment rate of 5%, the present value of the reversion is £783,526.

The decisions of the LVT

23 Cadogan Square

57. The application was heard by the LVT (Mr Leighton, Mr Casey and Mr Power) on 5 and 6 September, 30 November and 1 December 2006, and the LVT's decision was dated 23 March 2007.

58. There were a number of issues that were the subject of the hearing. One was the deferment rate. The tenants contended that the deferment rate should be 5.5% and the landlord that it should be 5%.

59. The LVT held that it should be 5% in section 10 of the decision. They said:

> "10.1 After the commencement of the hearing but before its conclusion, the Lands Tribunal handed down the decision in *Earl of Cadogan v Sportelli* (see above) in which it held that the appropriate deferment rate for flats with over 20 years unexpired would be 5% per annum and this had been accepted by both valuers as the starting point.
>
> 10.2 However, Mr Buchanan refers to paragraph 85 of the Decision which makes clear that in relation to leases with an unexpired term of less than 20 years, it might be necessary to have regard to the property cycle at the time of valuation in order to ascertain whether any adjustment to that figure would be required. Mr Buchanan concludes that if the property cycle is near its peak and the unexpired lease is less than 20 years, then the deferment rate should be higher because of the prospect of a downturn or at least much slower growth.
>
> 10.3 In this respect he refers to the Savills PCL indices showing the rise and falls of the index and noting that it rose from 283.5 in March 2004 to 293.6 in September 2005.
>
> 10.4 He also referred to a graph of real house prices in the UK 1953 to 2005 which was produced to the Lands Tribunal in *Sportelli* and notes that the figures in the graph show increases in house prices in excess of the general figure for inflation.
>
> 10.5 In the light of those documents, Mr Buchanan contends that a deferment rate of 5.5% should be applied in this case in order to reflect the risk that at the end of the term the property cycle would be at a lower level.
>
> 10.6 In his original report he also sought to rely upon what he considered to be serious management problems at the property as a factor in increasing the deferment rate, but abandoned this contention in his later report.
>
> 10.7 [Mr] Clark having analysed the decision in *Sportelli* stated that there was no evidence to indicate whether the current property cycle was near its peak and it would be dangerous to speculate as to where it would be when the lease expired in 2023. He therefore concluded that there was no basis upon which the Tribunal should depart from the figure specified in *Sportelli*.
>
> 10.8 The Tribunal having considered the contentions of both parties concludes that Mr Buchanan has not made out a convincing case for departure from the figure of 5% upheld by the Lands Tribunal in *Sportelli* and therefore concludes that the appropriate deferment rate to be applied in this case should be 5%".

31 Cadogan Square

60. The application was heard by the LVT (Mrs Silverman, Mr Avery and Mr Leonard) on 13 and 14 May and 3 July 2008 and the LVT's decision was dated 11 July 2008.

61. There were a number of issues that were the subject of the hearing. One was the deferment rate. The tenants contended that the deferment rate should be 5% and the landlord that it should be 4.75%.

62. The LVT held that it should be 4.75%. In their decision they said:

> "35 There is no dispute that the premises are in Prime Central London and the decision by the Court of Appeal in *Sportelli*, confirming the Lands Tribunal, determined that in the absence of persuasive evidence, reversions should be deferred at 4.75% for houses and 5% for flats. The Tribunal was invited by the Applicant [landlord] to adopt as the deferment rate 4.75% on the basis that the reversion is to the premises as a house with vacant possession. The Respondent [tenant] argued that, since the premises are presently flats and will remain so until the end of the lease, the rate for flats should be used, ie 5%. Mr Walker supported his argument by referring to the Lands Tribunal observation that, in valuing flats, there should be no distinction made whether or not a head lease were in existence, and that the Court of Appeal decision therefore made 5% binding on the Tribunal.
>
> 36 The Tribunal observes that the Court of Appeal did not consider the issue of the existence or otherwise of a head lease. Irrespective of that however the words used in the Lands Tribunal decision specifically refer to the valuation of <u>Flats</u> with and without a head lease. Since the quarter per cent difference is intended to relate to the additional management problems of flats compared to a house it is the position at reversion that is relevant to the deferment rate, ie when a head lease will have ended. If the basis of the valuation of the reversion is a house (as above), then the existence or otherwise of a head lease of flats is irrelevant, and the deferment rate should be as a house.
>
> …
>
> **Decision**
>
> A. The reversion is to be valued as a house.
> B. …
> C. The deferment rate is 4.75%."

37 Cadogan Square

63. The application was heard by the LVT (Ms Tagliavini, Mr Avery and Mr Packer) on 27 and 28 November and 6 December 2007, and the LVT's decision was dated 26 February 2008.

64. There were a number of issues that were the subject of the hearing. One was the deferment rate. The tenants contended that the deferment rate should be 5% and the landlord that it should be 4.75%.

65. The LVT determined that the deferment rate should be 4.75%. On that issue, it said:

“[10] On the issue of deferment, Mr. Scott-Barrett applied 4.75% adopting the approach for houses used in *Sportelli* [2007] EWCA Civ 1042. He stated that as there are no management difficulties affecting the freeholder, it was inappropriate to adjust the rate to 5%

...

[15] Mr. Orr-Ewing stated that a deferment rate of 5% would be appropriate, in line with *Sportelli*, as the building would be flats until expiry of the term.

…

[29] The Tribunal having determined the starting point as valuation as a house is of the opinion that the deferment rate should also be as for a house. Adopting the approach set out in Sportelli, the Tribunal adopts a deferment rate of 4.75%. The Tribunal can see no reason to make any adjustment to the deferment rate as suggested by Mr. Orr Ewing.”

38 Cadogan Square

66. The application was heard by the LVT (Professor Farrand, Mr Banfield and Mr White) on 5, 6 and 7 June 2007, and the LVT’s decision was dated 3 July 2007.

67. There were a number of issues that were the subject of the hearing. One was the deferment rate.

68. The tenants contended that the deferment rate should be 5.5% and the landlord that it should be 5%. Mr Buchanan for the tenants gave evidence in support of a deferment rate of 5.5%, and the tenants argued in their skeleton argument and closing speech for a 5.5% deferment rate.

69. The deferment rate is listed in para 4.3 of the ‘Issues’ section of the decision as one of the matters in dispute. It is then not mentioned again in the decision. When one looks at the attached valuation, it has, under the heading: “Determined by Tribunal” the words: “Deferment 5.00%”. Thus the LVT appears to have decided that the deferment rate should be 5%, but gave no reasons for that decision.

70. The LVT originally determined that the price (total premium) should be £2,243,434. As a result of corrections made to the decision on 26 July 2007, this was reduced to £1,888,685.

42 Cadogan Square

71. The application was heard by the LVT (Professor Farrand, Mr Banfield and Mr White) on 15, 16, 17 and 18 January 2007, and the LVT’s decision was dated 16 March 2007.

72. There were a number of issues that were the subject of the hearing. One was the deferment rate. The tenants contended that the deferment rate should be 5.5% and the landlord that it should be 5%. Mr Buchanan for the tenants gave evidence in support of a deferment rate of 5.5%, and the tenants argued in their skeleton argument and closing speech for a 5.5% deferment rate.

73. Despite that, the decision does not refer to the deferment rate as being in issue or, indeed, refer to the deferment rate at all. In the valuation attached to the decision, under the heading "agreed matters" are the words: "Deferment 5.00%".

74. Thus it appears that, despite the deferment rate having been the subject of evidence and submissions, the LVT mistakenly arrived at its decision on the basis that the parties had agreed a 5% deferment rate.

Later procedural history

75. Although the various appeals from the LVTs in these cases developed a fairly complicated procedural history which determined which issues could be the subject of the various appeals, it is not necessary to describe the detailed steps in that history. It will suffice to describe the final outcome as to the positions which the parties are permitted to advance on the preliminary issue as to the deferment rate.

76. In relation to 23 Cadogan Square, 31 Cadogan Square, 37 Cadogan Square and 38 Cadogan Square, the tenants are entitled to advance the case which they wish to advance which is that the deferment rate in relation to those unexpired terms which are below 20 years (but not the unexpired terms which expire in 2113) should be 5.8%. In relation to 42 Cadogan Square, by reason of the decision of the Tribunal reported as *Earl Cadogan v Erkman* [2009] 1 EGLR 87, the tenants may not contend for a deferment rate (for unexpired terms below 20 years) which is greater than 5.5%.

77. In relation to all five properties, the landlord contends for the generic rate established in *Sportelli*. It is not necessary to describe whether that position is the result of the landlord's own choice or the result of the decision in *Erkman* which ruled, in the case of 42 Cadogan Square, that the landlord would not be given permission to amend his case which had pleaded a deferment rate of 5%. Accordingly, the landlord's case in relation to 23 Cadogan Square, 38 Cadogan Square and 42 Cadogan Square is that the deferment rate should be 5%. In the case of 31 Cadogan Square and 37 Cadogan Square, the landlord contends that those properties should be regarded as houses and not as flats for the purpose of the deferment rate so that the appropriate rate would be the generic rate for houses of 4.75%, alternatively the generic rate for flats of 5%.

The *Sportelli* guidance

78. Before considering the evidence and the submissions in this case, it will be helpful to consider some earlier decisions of the Tribunal and of the courts. For this purpose we will consider *Sportelli* in some detail but will also refer to an earlier decision of the Tribunal in *Arbib v*

Earl Cadogan [2005] 3 EGLR 139 and then to the decision in *Erkman*, which was given by the Tribunal at an earlier stage in one of the appeals which is before us.

Arbib

79. The principal issue in *Arbib* related to the deferment rate. Before that decision, the Tribunal was aware that questions as to the deferment rate were arising frequently and led to a substantial number of applications for permission to appeal to the Tribunal. The question was clearly a matter of wide concern. *Arbib* concerned five appeals which were heard together to give the Tribunal the opportunity to consider the question of the deferment rate in what was intended to be a comprehensive way and to reduce the number of appeals on that subject thereafter.

80. Before *Arbib*, there had been a convention amongst valuers of adopting a standard figure of 6%. In *Arbib*, the landlords successfully challenged the appropriateness of adopting that conventional figure. The Tribunal gave its reasons for rejecting that rate. The Tribunal arrived at a norm in the prime central London ("PCL") area of 4.5% for houses and 4.75% for flats. It considered that there was a lack of reliable property market evidence in relation to the amount of the deferment rate. It assessed the deferment rate by reference to financial market evidence, in particular evidence as to index-linked gilts. It concluded that the norm (for houses) should be 4.5% which made sufficient allowance for the general risks perceived by the market as compared with 2% index linked gilts. The Tribunal accepted that the deferment rate could be subdivided into three components, linked in the following way: Deferment Rate (DR) = Risk Free Rate ("RFR") + Risk Premium ("RP") – Real Growth Rate ("RGR"). In the case of flats, the Tribunal added 0.25%, to produce a deferment rate of 4.75%, to reflect the greater management problems involved with flats and the better prospect of growth for houses as compared with flats.

81. In *Arbib*, the Tribunal considered whether the length of the unexpired term of the leases would affect the deferment rate. It said at [148] that: "the shorter the unexpired term, the more carefully the choice of rate must be reviewed". It also commented at [170] on the lack of evidence as to different deferment rates for different lengths of unexpired terms.

82. Importantly, the Tribunal in *Arbib* also recognised that there were gaps in the evidence before it, particularly the specialist financial evidence, which somewhat limited the scope of its conclusions.

83. Although the reasoning in *Arbib* remains apposite in many respects, in our view, it is not necessary to consider that reasoning more fully. The reasoning that remains apposite is essentially repeated in the later *Sportelli* decision and, in other respects, the reasoning in *Arbib* has been overtaken by the reasoning in *Sportelli*.

Sportelli: the Lands Tribunal

84. By the time of the decision in *Arbib*, there were already appeals outstanding to the Tribunal, which raised issues as to the deferment rate. The Tribunal sought to collect such cases to enable it

to give further guidance on the subject, hopefully having heard evidence to fill the gaps that had been identified in the evidence in *Arbib*. This led to five appeals being heard together where the decision of the Tribunal is known by the name of the lead case, *Sportelli*.

85. In the instant appeals, we will proceed on the basis that the decision of the Tribunal in *Sportelli* (in relation to PCL – as a result of the comments of the Court of Appeal in the same case) is correct. Indeed, much if not all of the reasoning in *Sportelli* was not the subject of any challenge before us, although the landlord would wish to reserve his position generally in the event of any appeal from our decision. Although the issue in the present appeals is a much narrower one than the many issues as to deferment rate which were considered in *Sportelli*, it is nonetheless important to have a full understanding of the reasoning in *Sportelli* to appreciate the context in which the present appeals fall to be determined.

86. The Tribunal referred to the statutory requirement to determine "the amount which at the valuation date [the freeholder's] interest might be expected to realise if sold on the open market by a willing seller. It added, at [2]:

> "[2] The ascertainment of this sum is only part of the valuation process required under the Acts. By valuers' convention, the value of the right to receive a ground rent during the term has been assessed separately from the value of vacant possession at the end of the term. The former is ascertained by capitalisation of the ground rent to arrive at the present value of the flow of income as at the valuation date. The latter is arrived at by ascertaining the open market value of the freehold interest with vacant possession as at the valuation date and then adjusting that value to reflect the fact that vacant possession will not be available until the end of the term. The adjusting factor is called the 'deferment rate'. The valuers in the present cases explain it thus: it is 'the annual discount applied, on a compound basis, to an anticipated future receipt (assessed at current prices) to arrive at its market value at an earlier date' (that is to say, the valuation date)."

87. It was agreed in *Sportelli*, at [16], that the deferment rate could be calculated from the addition of an appropriate risk free rate to an appropriate risk premium, with a deduction for capital growth.

88. Risk free rate ("RFR") was defined as "the return demanded by investors for holding an asset with no risk, often proxied by the return on a government security held to redemption": see at [16].

89. Risk premium ("RP") was defined as "the additional return required by investors to compensate them for the risk of not receiving a guaranteed return": see at [16].

90. The Tribunal then discussed the nature of the investment being sold for which a deferment rate was to be determined. At [50] – [53], it said:

"[50] It is important to be clear at the outset as to what it is that the deferment rate represents and the nature of the interest to which it is to be applied. We have identified the three elements of value in the landlord's interest that need to be considered: the right to receive the ground rent; the right to vacant possession at term; and the option of realising a share of the marriage value by an earlier sale to the tenant. Each of these elements has to be valued separately. The future income stream of the ground rent and the postponed realisation of vacant possession are such separate elements that their separate valuation is obviously appropriate. The right to vacant possession at term and the option of an earlier sale to the tenant are more closely linked, although they are distinct elements and are capable of separate valuation. It is, in any event, unavoidable that they should be valued separately since it is in dispute whether, as a matter of law, the latter – hope value – falls to be included, and we are therefore obliged, under r 50(4) of the Lands Tribunal Rules 1996 (SI No 1022), to give alternative values, with and without hope value.

[51] The deferment rate is an annual discount of a future receipt, the vacant possession value of the house or flat at term. It incorporates a rate to compensate for deferment of enjoyment, what in the course of the hearing was referred to as 'the time-preference rate', for which the risk-free rate was a proxy. The purpose, however, is ascertainment of the present value of an asset that consists, and consists only, of the right to vacant possession of a particular residential property at the end of the lease to which the freehold is subject. In the present cases, the leases had 21, 41, 23, 71 and 57 years respectively to run. The asset is a hypothetical one in that, in the real world, a reversion that does not carry with it an entitlement to ground rent and the opportunity to make a profit by selling the interest to the tenant is never in practice encountered. As was pointed out in *Arbib* (see [88] and [148]) the deferment rate is a valuation tool to enable the vacant possession value as at the valuation date to be used for the purpose of arriving at the present value of the freeholder's reversionary interest.

[52] It is implicit in this valuation process that there would be a market for such assets if they existed, and we are satisfied that there would indeed be a market. The nature of the investment being assumed may be analysed thus: the value of the asset consists of its prospect of appreciation; it will appreciate through the lapse of time as the term date gets nearer (inherent growth); if, however, the vacant possession value of the property increases in real terms, the reversion will appreciate through real growth in the same way as the property in possession. On the other hand, set against the relatively secure long-term nature of the investment that the asset represents are the risks and disadvantages that are associated with it. There is volatility in the market in residential property and there are prolonged periods of downturn. The property is illiquid in the sense that any sale will take time to achieve. Although it is a tradeable asset therefore, the reversion is subject to the risk that a sale may be achievable only after a delay and at a time when the market is low. It is an asset also that may become obsolescent and deteriorate physically.

[53] In seeking to establish a deferment rate, the experts have approached the matter by establishing a generic deferment rate applicable to long-term residential reversions generally before adjusting this, as necessary, to the individual property under consideration. We shall approach the matter by considering, first, the generic deferment rate and then turning to specific factors, both ones that affect the generic deferment rate

and ones that may apply so as to require its adjustment in relation to individual properties."

91. The Tribunal considered in detail four possible methodologies which might be adopted to determine the deferment rate. One of these involved the use of rack rental yields. On this subject the Tribunal said, at [60] – [61]:

> "[60] On the face of it, Mr Dumas' [*Mr Dumas was an economist called by one of the landlords*] identification of rack-rental yield with compensation for not enjoying possession provides a conceptually elegant means of assessing the deferment rate. It is, however, incomplete, in that the value of possession, in terms of control, opportunity to deal and even pride of possession are all elements in the difference between the value of a reversionary interest and an interest in possession, which are not reflected in the rack-rental value. These factors would appear to indicate that at least evidence of the rack-rental value would provide a minimum for the deferment rate, and Mr Cullum [*Mr Cullum was a valuer called by one of the landlords*] thought that it would serve that purpose. However, it is clear, we think, that rack-rental values can be seen, by the way that they move in relation to vacant possession values, to be unrelated to the deferment rate. When the residential property market is high (that is, above the historic long-term trend) rack-rental values fall, and they rise when the market is low. The deferment rate, on the other hand, being related to the prospect of long-term growth, would (if there were no counterbalancing effects, see below in [73]) tend to do the opposite. It would fall when the market was low because the prospect for long-term growth would be improved and would tend to rise when the market was high.
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> [*The last sentence of this paragraph was corrected by the Tribunal subsequent to the law report being published. The words "rise" and "fall" in the law report are transposed. The correct version – as shown here – is to be found on the Tribunal's website.*]
>
> [61] Rack-rental yields generate a market that is quite different from the hypothetical market in long-term reversions that we have to consider. The focus is essentially relatively short-term, with the different risk considerations that apply in consequence, and we can see no comparison that would enable rack-rental yields to be usefully employed in establishing the deferment rate."

92. The Tribunal rejected the use of the rack rental value (yield) method to determine the deferment rate as well as methods based upon the capital asset pricing model and market evidence. It adopted the method that was used by the Tribunal in *Arbib*. On the basis of the evidence before it, the Tribunal determined that the appropriate RFR should be 2.25%.

93. The Tribunal next considered the question of growth and the amount of the RGR. At [72], the Tribunal said that "there may well be an interaction between the growth rate assumption and the third component of the deferment rate, the risk premium". It held that the RGR should be taken at 2% with any concern on the part of the investor that this rate might not be achieved being reflected in the risk premium.

94. On the question of growth rates, the Tribunal added, at [73]:

> “[73] The second feature of the assumption that has to be considered, in our judgment, is that real house prices fluctuate significantly, so that at any one time they may be substantially above or substantially below the level that would have resulted from a projection of past average growth rates. Thus, at the present time, the recent sustained strength of the market has pushed prices well above the long-term trend. To base the deferment rate upon the same real growth rate when prices are above the trend as when they are below the trend would run the risk of overvaluing the reversion in the former case and undervaluing it in the latter. This was not, however, a matter to which evidence was directed. Nevertheless, it seems to us likely that the optimism of a buoyant market would be likely to feed through, to some extent, to investors in the sort of long-term reversions that we are considering, and that the same would be true when the market was low and pessimistic. It could therefore be expected that this would be reflected in a reduction or increase, as the case might be, in the risk premium, which would tend to counterbalance any adjustment that might otherwise seem appropriate to the growth rate. It is a reasonable working assumption, we think, that there would be an effective counterbalancing, so that the deferment rate would not need to change according to whether prices were above or below the trend. We therefore adopt 2% as the assumed growth rate.”

95. The Tribunal then considered the amount of the risk premium. It said that there would be a market for the type of asset being valued. It said that the risk of investment in long reversions involved risk through volatility, illiquidity, deterioration and obsolescence. In relation to deterioration and obsolescence, these were factors that required to be reflected in the general deferment rate to the extent that the risk related to them was common to all residential property viewed in the long term. To the extent that they were property specific they should be separately considered.

96. In relation to volatility and illiquidity, the Tribunal said, at [76]:

> “[76] It is, in our judgment, the combined effect of the other components, volatility and illiquidity, that must have the major effect upon the risk premium. If the market were composed of or contained a substantial number of people who intended to hold the reversion to term, the fluctuations in residential property prices and the illiquidity of the investment would have very little influence. The investor would simply lock away the investment and the passage of time would iron out the fluctuations. The illiquidity would have no influence because the investment would not be sold. Mr Cullum's assessment was based, it appears to us, upon the assumption of a market very much of this sort, and he identified pension funds and the great estates as the likely purchasers. We do not, however, accept that, in the market that we have to envisage, there would be any significant number of investors that would be looking to hold these very long-term assets throughout their lives. The attraction of the investment would be its relative security, the prospect of growth and the opportunity for both long-term retention and earlier sale. Tradeability would, we think, be important as one of its components, and it is this that would make the volatility of the housing market and the relative illiquidity of the investment significant factors in the mind of a purchaser.”

97. The Tribunal then held that RP should be taken to be 4.5%. At this stage in its decision, the Tribunal had therefore identified the amount of all three factors in the formula to be used as RFR (2.25%) + RP (4.5%) – RGR (2%) and the result was a deferment rate of 4.75%

98. The Tribunal then turned its attention to specific factors which might affect the appropriateness of using this generic deferment rate. It first considered in detail the significance of the length of the unexpired lease term. It referred to the very different views of the valuers and economists who had given evidence before it. It concluded at [85]:

> "[85] Our conclusion is that the deferment rate is constant beyond 20 years. Below 20 years, we accept the view of Mr Dumas, Professor Lizieri [*an economist who was called on behalf of one of the tenants*] and Mr Orr-Ewing [*a valuer who was called on behalf of one of the tenants*] that the rate would need to have regard to the property cycle at the time of valuation. Beyond 75 years, we see no reason on the evidence before us to conclude that the rate would be either higher or lower."

99. It will be remembered that in *Sportelli*, the lengths of the unexpired terms were 21, 41, 23, 71 and 57 years respectively: see at [51]. In the present appeals, the lengths of the unexpired lease terms are all below 20 years and it is therefore worth emphasising the Tribunal's comment at [85] that in a case where the unexpired lease term was under 20 years, the deferment rate **would need to have regard to the property cycle at the time of valuation.**

100. The Tribunal later considered as a potentially relevant specific factor the fact that the property consisted of a flat or flats, rather than a house. It said at [95] – [96]:

> "[95] In *Arbib*, the adjustment of 0.25% was intended to reflect both the greater management problems associated with flats and the possibility that there might be a better prospect of growth in the house as opposed to the flat market. As to the second of these factors, we accept Mr Clark's view [*Mr Clark was a valuer called on behalf of one of the landlords*] that any disparity between growth rates for houses and flats is likely to even out over the longer term. We think, however, that an adjustment needs to be made to reflect the management problems, although we do not consider it appropriate to differentiate between flats that are the subject of headleases and those that are not. Nor do we think that the management concerns are necessarily so much less for a single flat than for a block to warrant a different adjustment. Even where flats are efficiently managed, service charge and repairs problems inevitably occur, and the management exercise in itself is, we feel, sufficiently more complex to warrant a generalised 0.25% addition for flats. We do not consider that any fine-tuning below this percentage is justified.
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> [96] Because what we are considering is a long-term investment, it is the prospect of management problems arising during the course of the tenancy that is the important consideration rather than the state of affairs at the time of valuation. Our view is that the potential for problems to arise is inherent in all leases and that standard adjustment is therefore appropriate. We do not rule out the possibility that there could be a case for an additional allowance where exceptional difficulties are in prospect, but this would need to be the subject of compelling evidence."

101. Thus, in the case of flats, the generic deferment rate was increased from 4.75% to 5 %.

102. Finally, the Tribunal considered what the status of its decision as to the deferment rate should be. It went into this question thoroughly and cited a number of highly apposite cases. Its conclusions at [121] – [123] were expressed as follows:

> "[121] … It is obviously undesirable and, indeed, it would be impossible, for the sort of financial and valuation evidence that we have heard to be called and considered in every enfranchisement case. It is, in our judgment, unnecessary that it should be, because LVTs and this Tribunal are entitled to rely upon their own expertise, guided by this decision. The prospect of varying conclusions on the deferment rate in different cases reached on evidence that was less comprehensive than that before us can therefore be avoided by LVTs adopting the practice of following the guidance of this decision unless compelling evidence to the contrary is adduced. This is justified because, as we have explained above, the deferment rate is unlikely to vary according to factors particular to the individual case. Some factors, including, in particular, the prospect of long-term growth, will not vary from case to case, while other factors, such as location and obsolescence, will already be reflected in the vacant possession value. Hope value would be a factor that could lead to different deferment rates for different lengths of term if it was not reflected elsewhere in the valuation, but we have concluded that hope value is excluded as a matter of law. The case for adopting a single deferment rate (with a standard adjustment for flats) for all reversions in excess of 20 years is thus, in our view, strong. Indeed, we think that statutory prescription could well be appropriate and could usefully give a greater certainty to the market than a decision of the Tribunal setting a guideline is capable of doing.
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> [122] It is a necessary part of the concept of a guideline applicable to future cases that the deferment rate should be stable, although, clearly, its potential for change needs to be recognised. We sought the opinions of the experts in these appeals as to whether and to what extent the deferment rate could be expected to vary over time. Mr Clokey, of course, would vary his deferment rate as the yield on index-linked zero-coupon gilts moved from day to day. That approach, however, would, in our judgment, be inconsistent with recognising the function of the deferment rate as a valuation tool to assess a long-term investment in a particular form of asset, one of the features of which is stability rather than volatility. In our judgment, the deferment rate may be treated as being stable over time unless a trend movement in the risk-free rate can be identified or it can be established that the long-term prospects of growth in residential property have changed or that, for some other reason, the attraction of investment in residential reversions can be shown to have increased or diminished.
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> [123] The application of the deferment rate of 5% for flats and 4.75% for houses that we have found to be generally applicable will need to be considered in relation to the facts of each individual case. Before applying a rate that is different from this, however, a valuer or an LVT should be satisfied that there are particular features that fall outside the matters that are reflected in the vacant possession value of the house or flat or in the deferment rate itself and can be shown to make a departure from the rate appropriate."

103. The Tribunal also dealt with a separate legal point as to the correct treatment of certain hope value. It is not necessary for present purposes to refer further to that part of the Tribunal's decision.

Sportelli: the Court of Appeal

104. In *Sportelli* the landlords appealed to the Court of Appeal on the issue as to the correct treatment of certain hope value. We are not presently concerned with that point. The Court of Appeal also heard an appeal from two of the nominee purchasers as to the deferment rate. That appeal related to the way in which the Tribunal had dealt with the nominee purchasers' case that the deferment rate should be derived from evidence of market sales of long-term residential reversions. The Tribunal had rejected that methodology and it has not been necessary for us to summarise its reasons for so doing. The appeal to the Court of Appeal against that part of the decision was dismissed and, again, it is not necessary for us to summarise why that was so. However, this part of the appeal gave the Court of Appeal an opportunity to comment on that part of the Tribunal's decision which had sought to identify the status of its decision as to the deferment rate and the way in which future Tribunals should react to that decision. The only reasoned judgment was given by Carnwath LJ, with whom Sir Peter Gibson and Ward LJ agreed.

105. The nominee purchasers had severely criticised the Tribunal for its comments as to the status of its decision. It was said that the Tribunal's approach was "unprecedented" and involved a "fundamental misconception". It was held that this criticism was unjustified for properties within PCL although the Court of Appeal held that the decision of the Tribunal would not apply with the same force to properties outside PCL.

106. It will be remembered that all the properties in the present appeals are in PCL. Indeed, so were all the properties in *Sportelli* so that the qualification made by the Court of Appeal for properties outside PCL had no direct bearing on the outcome of those cases.

107. It is therefore important to see what the Court of Appeal said about the status of the decision of the Tribunal in *Sportelli*. Carnwath LJ quoted the essential parts of paragraphs 121 to 123 of the Tribunal decision. He pointed out that there was earlier authority which had not applied that approach to decisions of the Tribunal. He then said at [97] – [99]:

> "[97] Since that time, the role of specialist appeal tribunals in providing guidance on factual as well as legal matters has become more clearly recognised. A comparable example, from a very different field of law, is found in the practice of the former Immigration Appeal Tribunal (and its successor) of identifying suitable cases to provide authoritative guidance on conditions in particular countries ("country guidance cases") for use in asylum appeals. The status of such guidance was described by Laws LJ in *S v Secretary of State for the Home Department* [2002] EWCA Civ 539; [2002] INLR 416, in [28]:
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> > 'While in our general law this notion of a factual precedent is exotic, in the context of the Immigration Appeal Tribunal's responsibilities it seems to us, in principle, to be benign and practical. Refugee claims vis-à-vis any particular state are inevitably made against a political backdrop which over a period of time, however long or short, is, if not constant, at any rate

identifiable. Of course the impact of the prevailing political reality may vary as between one claimant and another, and it is always the appellate authorities' duty to examine the facts of individual cases. But there is no public interest, nor any legitimate individual interest, in multiple examinations of the state of the backdrop at any particular time. Such revisits give rise to the risk, perhaps the likelihood, of inconsistent results; and the likelihood, perhaps the certainty, of repeated and therefore wasted expenditure of judicial and financial resources upon the same issues and the same evidence.'

[98] Although the present context is very different, there is an equal public interest in avoiding wasted expenditure and the risk of inconsistent results in successive LVT appeals on an issue such as that of deferment rates. The Tribunal could hardly have done more to ensure that the issues were fully ventilated and exhaustively examined. It had already been discussed in detail in *Arbib*. I have already referred to the steps taken by the Tribunal to bring together the present group of cases. Furthermore, it is difficult to envisage a better qualified panel of experts for the purpose than those called in this case, or of specialist counsel on both sides of the argument.

[99] I agree with the Tribunal that an important part of its role is to promote consistent practice in land valuation matters. It was entirely appropriate for the Tribunal to offer guidance, as it has done in this case, and unless and until the legislature intervenes to expect LVTs generally to follow that lead, Mr Munro invited us to go further and to consider the status of Tribunal decisions respectively on issues of law, valuation and fact. However, I bear in mind that, under the Tribunals, Courts and Enforcement Act 2007, the jurisdiction of the Tribunal is likely in the near future to be subsumed into that of the new Upper Tribunal, which will be a "superior court of record" under the Act. It will be principally for the new Tribunal to lay down guidelines as to the precedent effect of its decisions for different purposes."

Sportelli: the House of Lords

108. In *Sportelli,* the landlords appealed to the House of Lords on the separate question as to the treatment of certain hope value. There was no appeal in relation to the deferment rate. Accordingly, there is nothing in the speeches in the House of Lords which bears on that question.

Earl Cadogan v Erkman

109. It is relevant to refer to one part of this decision which relates to the status of the decision of the Tribunal in *Sportelli*.

110. The decision in *Erkman* was an interlocutory ruling by the Tribunal (the President and A J Trott FRICS) as to the ability of the landlords to call evidence which challenged the guidance in *Sportelli*. The ruling was given in relation to one of the appeals that is now before us. The Tribunal considered its powers to grant or refuse permission to amend a statement of case. In the event, the Tribunal concluded that the landlord should not be given permission to amend its statement of case to allow him to contend for a deferment rate below 5% and the nominee purchaser should not be allowed to amend her statement of case to allow her to contend for a deferment rate above 5.5%.

111. In the course of its decision, the Tribunal considered the status of the guidance as to the deferment rate given by the Tribunal in *Sportelli*. It held that the Tribunal ought in general to exclude evidence designed to show that the guidance was wrong. This general approach was subject to there being exceptional circumstances that would justify the admission of the evidence.

The evidence

112. We heard evidence from four witnesses, two for the tenants and two for the landlord. In the next two sections of our decision we will identify the evidence as presented by these four witnesses in their written reports. This will identify the cases which were put forward on each side. Each of these witnesses was cross-examined in detail. We will not attempt to set out *in extenso* the evidence given in cross-examination but when we come, later in this decision, to our discussion of the issues, we will identify passages in the evidence, including evidence given in cross-examination, which we wish to discuss on our way to reaching our conclusion.

The tenants' evidence

113. The tenants called two witnesses, namely Professor Colin Lizieri and Mr Gavin Buchanan.

Professor Lizieri

114. Professor Lizieri is essentially an economist in the fields of property and finance. He is also a Fellow of the Royal Institution of Chartered Surveyors. He is the Grosvenor Professor of Real Estate Finance at the University of Cambridge. At various dates he prepared reports setting out his views in relation to all five of the properties with which we are concerned. He later prepared supplementary statements in response to evidence which had been prepared by Mr Bezant, a witness for the landlord.

115. Professor Lizieri's evidence is very detailed and relies upon a large amount of data which he appended to his reports. At this stage, we will attempt a summary of his views which will necessarily be much briefer than his own exposition of them but which will indicate the main steps in his reasoning.

116. Professor Lizieri referred to the *Sportelli* guidance and to the fact that the guidance relates to unexpired terms above 20 years, whereas the cases with which his evidence was concerned involved unexpired terms of below 20 years. He referred to the statement in the decision of the Tribunal in *Sportelli* which referred to the need to have regard to the property cycle at the time of valuation for unexpired terms below 20 years. He then considered the evidence, as he saw it, as to the property cycle at the valuation dates and he considered the effect of that evidence on the factor RGR, dealing with predicted growth, in the formula adopted in *Sportelli*. His evidence in the first instance did not address the other factors in the formula, i.e. RFR and RP.

117. Professor Lizieri expressed the view that the evidence showed him that at the valuation dates in question many commentators believed that residential prices in PCL had reached a point where they were well above sustainable levels and that a downward adjustment was likely. There was no consensus as to when that adjustment would come about nor as to the scale of the adjustment. These beliefs had wide currency. Investors would be aware of the risk that the market had peaked and that prices would, at best, rise slowly, or, at worst, fall sharply in real terms. Models based on economic fundamentals suggested that residential prices were at least 15% above their fundamental values and might be expected to return to their fundamental value over the unexpired term. He said that the most likely assumption which would be made by rational investors would be that prices would adjust to their fundamental values over the unexpired term.

118. Professor Lizieri derived the RGR using two calculations. He expressed what he called the fundamental value at the valuation date as 100 (as compared with the actual market value at that date of 115). The difference between 100 and 115 is the same 15% as is referred to in the last paragraph. If the fundamental value of 100 grew at the *Sportelli* RGR of 2% over the unexpired term in each case, the first calculation showed the resulting fundamental value at the end of the unexpired term. The second calculation started with a value of 115 rather than 100 and calculated what growth would be needed throughout the unexpired term to arrive at the same figure for fundamental value as was produced by the first calculation. Because the unexpired terms in the five cases were different, the answers produced by the calculations were also different. His second calculation produced growth rates of 1.19% for 23 Cadogan Square, 1.11% for 31 Cadogan Square 1.11% for 37 Cadogan Square, 1.2% for 38 Cadogan Square and 1.19% for 42 Cadogan Square.

119. The conversion to the deferment rate can be illustrated by taking the RGR figure of 1.2% for 38 Cadogan Square as an example. Professor Lizieri pointed out that this was, of course, below the RGR of 2% used in *Sportelli*. He said that 1.2% should be substituted for the 2% used in *Sportelli* and if one did that substitution, the resulting deferment rate would be 5.8% rather than 5%.

120. In a supplementary report, Professor Lizieri considered a report prepared by Mr Bezant and dealt, in particular, with the suggested linkage between risk premium and growth rate and also with an approach using net rental yields.

121. As regards the suggested linkage between risk premium and growth rate, Professor Lizieri expressed the view that the risk premium is a long-run concept. Changes in the risk premium operate separately from cyclical effects. An informed investor would not consider a property asset to be less risky simply because it is expected to deliver below average capital appreciation (or even suffer depreciation) over the investment horizon because of where the investor stood in the property cycle. Further, the risk premium reflected, amongst other things, illiquidity and volatility. He did not think that they were likely to be any less significant if the deferment period was shorter. If the factors which influenced the amount of the risk premium were not affected by fluctuations in the growth rate, then a reduction in the growth rate used to calculate the deferment rate would not be offset by a reduction in the risk premium. There was neither a theoretical basis nor empirical evidence to support Mr Bezant’s view that a change in RGR would be cancelled by an equal change in RP.

122. As to the use of the net rental yield approach relied upon by Mr Bezant, Professor Lizieri accepted that mathematically it could be shown that the use of an investment yield as a proxy for the deferment rate might be approximately correct. But such mathematics were based on a set of assumptions and conditions that were extremely difficult to maintain in realistic market environments and very unlikely to hold when markets were out of equilibrium. If the rental yield in the current market is not at equilibrium level and/or is not likely to be the same yield at the end of the unexpired term, then the method breaks down. At the valuation dates, because capital values were above their fundamental values, but rental values were not, rental yields had been driven downwards. It was therefore inappropriate to use the then current rental yield as a proxy for the deferment rate.

123. In the course of the hearing, Professor Lizieri expressed more general views about the approach to be adopted if one was asked to determine the deferment rate for unexpired terms below 10 years. In such a case, he suggested that it would be necessary to forecast price movement and make appropriate individual adjustments.

Mr Buchanan

124. Mr Buchanan is a Member of the Royal Institution of Chartered Surveyors and a partner in Knight Frank LLP. He had given evidence before the LVT in relation to 23, 38 and 42 Cadogan Square where he had spoken to a deferment rate of 5.5%. He told us that having considered the evidence of Professor Lizieri, he was persuaded that Professor Lizieri's higher figures were correct.

125. Mr Buchanan prepared a short report dealing with Mr Bezant's evidence (to which we refer below) as to the appropriateness of using net rental yields to determine the deferment rate. He referred to the decisions of the Tribunal in *Arbib* at [130] – [132] and in *Sportelli* at [61] to show that the Tribunal gave reasoned decisions as to why it was inappropriate to use net rental yields to determine the deferment rate. He said that he agreed with those reasons.

126. Mr Buchanan said that if one was considering an unexpired term of 1 year, the analogy with a net rental yield might be useful. The same might be true with an unexpired term of 2 or 3 years. However, it would not be true with an unexpired term of 5 years and certainly not true with an unexpired term of 10 years.

127. Mr Buchanan explained his view that the rental market and the capital market were different. He gave detailed reasons as to why people rent property short term. He added that the grant of a short assured shorthold tenancy would depress the value of the freehold as the owner would not be able to give immediate vacant possession to a purchaser following the grant. The discount in value might be as much as 5%. Flats and houses in PCL were normally sold with vacant possession. Further, the market for reversions on long leases was a very small one compared to the market for properties sold with vacant possession.

128. If the Tribunal were to think that a rental yield approach might be helpful, Mr Buchanan stated that a question would arise as to what rental yield to take. Rental yields have varied widely

over time and this itself suggested that rental yields were unlikely to be a useful guide. Further, the owner occupier net yield (see the Tribunal decision in *Sportelli* at [33] – [34] and [42]) was a better guide than an investment net yield.

The landlord's evidence

129. The landlord called two witnesses, namely, Mr Mark Bezant and Mr Julian Clark.

Mr Bezant

130. Mr Bezant is a Fellow of the Institute of Chartered Accountants and the senior managing director of FTI, a firm specialising in the provision of economic and financial analysis. He has advised on the valuation of businesses, companies, securities, intellectual property rights and intangible assets.

131. Mr Bezant initially prepared a report in relation to 42 Cadogan Square in which he expressed his view that the guidance in *Sportelli* was wrong and the generic deferment rates which emerged from that guidance were too high. Following the decision of the Tribunal in *Erkman*, he revised that report to remove those parts which challenged the guidance in *Sportelli*. However, Mr Bezant stated that he had not changed his view on those matters. He continued to state his view that the deferment rate for the unexpired terms in the present appeals should be no higher than the generic deferment rates determined in *Sportelli*.

132. As we have done in the case of Professor Lizieri, we will attempt a summary of the views of Mr Bezant to indicate the main steps in his reasoning.

133. Mr Bezant first addressed the question of the risk free rate (RFR). Having considered the matter in a little detail he concluded that the appropriate RFR for these unexpired terms was 2.25%, which was the same RFR as was determined in *Sportelli*. Professor Lizieri had not considered the RFR but the tenants' case had simply adopted a RFR of 2.25%. However the parties arrived at the RFR, the result is that there is no difference between them which we have to resolve and we need not go further into Mr Bezant's evidence on that point.

134. Mr Bezant then considered the questions of the risk premium (RP) and the real growth rate (RGR). He considered those questions together. He referred to the comments in *Sportelli* that these matters were interrelated. He expressed the view that if future growth expectations were reduced then so would be the risk that the expected growth would not be achieved. It was clear that it was his view that any change in the RGR would, in effect, be cancelled by a matching change in RP. He stated that if one changed only RGR or only RP, that would imply that the current market value was an incorrect value. Accordingly, he stated that with unexpired terms of less than 20 years, other than very short terms of less than 5 years, the deferment rate would be adjusted primarily for changes in RFR (and not for changes in RGR or RP). As explained, he had already concluded that the RFR would be 2.25% which was the same as the factor used in the *Sportelli* guidance.

135. The above reasoning produced the conclusion that the deferment rates in the present cases should be the same as the generic rates determined in *Sportelli* or, perhaps Mr Bezant would say, not higher than those generic rates.

136. Mr Bezant also considered whether there were additional or alternative approaches to the use of the *Sportelli* formula. He stated that one could use a net rental yield approach to determine the deferment rate. He stated that the value of a reversion could be understood as the current open market value of a freehold less the present value of net rents received prior to reversion. Accordingly, the value of a reversion could be calculated by using the net rental yield over the term as the deferment rate. He then illustrated this method in the case of an unexpired term of 1 year and concluded that, in such a case, the value of the freehold was equivalent to the value of a 1 year reversion plus the market value of the net rent of the property for 1 year. In other words, the current value of a reversion is to be determined by considering the current freehold value and subtracting the net present value of the 1 year rent. He then extrapolated from this example of an unexpired term of 1 year and stated that the same conclusion applied with longer unexpired terms. One could use this method instead of the *Sportelli* guidance. Indeed, it might be easier to obtain market data for net rental yields than for each component in the *Sportelli* formula. He then collected the evidence given by valuers and others in *Sportelli* as to net rental yields and concluded that the deferment rates for unexpired terms below 20 years should not be any higher than the generic rates in *Sportelli*.

137. In the course of the hearing, Mr Bezant produced a note recording his views in response to the evidence given by Professor Lizieri. He criticised the suggestion that one should calculate RGR by assuming that there would be a return to an equilibrium value at the term date. He pointed out that two investors (or even more starkly, one investor) assessing two different unexpired terms at the same valuation date would have to assume that there would be a return to an equilibrium value at two different dates. He described the assumption of a return to equilibrium at whatever happened to be the term date in any particular case as arbitrary. He did not think that it was in any event necessary to predict whether the market would or would not be in equilibrium at the term date. Further, the purchase of a reversion was the purchase of a freehold which was an interest in perpetuity. He also pointed out that Professor Lizieri's thesis based on a return to equilibrium from a current, non-equilibrium position, required Professor Lizieri to say that current open market values were "wrong".

Mr Clark

138. Mr Clark is a Member of the Royal Institution of Chartered Surveyors and a partner in Gerald Eve.

139. Mr Clark commented on the nature and the length of property cycles. He stated that there was no way of knowing where one was in the current property cycle. It was impossible to say where the property cycle would be in 2023. He remained of the view that he had expressed in *Sportelli* that a long term RGR of 2% was modest for PCL. Even accounting for a period of a depressed market after the valuation dates in the present cases, he was confident that an RGR of 2% per annum was not unrealistic.

140. Mr Clark also considered the appropriate RFR and RP in the present appeals. He gave his reasons for concluding that these should be 2.25% and 4.5% respectively. He added that if the Tribunal were to take a RGR of less than 2% then the RP should similarly be adjusted in consequence.

141. Mr Clark criticised Professor Lizieri's conclusions as to the choice of a deferment rate above 5% for flats where the unexpired terms were less than 20 years. Mr Clark took the example of the case where the unexpired term was 17.47 years at the valuation date, where Professor Lizieri had said that the right deferment rate was 5.8%. If one combined that evidence with the *Sportelli* guidance, and considered what the value would be if the unexpired term was 20 years at the valuation date (leading to the use of the generic rate for flats of 5%) this would produce the anomalous answer that a reversion subject to an unexpired term of 17.47 years would be worth less than the same reversion subject to an unexpired term of 20 years, which Mr Clark said simply could not be right. He pointed out that applying a deferment rate of 5.85% for a reversion due in 17.47 years time produced the same result as applying a deferment rate of 5% for a reversion due in 20.185 years. Mr Clark produced a detailed table to show his workings on this point.

The tenants' submissions

142. In the course of his opening on behalf of four of the tenants, Mr Jourdan identified a number of issues which required attention. In particular, he identified the questions which arose in relation to an adjustment to the RGR for these sub-20 year terms, whether a reduction in RGR would be matched by a lower risk premium and whether the Tribunal would derive any assistance from short term rental yields. He also identified an issue as to whether the deferment rate for 37 Cadogan Square should be the appropriate rate for a house or for flats. Mr Jourdan explained to us that the tenants' case relied upon our acceptance of the evidence of Professor Lizieri, which we have described above.

143. Mr Walker, on behalf of the tenant of 31 Cadogan Square, submitted by way of written opening that we should accept the evidence of Professor Lizieri. He also addressed the issue whether the deferment rate for 31 Cadogan Square should be the appropriate rate for a house or for flats.

144. In his closing submissions, Mr Jourdan analysed the evidence of the witnesses. He also developed a submission of law in support of Professor Lizieri's approach which assumed that the freehold vacant possession ("FHVP") value of the property would revert to the equilibrium value at the expiry of the term. Mr Jourdan relied on a passage in the speech of Lord Hoffmann in *South Australia Asset Management Corporation v York Montague Ltd* [1997] AC 191 at 221F – 222A. That case concerned the right approach to be adopted when assessing the damages payable in a case of a surveyor's negligent over-valuation. The main part of the decision is not material and need not be described. At the passage cited, Lord Hoffmann dealt with a discrete argument as to the assessment of damages. The argument (for the negligent surveyor) was that the damage should not be the loss which flowed from the valuation having been in excess of the true value but should be limited to the excess over the highest valuation which would not have been negligent. That argument was rejected as confusing an inquiry as to whether the surveyor's valuation had been non-negligent (if it fell within a permissible range of valuations) with the true inquiry as to the

damage which flowed from any negligence. For the purpose of assessing damages, the court must form a view as to what a correct valuation would have been. In a case where there was a range of values which a reasonable valuer might put forward, the figure which it was most likely that a reasonable valuer would have put forward would have been the mean figure of the range. Mr Jourdan submitted that as a matter of law, when one seeks to predict what will happen to the FHVP value in the future, perhaps in 15 or 17 years time, one must recognise that there is a range of possibilities. Some of those possibilities will involve the FHVP at that future date being above the equilibrium value and some will involve the FHVP being below the equilibrium value. It was submitted that the correct legal answer was to adopt a prediction that the FHVP value would be neither above nor below, but exactly at, the equilibrium value at the expiry of the term.

145. Mr Walker dealt, in his closing submissions, with the question whether the deferment rate for 31 and 37 Cadogan Square should be the appropriate rate for flats or the appropriate rate for a house.

The landlord's submissions

146. In his opening submissions, Mr Munro on behalf of the landlord submitted that if the RGR were to be adjusted for these sub-20 year terms to reflect an assessment of the position in the property cycle at the valuation dates, then one also had to adjust the "associated" RP. He submitted that the tenants were wrong because: (1) they did not adjust the RP; (2) no adjustment was made to RFR; (3) Professor Lizieri was wrong to identify a "theoretical" equilibrium for each property; (4) if the tenants were right, the deferment rate would change depending upon where the valuation date happened to be in the property cycle; if the tenants were right, the deferment rate would go up when property was "overpriced" and go down when property was "underpriced"; (5) the tenants' evidence did not distinguish between the different valuation dates; and (6) the tenants' methodology produced a yield curve that bore no relation to reality or to the hypothetical world in which the valuation was to be carried out.

147. In his closing submissions, Mr Munro commented on some of the evidence before the Tribunal. He emphasised a graph which had been produced as an illustration of different deferment rates for cases where the unexpired terms were between 0 and 20 years. This graph showed a deferment rate of 3% for a small number of years; it was said that it was not necessary to define the number of years for which this rate would be appropriate. We were not asked to make a finding on the evidence that the appropriate deferment rate should be 3% for any particular length of term. The 3% was said to be "illustrative" and that the right rate, whatever it might be would be based on information on rental yields available for the appropriate term of years. At the end of the years (for which 3% was taken as illustrative), the graph continued on a straight line so that it reached 5% for an unexpired term of 20 years. This rate of 5% was, of course, the generic rate for flats identified in *Sportelli* for terms of 20 years and above. Because the starting point of the ascending line was 3% and the end point was 5%, it followed that every point on the ascending line showed a rate which was below 5%. Mr Munro submitted that this showed that for every one of the appeals before us, we were therefore bound to hold that the deferment rate was below 5%. As he was content for the Tribunal to find that the rate in these cases (for flats) was the generic rate of 5%, the tenants' appeals had to be dismissed. In his closing submissions, Mr Munro said that this graph represented his case and that he did not have an alternative case.

Discussion

148. In *Sportelli*, the Tribunal determined that the appropriate deferment rate, for a reversion subject to leases with 20 or more years to run, was 4.75% for houses and 5% for flats. In reaching this conclusion, the Tribunal used the following formula ("the *Sportelli* formula"):

> Deferment rate (4.75%) = risk premium (4.5%) + risk free rate (2.25%) less real growth rate (2%)

In the case of flats, an addition of 0.25% was made to the risk premium. These rates were appropriate for cases in PCL. In *Sportelli,* the Tribunal added that for a reversion subject to leases with unexpired terms of below 20 years, the deferment rate should have regard to the property cycle at the valuation date. *Prima facie,* it would seem that the way to apply the guidance in *Sportelli* to cases like the present, where the leases are for unexpired terms of below 20 years, is to take the formula in *Sportelli* and then to consider whether to alter any one, or more, of the three components in the formula, to reflect the position in the property cycle at the relevant valuation dates.

149. However, we consider that the submissions put forward in the present cases on behalf of the landlord require us to determine first of all whether the *prima facie* approach is the appropriate one, or whether we should put the formula in *Sportelli* on one side and use a different method to decide the present cases. We will explain why we think that the landlord's submissions make it necessary for us to answer this question in the first instance.

150. In his written opening submissions, Mr Munro expressly accepted that the *Sportelli* formula was correct and the figures used in *Sportelli* in the application of the formula were correct, although the landlord reserved his position in these respects should any of the appeals go further. However, the landlord's case did not rely upon the *Sportelli* formula, other than by acceptance of its determination of the appropriate deferment rate (5%) for unexpired terms of 20 years or more. For terms less than this the landlord did not use the *Sportelli* formula but instead turned to evidence from net rental yields (NRY). Mr Munro argued that these yields could be used to determine the deferment rate for unexpired terms of 1 to n years where n was the largest number of years for which evidence of NRYs existed. Mr Munro suggested in his closing submissions that there was no evidence before the Tribunal (and none that he had called) as to where n was nor what rate was appropriate for the period from 0 to n years. The use of 3% was, he said, simply illustrative. Mr Munro suggested that the landlord could show, on the tenants' own evidence, that n was less than 5 years. The net rental yield evidence was that the deferment rate for such terms was less than 5%. (Transcript day 5, pages 27, 28 and 44).

151. In answer to a subsequent question from the Tribunal, Mr Munro submitted that the NRY was less than 5% at the valuation date. This being so, Mr Munro submitted as his primary case (there being, he said, no alternative) that by drawing a straight line between the NRY at n years (also less than 5%) and the deferment rate of 5% at 20 years, the deferment rate for intermediate unexpired terms (from n to 20 years) must be less than 5%, which was the landlord's pleaded deferment rate.

152. Accordingly, we conclude that we do need to consider whether to adopt the *prima facie* approach we identified in paragraph 148 above or to accept the landlord's submission that a graph

based on illustrative net rental yields produces the answer that the deferment rates in these cases will always be below the landlord's pleaded case of 5%.

153. In his expert report, Mr Bezant had considered the application of NRYs for the length of the unexpired terms in these appeals. Mr Bezant did not present his evidence in the way ultimately contended for by Mr Munro until, on day 4 of the hearing, Mr Bezant produced a graph illustrating Mr Munro's submission. At the very end of Mr Munro's closing submissions, on the last day of the hearing, and before we heard Mr Jourdan and Mr Walker's closing submissions, worked examples were provided which were said to illustrate Mr Bezant's NRY model. These examples were not the subject of any evidence from Mr Bezant and were therefore not the subject of cross examination. Mr Jourdan, without the benefit of an opportunity to consider them in detail, dismissed them as nonsensical because, he said, they showed that an investor would pay the same price regardless of the amount of rent he would receive until reversion. This (he said) reflected Mr Bezant's "extraordinary belief" that rising growth expectations would be matched by a rising risk premium. In our opinion, Mr Bezant's examples show the unsurprising result that, for a given current market value of the freehold, the greater the prospect of capital and/or rental growth the greater will be the total return on the investment. We do not find the examples helpful in illuminating the issue in dispute.

154. Mr Bezant acknowledged that:

> "The estimation of an appropriate net rental yield for use in a deferment rate calculation, and the period over which such a net rental yield can be reliably estimated, are matters for property experts."

155. The property experts in these appeals were Mr Buchanan for the tenants and Mr Clark for the landlord. Mr Buchanan said that, depending on the circumstances, the net rental yield approach might have merit as a reliable guide to the deferment rate for unexpired terms of up to 5 years. There would be no market for tenancies beyond that length of time and there was no evidence of any such lettings. Mr Clark produced limited evidence about net rental yields in that part of his report rebutting Professor Lizieri's adopted deferment rate of 5.8%. Mr Clark referred to Savills' published data about Prime Central London Residential Gross and Net Yields which showed a net yield of 2.8% for flats in September 2005 falling to 2.5% in September 2007. In our opinion there is no adequate evidence to support the use of Mr Bezant's NRY model for the unexpired terms in these appeals and we do not adopt it.

156. In paragraph 153 above, we referred to Mr Bezant's graph which was said to illustrate Mr Munro's submission that the DR must be below 5% for all of the unexpired terms in these appeals. But that is not a method for calculating the deferment rate itself. The graph shows a straight line from year n (not specified but said to be below 5 years) at an illustrative rate of 3% to year 20 at 5% (the deferment rate adopted in *Sportelli*). Mr Munro explained that the line is not necessarily straight but may be curved. He said:

> "I also accept that that line might not be straight if any guidance is to be extracted from *Sportelli* as to the way in which the deferment rate might be built up at any periods between n and 20." (Transcript day 5, page 38, line 1)

It seems to us, looking at the *Sportelli* formula and the landlord's argument that any change in the RGR would be matched by a corresponding change in the RP for terms under 20 years, that, on Mr Munro's case, the only explanation for a sloping line on the graph would be that the RFR was changing over the period from year n to 20 years, either at a constant rate (straight line) or at a changing rate (curved line).

157. The Tribunal pressed Mr Munro on this point which led to the following exchange:

> "THE CHAIRMAN: But you have explained that growth and risk premium-- you don't change them because it is all self-cancelling. So they cannot be the reason for the changing line, the only thing that can then change the line is the risk free rate. It is logical, isn't it?
>
> MR MUNRO: So long as you take n and 5 per cent as your fixed points. As the Tribunal knows from the *Erkman* decision, he [*Mr Bezant*] would not have started at 5 per cent. He would have started at 3.6 per cent.
>
> THE CHAIRMAN: But you are asking us to draw a line between n and 20 and the rates move.
>
> MR MUNRO: I'm not asking you to draw a line between n and 20, I am saying that however you get from n to 20, you are below the 5 per cent and that's why I say that the Tribunal needs to consider long and hard whether there is evidence." (Transcript day 5, page 43 line 15 to page 44 line 5)

This exchange suggests to us that the landlord has no rational or consistent explanation for how this graph should be constructed or interpreted. It tells us nothing, in fact, about where the slope of the line begins, either in terms of time (relying as it does upon an unspecified value for n years until reversion), net rental yields (it being emphasised that the 3% used on the graph was only "illustrative") or in terms of where the line goes between the fixed points of 3% at n years and 5% at 20 years (it could be a straight line or a curve depending upon the value of the RFR). Furthermore, in answer to further questions from the Tribunal Mr Munro said of the graph:

> "… So it is not intended to enable the tribunal to issue guidance so that any party hereafter can say, 'We will find our spot on the line and that's what our deferment rate is going to be', it is not intended to do that, never was intended to do that." (Transcript day 5, page 45, line 7)

It seems to us that there is very little assistance to be obtained from the landlord's graph. As we said at the hearing, it is very much an advocate's tool to try and arrive at a result and was not supported by the evidence. It was not Mr Bezant's written evidence and it is not his theory (although it was he who illustrated it by preparing the graph). We are not persuaded by Mr Munro's submissions that the deferment rate cannot be higher than 5% in any of these appeals.

158. We therefore reject an approach which relies on Mr Bezant's use of net rental yields and the graph which Mr Munro submits supports the landlord's primary case. Accordingly, we revert to the position, which we described as the *prima facie* position in paragraph 148 above, that we should attempt to answer the preliminary issue in these appeals by using the *Sportelli* formula and assessing the value to be given to the inputs into that formula, following the direction that we should have regard to the property cycle at the valuation dates.

159. The first input into the formula which we will address is the RFR. At the outset of the hearing, it seemed to us that the parties were agreed that the RFR to be used in the *Sportelli* formula for these sub-20 year terms should be 2.25%, the same as for terms of 20 years or more. However, during the hearing the landlord's position did not seem to be quite so straightforward. Mr Munro said that the graph prepared by Mr Bezant and exhibited before the Tribunal on day 4 of the hearing showed a straight line drawn from the yield at year n (illustrated by, but not adopted as, a rate of 3% on the graph) to 5% (the *Sportelli* rate) at year 20. Mr Munro submitted that the risk free rate would alter over the shorter term (less than 20 years) resulting in the line from n years being a curve rather than a straight line. Mr Jourdan also said that as the unexpired lease term gets shorter and shorter, especially for the period below 10 years, there may well be a different risk free rate. He pointed out that the matter had not been investigated and that Professor Lizieri said that he had not looked at the risk free rate since he understood that it had been agreed at 2.25%. In his expert report Mr Bezant adopted this rate in respect of the unexpired terms in the current appeals. Neither party produced any evidence to establish what the risk free rate might be for shorter periods than 20 years. In the absence of such evidence we have adopted the *Sportelli* risk free rate of 2.25%.

160. The second point at issue regarding the inputs into the *Sportelli* formula relates to the amount of the RGR. In *Sportelli,* the Tribunal considered a large body of evidence and concluded that the appropriate RGR for terms of 20 years and more was 2%. Before considering what RGR should be adopted in the present appeals for sub-20 year terms, we will consider whether we should use this rate of 2% for terms of 20 years or more as a starting point. Mr Munro submitted that this rate was derived from a consideration of nationwide residential price movements and that more recent and specific evidence of price movements in PCL, based upon data published by Investment Property Databank Limited (IPD) which was not available to the Tribunal in *Sportelli*, established that there was "plenty of headroom in PCL and Central London above the 2% for our investor to take a view …" Any investor who adjusted the 2% downwards would always be outbid. Mr Munro submitted that the Tribunal's chosen real growth rate of 2% in *Sportelli* was based upon nationwide statistics and, given that the Court of Appeal said that it should not be used outside London if there was evidence to displace it, it should not be adopted in PCL if there was contradictory evidence. But the IPD evidence adduced by the landlord does not, in our opinion, satisfy this test. Neither of the landlord's witnesses relied upon it or apparently found the IPD evidence to be helpful and it was not accepted by Professor Lizieri who said that he did not know enough about IPD's methodology to draw any conclusions from the data. He also noted that IPD's residential database had only been created in 2001 and that it continued to grow.

161. Mr Clark, whilst not relying upon the IPD data, sought to rely upon the arguments about the PCL growth rate that he previously presented to the Tribunal in *Sportelli*. He stated that:

> "In my view in formulating their bids, potential purchasers would have regard also to the long run of the above inflation capital appreciation that the prime central London area had experienced over the previous 25 years."

He relied upon Savills' research for the prime central London south west flats area which showed that:

> "… the capital appreciation of flats in the PCL south west area, on average, outstripped inflation by 3.59% per annum over the 25 years to mid 2005."

This is 1.59% higher than the rate adopted in *Sportelli* and led Mr Clark to conclude:

> "In these circumstances, I consider that an investor purchaser, aware of the published market commentaries and also aware that if he were to be cautious in his level of bid he would risk losing to another investor taking an optimistic view, would be content to formulate his bid on the basis that real growth in the PCL SW flats area would revert to the *Sportelli* mean of 2% per annum over the remaining period to the reversion in 2023 of just under 17.5 years."

Under cross-examination Mr Clark said:

> "… The *Sportelli* rate of 2% is quite a cautious rate in the first place." (Transcript, day 4, page 149, line 4)

He went on to say that he expressed the view in *Sportelli* that the growth rate should be 2.5%.

162. We accept Mr Jourdan's submission that Mr Clark was seeking to revisit his evidence in *Sportelli* and to persuade this Tribunal that the real growth rate of 2% was too cautious for PCL. In *Sportelli* the Tribunal described this growth rate as realistic or neutral, not cautious, and in our opinion it unquestionably applied that rate to PCL. We are not satisfied that the evidence adduced before us, and that was not before the Tribunal in *Sportelli*, justifies any departure from that rate for terms of 20 years or more.

163. We therefore see no reason to depart from the *Sportelli* formula, or the adoption of an RGR of 2% for terms of 20 years or more, in PCL, as a starting point for the determination of the deferment rate in these appeals.

164. We next consider whether, for reversions less than 20 years, any change in the real growth rate above or below 2% would be matched by a change in the risk premium, thereby maintaining the deferment rate at 5%. The Tribunal in *Sportelli* concluded at paragraph [73] that it was a reasonable working assumption for leases with unexpired terms of more than 20 years that there would be an effective counterbalancing between the RGR and the RP such that the DR would not need to change according to whether the FHVP value was above or below trend. Below 20 years it stated at paragraph [85] that:

> "We accept … that the [deferment] rate would need to have regard to the property cycle at the time of valuation."

Mr Munro argued that such property cycles were of uncertain duration and extent and that it was not possible to say at the valuation date where one was in the cycle. He argued that the only way it was possible to take account of the property cycle was to adduce evidence that showed that there was a market consensus about the position in the cycle and that this influenced the bids and the price. The behaviour of the market after the valuation date was good evidence of whether the market thought that it was at the top of the cycle at that time. For example, why in 2005, if the market thought the top of the cycle was near, did prices continue to rise substantially over the next two years?

165. Mr Bezant said that it did not matter where one was in the property cycle because, in terms of the *Sportelli* formula, the risk premium and the real growth rate were coupled such that a movement in one would always be matched by a compensatory movement in the other. If a growth rate lower than 2% was expected because the market was currently above the long-term trend then the risk premium would decline by an identical amount to reflect the lower risk of meeting a reduced growth rate. The net impact on the deferment rate would be zero. This effect was identified by the Tribunal in *Sportelli* at paragraph [73] (previously quoted) in relation to long term reversions.

166. Mr Bezant said that we are looking at a freehold interest in perpetuity and its associated risks. These would not be affected by the length of the unexpired term of the lease. He said:

> "So let's say that we have some longer term statistics that we are happy with for risk and growth and we then want to say, 'what would I do in the short-term?' Then we get back to, if I was minded and confident enough to adjust those statistics, I would still have to be mindful of the interrelationship between risk and growth because it is not a relationship which breaks down at the short term. That is why prices of shares and things move, because as views of return move, so prices move, so you get the relevant return for the relevant risk. So the relationship does not break down at the short-term, which is why I say if you were minded to adjust one of these long-term statistics, then you need to be minded to adjust the other long-term statistic." (Transcript, day 4, page 17).

167. Professor Lizieri accepted that for long-term reversions changes in the expected growth rate would be offset (but not necessarily matched) by changes in the risk premium. He emphasised that this was "very much a long term concept". He elaborated upon this by saying:

> "These are long-run growth and long-run risk components of a particular type of asset, an asset class. When we are talking about adjusting the growth for a shorter period, because we are above the market or below the market, then that does not necessarily mean that our long term growth expectation has changed. The assumption here is that the investor has the same long term growth expectation, it is just that in this particular period, because we are above trend, above fundamental value, we have to make an adjustment to bring us back to trend, but that does not alter the investor's long term growth assumption and it is the long term growth assumption that is leading to the adjustment to that component of the risk premium that might relate to it."
> (Transcript, day 2, page 40)

168. We agree with Professor Lizieri that a distinction should be made between the long-term and short-term coupling of the growth rate and the risk premium. In the short-term we do not accept that such a relationship necessarily exists. An investor will take an informed view about the short-term growth prospect of an investment. If he believes a low growth rate is appropriate because the property cycle is above trend then he will increase his deferment rate accordingly. It does not make sense to us that, having taken such an informed decision about the short term growth rate, an investor would then negate that assessment by assuming that the risk of achieving that low growth rate would be reduced by the same amount. In our opinion the deferment rate would change to reflect the explicit, and separately identified, expectations about the short-term growth rate by comparison with the long-term trend. The argument that an investor would adopt the same short-term deferment rate regardless of whether the market was buoyant or depressed is,

in our opinion, unrealistic. What matters is not an accurate assessment of the timing of the peak of the property cycle but a reasoned identification of the position in the cycle compared with the long-term trend of value. In these appeals we accept the tenants' evidence that there had been a prolonged period of above trend growth and that at the valuation dates values were in the top half of the cycle.

169. Our conclusion is supported by the evidence of the expert valuers. The following exchange took place between the Tribunal and Mr Buchanan:

> "MR TROTT: … as a valuer, would you follow the line that Mr Bezant took, which was that if you are assuming a lower growth rate you would have this coupling effect with the risk premium and you would have a counterbalancing reduction in the risk premium such that the net effect on the deferment rate was zero … Would you adopt the same approach or would you either increase the risk premium, or decrease the growth rate without making an equivalent adjustment to the other factor?
>
> A. [MR BUCHANAN]: From a valuer's perspective I can see the logic and the reasons behind a lower growth rate, which came out of the Calthorpe decision, but what I would not do is to make a corresponding adjustment to the risk premium … You would factor in your adjustment on one or other of the figures, but not both.
>
> … My preference would be to look at the growth rate rather than the risk premium." (Transcript, day 4, pages 123 to 125).

170. In cross-examination Mr Clark gave his opinion on the same issue:

> "MR JOURDAN: There is an issue between us as to whether that counter balancing effect has to apply below 20 years. We say, as you know, that paragraph 85 of *Sportelli* which says you have to have regard to the property cycle below 20 years means that it does not apply below 20 years. So if you can assume that *Sportelli* does not require a matching below 20 years and you are allowed to consider it free from the *Sportelli* guidance, would you, as a valuer, looking at a property which has a prospect of real growth of 1.5 per cent rather than 2 per cent, value it at the same price as if it had a prospect of growth of 2 per cent?
>
> A. [MR CLARK]: I think the investor probably would be more cautious. I think that there is a point on paragraph 85 when you look at the property cycle, I think that you have to look at certain elements of the *Sportelli* formula in totality because different parts might have an influence in different parts of the property cycle, but I accept that he probably would be a little bit more cautious if he perceives that his growth rate is going to be lower.
>
> Q. He would pay a lower price?
>
> A. Yes, in effect, I think he probably would, because he is anticipating that on reversion he would be achieving a lower figure, but then, I think, he would have to be fairly cautious against how that lower growth rate has been achieved, because the *Sportelli* rate of 2% is quite a cautious rate in the first place."
> (Transcript, day 4, pages 148-149)

171. We conclude that, in the short term, the *Sportelli* formula can be adjusted to reflect the fact that, at the valuation dates, the residential property market was above its long-term trend line of a real growth rate of 2% (or, as Professor Lizieri described it, the equilibrium position). Our preference is to adjust the growth rate rather than the risk premium, although the effect on the deferment rate will be the same. We note that in *Zuckerman and Others v The Trustees of the Calthorpe Estates* [2009] UKUT 235 (LC) the member, N J Rose FRICS, adjusted the risk premium rather the growth rate. This may be because in *Sportelli* the Court of Appeal said at 2170B, [102]:

> "However, it is possible to envisage other evidence being called, for example, on issues relevant to the risk premium for residential property in different areas."

In these appeals the evidence focused upon the growth rate and we see no advantage in, or necessity for, adjustments to the risk premium instead.

172. Professor Lizieri's general approach to the assessment of the real growth rate for unexpired terms of less than 20 years (and the consequent deferment rate) faces three main criticisms. Firstly, the landlord argues that Professor Lizieri's source material, which he uses to determine the point in the property cycle at the valuation date, is not used by the market. Indeed Mr Buchanan confirmed in cross-examination that he had not previously seen several of the sources upon which Professor Lizieri relied. We do not accept this criticism. The market may well not have regard to much of this material when determining the freehold vacant possession (FHVP) value of the appeal properties at the valuation date, but that is not what we are required to ascertain. We are concerned with the deferment rate to apply to a freehold reversion. This is a different type of investment, fairly described by Mr Jourdan as essentially a property futures contract. There is no comparable evidence upon which we can rely and we consider that Professor Lizieri's approach, using a variety and depth of economic and market commentaries, is reasonable. It provides, in our opinion, a fair and balanced analysis of where the FHVP values of the appeal properties, as established in the market, lie in comparison with a long term trend of capital values.

173. The results of that analysis suggest that a figure of 15% above that trend was reasonable in 2005. Professor Lizieri has adopted the figure of 15% for all the valuation dates in these appeals. Those dates range from 22 June 2005 (No.38) to 29 August 2007 (No.31). The landlord's second main criticism is that it is not appropriate to take the same figure for valuation dates in 2005 and also in 2007. In cross-examination Professor Lizieri explained why he had kept this figure constant for all the valuation dates:

> "Q. [Mr Munro] That 15 per cent is applied to different valuation dates spread across two years. How wide a spread would you go with that 15 per cent before you said to yourself 15 per cent is not right?
>
> A. [Professor Lizieri] The balance of the evidence in 2005 drew me to 15 per cent. The balance of the evidence in 2007, the fundamental models were showing, as I recall, there were estimates showing higher numbers but I was still relying perhaps on the OECD numbers, the IMF numbers and various other forecasts. I tempered that and retained the 15 per cent assumption because I felt that many investors might be influenced by the fact that the process had continued to grow between 2005 and 2007. So the increase in prices above their trend level was tempered by the optimism that that might engender.

Q. Is the short answer to my question that you chose the 15 per cent because that was right for your early valuation dates and you saw no reason to depart from it for your later valuation dates?

A. Yes, in the sense that that was my view of what an informed investor would think.

Q. Have you formed any view for how long on either side of our valuation dates that 15 per cent would hold good?

A. It would depend on what had happened in the property market.

…

In my view it would not apply to a market in 2009.

Q. Is that because the market in 2009 is now below trend, at trend or above trend but less than 24, 26 or 30 per cent?

A. Based on the fact that one had seen a 28 per cent real fall in values which must have made an adjustment to the position relative to trend." (Transcript, day 2, page 57 line 10 to page 59 line 3)

174. In our opinion, just as the 28% real fall in values from 2007 to 2009 merited an adjustment to the position of the FHVP value relative to trend, so too did the sharp increase in values between June 2005 and August 2007 (approximately 25%). Mr Jourdan referred to "massive growth in 2006" (Transcript, day 5, page 143, line 9). Mr Munro said that:

"…evidence after the valuation date is evidence that at the valuation date people did not think that they were at the top of the cycle, they kept bidding it up. So for – take the 2005 dates. It is said: oh, we think that we are at the top of the cycle or very close to the top of the cycle, there may not be as much growth in the future. Then if that was right, if that was the perception, why did the market keep growing and growing substantially for the next two years. That's why the evidence is relevant because it shows that there is this complete mismatch between what Professor Lizieri says the rational investor should do at the valuation dates in 2005 and 2007." (Transcript, day 5, page 35, line 7)

We accept Mr Munro's submission on this point. In our opinion a prospective purchaser considering the PCL market in August 2007 would not form the same view about the position of the FHVP value relative to trend as he would have done in June 2005. The market in 2007 would have been perceived as being further above that trend. We consider that Professor Lizieri's figure of 15% above trend in 2005, and which he described as a blend between the more pessimistic view of market fundamentals and the more optimistic view of market commentators, is reasonable. As Mr Jourdan pointed out, nobody else has put forward a different estimate. But we would have great difficulty in accepting that it would remain an appropriate estimate by 2007. If we were to adopt Professor Lizieri's method of calculating the real growth rate and the consequent deferment rate, then it may be that we should not allow the tenants to contend for a figure of more than 15% by which the market was above trend in 2007. However, as will be seen, we do not ultimately adopt Professor Lizieri's method. Instead, we consider the result which would be arrived at in negotiations between the hypothetical parties so as to reflect market forces at the relevant valuation dates. It is not necessary for our approach to make a precise finding on the question: what is the correct percentage in 2007 if 15% were the correct percentage in 2005. Our method involves us in assessing the state of the market at the different valuation dates. For that purpose, we will make our decision based on the evidence which has been put before us by both sides.

175. The third main criticism levelled at Professor Lizieri's approach, and one with which we also agree, is that his assumption that the market value will always return to the equilibrium position by the term date, regardless of the length of the unexpired term, is unrealistic. In cross-examination Professor Lizieri said:

> "I am not saying, let me be clear, that the necessary position at the end of the term date is that the value will be at its trend or fundamental value. What I am doing is looking at the problem from the investor's perspective to say what is their best estimate. Their best estimate, given that – because it might be above or below that trend, their best estimate is that they will be on that trend." (Transcript, day 2, page 22, line 12)

We do not accept that an investor would necessarily reach that conclusion. It seems to us that an investor on any given date would make an informed and objective assessment about when the market would return to the trend line. That judgment would not be influenced by the length of the unexpired term of any particular investment. In our opinion it is not plausible that an investor, when considering at the same date two investments with different unexpired terms, would treat the return to trend as a function of lease length. To do so would mean that there would be a different estimate about when the trend would be regained in every case and we do not consider that to be realistic. Although Professor Lizieri used the word "estimate" when describing this point, in truth, he did not make an estimate as to what the future would hold but rather he made an assumption that the FHVP would revert to equilibrium at the term date, whenever that date might be. Such an assumption is necessarily an arbitrary one.

176. The effect of Professor Lizieri's assumption about the return to the equilibrium position, when coupled with the *Sportelli* formula for leases with 20 years or more to run, is to produce a deferment rate graph that drops suddenly from 5.71% at just under 20 years to 5% at 20 years. Mr Munro says that this would create an arbitrage opportunity with the market exploiting this (artificial) discontinuity. Mr Clark gave a telling example by applying the tenants' pleaded deferment rate of 5.8% to a property with a 17.5 year unexpired term and comparing it with an identical property with a 20 year unexpired term but which, according to *Sportelli*, would have a 5% deferment rate. The anomalous result is that the 20 year reversion would enjoy the higher net present value.

177. Professor Lizieri proposed a way of smoothing out the discontinuity in the deferment rates by adjusting the risk premiums. But he said that there was no economic foundation for making such adjustments and he did not favour this approach. Mr Jourdan suggested that the figures used when calculating this alternative method "were produced in something of a hurry" and that given more time they could have been refined. But Professor Lizieri repeated these calculations more recently when commentating upon a different approach suggested by the Tribunal (see paragraph 180 below). We agree with Professor Lizieri's reservations and we reject this variation of his method.

178. At this point, it is appropriate to consider the legal submission made by Mr Jourdan based on the observations of Lord Hoffmann in *South Australia Asset Management Corporation v York Montague Ltd* [1997] AC 191 at 221F – 222A. In that case, what the court had to determine was what would have happened at a time in the past if the surveyor had not been negligent. In a case where there were different possible valuations within a range of valuations, the court held that the most likely thing which would have happened was a valuation at the mid point of that range. In the present case, the position is different. The question involves a prediction as to what will happen in, say, 15 years or 17 years time. There is no certainty as to these future events. No finding can be made as to the existence of a range with a top and a bottom or a middle. The equilibrium position is not the mid point of a range that must occur. Accordingly, we do not accept that we are bound as a matter of law to predict that at the term date, whether that date is 15 years or 17 years away, or at any other date, that the FHVP value will always be at an equilibrium level at every one, or any one, of those dates.

179. Professor Lizieri also considered in a supplementary report an approach whereby an informed investor would assume that values would revert to their fundamental, trend levels at year 20 rather than at the term date. He concluded that:

> "… then there would be a single deferment rate applying to all properties deemed to be a certain amount above (or below) their fundamental level. For a 15% over valuation, that produces a deferment rate of 5.7% … that does, though, mean that there is a discontinuity before and after the 20 year term date set by *Sportelli*."

180. After the hearing, the Tribunal considered whether it was possible to devise a formula which could build upon the approach taken by Professor Lizieri, in respect of leases with terms below 20 years, as to the extent to which the FHVP value is above the equilibrium position at a particular date but which would also reflect the *Sportelli* formula in respect of leases with terms of 20 years and above and which would avoid a stepped change in the deferment rate at the 20 year point. The Tribunal developed a formula that was based upon the assumption that the FHVP value would return to its equilibrium position after 20 years since, following *Sportelli*, this is the period after which property cycles need not be taken into account. The formula produced results that avoided the discontinuity after 20 years that had been identified by Professor Lizieri. The method was sent to both parties to enable them to make submissions on such an approach. Neither party considered it to be a satisfactory solution. The tenants pointed out that it did not achieve a position where the predicted growth would return the FHVP value of the property to its equilibrium value over 20 years and that it presented significant other difficulties. In short, like Professor Lizieri's alternative method that varied the risk premium, it lacked a clear economic rationale. The landlord argued that there was no evidence from which the Tribunal could determine that equilibrium would be achieved after 20 years and that the method was based upon assumptions that did not describe a view of the property cycle as at the date of valuation. We accept these criticisms and we do not pursue our alternative method further.

181. Having considered Professor Lizieri's alternative approaches and having given considerable thought to the possibility of devising a formula which would allow a seamless transition for terms below 20 years to terms of 20 years and above, we are driven to the conclusion that there are difficulties in any formulaic approach. Those difficulties are centred on the determination of the FHVP value with respect to its equilibrium position, the length of time that it will take to return to trend and the discontinuity in the deferment rate that will occur, to a greater or lesser extent, at 20

years when the *Sportelli* deferment rate of 5% will apply. Mr Jourdan submits that such a discontinuity is the inevitable consequence of the "broad brush approach" adopted in *Sportelli* and that the Tribunal in that appeal demurred from "fine tuning" its results, for example in its approach to the generalised 0.25% addition to the risk premium for flats. Mr Jourdan concluded:

> "…So if you get a quarter per cent or a half per cent or a three quarter per cent step [at] 20 years, that is simply a reflection of the *Sportelli* method. You have to draw the line somewhere between long-term and short-term and when you are in the short-term and you are having regard to the property cycle you may get a different deferment rate. It may be higher or it may be lower but that is simply an inevitable consequence of applying the guidelines faithfully, which we all have to do." (Transcript, day 5, page 156, line7)

In our opinion the only way that such a discontinuity can be avoided is by using a formula that mathematically smoothes the deferment rate transition at 20 years. We reject all such approaches because they are not economically justified.

The approach to be adopted

182. Having rejected Mr Munro's net rental yield graph and, with some reluctance, the approaches, and their alternatives, put forward by Professor Lizieri, there remains one approach open to us on the evidence. This was espoused by Mr Buchanan before the LVT and relies upon the exercise of valuation judgment. The LVT in 23 Cadogan Square said that:

> "10.5…Mr Buchanan contends that a deferment rate of 5.5% should be applied in this case in order to reflect the risk that at the end of the term the property cycle would be at a lower level."

In cross-examination Mr Buchanan accepted that he had spoken to a deferment rate of 5.5% in each of the three cases with which he was concerned before the LVT (Nos.23, 38 and 42). The valuation dates in those three cases were all in 2005. Mr Buchanan also agreed that he had described the 0.5% uplift from the Sportelli deferment rate of 5% as a "modest adjustment". The LVT in No.23 rejected this argument saying that Mr Buchanan "has not made out a convincing case for departure from the figure of 5% upheld by the Lands Tribunal in Sportelli…" The LVT in Nos. 38 and 42 apparently ignored his evidence on the point and failed to address it in terms. Mr Buchanan said before us that any adjustment in the deferment rate that was made by exercising valuation judgment "would tend to go by a quarter of a per cent" and not by smaller gradations.

183. Mr Jourdan accepts that it is open to us to have regard to the property cycle at the valuation date by exercising valuation judgment, though he says:

> "But that does have a disadvantage, which is it is somewhat subjective, although perhaps no more subjective than many other adjustments the valuers have to make and it would be open to this tribunal to say it is a difficult matter, it is a subjective matter, doing the best we can, we think this is the right adjustment to make and give no further analysis than that. That isn't the course that we are inviting the tribunal to take but it is a possible course.

> …
>
> So we have the valuation approach, which has the merit of simplicity, the attraction that it doesn't really require anything much more than licking your finger and putting it in the air [and] has the disadvantage in that it is very difficult to predict which way the wind is blowing by using that particular technique." (Transcript, day 5, page 136, lines 9 to 18 and page 140, line 25)

184. At the hearing we suggested that the choice of a deferment rate for terms under 20 years would result from negotiation between the parties and would reflect their views, informed by professional valuation advice, about the position of the FHVP value in the property cycle as at the valuation date. Mr Jourdan said that had the point been put to Professor Lizieri he would have said that his figure of 15% above trend (at all the valuation dates) was cautious and that it was only half of the growth rate at that time:

> "So in this hypothetical negotiation, the seller is saying 5 per cent and the buyer is saying 6.5 per cent and 5.8 per cent is itself the mid point of that negotiation." (Transcript, day 5, page 140, line 7)

185. Professor Lizieri said that his choice of 15% above trend was a blend of market fundamentals (pessimistic) and market commentary (optimistic). It was not presented as a negotiated outcome and we do not understand it in that way. In our opinion the 15% may be a reasonable estimate of where the market stood in relation to its equilibrium position as at June 2005 (but not right in relation to the valuation dates in 2007). In those circumstances, we now consider how the parties would negotiate about future capital growth. We do not consider that the vendor landlord could sustain an argument that the growth rate would continue at its long term level of 2% and, in 2005, the purchaser would not have been able to establish objectively that there was no prospect of further growth. In our opinion the growth rate in respect of No. 38 (valuation date 22 June 2005) would have been agreed at something below 2%. Doing the best we can on the evidence before us, we conclude that the parties would have settled on a real growth rate of 1.75% and the deferment rate, based upon the *Sportelli* formula, would be agreed at 5.25%. The market was stable between June and December 2005 (rising by less than 1.4%) and we consider that 5.25% would also be the negotiated deferment rate in respect of No.23 (valuation date 3 October 2005) and No.42 (valuation date 29 November 2005).

186. During 2006 the market increased dramatically, rising by 15%. It continued to grow by another 8% by September 2007. A purchaser considering buying the reversion on No.37 (valuation date 19 February 2007) or No.31 (valuation date 29 August 2007) would, in our opinion, be in a stronger position to argue successfully that the future growth in capital values would be less than 1.75%, the appropriate figure some two years earlier. Again, doing the best we can on the evidence before us, we consider that the parties in these two cases would agree that the growth rate would be 1.5% and that the deferment rate should therefore be 5.5%.

187. The evidence which was tendered in these cases, and the submissions which were made to us, have tended to complicate the issues arising. Of necessity, we have had to deal with that evidence and those submissions and that may have given the misleading impression that there is something complex about the exercise which we conclude is appropriate in order to determine the

outcome in these cases, and in cases like them. We therefore feel that it is appropriate to summarise the approach which we consider to be appropriate in order to demonstrate that it is a relatively simple one and that it proceeds on conventional valuation lines.

188. We have adopted the *Sportelli* formula as a starting point. We have asked ourselves whether, on the evidence, the position in the property cycle at the valuation dates should lead to a change in one or more of the components in that formula. No party suggested that the evidence as to the position in the property cycle justified an alteration to the risk free rate in the formula. We have concluded that with the unexpired terms in the present cases, it is not appropriate to regard the real growth rate and the risk premium as coupled together. It may be appropriate to adjust one of the components (the real growth rate or the risk premium) but not both. In a case where the argument has been about expected growth rates, the obvious component to consider is the real growth rate. In selecting the real growth rate to be used in the formula, it is important to remember that one is attempting to value a property interest and, furthermore, to do so by assessing what hypothetical parties in the open market would arrive at as a result of a negotiation. We also consider that when the Tribunal in *Sportelli* held that it was appropriate to adopt a generic deferment rate of 4.75 % (for houses) and 5% (for flats), the Tribunal was in effect holding that hypothetical parties in the open market negotiating a purchase of a reversion subject to a lease or leases of 20 years, would agree that the appropriate real growth rate was 2%. In a case where the unexpired terms are below 20 years, the hypothetical parties would know how the negotiations would have proceeded if the terms were equal to 20 years and (in a case where the growth has been above the trend) it would be the purchaser who would need to persuade the hypothetical willing vendor that the position in the property cycle at the valuation date should lead to some adjustment to the expected real growth rate (and the consequent deferment rate).

189. We add these further observations about this approach to determining the deferment rate:

(i) The question of what the parties would agree in their hypothetical open market discussion is a valuation question. Our method of answering that question involves the use of valuation judgment. Although any valuation judgment involves a subjective element, that element does not invalidate the judgment or render its use inappropriate.

(ii) The approach reflects both the position of the FHVP value in relation to trend at the valuation date and the length of the unexpired term.

(iii) Unlike Professor Lizieri's approach, the approach does not produce deferment rates that vary mathematically and precisely according to the lease length. Our method produces deferment rates that are applicable for terms of under 20 years such as those in the range in the present cases (from 15.6 to 17.8 years). Our method selects a real growth rate, and the consequent deferment rate, by reference to the evidence of market conditions at the valuation dates in question.

(iv) We accept Mr Buchanan's view that a negotiated settlement between the parties would not be finessed below 25 basis points.

(v) We will separately discuss, below, the application of our approach where the reversion is subject to unexpired terms which are only a little shorter than 20 years. That discussion shows that our approach will probably avoid a stepped change between the price for the reversion where the unexpired term is just under 20 years and the price for the reversion in a case where the unexpired term is 20 years.

(vi) All the other attempts made by the parties, or by ourselves, to eliminate the possibility of a stepped change between terms of under 20 years and terms of 20 years and more, by introducing a mathematical solution, lacked economic justification. We do not consider that such a solution is appropriate.

(vii) The approach is suitable for use with lease lengths of 10 to 20 years. Below 10 years Professor Lizieri said, and we accept, that different questions arise, in particular as to whether the risk free rate adopted in *Sportelli* would remain appropriate and whether a forecasting model should be used. Such considerations were not explored during the hearing. We also accept that for very short unexpired lease terms the possibility of using net rental yields as a guide to the deferment rate should be examined more closely.

190. We referred earlier to the difficulty of combining whatever approach is adopted in order to determine the deferment rate for terms of under 20 years with the adoption of the *Sportelli* formula for terms of 20 years and over. If the deferment rate for terms of under 20 years is above 5% (where growth in the market has been above trend), does one nonetheless reach the conclusion that for an unexpired term of, say, 19.5 years, one takes the figure which is above 5% and then with an unexpired term of 20 years, one takes the figure of 5%? As was pointed out at the hearing, where the market is above trend and the deferment rate is above 5%, this could produce the result that a reversion on an unexpired term of below 20 years is valued at less than a reversion on an unexpired term of 20 years. Having made our determination of deferment rates of 5.25% for 2005 (for terms between 17.3 and 17.8 years) and 5.5% for 2007 (for terms of 15.6 and 16.1 years), this problem does not arise as the present values at the valuation dates of the reversions are above the present values at those dates of a reversion which is subject to an unexpired term of 20 years deferred at 5%. Nonetheless, we will offer our views as to how our approach may well remove a stepped change in the price for the reversion as the length of the unexpired term gets nearer to 20 years.

191. In this context, we restate that our approach involves predicting the outcome of notional negotiations. If a purchaser buying a reversion on a lease with an unexpired term of under 20 years offered a price for the reversion which was less than the price which would be appropriate (following the *Sportelli* guidance as to how the market would behave in relation to a reversion on a 20 year term) for a reversion on a 20 year term, then one can confidently state that the vendor would not accept that lower price. In order for the parties to be persuaded to reach an agreement, the purchaser must offer at least, and probably something more than, the price which would be appropriate for a reversion on a 20 year term. Thus the price for a reversion on a 20 year term (arrived at in accordance with the *Sportelli* guidance) will be a floor for the price for a reversion on a term of under 20 years where the deferment rate is above 5% for the shorter term. So although there may be a stepped change in the deferment rate (on our findings in 2007, from 5.5% to 5%) there will not be a corresponding stepped change in the price for the reversion because this step will be smoothed by arms length negotiations on price.

192. There remains one further issue. In the case of 31 and 37 Cadogan Square, the Tribunal (HH Judge Huskinson and A J Trott FRICS) has already determined that, at the valuation date for those

properties, the freehold value should include an element to reflect the prospect of a development of the relevant property by a way of a reconversion of the property from one containing several flats back to a single house. The landlord submits that the result of that finding should be that we should adopt a deferment rate appropriate for the relevant property considered as a house rather than as flats. The tenants submit that this involves a *non sequitur*. They submit that the change in the generic deferment rate in *Sportelli* from 4.75% for a house to 5% for flats was to reflect one thing only, namely, the possibility of management problems during the unexpired terms: see *Sportelli* at [95] – [96], which we have quoted above. The tenants submit that the possibility of management problems exists with 31 and 37 Cadogan Square during the unexpired terms and what happens at the end of those terms, and in particular, whether there is then the potential of conversion from flats to a house is irrelevant to the period before the term date. It seems to us that the tenants are self-evidently right on this point. The deferment rates under consideration should in every case, including 31 and 37 Cadogan Square be those applicable to flats rather than houses.

The precedent effect of this decision

193. Earlier in this decision, we drew attention to the fact that the Tribunal in *Sportelli* consciously laid down guidelines as to the deferment rate to be adopted for unexpired terms of 20 years or more. That approach was welcomed and endorsed by the Court of Appeal in that case. The Court of Appeal referred to the coming into being of the Upper Tribunal (Lands Chamber), the Tribunal which is hearing the instant appeals. The Court of Appeal stated that it would be for the Upper Tribunal, as a superior court of record, to lay down guidelines as to the precedent effect of its decisions.

194. We will take up the invitation of the Court of Appeal to state what we consider should be the precedent effect of this decision.

195. We consider that all of the reasons that led the Tribunal in *Sportelli* to consider it desirable and appropriate to lay down guidelines in that case apply with equal force in this case. We consider that the approach which we have identified in paragraph 188 above, together with the further observations in paragraphs 189 to 191 above, should have the same effect in future cases as the guidelines in *Sportelli* itself. As we made clear above, our approach in these cases should be adopted when determining the deferment rate for unexpired terms from 10 years up to (but not including) 20 years, in PCL. As regards terms of less than 10 years, the method used in this decision should be the starting point for the determination of the deferment rate.

The result

196. The deferment rates to be adopted in these appeals are as follows:

(1) 23 Cadogan Square – 5.25%;

(2) 31 Cadogan Square – 5.5%;

(3) 37 Cadogan Square – 5.5%;

(4) 38 Cadogan Square – 5.25%;

(5) 42 Cadogan Square – 5.25%

Dated 3 December 2010

The Honourable Mr Justice Morgan

A J Trott FRICS