LRA/114/2006
LRA/47/2007
LRA/89/2007
LRA/90/2007
LRA/106/2007

LANDS TRIBUNAL ACT 1949

LEASEHOLD ENFRANCHISEMENT – intermediate leasehold interests – how to be valued – Leasehold Reform, Housing and Urban Development Act 1993 Schedule 13 paras 6, 7 and 8

IN THE MATTER OF APPEALS AGAINST DECISIONS OF THE LEASEHOLD VALUATION TRIBUNAL OF THE LONDON RENT ASSESSMENT PANEL

BETWEEN	**NAILRILE LIMITED**	**Appellant**
	and	
	(1) EARL CADOGAN **(2) WILLIAM HALLMAN AND NANCY HALLMAN**	**Respondents**

Re: Flat 2, 12 Sloane Gardens, London SW1W 8DL
(LRA/114/2006)

BETWEEN	**DAEJAN PROPERTIES LIMITED**	**Appellant**
	and	
	(1) THE TRUSTEES OF THE EYRE ESTATE **(2) VARIOUS LESSEES**	**Respondents**

Re: Regency Lodge, Adelaide Road, London NW3 5EE
(LRA/47/2007)

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BETWEEN **GULU LALVANI AND OTHERS** **Appellants**

and

(1) EARL CADOGAN **Respondents**
(2) CADOGAN ESTATES LIMITED

Re: 62 Cadogan Square, London SW1X OEA
(LRA/89/2007)

BETWEEN **METROPOLITAN PROPERTIES CO (FGC) LIMITED** **Appellant**

and

(1) TERENCE GEORGE KINGSTON **Respondents**
(2) CYNTHIA MARGARET HAYNES

Re: Flat 8, Elms Court, Montagu Road, London SW19 1SZ
(LRA/90/2007)

BETWEEN **UAE INVESTMENTS LIMITED** **Appellant**

and

(1) ALIM INVESTMENTS LIMTIED **Respondents**
(2) THE COMMISSIONERS OF THE EXHIBITION OF 1851

Re: Flat 32, Albert Hall Mansions, Kensington Gore, London SW7 2AL
(LRA/106/2007)

Before: The President and A J Trott FRICS

Sitting at Procession House, 110 New Bridge Street, London EC4V 6JL
On 16-20, 23 and 25-27 June 2008

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Philip Rainey and *James Fieldsend* instructed by Wallace LLP for Daejan Properties Limited, Metropolitan Properties Co (FGC) Limited and UAE Investments Limited; by Forsters LLP for Nailrile Limited; and by Goodman Derrick LLP for Gulu Lalvani and Others

Nicholas Dowding QC and *Mark Sefton* instructed by Pemberton Greenish for Earl Cadogan and Cadogan Estates Limited

Anthony Radevsky instructed by Pemberton Greenish for The Trustees of the Eyre Estate and by Farrer & Co LLP for The Commissioners of the Exhibition of 1851

Timothy Harry instructed by Portner and Jaskel LLP for the Regency Lodge Lessees

The following cases are referred to in this decision:

Visible Information Packaged Systems Ltd v Squarepoint (London) Ltd [2000] 2 EGLR 93
Cadogan v Sportelli [2006] RVR 382
Railtrack plc v Guinness plc [2003] 1 EGLR 124
Woozley v Woodall Smith [1950] 1 KB 325
Compton Group Ltd v Estates Gazette Ltd (1978) 26 P & CR 148
Fawke v Viscount Chelsea [1980] QB 441
R (on the application of Edison First Power) v Central Valuation Officer [2003] 4 All ER 209
Jones v Wrotham Park Settled Estates sub nom Wentworth Securities Ltd v Jones [1980] AC 74
Ghaidan v Godin-Mendoza [2004] 2 AC 557
Craven (Builders) Limited v Secretary of State [2000] 1 EGLR 128
F R Evans (Leeds) Limited v English Electric Co Limited (1977) 36 P & CR 185
Arrowdell Limited v Coniston Court (North) Hove Limited [2007] RVR 39
Arbib v Earl Cadogan [2005] 3 EGLR 139
Henry Smith's Charity Kensington Estate Trustees v Frampton [1985] 1 EGLR 239
Cadogan Holdings Limited v Pockney [2004] LRA/27/2003 unreported
Langinger v Cadogan LRA/46/2000 unreported

The following further cases were referred to in argument:

Jones v Wentworth Securities [1980] AC 74
Moseley v Hickman [1986] 1 EGLR 161
Szoma v Secretary of State for Work & Pensions [2006] 1 All ER 1
Hoare (VO) v National Trust [1999] 1 EGLR 155
James v UK (1986) 8 EHRR 123
Majorstake v Curtis [2008] 2 WLR 338
Howard de Walden v Aggio [2008] Ch 28
Wilson v First County Trust (No.2) [2004] 1 AC 816
Holy Monasteries v Greece (1994) 20 EHRR 1
Lithgow v UK (1986) 8 EHRR 329
Mellacher v Austria (1989) 12 EHRR 391
Papachelas v Greece (1999) 30 EHRR 923
Hentrich v France (1994) 18 EHRR 440
R (Gillan) v Commr of Police for the Metropolis [2006] AC 307

Vogt v Germany (1995) 21 EHRR 205
Fitzpatrick v Sterling Housing Association Ltd [1999] 4 All ER 705
Pepper v Hart [1993] AC 593
Fraser Pipestock v Gloucester City Council [1995] 2 EGLR 90
Shortlands Investments Ltd v Cargill plc [1995] 1 EGLR 51
Lloyds Bank Ltd v Lake [1961] 1 WLR 885
Dennis & Robinson Ltd v Kiossos Establishment [1987] 1 EGLR 133
Gray v IRC [1994] 2 EGLR 185
Nicholson v Goff [2007] 1 EGLR 83
Re Castlebeg Investments (Jersey) Ltd's Appeal [1985] 2 EGLR 209
Ryde International plc v LRT [2004] 2 EGLR 1
Customs and Excise Commrs v Cantor Fitzgerald International [2002] QB 546
Lloyd Jones v Church Commissioners [1982] 1 EGLR 209
Northern Electric v Addison [1997] 2 EGLR 111
Walton v Inland Revenue [1996] 1 EGLR 159
Trocette Property Co v GLC (1974) 28 P & CR 408
Wellcome Trust Ltd v Romines [1999] 3 EGLR 229
Re Westminster Property Group [1984] 1 WLR 1117
Simpson v Connolly [1953] 1 WLR 911
Robshaw Bros Ltd v Mayer [1957] 1 Ch 125
Lloyds Bank v Lake [1961] 1 WLR 885
Shortlands Investments v. Cargill [1995] 1 EGLR 51
Fitzpatrick v Sterling Housing Association [1999] 4 All ER 705
J A Pye (Oxford) v Graham [2005] 3 EGLR 1
Mason v Totalfinaelf UK Ltd [2003] 3 EGLR 93
National Westminster Bank plc v. Co-operative Wholesale Society [1995] 1 EGLR 97
Brown v Gloucester City Council [1998] 1 EGLR 95
Pitts & Wang v Earl Cadogan [2007] RVR 272
Raja Vyrcherla Narayana Gajapatiraju v Revenue Divisional Officer, Vizagapatam (The Indian Case) [1939] AC 302
A-G of Ceylon v Mackie [1952] 2 All ER 775
Carl v Grosvenor Estate Belgravia [2000] 3 EGLR 79

The following LVT decisions were referred to:

Sussex Lodge Freehold Ltd v Church Commissioners for England LON/ENF/1173/04 (17 November 2005)
SCMLLA v Gesso Properties (BVI) Ltd LON/00BK/OCE/2007/0070-71 (21 December 2007)
Weiss v Shawview International Ltd LON/NL/604/98 (4 August 1999)
Podd v Howard de Walden Estates LON/NL/1407/01 (18 May 2001)
Lee and Blackmun v The Portman Estate CAM/93/LVT/NL/013 (2004)
Norman Sinclair Properties Ltd LON/NL/1890-1909/03 (20 August 2003)
Matley v Liddell LON/NL/4573&4577/05 (4 June 2006)
Cadogan v Panagopoulos LON/NL/464/06 (18 September 2006)
Cadogan v Newman LON/NL/2275/03 (29 January 2005)
Chawdhary v HC Jones & Co (Surrey) Ltd LON/NL/3583, 3584 and 3585/04 (27 October 2005)
Grosvenor West End Properties v Harrison [2006] (LON/LVT/1807/2004)

INTERIM DECISION

Introduction

1. These appeals arise from applications made to leasehold valuation tribunals under section 48 of the Leasehold Reform, Housing and Development Act 1993 to determine the terms of acquisition of new leases to be granted under the Act. Under Chapter II of Part I of the Act (in which section 48 appears) the "qualifying tenant" of a flat held on a long lease has the right to acquire, in substitution for his existing lease, a new lease at a peppercorn rent for a term expiring 90 years after the term date of the existing lease. He does this by serving notice on the person who is the "competent landlord" and following the statutory procedures that lead to the grant of a new lease by that person on payment by the tenant of a premium determined under the Act. The "competent landlord" is the owner of an interest in the flat that fulfils two conditions: firstly that it is an interest in reversion expectant (whether immediately or not) on the termination of the tenant's lease; and secondly that it is either a freehold interest or a leasehold interest of sufficient duration to enable the new lease to be granted.

2. There may, of course, be interests intermediate between those of the tenant and the competent landlord, ie leases that expire after the term date of the existing lease but before the term date of the new lease. The Act makes provision for these intermediate leasehold interests in terms of procedure and the payment to be made to the owners of them. An intermediate interest is not extinguished. It continues, shorn of the expectation of possession on its termination but with the obligation to pay rent continuing. Procedurally the competent landlord acts on behalf of the owner of the intermediate interest in relation to proceedings under the Act, except that the owner of the intermediate interest is entitled, on giving the requisite notice, to be separately represented in any legal proceedings, including those for the determination of the amount that is payable to him.

3. A number of particular features of intermediate interests are to be noted. The first is that an intermediate interest is frequently an interest that is not confined to the flat in issue but includes other flats in the same building. Secondly the existing value of an intermediate interest may be very small, typically where the reversion is for a short period and the rent payable to the owner of the intermediate interest is the same or little more than the rent payable by him. Thirdly, because every owner of an intermediate interest loses the expectation of possession of the flat and the owner of the intermediate interest immediately superior to the lease of the qualifying tenant loses his entitlement to rent but remains liable to pay rent to his landlord, the value of the interest after the grant of the new lease will often be negative.

4. It may be helpful if we adopt a defined vocabulary for the purposes of this decision. The "competent landlord", ie the grantor of the new lease, may be the freeholder or he may be a leaseholder. In each of the present cases the competent landlord is the freeholder, and we will therefore refer to him as such. There may be more than one intermediate leaseholder, but in none of the present cases is there more than one. We will refer to the intermediate leaseholder

in each case as the leaseholder. The tenant we will refer to as the tenant: so that the three parties in each case are referred to as freeholder, leaseholder and tenant. The interest of the leaseholder in each case includes not only the particular flat for which a new lease is granted but other flats as well. We will use the term the intermediate lease when referring to the entirety of that interest and the term the ILI when referring to the leaseholder's interest in the subject flat.

5. The amount payable to the owner of an ILI is determined in accordance with Part III of Schedule 13 to the Act. The application of these provisions has given rise to differences of approach between valuers, and LVTs have themselves adopted varying approaches. In the sole Lands Tribunal decision, *Visible Information Packaged Systems Ltd v Squarepoint (London) Ltd* [2000] 2 EGLR 93, the approach adopted was to capitalise the gross rent lost by the intermediate leaseholder. This approach has been followed in some but not all LVT decisions. In addition the Schedule contains a formula for the valuation of such an interest if it is a "minor intermediate interest" (or "MILI"). A minor intermediate interest is defined as one that has an expectation of possession of not more than one month and a profit rent of not more than £5 pa. Different conclusions have been reached by LVTs as to the meaning of the MILI definition and hence the circumstances in which the MILI formula falls to be applied.

6. In the course of 2006 and 2007 the Tribunal received a number of appeals in which the valuation of ILIs under Chapter II of Part I of the 1993 Act was in issue, and it was thought appropriate to attempt to group these for hearing together, thus enabling a representative variety of cases to be considered with the objective of producing a decision that would have general application. In the event we were able to hear together five appeals.

7. The difficulty facing the valuers in these appeals is how they should value an ILI where the rent payable by the leaseholder to the freeholder exceeds the rent that it receives from the tenant following the abatement of the tenant's rent to a peppercorn under section 56(1) of the 1993 Act. The LVTs' approach to the problem in three of the appeals favours the capitalisation of the leaseholder's loss of rental income using a dual rate years' purchase (the *Squarepoint* approach). The leaseholders in these appeals argue that this approach is wrong. In four of the appeals they contend that the appropriate valuation method is to calculate the amount which a purchaser of the ILI would require in order to establish a fund (to include costs and the VAT on any reverse premium) sufficient to meet the leaseholder's continuing obligation to pay rent while at the same time producing an adequate return for the purchaser (referred to as the reducing fund approach). In the remaining appeal, that by Gulu Lalvani, the leaseholder's approach is to capitalise its negative income flow at the risk free rate of 2.25% adopted by the Tribunal in *Cadogan v Sportelli* [2006] RVR 382. This gives the amount of the reverse premium that it would have to pay a purchaser of its interest.

8. The question of how to value a negative income flow is the sole issue in three of the appeals. Of the remaining two appeals, that by Daejan Properties also raises the issue of the deferment rate to be applied to the value of the ILI where there is a substantial reversion before the grant of a new lease. In the case of 62 Cadogan Square (Lalvani) the freeholder also appealed. He argued, inter alia, that the ILI should have been valued as a MILI in accordance with paragraph 8(2) of Schedule 13 to the 1993 Act. He also argued that hope value should be

included in the valuation of the freehold reversion. Both parties have appealed against the LVT's determination of the relativity to be applied to the valuation of the existing tenants' leases.

9. The appeals raise a multiplicity of issues as to how ILIs are to be valued as a matter of law and valuation principle. Because of the great number of alternative valuations that would be needed if all the permutations of the possible outcomes on these issues were to be covered the parties agreed that we should produce an interim decision setting out our conclusions on the issues. The parties will then be able to provide us with their valuations on the basis of our approach and, if they wish, on any alternative basis that they contend that we should as a matter of law have adopted instead.

10. We begin by summarising the essential facts about each appeal, and we then proceed to deal in turn with the individual issues.

The appeals

LRA/114/2006: Nailrile Limited v (1) Earl Cadogan (2) William Hallman and Nancy Hallman

11. This is an appeal (which we refer to as Nailrile or 2/12 Sloane Gardens) by the leaseholder, Nailrile Ltd, of Flat 2, 12 Sloane Gardens, London SW1W 8DL against the LVT decision dated 14 May 2006 determining the premium to be paid for a new lease at £196,400, of which £5,600 was payable to the leaseholder and £190,800 to the freeholder. The freeholder, Earl Cadogan, is the first respondent. The valuation date is 28 July 2004.

12. The property, which was constructed as a terraced house, is divided into five flats, one of which is for the use of a caretaker. It is held by the leaseholder on a lease which expires on 29 September 2045. The rent at the valuation date was £1,000 pa, with rent reviews in 2007 and 2028 to 0.2% of the "leasehold value" of the whole building as defined in the lease. The underlease of Flat 2 expires on 26 September 2045 (so that the leaseholder has a 3 day reversion), and the rent reserved is £200 pa, which is to be reviewed on the same dates as for the headlease rent reviews to 20% of the rent payable under the headlease. Before any new lease claims were made the rent payable by the leaseholder was exactly matched by the rents it received from the underleases, so that its profit rent was nil. This would continue to be the case after each rent review. Following the grant of the new lease, therefore, the intermediate lease became onerous, with the headrent exceeding the underlease rents by £200 pa (and with the prospect of a greater annual deficit following the rent reviews).

13. The LVT concluded that the leaseholder's interest was a MILI following the grant of the new underlease, so that the MILI formula was to be applied to its valuation. The leaseholder contends that it was wrong to do so. On its behalf Mr Philip Rainey and Mr James Fieldsend (who also appeared for the leaseholders in the other appeals) called Miss Jennifer Ellis FRICS, a Member of Langley-Taylor LLP, Chartered Surveyors, to give expert valuation evidence. Mr

Peter Michael Sonneborn FCA of Sonneborn & Co, Chartered Accountants, adduced expert taxation evidence. All the parties accepted his report and by agreement he was not called to give oral evidence. Miss Ellis valued the ILI on the basis of the fund that she said would need to be established by a purchaser of that interest in order to meet the leaseholder's liabilities under the lease. Her estimate of the diminution in the value of the ILI was £33,840. Mr Mark Sefton appeared for the freeholder and called Mr Julian Mansfield Clark MRICS, a partner at Gerald Eve, to adduce expert valuation evidence. Mr Clark produced four valuations, reflecting different bases of valuation. His primary valuation was on the basis of a commutation of the headrent, which produced a nil estimate for the diminution in the value of the ILI. In the alternative he relied upon the LVT's valuation, which estimated the diminution in the value of the ILI at £3,509. The tenants did not appear.

LRA/47/2007: Daejan Properties Limited v (1) The Trustees of the Eyre Estate (2) Various Lessees

14. This is an appeal (which we refer to as Regency Lodge) by Daejan Properties Ltd, the leaseholder, against the LVT decision dated 23 February 2007 determining the total premiums to be paid by 22 underlessees for new leases in their flats at Regency Lodge, Adelaide Road, London NW3 5EE, at £794,234, of which £619,982 was payable to the leaseholder and £174,252 to the freeholders. Regency Lodge contains a total of 109 flats as well as 13 commercial units. The freeholders are The Trustees of the Eyre Estate. It is subject to a headlease to the leaseholder dated 11 March 1937 and varied by a deed of variation dated 28 April 1988. This lease expires on 25 December 2086 and is at a fixed annual rent of £4,500. Seventeen of the underleases were for terms of 99 years from December 1987. The remaining 5 underleases were for terms of 99 years from December 1933. The rents payable are in each case a matter of hundreds of £s, and the leases provide either for fixed increases or for review.

15. The LVT valued each ILI on the *Squarepoint* approach. The leaseholder said that it was wrong to do so and that the reducing fund approach should have been applied. When valuing the leaseholder's reversion after 27 years in respect of the 5 shorter underleases the LVT adopted a deferment rate of 6%. The leaseholder said that this was wrong and that the correct deferment rate was 5.25%. Miss Ellis gave valuation evidence for the leaseholder. Mr Anthony Radevsky appeared for the freeholder and called Mr Julian Edward Christian Briant MRICS, a Partner in Cluttons LLP, Chartered Surveyors, to give expert valuation evidence. Mr Timothy Harry represented the tenants and called Mr Simon Martin Radford MRICS, a Partner in Boston Radford, Chartered Surveyors, to give expert valuation evidence.

LRA/89/2007: Gulu Lalvani and Others v (1) Earl Cadogan (2) Cadogan Estates Limited

16. This is a consolidated appeal (which we refer to as 62 Cadogan Square) by the tenants and by the freeholders against a decision of the LVT dated 23 April 2007. The property, 62 Cadogan Square, London SW1X 0EA, contains six flats and a caretaker's flat. The headlease was granted by the freeholders, Earl Cadogan and Cadogan Estates Ltd, to the leaseholder Mallonbond Limited (a company that is owned by the tenants) on 25 March 1986 for a term of 65 years from 25 December 1984 in consideration of a premium of £120,000. The rent,

initially £2,500 pa, is subject to upwards only review at the end of the 21st, 42nd and 63rd years of the term to 0.55% of the leasehold value of the premises (on the assumption that the lease has a term of 65 years from the revision date at a peppercorn rent). The head rent on review as at 25 March 2006 is agreed at £45,500 pa. All of the underleases were granted on 25 March 1986 for terms of 65 years less 5 days from 25 December 1984 at rents that both initially and on review in total match the headlease rent. Following deeds of variation made on 26 January 1996 the underlease rents now total 97.54% of the headlease rent.

17. Each of the six tenants gave notice claiming a new lease under section 42 at almost exactly the same time (on 8,14 and 21 November 2005). They did so on advice, with the intention of proceeding to a collective enfranchisement under Chapter I of Part I of the 1993 Act after the individual lease extensions had been agreed. The objective of this method of proceeding was to reduce the total amount payable to the freeholder. Notice of the separate representation of the leaseholder was served on the freeholder. The LVT determined the valuation issues between the parties, who had said at the hearing that they would produce, on the basis of the LVT's decision, a schedule of premiums for the LVT's approval. The tenants appealed on two grounds. Firstly, on the issue of relativity, they argued that the LVT was wrong to deduct a 4% allowance for onerous ground rents (OGR) from the relativity figure of 74.9% that was derived from the comparable data because those comparables already reflected OGRs. They argued that the correct relativity before any allowance for OGRs should be 78%. Secondly, the tenants said that the LVT was wrong to apply the *Squarepoint* approach when capitalising the leaseholder's loss in headrent rather than a single rate years' purchase at a risk free rate of interest.

18. The freeholders appealed on three grounds. Firstly, they said that the LVT was wrong to reject their contention that in valuing the ILI in each instance the headlease rent in respect of the flat concerned should be commuted. Alternatively, it was said, the LVT should have valued the ILI as a MILI, or, in the further alternative, held that compensation was payable under paragraph 5 of Schedule 13 to the 1993 Act to reflect the reduced amount that would be payable to the freeholders under the two-stage enfranchisement process. Secondly, the freeholders said that hope value should have been included in the valuation of the freehold reversion, or, alternatively, that hope value should have been excluded from the valuation of the existing leasehold interests. Thirdly, the freeholders said that the LVT's determination of a relativity of 70% was wrong and it had erred in saying that this was consistent with the freeholders' case. Mr Rainey for the tenants called Mr Richard David Kay MRICS and Mr Peter Beckett FRICS, both Partners in Beckett and Kay, Chartered Surveyors, as expert valuation witnesses. Mr Nicholas Dowding QC and Mr Mark Sefton appeared for the freeholders and called Mr Clark and Mr James Geoffrey Goddard Wilson MRICS, a Partner in W A Ellis, to give expert valuation evidence. The leaseholder did not respond to the appeal.

LRA/90/2007: Metropolitan Properties Co (FGC) Limited v (1) Terence George Kingston (2) Cynthia Margaret Haynes

19. This is an appeal (which we refer to as Elms Court) by the leaseholder, Metropolitan Properties Co (FGC) Ltd, of Flat 8, Elms Court, Montagu Road, London SW19 1SZ, against the decision of the LVT dated 5 April 2007 determining the total premium payable for the

grant of a new lease at £58,066, of which £56,414 was payable to the freeholder and £1,652 to the leaseholder. The flat is one of 18 flats contained in two blocks, the freehold of which is vested in the second respondent, Cynthia Margaret Haynes. The leaseholder has a leasehold interest in the two blocks for a term of 99 years from 29 September 1938 at a fixed rent of £135 pa. The tenant, Terence George Kingston, holds the subject flat under a lease for 99 years less 3 days from 29 September 1938 at a rent of £50 pa, rising to £75 pa on 5 March 2009. Before the LVT all three parties agreed to use the fund approach in valuing the ILI, and accordingly the LVT did so too, although it said that, but for this agreement, it might well have been inclined to apply the *Squarepoint* approach. The LVT rejected Miss Ellis's method of valuing the fund, and the sole ground of appeal is that it was wrong to do so. Mr Rainey called Miss Ellis to give expert valuation evidence. Neither respondent appeared.

LRA/106/2007: UAE Investments Limited v (1) Alim Investments Limited (2) The Commissioners of the Exhibition of 1851

20. This is an appeal (which we refer to as Albert Hall Mansions) by the leaseholder, UAE Investments Ltd against the decision of the LVT dated 30 March 2007 determining the total premium payable for the grant of a new lease of 32 Albert Hall Mansions, Kensington Gore, London SW7 2AL, at £98,103, of which £81,328 was payable to the freeholder (the second respondent, The Commissioners of the Exhibition of 1851) and £16,775 was payable to the leaseholder. The leaseholder holds flats 1 to 83 Albert Hall Mansions under a lease granted by the freeholder for a term of 84 years from 29 September 1977 at an annual rent rising from £8,000 to £32,000 (£16,000 at the date of valuation). The tenant, Alim Investments Ltd, holds flat 32 under a lease for 84 years less 10 days from 29 September 1977 at an annual rent of £300, rising to £1,200 (£600 at the date of valuation). In valuing the ILI the LVT used the *Squarepoint* approach, and the sole ground of appeal is that it was wrong to do so and should instead have used the fund approach, which was favoured by all the valuers who gave evidence before it. Mr Rainey called Miss Ellis to give expert valuation evidence. Mr Anthony Radevsky appeared for the freeholder and called Mr Briant to give expert valuation evidence. The tenant withdrew from the appeal.

Valuation of ILIs under Schedule 13: overview

21. As we have noted above, the intermediate lease will usually extend to other flats besides the subject flat. This is the position in each of the appeals before us. Flat 2/12 Sloane Gardens is one of 5 flats (including a caretaker's flat). Regency Lodge contains 109 flats (as well as 13 commercial units), and 22 of these are the subject of the present appeals. There are 6 flats at 62 Cadogan Square (as well as a caretaker's flat) and all these are the subject of the present appeals. Flat 32 Albert Hall Mansions is one of a large number of flats contained in five blocks. Number 8 Elms Court is one of 18 flats.

22. In the case of 12 Sloane Gardens, the rent payable under each underlease is one-fifth of the headrent (£1000, with reviews to 0.2% of the leasehold value of the building in 2007 and 2028), so that there is no net rental income and the value of the intermediate lease (and the ILI before the new lease) is nil. The new lease removes one-fifth of the leaseholder's rental

income (£200 before the 2007 review), thus giving the leaseholder a net annual liability of this amount and making the interest negative in value. The position is the same in respect of 62 Cadogan Square, where the original rents under the underleases in total match the headrent (£2,500 pa up to the 2006 review, £45,500 pa from then until the next rent review, at 0.55% of the leasehold value of the block. The underlease rents were reduced by deeds of variation in 1996 to a little less than 100% of the headrent). By contrast each new lease in Regency Lodge will reduce the leaseholder's rental income but will not create a net liability (nor will the 22 new leases have this effect cumulatively). The same goes for 32 Albert Hall Mansions and 8 Elms Court.

23. Where the effect of the grant of the new lease is just to reduce the leaseholder's profit rent for the block as a whole, there is a simple but compelling argument for saying that the proper measure of what the leaseholder has lost is the capital value of the gross rent of the flat. In practice a leaseholder, faced with this loss of income, would retain the ILI and value what he has lost in this way (subject to our detailed comments on this valuation approach below). This was the approach of the Tribunal in *Squarepoint*. Where the effect of the grant of the new lease is to make the ground rent onerous, there is also a simple but compelling argument for saying that what would happen is that the leaseholder would agree with the freeholder to surrender his interest and pay the freeholder for this. It is said that, while the leaseholder would wish to relieve himself of the obligation to pay rent that was not covered by rent received from tenants, the freeholder would regard a leaseholder with a negative profit rent as a poor covenant and would be very ready to receive a lump sum payment in lieu. Mr Clark expressed the view that this is what could be assumed to happen, and we accept this view.

24. These approaches would, in our view, provide the truest reflection of the leaseholder's loss. For reasons that we give below, we conclude that, where the ground rent of the leasehold interest does not become onerous, the measure of what the leaseholder has lost is effectively the capitalised value of the gross rent of the flat. However, we do not think that it is open to us to conclude that, where the ground rent becomes onerous, the measure is what the leaseholder would pay the freeholder to accept a surrender of his lease. That approach, as we shall say, is excluded by the requirement to exclude the freeholder as a possible purchaser in such a sale.

Valuation of ILIs under Schedule 13: statutory provisions

25. Schedule 13 makes provision for the amount payable to the owner of an intermediate interest. Paragraph 1, as read with section 40(4)(c), defines "intermediate leasehold interest" to mean:

> "the interest of any person [in whom there is vested a concurrent tenancy intermediate between the interest of the competent landlord and the tenant's lease], to the extent that it is an interest in the tenant's flat subsisting immediately before the grant of the new lease."

26. The Schedule provides:

“6 In connection with the grant of the new lease to the tenant there shall be payable by the tenant to the owner of any intermediate leasehold interest an amount which is the aggregate of –

(a) the diminution in value of that interest as determined in accordance with paragraph 7; and

(b) the amount of any compensation payable to him under paragraph 9.”

We deal with (b) (compensation) in a separate section of this decision.

27. Schedule 13 continues:

“7 (1) The diminution in value of any intermediate leasehold interest is the difference between –

(a) the value of that interest prior to the grant of the new lease; and

(b) the value of that interest once the new lease is granted.

(2) Each of those values shall be determined, as at the relevant date, in accordance with paragraph 8…

8 (1) Subject to sub-paragraph (2), paragraph 3(2) to (6) shall apply for determining the value of any intermediate leasehold interest for the purposes of any provision of this Schedule with such modifications as are appropriate to relate those provisions of paragraph 3 to a sale of the interest in question subject to the tenant’s lease for the time being and to any leases intermediate between the interest in question and that lease.

(2) The value of an intermediate leasehold interest which is the interest of the tenant under a minor intermediate lease shall be calculated by applying the formula set out in sub-paragraph (6) instead of in accordance with sub-paragraph (1)...”

We consider later sub-paragraphs (3) to (6) of paragraph 8, which deal with minor intermediate leasehold interests (MILIs).

28. Paragraph 8(1) applies paragraphs 3(2) to (6) of the Schedule (with appropriate modifications to relate them to the sale of an intermediate interest). Paragraph 3 provides for the valuation of the diminution in value of the landlord’s interest. Sub-paragraph (1) says that this is the difference between (a) the value of the landlord’s interest in the tenant’s flat prior to the grant of the new lease and (b) the value of his interest in the flat once the new lease is granted. Sub-paragraph (2) provides:

“(2) Subject to the provisions of this paragraph, the value of any such interest of the landlord as is mentioned in sub-paragraph (1)(a) or (b) is the amount which at [the relevant date] that interest might be expected to realise if sold on the open market by a willing seller (with neither the tenant nor any owner of an intermediate leasehold interest buying or seeking to buy) on the following assumptions –

(a) on the assumption that the vendor is selling for an estate in fee simple or (as the case may be) such other interest as is held by the landlord, subject to the relevant lease and any intermediate leasehold interests;

(b) on the assumption that Chapter I and this Chapter confer no right to acquire any interest in any premises containing the tenant's flat or to acquire any new lease;

(c) on the assumption that any increase in the value of the flat which is attributable to an improvement carried out at his own expense by the tenant or by any predecessor in title is to be disregarded; and

(d) on the assumption that (subject to paragraph (b)) the vendor is selling with and subject to the rights and burdens with and subject to which the relevant lease has effect or (as the case may be) is to be granted."

Valuation of ILIs under Schedule 13: issues of law

29. A number of issues on the effect in law of the provisions in Schedule 13 dealing with the valuation of ILIs were raised and we should deal with them at this point. They were as follows.

30. *Before and after valuation required.* Mr Rainey submitted that, since paragraph 7 defined the diminution in value of the ILI as the difference between its value prior to the grant of the new lease and its value after the grant of the new lease, it was necessary for two valuations to be carried out; and the *Squarepoint* approach, capitalising the loss of gross rent in a single valuation, was therefore incorrect in law. It is the case that paragraph 7 provides in terms for the determination of a before value and an after value in order to ascertain the diminution in value of the ILI. This does not, however, mean that the *Squarepoint* approach is wrong in law. If it can be shown to establish correctly the difference between the before and after values in particular circumstances there can be no objection to its application in such circumstances as a convenient device. We return to this later.

31. *ILI as part of interest that includes other flats*. Mr Rainey's submission was that the ILI has to be valued in isolation and that it was not permissible to do what the Tribunal in *Squarepoint* had done, which was to take into account the fact that the leaseholder's interest included the other flats in the block and that he would not in practice sell the ILI alone. "Intermediate leasehold interest" is defined in paragraph 1. It is the interest of the intermediate leaseholder "to the extent that it is an interest in the tenant's flat". To the extent that the intermediate lease is an interest in property other than the tenant's flat, therefore, it is said, it is not part of the "intermediate leasehold interest" for the purposes of the Schedule and is not to be taken into account under paragraph 7. The submission of Mr Radevsky for the freeholders in Albert Hall Mansions and Regency Lodge and of Mr Harry for the Regency Lodge lessees was that to assume the isolated sale of the ILI was unreal and that the Act should not be construed so as to produce such an unreal result. It was uncontroversial that in the real world the leaseholder would not sell his interest in a single flat in the block. Moreover, Mr Radevsky said, in the case of Albert Hall Mansions, clause 13(i) of the headlease imposed an absolute covenant on the leaseholder not to assign any part of the demised premises less than the whole.

Accordingly if the leaseholder's interest were the subject of a sale by itself the headlease could be subject to forfeiture and/or other claims for breach of covenant. On a proper construction of the Act there was no need to assume a severance of the leaseholder's interest and a separate and unlawful assignment of the ILI.

32. Although what has to be valued is the ILI as defined in paragraph 1 and although the value is to be ascertained on the basis of a sale by a hypothetical seller to a hypothetical buyer, it is not, in our judgment, the effect of the provisions that, if in reality the ILI would not (or indeed could not lawfully) be sold in isolation, such an isolated sale must be assumed. In such an assumed sale regard can be had to the likely attributes of the hypothetical seller. Thus in *Railtrack plc v Guinness plc* [2003] 1 EGLR 124, which concerned the assumed sale pursuant to compulsory powers of land over a railway, the Court of Appeal upheld the conclusion of this Tribunal that the hypothetical seller would be a company or authority with the function of maintaining the track. In Chapter II lease extension cases, if the hypothetical seller could be expected to have an interest not just in the subject flat but also in the other flats in the block and if it could be expected also that he would only sell his interest in the block as a whole, the proper way to value the ILI, in our judgment, would be as a component of such a sale of the intermediate interest. That these conditions apply in the case of Albert Hall Mansions and the Regency Lodge flats is not in dispute, and we think that the ILIs in each case should be valued as part of the leaseholder's interest. Similar considerations might have been expected to apply in the case of Elms Court (and the LVT made clear that its inclination would have been to value on the *Squarepoint* basis; but the parties agreed that the valuation should be on the fund basis, and the only matter in issue is whether the LVT was wrong to reject Miss Ellis's approach on this).

33. *Freeholder as purchaser.* Paragraph 8(1) of Schedule 13 provides that paragraph 3(2) to (6) is to apply for determining the value of any intermediate leasehold interest "with such modifications as are appropriate to relate those provisions of paragraph 3 to a sale of the interest in question..." Paragraph 3(2) provides for the assumed sale of the landlord's interest, before and after the grant of the new lease, "with neither the tenant nor the owner of any intermediate leasehold interest buying or seeking to buy". Where what has to be assumed is the sale of the ILI, Mr Rainey submitted, the appropriate modification is to substitute "landlord" for "owner of any intermediate leasehold interest."

34. Mr Dowding submitted that the only modification to paragraph 3(2) that was appropriate to relate it to the assumed sale of the ILI was to exclude the reference to the leaseholder. There was no warrant for writing in an exclusion of the freeholder from the market. The express exclusion from the market of the tenant and the leaseholder were necessary when valuing the freehold in order to prevent the sitting tenant's overbid. The same was true of the exclusion from the market of the tenant when valuing the intermediate lease. No such considerations applied, however, to exclude the freeholder when valuing the intermediate lease. Support for this approach was to be found, Mr Dowding said, by contrasting the provisions in Schedule 13 with the broadly corresponding provisions in Schedule 6, in which there had been expressly inserted, by amendment, a provision excluding the freeholder from the market.

35. The purpose of excluding the tenant and any owner of an ILI as potential purchasers when valuing the freehold is because their interests are involved in the grant of the new lease and they are potential special purchasers, each of whom might be prepared to pay more than others in the market in order to add to his ownership another interest in the flat. The same would clearly apply to the valuation of the ILI prior to the grant of the new lease: for this the tenant, the owner of any other intermediate leasehold interest and the freeholder would all be potential special purchasers. For this reason it seems to us inescapable that the competent landlord should be added to the tenant and the owner of any intermediate interest in the list of those excluded as possible purchasers. (It would not, however, be necessary to exclude the owner of any interest superior to that of the competent landlord, since such a person would not be involved in the grant of the new lease.)

36. We do not think that any assistance is to be derived from the exclusions in Schedule 6. It is not, we hope, necessary to set out the relevant provisions. Paragraph 3 of Schedule 6 is constructed rather differently from paragraph 3 of Schedule 13. The explanation for the provision in paragraph 7 of Schedule 6 that expressly excludes the freeholder in valuing the ILI appears to be this. An additional sub-paragraph, (1A), was included as an amendment to paragraph 3 in Schedule 6 specifying the persons excluded as possible purchasers of the freeholder's interest, and it was because of this that the further amendment in paragraph 7 was made adding to the list, for the purpose of valuing an ILI, the freehold owner. It is not in our view possible to derive from a contrast between this set of provisions and the amendments made to them on the one hand and the Schedule 13 provisions on the other an intention that paragraph 3 of Schedule 13, when applied to the valuation of an ILI, should not be treated as excluding the freeholder as a possible purchaser.

37. In the case of Albert Hall Mansions the LVT considered that it was not necessary to exclude the freeholder as a potential purchaser by assuming a modification to that effect of paragraph 3(2). It said that there was no indication that the exclusion of superior landlords or freeholders would be appropriate and that, where such an exclusion had been intended, it had been made explicit "(see paras 4A(1) and 4B(1) of Sched 13 as to marriage value)". As far as paragraphs 4A(1) and 4B(1) are concerned, these deal, for the purposes of marriage value, with the value of the tenant's interest respectively before and after the grant of the new lease. Excluded as a possible purchaser in the before valuation is the landlord, and in the after valuation the owner of any superior interest is excluded. Those exclusions are express because each of those paragraphs is making self-contained provision for the valuation of the interest to which it relates. There is, however, no such self-contained provision for the valuation of intermediate interests in view of the provisions of paragraph 8(1). The requirement to make "such modifications as are appropriate to relate those provisions of paragraph 3 to a sale of the interest in question" would clearly require the freeholder to be excluded as a potential purchaser if this was appropriate in order to give effect to the purpose of the exclusions in paragraph 3(2). The purpose of the exclusions in paragraph 3(2) is, as we have said, to exclude those who are involved in the grant of the new lease and who, by reason of their interest in the flat, could be special purchasers, prepared to pay more than the market in general. Where it is not the landlord's interest but that of an intermediate lessee that is being valued it seems to us to be inescapably necessary, in order to apply the provisions in accordance with this purpose, to exclude the landlord as a potential purchaser.

38. *Negative value.* The question was raised in argument whether the provisions of Schedule 13 were in any event apt to encompass negative values. Although the language of paragraph 3, with its reference to the amount which an interest might be expected to realise if sold on the open market by a willing seller, is only in terms applicable where the interest has a positive value, it is clear in our view that the provisions of Schedule 13 require to be operated where the interest has a negative value. Corresponding provisions in Schedule 6 unarguably extend to negative values since Part V of that Schedule expressly deals with interests with a negative value, and this clearly suggests that the provisions in Schedule 13 similarly encompass negative values. We do not in any event see how those provisions would be workable unless they did so.

MILI provisions

39. Schedule 13 makes provision for the valuation of minor intermediate interests (MILIs) in paragraph 8 as follows:

> " (3) 'A minor intermediate lease' means a lease complying with the following requirements, namely –
>
> (a) it must have an expectation of possession of not more than one month, and
>
> (b) the profit rent in respect of the lease must be not more than £5 per year.
>
> (4) 'Profit rent' means an amount equal to that of the rent payable under the lease on which the minor intermediate lease is in immediate reversion, less that of the rent payable under the minor intermediate lease.
>
> (5) Where the minor intermediate lease or that on which it is in immediate reversion comprises property other than the tenant's flat, then in sub-paragraph (4) the reference to the rent payable under it means so much of that rent as is apportioned to that flat.
>
> (6) The formula is –
>
> $$P = £\frac{R}{Y} - \frac{R}{Y(1+Y)^n}$$
>
> Where –
>
> P = the price payable;
> R = the profit rent;
> Y = the yield (expressed as a decimal fraction) from 2½ per cent Consolidated Stock;
> n = the period, expressed in years (taking any part of a year as a whole year), of the remainder of the term of the minor intermediate lease as at the relevant date."

40. In three of the appeals, Regency Lodge, Albert Hall Mansions and Elms Court, the existing interest in the tenant's flat is not a MILI. In each case the profit rent exceeds £5 per annum, and, in relation to five of the Regency Lodge flats, there is also more than a nominal

reversion. In Nailrile and 62 Cadogan Square, the present interest of the headlessee is clearly a MILI.

41. Equivalent MILI provisions appear in paragraph 7 of Schedule 6 to the 1993 Act and in paragraph 7A of Schedule 1 to the 1967 Act, where they are called minor superior tenancies. In each case the requirements with which a lease has to comply to make it a MILI are the same. The difference, however, between those provisions and the ones in Schedule 13 is that the former fall to be applied in a once-for-all valuation. In Schedule 13 by contrast they fall to be applied in the course of before and after valuations that establish the diminution in value of the ILI.

42. A number of issues arise in relation to the application of the MILI provisions. They are as follows. (a) *"Once a MILI always a MILI"*. A contention advanced by Cadogan is that paragraph 8(2), which provides that the value of an intermediate lease which "is" the interest under a MILI is to be calculated by applying the paragraph 8(6) formula, can only be referring to the period prior to the grant of the new lease. There is no reference to whether the interest "will be" a MILI after such grant. So, it is said, the statutory language contemplates that the test is to be applied once only, with the consequence that if the ILI is a MILI in the "before" valuation it must equally be a MILI in the "after" valuation. Were that not the case, the before and after valuations would be on different bases, so that the capitalisation rate in the after valuation could be quite different from the predetermined rate in the before valuation.

43. We do not think that this contention is correct. The function of the MILI provisions, it appears to us, is quite clearly to provide a convenient formula to apply where an interest is of very small value. It saves the parties the need to decide what capitalisation rate to use and it avoids time and money being spent on resolving any difference on this that there might be between them. Because the before value of the ILI is very small, and would not be significantly different if another capitalisation rate were used, it does not seem to us to matter if the MILI formula is not applied to the after valuation rather than a formula that is justified on the evidence. Nor is there anything in the use of the word "is" in paragraph 8(2) to compel the application of the MILI formula to the after valuation even if it does not meet the requirements in paragraph 8(3).

44. (b) *"An expectation of possession of not more than one month"*. The intermediate lease will necessarily have an earlier term date than the term date of the new lease, so that the owner of the ILI has no expectation of possession. Cadogan's argument is that a person with an expectation of no time at all is someone who has an expectation of possession of not more than one month. That argument was accepted by the LVT in the case of Nailrile and was rejected by the LVT in the case of 62 Cadogan Square. In our judgment the argument is not correct. The requirement under paragraph 8(3)(a) is that the lease "must have an expectation of possession of not more than one month". The literal meaning of these words is in our view the right one: there must be an expectation of possession but it must not be for more than one month.

45. Cadogan point out that, if this construction is correct, then the after valuation can never be on the MILI basis since the owner of the ILI will never have an expectation of possession for the purposes of the after valuation. We can see nothing at all remarkable in this. The MILI formula performs an obviously useful function in relation to existing ILIs of small value, but there is no reason to suppose that it must have been intended to have a wider role than this. As we have said, the formula was imported into Schedule 13 from Schedule 6, where its function was to assist in the single valuation that was required of an intermediate interest that was extinguished in the collective enfranchisement process. We can detect no purpose that would require the wording to be strained so as to apply it to the after valuation in the case of a lease extension.

46. (c) *"The profit rent"*. A similar issue arises in relation to the other limb of paragraph 8(3). Cadogan contend that where there is no profit rent or where there is a negative return there is, within the terms of the provision, a profit rent of not more than £5. Before the LVTs Cadogan succeeded on this issue in the case of Nailrile and failed on it in the case of 62 Cadogan Square. It does not arise if we are correct in our conclusion on issue (b). But we are in any event of the view that the requirement is only met if there is a positive profit rent. The reference to £5 can only be to a positive amount of £5, and this necessarily implies in our view that a profit rent of not more than £5 must be a positive amount. Since the rent under the new lease is a peppercorn the profit rent under the ILI in the after valuation will always be a negative amount unless the headrent is itself a peppercorn, in which case it will be nil. If it had been intended that the MILI provisions should apply to the after valuation, in which there is always a nil or negative profit rent (and there is no expectation of possession) it seems unlikely that this would not have been stated expressly – as it could have been, very shortly – rather than leaving the world to infer this from words in the MILI requirements that are not obviously apposite for this purpose.

47. The function of the MILI provisions, as we have said, is quite clearly to provide a convenient formula to apply where an interest is of very small value. Cadogan's argument, if correct, would mean that an ILI with a very large headrent remaining after the lease extension would fall to be valued by the formula. That would not be consistent with the function of the provision. In such a case it would not be right to deny the parties the opportunity to adduce their own valuations, which could be wide apart, for decision by the tribunal.

48. (d) *Whether the MILI formula includes rent reviews.* The appellants in the two Cadogan appeals contend that, if a rent is subject to review, the reviewed rent must be taken into account in applying the MILI formula. Cadogan say that this is wrong. The MILI formula, they say, was clearly intended to be a simple and straightforward calculation by reference to a fixed capitalisation rate and a known rent, and, if it had been intended to take account of rent reviews, express provision would have been made for how that was to be done. There would have been no point in providing a formula in which all the inputs were carefully defined save one. Moreover there would be no particularly obvious or reliable way of taking account of future rent reviews, since the conventional way of doing this, by adjusting the yield, would not be permissible under the MILI formula.

49. The appellants rely on three authorities for their interpretation of "the rent payable under the lease" in paragraph 8(4). *Woozley v Woodall Smith* [1950] 1 KB 325 (a case under the Rent Restrictions Acts), *Compton Group Ltd v Estates Gazette Ltd* (1978) 26 P & CR 148 (in which the issue was whether or not the reviewed rent was to be fixed having regard to counter-inflation legislation) and *Fawke v Viscount Chelsea* [1980] QB 441 (a case concerning the court's power under the Landlord and Tenant Act 1954 to order an interim rent).

50. In our view the questions of whether and how the MILI formula should be applied to take account of rent reviews is unlikely to arise in practice other than exceptionally. This is because of requirement (b) in paragraph 8(3). We have already said that this is not satisfied where the profit rent is nil or a negative amount. It is also the case, in our judgment, that the requirement is not satisfied where the post-review profit rent attributable to the flat is or could be in excess of £5. Clearly, when reference is made to the rent that "is" payable under the lease, this means the rent for which the lease provides. There is no reason why it should be confined to the rent that is payable on the next rent day following the valuation and should not extend to that payable on all subsequent rent days. For this reason, unless the effect of the review provisions in the lease is that the rent will never exceed £5, requirement (b) will not be satisfied.

51. Given this construction of requirement (a), it is in our view not surprising that there is no prescription for applying the MILI formula to rent review cases since the problem is very unlikely to arise. Were it to do so we rather think that the solution would be to take R as being the weighted average, or equivalent, profit rent over the term of n years. But on the facts of the present cases the problem does not arise.

Two-stage enfranchisement: background

52. In the case of the acquisition of the freehold or extended lease of a house under the 1967 Act or the acquisition of the freehold of premises containing flats on a collective enfranchisement under Part I of the 1993 Act any intermediate interest, to the extent that it is an interest in the house or premises, is also acquired in the enfranchisement process by the tenant or the nominee purchaser. In the case of a lease extension under Part II of the 1993 Act by contrast an ILI is not acquired. Under paragraph 10 of Schedule 11 the tenant's new lease, and his rights and obligations under it, takes effect as if there had been a surrender and re-grant of the ILI. The owner of the ILI loses his reversion and, since the tenant's rent is a peppercorn, he loses the rent receivable under the ILI.

53. In the case of 62 Cadogan Square the tenants own the ILI, and what Mr Beckett, advising them, perceived was that they would be substantially better off if each tenant secured an individual lease extension before together they effected a collective enfranchisement. The landlord, however, would be substantially worse off, and it is this consequence that Cadogan said was unfair. Mr Clark produced a notional valuation to illustrate how a two-stage approach to collective enfranchisement can diminish the amount that the freeholder receives. It assumes a 40-year headlease, with underleases of 40 years less 5 days of five flats, each with a freehold (long leasehold) vacant possession value of £1m. The rent payable by the intermediate leaseholder under the headlease is the same as that receivable by him under the underleases and

is substantial. The value of the ILI before enfranchisement is thus nil, and on a one-stage collective enfranchisement the intermediate leaseholder therefore receives nothing and the freeholder receives £1.5153m. If individual lease extensions under Part II precede the collective enfranchisement, however, a substantial amount (£440,685) is payable to the intermediate leaseholder because he is left in receipt of peppercorn rents but his liability for the substantial headlease rent remains. The amount payable to the freeholder (£969,500) is diminished because of this. At stage 2, the collective enfranchisement, the negative value of the ILI has to be offset against the smaller value of the freehold interest so that the amount payable to the freeholder is nil. Overall, therefore, the freeholder in fact receives £545,800 less under this two-stage enfranchisement. The owner of the ILI, by contrast, the value of whose interest before the enfranchisement process was nil, receives £440,685 simply as the result of the collective enfranchisement having been effected in two stages rather than one.

54. Mr Clark's example values the leaseholder's interest after the grant of new leases as though it is a MILI. We have rejected this approach for the reasons given in paragraph 46 above. Mr Beckett values the 'after' interest in 62 Cadogan Square by capitalising the negative profit rent at a single rate years' purchase at 2.25%. The effect of using Mr Beckett's approach in the current example (keeping everything else constant) is to increase the adverse effect upon the freeholder by proceeding under a two-stage enfranchisement. The negative value of the leaseholder's interest increases from £440,685 to £605,070 and the amount payable to the freeholder reduces from £969,500 to £896,730, making the freeholder £618,570 (41%) worse off by comparison with a single stage enfranchisement.

55. Cadogan contended that the Act should be so construed that the unfairness arising from such a two-stage enfranchisement process was avoided. The unfairness would be avoided, they said, if the Act were construed so as to reduce the rent payable under the ILI to a peppercorn, or, as it was put, commuted. They urged such a construction on the basis of conventional principles of construction or alternatively in reliance on the Human Rights Act. The unfairness could alternatively be mitigated, they said, if the ILI was valued as a MILI in the after valuation or if the landlord were held to be entitled, under paragraph 5 of Schedule 13, to compensation that reflected his potential loss as a result of the collective enfranchisement being effected in this way. We have already concluded that an ILI is not to be valued as a MILI in the after valuation. Our conclusion is that compensation under paragraph 5 of Schedule 13 is payable for such diminution in value of the landlord's interest as results from his prospective loss on the second-stage collective enfranchisement. Since compensation is provided for in this way there is no justification in our view in seeking to construe other provisions in the Act so as to provide for commutation; but in any event we do not think that it is possible on any basis to construe any of the provisions to this effect.

56. We will deal first with paragraph 5 of Schedule 13 and then with the commutation issue. We should say that we have no difficulty in accepting Cadogan's submission that in a case such as that illustrated by Mr Clark's example the Act, construed as it is expressed (and leaving out of account the possibility of compensation under paragraph 5), would operate unfairly in enabling the two stage process to be followed to the substantial prejudice of the landlord. Of course, it is the combination of a minimal reversion under the ILI, a substantial headrent and a nil profit rent that produces this effect, and these elements will only sometimes be present together. But we have no reason to believe that they are exceptional. It is also the case, as

Mr Rainey pointed out, that it is the tenants' ownership of the ILI that makes it worth their while to follow the two-stage process. In Mr Clark's example the overall cost of the two-stage process is rather higher than that of a single-stage collective enfranchisement. It may be that such an ILI owned by the tenants is not a frequent occurrence. But, where they do not own the ILI, the prospect of their purchasing it from the owner, who would stand to receive nothing in a one-stage collective enfranchisement, is manifest. We do not think, therefore, that the consequences of which Cadogan complain are to be dismissed as being a very rare exception in the operation of the statutory provisions.

Two-stage enfranchisement: compensation under paragraph 5 of Schedule 13

57. Paragraph 5 of Schedule 13 provides:

> "5. (1) Where the landlord will suffer any loss or damage to which this paragraph applies, there shall be payable to him such amount as is reasonable to compensate him for that loss or damage.
>
> (2) This paragraph applies to –
>
> (a) any diminution in value of any interest of the landlord in any property other than the tenant's flat which results from the grant to the tenant of the new lease; and
>
> (b) any other loss or damage which results therefrom to the extent that it is referable to the landlord's ownership of any such interest.
>
> (3) Without prejudice to the generality of paragraph (b) of sub-paragraph (2), the kinds of loss falling within that paragraph include loss of development value in relation to the tenant's flat to the extent that it is referable as mentioned in that paragraph..."

58. It is this provision on which, in an alternative argument, *Cadogan* relied. They said that, since the effect of the grant of the new lease of a flat, with the head rent remaining the same, was to create a negative value in the intermediate interest in relation to the flat, the prospect of a collective enfranchisement, in which the negative value was deducted from the price, would damage the value of the reversion. If the landlord were to seek to sell the reversion the purchaser would realise that there was the prospect of a collective claim at the reduced price, and he would pay less for it. The loss was a proper subject for compensation under paragraph 5.

59. Mr Rainey submitted that paragraph 5(2) only applies where the diminution in value or the loss or damage relates to "any interest of the landlord in any property other than the tenant's flat"; and that the suggested disadvantage to the competent landlord related to his interest in the flat and not to his interest in any other part of the building. Accordingly, he said, the landlord could have no claim to compensation under paragraph 5. Even if the landlord did have a theoretical claim, any assessment of compensation would have to assume that there was a certainty of collective enfranchisement taking place immediately following the valuation

date. But the collective enfranchisement might never happen, in which case the landlord would have received compensation for a loss that he had not suffered.

60. This submission seems to us to be erroneous. The basis of the claim for compensation is that, on a collective enfranchisement after the grant of the new lease, the price payable to the landlord would be less, by a greater amount than the price payable for the lease extension, than it would be if the new lease had not been granted. To the extent that the prospect of such reduced price is reflected by a diminution in the present value of his interest in the flats (after the grant of the new lease) this would in our judgment constitute a loss for which compensation is payable under paragraph 5. Insofar as that diminution in value is a diminution in value of his interest in the other flats, it would constitute a loss under paragraph 5(2)(a); and, insofar as the diminution in value is a diminution in value of his interest in the subject flat, it would in our judgment fall under paragraph 5(2)(b).

61. As read with paragraph 5(2)(a), paragraph 5(2)(b) applies paragraph 5 to:

> "any... loss or damage [other than a diminution in value of the landlord's interest in any property other than the tenant's flat] which results [from the grant to the tenant of the new lease] to the extent that it is referable to the landlord's ownership of any [interest in any property other than the tenant's flat]."

62. To the extent that the diminution in value of the landlord's interest is a diminution in value of his interest in the subject flat it constitutes a loss within paragraph 5(2)(b) because:

i. it is not a diminution in value of the landlord's interest in any property other than the tenant's flat;
ii. it results from the grant to the tenant of the new lease; and
iii. it is referable to the landlord's ownership of his interest in the other flats.

Only (iii) requires explanation. The loss is referable to the landlord's ownership of his interest in the other flats because it is by reason of such ownership that he can be compelled on a collective enfranchisement of those flats and the subject flat to transfer his interest to a nominee purchaser at a price determined under the provisions of Schedule 6. Such a loss is analogous to the loss of development value, for which express provision is made in subparagraph (3). If the amount received by the landlord on a collective enfranchisement would be less by reason of the earlier grant of the new lease, there is a prospective loss to him; and to the extent that that prospective loss is reflected in a diminution in the value of his interest in the flat on the grant of the new lease it is a loss that falls within paragraph 5(2)(b).

63. The loss that is suffered (and for which paragraph 5 provides compensation) consists of a diminution in value of the landlord's interest in the tenant's flat. It does not fall within paragraph 2(a) and paragraph 3, however, because of the assumption in paragraph 3(2)(b) that Chapter I confers no right to acquire any interest in premises containing the tenant's flat. We can see no reason why a loss consisting in a diminution in value of the landlord's interest in the tenant's flat, although excluded as an element of the premium payable under paragraph 2(a), should not be included as an element of the premium payable under paragraph 2(c) where it

satisfies the requirements of paragraph 5(2)(b). Indeed in circumstances such as those in the case of 62 Cadogan Square it is this provision that constitutes the corrective for the unfairness that would result from the two-stage enfranchisement process.

64. Because the diminution in value of the landlord's interest falls either within paragraph 5(2)(a) (to the extent that it is a diminution in value of the other flats) or within paragraph 5(2)(b) (to the extent that it is a diminution in value of the subject flats) there is no need to determine the extent to which it falls within either of these provisions: but we rather think that the diminution in value is one that falls wholly within paragraph 5(2)(b).

65. It is no objection to the claim for compensation that collective enfranchisement may never occur. The present value of an interest in land may well depend on the view that the market takes of the possibility of future events occurring. The assessment of the loss for which paragraph 5 provides compensation will, of course, depend on the degree of likelihood that the tenants of the premises will proceed to a collective enfranchisement. If the probability of this is perceived to be low, the diminution in value of the landlord's interest by reason of the prospect of such collective enfranchisement will no doubt be small. In the case of 62 Cadogan Square, however, the evidence is that there is a firm proposal on the part of the tenants to proceed to a collective enfranchisement (indeed Mr Beckett said that this was the intention of the tenants), and each of the tenants has given notice seeking a lease extension. The valuation of the ILI in relation to each individual flat must accordingly be made with this in mind. In other cases there may be no such stated intention, and the probability of collective enfranchisement occurring would then have to be assessed in the light of the surrounding circumstances.

Two-stage enfranchisement: commutation

66. As we have said, because of our conclusions on compensation under paragraph 5 of Schedule 13, there is not in our judgment any justification for seeking to construe the provisions of the Act as providing for the commutation of the headrent. We will nevertheless address Cadogan's arguments on this. It is to be noted that they were also supported by them in the other Cadogan appeal, 2 at 12 Sloane Gardens, and by the freeholders in the Regency Lodge and Albert Hall Mansions appeals. Those freeholders, the Trustees of the Eyre Estate and The Commissioners of the Exhibition of 1851, represented by Mr Radevsky, did not seek to add anything to Cadogan's arguments, but they noted that commutation of rent is in practice adopted in the market as a practical solution because it produces a fair result.

67. Cadogan focussed on paragraph 10(1) of Schedule 11 as the provision that ought to be construed so as to provide for commutation of the headrent. So far as relevant paragraph 10(1) provides:

> "Where a lease is executed under section 56.... then (subject to sub-paragraph (3)) that instrument shall have effect for the creation of the tenant's new lease of his flat, and for the operation of the rights and obligations conferred and imposed by it, as if there had been a surrender and re-grant of any subsisting lease intermediate between the

> interest of the competent landlord and the existing lease; and the covenants and other provisions of that instrument shall take effect accordingly."

68. Mr Rainey said that the purpose of this provision for a notional surrender and re-grant of the intermediate lease was as a mechanism that enabled the new lease to take effect in possession. Mr Dowding accepted this but said that there was no need to limit its operation in this way; it did not say in terms that the re-grant was in identical terms (indeed in at least one respect the terms were different in that the rent was reduced to a peppercorn), and on conventional canons of statutory construction it was appropriate to construe the provision as providing for commutation of the headrent.

69. Mr Dowding relied on the principle stated by Lord Millett in *R (on the application of Edison First Power) v Central Valuation Officer* [2003] 4 All ER 209 at paragraph 116:

> "The Courts will presume that Parliament did not intend a statute to have consequences which are objectionable or undesirable; or absurd; or unworkable or impracticable; or merely inconvenient; or anomalous or illogical; or futile or pointless. But the strength of these presumptions depends on the degree to which a particular construction produces an unreasonable result. The more unreasonable a result, the less likely it is that Parliament intended it..."

70. In appropriate circumstances, therefore, Mr Dowding said, it was proper to find an implication within the express words of a statute to avoid the consequences referred to in this passage. The question whether an implication was to be found depended on whether it was proper, having regard to the accepted guide to legislative intention, and not on whether it was "necessary" or "obvious". Paragraph 10(1) was therefore to be read purposively as follows (with italics added to show the insertions):

> "Where a lease is executed under section 56.... then (subject to sub-paragraph (3)) that instrument *and any intermediate lease* shall have effect for the creation of the tenant's new lease of his flat, and for the operation of the rights and obligations conferred and imposed by it *and any intermediate lease*, as if there had been a surrender and re-grant of any subsisting lease intermediate between the interest of the competent landlord and the existing lease *on terms which provide for the rent payable under any intermediate lease to be abated to the same extent as the rent abatement under section 56*; and the covenants and other provisions of that instrument *and of such intermediate lease* shall take effect accordingly."

71. There is clear and high authority, closely related in subject-matter, on the question of reading words into a statute in order to reflect a purposive instruction. In *Jones v Wrotham Park Settled Estates sub nom Wentworth Securities Ltd v Jones* [1980] AC 74, a case relating to the enfranchisement of the freehold of a house under the 1967 Act, very shortly before the leaseholder's notice was served the freeholder had granted to a property company a concurrent lease of the house (and all other houses on the freeholder's estate) for 300 years at a peppercorn rent until the expiry of the tenant's lease. The lease provided that, if the company should grant a sublease to the tenant, the rent payable should become a rack rent. If this provision fell to be

taken into account the price payable under the enfranchisement to the freeholder was £4,000 and to the company £nil. If the provision were left out of account the freeholder's entitlement was £50 and the company's £250. The tenant contended that the provision should be left out of account under section 23(1) of the 1967 Act as "an agreement relating to a tenancy" that purported "to modify any right to acquire the freehold" and/or provided for "the imposition of any penalty or disability on the tenant" in the event of his making application to enfranchise under the Act. The question was whether this provision should be construed as applying to an agreement to which the tenant was not a party.

72. The House of Lords, reversing the Court of Appeal and restoring the decision of the Lands Tribunal (V G Wellings QC), concluded in favour of the freeholder. Lord Russell of Killowen, with whom the other law lords agreed, said (at 113D) that the provision in the lease, while its effect was to modify the terms on which the tenant might acquire the freehold, did not modify the right itself and (at 114C) that it did not provide for the imposition of any penalty or disability on the tenant. He said (at 114B) that there was "ample scope for the operation of section 23(1) without embracing this case".

73. At 106H to 107B Lord Salmon said:

> "In my opinion, it was clearly the policy of the legislature under the Act of 1967 that the tenant should obtain the freehold of his home at the ordinary market price and not at a price which had been inflated by a transaction such as the present. I have no doubt that if it had ever occurred to the legislature that a transaction such as the present might have been devised and put into operation, clear words would have been introduced into the Act, which would preclude such a transaction from affecting the market price which the tenant would have to pay for the freehold of his home. As it is, no such words appear in the Act; and accordingly it contains a gap. It is well settled, however, that the courts have no power to fill in any gap in an Act, even if satisfied that, had the legislature been aware of the gap, it would have filled it in: *Johnson v Moreton* [1980] AC 37; *Gladstone v Bower* [1960] 2 QB 384 and *Brandling v Barrington* (1827) 6 B & C 467, 475 per Lord Tenterden CJ. Accordingly, there is nothing to be done by this House, sitting in its judicial capacity, other than to allow the appeal. It may, however, perhaps be worth consideration in other quarters whether the Act should be amended."

In the event the Act was amended shortly afterwards by the Leasehold Reform Act 1979.

74. Lord Diplock at 105E to 106A said this:

> "My Lords, I am not reluctant to adopt a purposive construction where to apply the literal meaning of the legislative language used would lead to results which would clearly defeat the purposes of the Act. But in doing so the task on which a court of justice is engaged remains one of construction; even where this involves reading into the Act words which are not expressly included in it. *Kammins Ballrooms Co Ltd v Zenith Investments (Torquay) Ltd* [1971] AC 850 provides an instance of this; but in that case the three conditions that must be fulfilled in order to justify this course were satisfied. First, it was possible to determine from a consideration of the provisions of

> the Act read as a whole precisely what the mischief was that it was the purpose of the Act to remedy; secondly, it was apparent that the draftsman and Parliament had by inadvertence overlooked, and so omitted to deal with, an eventuality that required to be dealt with if the purpose of the Act was to be achieved; and thirdly, it was possible to state with certainty what were the additional words that would have been inserted by the draftsman and approved by Parliament had their attention been drawn to the omission before the Bill passed into law. Unless this third condition is fulfilled any attempt by a court of justice to repair the omission in the Act cannot be justified as an exercise of its jurisdiction to determine what is the meaning of a written law which Parliament has passed. Such an attempt crosses the boundary between construction and legislation. It becomes a usurpation of a function which under the constitution of this country is vested in the legislature to the exclusion of the courts."

75. In the present case we are concerned with provisions in the 1993 Act which, in the vast majority of cases, do not cause the injustice of which complaint is made. There is, to apply Lord Russell's words, ample scope for the operation of the provisions without the production of an unfair result other than in particular circumstances. The construction for which Cadogan extend would, however, change the wording of the provision so as to affect its operation in all cases.

76. Cadogan said that there is a "statutory ellipsis" in that paragraph 10(1) provides for the deemed surrender and re-grant of the ILI without stating on what terms it is re-granted. It is, in our judgment, necessarily implicit, however, since what is being re-granted is the lease, that the terms of the lease continue. There is no failure, therefore, to make a provision that is needed if the statutory machinery is to operate, and accordingly there is no need to imply a specific term relating to the rent. The rent is that payable under the lease.

77. The unfairness that we find to be capable of arising in a two-stage enfranchisement is not caused by some inherent unfairness in the first stage, the individual lease extensions. It arises because at the second stage, the collective enfranchisement, the valuations are carried out without reference to the valuations carried out and the amount paid at the first stage. Correction of the unfairness is thus not obviously to be sought in giving one of the provisions relating to individual lease extensions a meaning that it does not naturally bear through the insertion of the words which Cadogan suggested should be added. Paragraph 10(1) is a deeming provision. It provides, through a statutory fiction, the mechanism by which the new lease may take effect in possession. The intermediate lease is deemed to be surrendered and re-granted, and the covenants in it "take effect accordingly". It is by no means certain, indeed it seems to us improbable, that, in order to avoid the consequences of which complaint is made, Parliament would have chosen to insert in this deeming provision an actual alteration to the terms of the lease. Commutation of the headrent would not necessarily be the only possible solution to the two-stage enfranchisement problem. The price-determination provisions of Schedule 6 on the second, collective enfranchisement, stage would be an alternative possibility. It follows, applying *Jones v Wrotham Park*, that commutation of headrent cannot be achieved under principles of conventional construction by re-writing paragraph 10(1) as suggested.

78. The alternative basis for Cadogan's commutation case was section 3 of the Human Rights Act 1998 and Article 1 to the First Protocol. Section 3(1) provides:

> "So far as it is possible to do so, primary legislation and subordinate legislation must be read and given effect in a way which is compatible with the Convention rights."

Article 1 to the First Protocol, under the heading "Protection of Property", provides:

> "Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.
>
> The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties."

79. Relying on *Ghaidan v Godin-Mendoza* [2004] 2 AC 557 Cadogan submitted that there are two relevant questions: whether the provisions of the 1993 Act are convention-compliant; and, if they are not, whether the interpretation of paragraph 10(1) for which they contend is "possible" for the purposes of section 3 or whether it is contrary to the underlying thrust of the 1993 Act. Mr Rainey accepted that the role of the court under section 3, if it is of the view that a conventional construction would be incompatible with convention rights, is to give effect to the provision in a way that would be compatible, provided that it is possible to do so. But, he said, any such construction must "go with the grain of the legislation"; and the "grain" of the valuation provisions of Schedule 13 is to compare like with like, before and after. The construction urged by Cadogan would cut across that grain by seeking to alter the terms of the intermediate leasehold interest. In any event it was not at all obvious that it was paragraph 10(1) of Schedule 11 that was at fault rather than some other provision in the interacting Schedules 6, 11 and 13.

80. The difficulty that faces Cadogan is that paragraph 10(1) is not itself productive of unfairness. It is the combined effects of Schedules 6, 11 and 13 that produce the consequences of which they complain where a two-stage enfranchisement is affected. They fasten on paragraph 10(1) as offering a means, if it is given a particular effect, contrary to its conventional meaning, of avoiding the unfairness that they would suffer on a two-stage enfranchisement. But as we have said, paragraph 10(1) is there purely to provide the mechanism for the new lease to take effect and not for the purpose of prescribing the terms of the existing intermediate lease that is deemed to be re-granted. The scheme of the Act is that the intermediate lease continues, but subject to the new lease. To make paragraph 10(1) operate so as to alter the terms of the intermediate lease would thus be contrary to the scheme of the Act. Moreover the effect which Cadogan say should be given to the provision in order to meet the unfair situation in which they find themselves would not be confined to their particular situation. It would apply generally, even though in the great majority of cases the re-writing that they seek would not be needed to avoid unfairness.

81. In *Ghaidan* Lord Nicholls of Birkenhead, in considering the operation of section 3, said this at 33A-C:

> "33. Parliament, however, cannot have intended that in the discharge of this extended interpretative function the courts should adopt a meaning inconsistent with a fundamental feature of legislation. That would be to cross the constitutional boundary section 3 seeks to demarcate and preserve. Parliament has retained the right to enact legislation in terms which are not Convention-compliant. The meaning imported by application of section 3 must be compatible with the underlying thrust of the legislation being construed. Words implied must, in the phrase of my noble and learned friend, Lord Rodger of Earlsferry, 'go with the grain of the legislation'. Nor can Parliament have intended that section 3 should require courts to make decisions for which they are not equipped. There may be several ways of making a provision Convention-compliant, and the choice may involve issues calling for legislative deliberation."

82. In our judgment section 3 cannot here be invoked to change the effect of paragraph 10(1) in the way Cadogan seek. The scheme of the provisions of the Act relating to lease extensions, so far as intermediate leases are concerned, is that the relevant ILI is not acquired but continues in existence with no provision being made in relation to the terms on which it continues. To import the words that Mr Dowding suggested should be imported into paragraph 10 would constitute a substantial amendment inconsistent with the scheme of the provisions.

Deferment rate

83. A particular issue arises in relation to five of the flats in Regency Lodge, namely flats 27, 30, 46, 57 and 79. Daejan Properties Ltd's intermediate lease, which had 81 years unexpired at the valuation date, was subject to underleases of each of these flats with about 27 years unexpired. In each case, therefore, after the expiry of the underlease, Daejan will have a reversion in possession 54 years in length. The issue is as to the deferment rate that should be applied to the vacant possession value of Daejan's intermediate leasehold interest in each flat in order to reflect the fact that vacant possession will not be enjoyed until 27 years have elapsed. In *Sportelli* this Tribunal determined generic deferment rates of 4.75% for houses and 5% for flats. Those deferment rates, however, were applicable to freehold interests, and the parties to the appeals on the five Regency Lodge flats agree that a higher deferment rate than the 5% applicable to flats is appropriate in the case of a 54-year leasehold reversion. They disagree as to what the rate should be. Miss Ellis, giving evidence for the leaseholder, says that the rate should be 5.25%; and Mr Briant for the freeholder (the Eyre Estate) and Mr Radford for the tenants says that it should be 6%.

84. The LVT determined a rate of 6%. In its decision (at paragraph 18) it said:

> "We consider Miss Ellis' 0.25% addition to be inadequate having regard to the very significant differences between the reversion to the freehold and the reversion to a 54-year leasehold interest. Miss Ellis acknowledged the difficulties which might be faced by a purchaser at the point in the property cycle when the reversions fall due but in our

view has not given sufficient regard to the limited nature of this interest. We would have expected to see a strong market in 50-year leasehold interests to support Miss Ellis' opinion but no such evidence was presented to us."

85. In her evidence before us Miss Ellis said that she thought that the tenure on reversion was probably a special factor that was not considered in the *Sportelli* decision and could justify an addition to the risk premium. She did not consider, however, that restrictions under the headlease should affect the risk premium, since these would be factored in to the vacant possession value, so that to make a further allowance for them would be double-counting. The effect of the finite term, on the other hand, was to render the leaseholder more prone to the vagaries of the market, so that if, on reversion, the market was in decline, he had less of an option than the freeholder in delaying any sale until the market revived. As a matter of judgement she added 0.25% absolute to the risk premium, which was 5.56% relative to the generic risk premium of 4.5%.

86. Mr Briant said that he thought that a yield difference of only 0.25% (or 5.56% on the risk premium) did not reflect the differences between investment in a freehold and investment in a 54-year leasehold reversion. The risk for the leaseholder that the market might be depressed at the time that he wished to sell was greater, and in addition his interest was restricted by the terms of the headlease. He did not agree that such restrictions were already reflected in the capital values adopted because in the market purchasers were not always properly advised and did not have perfect knowledge. He considered that an addition of 1% was appropriate. Mr Radford agreed with this. He said that the impact of receiving a leasehold reversion during a downturn in the market had much more significant investment implications than for a freehold. If the leaseholder continued to hold the asset without extending the lease its value as a percentage of the freehold declined. But lease extensions in today's market were a matter of necessity that rarely led to any element of profit for the leaseholder and gave him the problem of deciding when to begin the process.

87. We accept, as all the witnesses agreed, that an addition to the generic deferment rate is appropriate in the case of a leasehold reversion. We do not accept Mr Briant's view, which the LVT appears to have shared, that such an addition is in part needed to reflect restrictions contained in the headlease. These are matters that would be reflected in the capital value of the reversion, and we see no justification for assuming, as Mr Briant contended, that such values were likely to be inflated by an ill-informed market. We agree with Miss Ellis that an adjustment is needed simply to reflect the fact that, because his leasehold is a declining asset, the risk of receiving the reversion at a downturn in the market is greater for the leaseholder than the freeholder. As an additional adjustment for risk this is properly to be related to the risk-free rate (4.5%) that was adopted as a component of the *Sportelli* generic deferment rate. Miss Ellis's adjustment, so related, is 5.56%; that of Mr Briant and Mr Radford 22.22%. We think that the former is rather too low and the latter substantially too high and that an adjustment in the region of 10% is appropriate. We therefore add 0.5% to the generic deferment rate for flats to reach a rate of 5.5%.

Hope value

88. An issue that arises only in the case of 62 Cadogan Square is hope value. It is common ground between the parties that some freehold hope value exists but that, under the Court of Appeal decision in *Sportelli*, such value must be left out of account in valuing the reversion. Cadogan, however, said that they wished to contend for it if it became open to them to do so in the light of the House of Lords decision in *Sportelli*. Cadogan also said that if, in accordance with the Court of Appeal decision in *Sportelli*, hope value was not a permissible element in the valuations to be carried out under Schedule 13, any hope value in the existing underleases must be stripped out. For the tenants Mr Rainey submitted that while the wording of the relevant statutory provision (paragraph 4A(2)) precluded taking into account any hope value attributable the possibility of the landlord buying the existing lease, it did not preclude taking into account any hope value in the tenant's interest that was attributable to possibility of the landlord selling him the freehold or an extended lease. It seems to us that, since the House of Lords decision in *Sportelli* has now been given, the best course is for the parties to address to us any submissions they may wish to in the light of that decision before we express any view on the matter.

Valuing the ILI: Introduction

89. There is a consensus among the parties about the main features of the open market sale that has to be assumed under Schedule 13. The interest being sold is real but both the transaction and the market are hypothetical. A willing purchaser is to be assumed who, together with the willing seller, is also hypothetical. A willing seller does not mean one who is anxious or forced to sell and is not one who can be ransomed. However, it must be assumed that there will be a sale at the best price reasonably obtainable; the willing seller cannot refuse to sell. But that price must reflect the options available to the willing seller in negotiations, one of which would be to refuse to sell and to retain the ongoing liability to pay the headrent.

90. There is no such consensus among the five expert valuation witnesses about how to determine the diminution in the value of the ILI. There is no problem with the valuation of that interest prior to the grant of a new lease; the valuers are in general agreement as to the approach and yields to be adopted. The difficulty is with the valuation of the ILI once the new lease is granted. Several valuation methods have been proposed by the experts, all of which seek to address the fact that after the grant of the new lease the ILI will always bear a negative (or at best nil) profit rent.

91. It is important to bear in mind that a range of different factual situations may arise in practice when valuing an ILI after the grant of a new lease. They include in particular the following:

(a) Although the ILI itself will always have a nil or negative profit rent after the grant of the new lease, the leaseholder's interest as a whole may remain positive, so that, considered from his point of view, the effect of a grant of the new lease is just to reduce his profit rent. This is the situation that applied in *Squarepoint*. It is the situation that applies here in relation to Regency Lodge, Albert Hall Mansions and Elms Court.

(b) The headrent payable by the leaseholder may be very small. In the case of Elms Court it is agreed at £8.88 pa.

(c) The headrent may be fixed for the duration of the intermediate lease (as it is in Regency Lodge and Elms Court), or it may be subject to review in fixed amounts (as it is in Albert Hall Mansions), or it may be subject to review to a percentage of a notional leasehold interest (as it is in 62 Cadogan Square and Nailrile)

A coherent approach to the valuation of ILIs needs to be capable of encompassing these differences.

92. Five valuation methods were suggested by the experts in circumstances where, as we have determined, there is no MILI and no commutation of the headrent:

(a) The *Squarepoint* approach. This approach capitalises the gross ground rent lost by the leaseholder using a dual rate years' purchase (YP). This method was used by Mr Clark in 62 Cadogan Square and in Nailrile; by Mr Briant in Regency Lodge and Albert Hall Mansions; and by Mr Radford in Regency Lodge.

(b) The capitalisation approach. The negative profit rent of the ILI following the grant of a new lease is capitalised using a dual rate YP. This was the preferred method used by Mr Briant in Regency Lodge and Albert Hall Mansions.

(c) The total profit rent approach. The profit rent of the intermediate lease (not just the ILI), both before and after the grant of a new lease, is capitalised using a dual rate YP. Mr Briant used this as an alternative method in Albert Hall Mansions.

(d) The single rate approach. This approach capitalises the negative profit rent of the ILI following the grant of a new lease using a single rate YP. Mr Beckett used this method in 62 Cadogan Square. Mr Clark used it as an alternative to the *Squarepoint* approach in that appeal.

(e) The reducing fund approach. This involves the calculation of a reverse premium, the core element of which is an endowment fund that allows for management costs, tax and profit, from which the purchaser of the ILI can meet future rental liabilities after the grant of the new lease. Miss Ellis favoured this method in Regency Lodge, Albert Hall Mansions, Nailrile and Elms Court. Mr Clark considered the method in 62 Cadogan Square but made no allowance for management costs or tax.

We consider each of these valuation methods in turn.

Valuing the ILI: the *Squarepoint* approach

93. In *Squarepoint* the Tribunal, Mr Paul Francis FSVA, found that the correct approach to the valuation of the intermediate lease was to capitalise the loss of the gross rent following the enfranchisement of one out of fifteen flats that formed the subject of the demise. He said:

> "In the present case – as, no doubt, in many others – the intermediate leaseholder's interest is a single lease for a number of flats, of which No.22 is but one ... It is this interest that had to be valued, and not a notional lease of No.22 alone. The diminution in the value of this interest is, in my judgment, properly to be measured on a before and after basis (as set out in paragraph 7(1)(a) and (b) of the 1993 Act), taking into account the gross rental of the premises."

94. Regency Lodge, Albert Hall Mansions and Elms Court are all appeals where only some of the flats included within the leaseholder's demise are the subject of claims to acquire a new lease. The leaseholder will continue to enjoy a profit rent from the demised premises notwithstanding the loss of income from those flats that are the subject of new leases at a peppercorn. These are similar circumstances to those in *Squarepoint* and Mr Briant used this approach in the Regency Lodge and Albert Hall Mansions appeals. Mr Radford, appearing for 21 of the 22 respondent lessees at Regency Lodge, also argued in favour of the *Squarepoint* approach and produced identical valuations to those of Mr Briant.

95. The situation at 62 Cadogan Square and 2/12 Sloane Gardens is different. At 62 Cadogan Square all six tenants have claimed new leases. The leaseholder already had a negative profit rent because the rents receivable from the tenants (following four deeds of variation in 1996) only amounted to 97.54% of the rent payable by the leaseholder to the freeholder. The grant of new leases at a peppercorn will increase that negative profit rent. At 2/12 Sloane Gardens although only one of the five flats is the subject of a claim, the loss of the rent currently paid to the leaseholder will mean that the leaseholder's profit rent will become negative instead of nil. Mr Clark applied the *Squarepoint* approach in both these appeals.

96. Ms Ellis rejected the *Squarepoint* approach because it only made a single valuation of the loss of gross rent receivable. There was no valuation of the ILI after the grant of a new lease. She argued that *Squarepoint* failed to take account of the headrent payable by the leaseholder. It simply ignored it. Consequently the leaseholder would receive the same amount regardless of whether he had a large or a small profit rent. She did not understand how such an approach could possibly be right. She also noted that the appeal in *Squarepoint* was effectively uncontested and involved no qualified valuers other than the Tribunal member. Mr Beckett rejected the idea of capitalising the gross income receivable by the leaseholder because he said what fell to be valued was the profit rent. At 62 Cadogan Square this did not exist. He said that to value the gross rents in these circumstances did not make any sense.

97. Mr Rainey said that the *Squarepoint* approach would be appropriate if there was no headrent payable under the intermediate lease since then the leaseholder would lose an income from the ILI but not incur a negative rental liability. But the method made no sense where, as

in 62 Cadogan Square, such a headrent was payable. The approach implicitly assumed a cross subsidy from the positive value of the remainder of the intermediate lease to the flat whose lease was extended. This was misconceived and failed where there was no positive value left after lease extension.

98. It was simply not the case that an ILI could be sold on the open market for a sum equal to the rent formerly payable by the tenant, capitalised at dual rates as though it continued to be rent receivable by the leaseholder. At 62 Cadogan Square the before value of the intermediate lease was nil and the after value would therefore be a negative sum even after one lease was extended. The market value of the intermediate lease, whether viewed as a whole or apportioned between each flat, would be the reverse premium that was required to induce a person to take an assignment of it. The intermediate lease endured after lease extension and became what Mr Rainey described as a bitter interest of negative value.

99. Mr Radevsky argued that the *Squarepoint* approach gave full and fair compensation to the appellants. It effectively involved a before and after valuation and calculated the diminution in the value of the leaseholder's interest in the flat resulting from the grant of the new lease. It examined what the leaseholder had lost by reason of that grant, namely the income from the tenant. Before the new lease was granted the value of the leaseholder's interest in the flat included (or comprised) the rental income from the tenant of the subject flat; after the grant of the new lease, the value of his interest in the flat was reduced to nothing because of the peppercorn rent then receivable. In every case the diminution in the value of the leaseholder's interest was the capitalised loss of the rental income from the flat concerned. It did not matter whether the value of the intermediate lease was positive, negative or neutral. The so called "tipping point" argument propounded by Mr Rainey, that as soon as the leaseholder paid more rent than he received the *Squarepoint* approach became insupportable, was a red herring and in any event did not arise in either the Regency Lodge or Albert Hall Mansions appeals.

100. Mr Dowding said that on any fair view of the matter what the leaseholder had lost was the value of the rent received. There was no justification for giving it anything more. In the 62 Cadogan Square appeal the leaseholder enjoyed no profit rent prior to the lease extensions. Adopting the appellant's valuation approach would make it better off (perhaps substantially so) after the lease extensions. That was wrong in principle.

Valuing the ILI: the capitalisation approach

101. In this valuation approach Mr Briant took account of the rent payable by the leaseholder as well as the rent receivable from the tenants. In the Regency Lodge appeals the parties agreed the "before" value of the ILIs. These were calculated by capitalising agreed profit rents at an agreed dual rate YP, with no tax adjustment (single rate in the case of flat No.27). Mr Briant's "after" valuation of the ILIs capitalised the headrent payable by the leaseholder for each flat at the agreed rates. These headrents had now become negative profit rents following the grant of the new leases.

102. Mr Rainey submitted that it was wrong in principle to use a sinking fund where what was being valued was a negative income stream. A sinking fund was necessary to recover the initial capital outlay on a leasehold interest. Where there was a negative profit rent a purchaser would receive a capital payment from the seller out of which the purchaser had to meet his rental liabilities and derive a return. At the end of the lease that payment ought to be exhausted since it was a reducing fund. It was wrong in principle to use the same remunerative rate to value the positive profit rent before the grant of a new lease and the negative profit rent after it. The risk factors associated with capitalising a positive income were not the same as those associated with meeting a liability. The higher the yield used to quantify the latter, the smaller the inducement payment would be and the greater the risk of not being able to meet the rental outflow or making a return.

Valuing the ILI: the total profit rent approach

103. Mr Briant introduced this alternative valuation approach in Albert Hall Mansions. He capitalised the profit rent on the whole intermediate lease before the lease extension on No.32 and he deducted from this the capitalised profit rent of the whole interest after such lease extension. Both valuations were undertaken on a dual rate basis with no adjustment for tax. The approach produced the same result as the capitalisation approach because they used the same dual rate YP and discount rates.

Valuing the ILI: the single rate approach

104. Mr Beckett said that the need to assume a sale under the Act meant that it was not an option for the leaseholder to say that he would retain his interest if he considered that the amount of the reverse premium required by a purchaser was too high. Ultimately he had to take the best proposition that was available to him in the open market. The person acquiring the ILI would have to be of sufficient financial probity and substance to be sure to discharge the future rental liabilities. Otherwise failure on the part of the assignee to pay the rent would mean that the current leaseholder would retain the obligation to do so under the principle of privity of contract. A person who accepted a liability to pay a future headrent (subject to upwards review) without the benefit of any rent receivable would only do so on the basis of total certainty with respect to his ability to discharge that liability. This meant that he would require a reverse premium equal to the amount of the rental liability capitalised at a single rate YP at the risk-free rate of 2.25% as determined in *Sportelli*.

105. He argued that the assignee would want to make a profit on the deal, represented by the difference between the risk-free rate of interest and the rate he would obtain by investing the reverse premium in gilt edged stock rather than from a higher, speculative property based return such as that suggested by Mr Clark. During cross-examination Mr Beckett said that although his instinct told him that the risk free rate was the correct capitalisation rate it may be that he "should edge that up touch" to allow for the fact that such a low yield provided no incentive for the intermediate leaseholder to sell. Mr Rainey later confirmed that upon further consideration Mr Beckett would not move from 2.25% "because of the effect of the rent review and the uncertainty. If it were not for that ... Mr Beckett could be persuaded to move to 3%".

106. Mr Clark did not accept that the single rate approach was correct because he doubted that in reality such an interest in residential property would come to market or, if it did, that it would attract interest from purchasers. Nevertheless he prepared alternative valuations using this approach. In his expert report he took a capitalisation rate of 4.25%, which was the yield derived from 2.5% Consolidated Stock. This was the yield used in the 1993 Act to value a MILI. At the hearing, and having listened to Mr Beckett's evidence, Mr Clark revised his capitalisation rate to 3.5% from 4.25%. He said that on reflection the latter yield provided an insufficient margin for the purchaser of the intermediate lease.

107. Mr Rainey submitted that the use of 2.25% as the capitalisation yield was reasonable. He pointed out that, according to *Sportelli*, property values will grow at an average annual rate of 4.5% (2.5% inflation + 2% real growth). Thus the agreed rent of 62 Cadogan Square from March 2006 of £45,500 would grow to £114,671 by the time of the next rent review in 2027. It was not credible to suppose that the assignee of the intermediate lease would accept such a negative liability without adequate cover against future rent reviews and without ensuring that they would make an adequate profit.

Valuing the ILI: The reducing fund approach

108. Miss Ellis introduced her approach, which she used in Regency Lodge, Albert Hall Mansions, Nailrile and Elms Court, by outlining a number of characteristics of the ILI after the grant of the new lease. She then considered who might be attracted to acquire such an interest. Ownership of the ILI would confer no beneficial occupation because there was no rental income, no certainty that any soft income (from the grant of licences or consents) could be achieved and no capital appreciation. She concluded that any prospective assignee would require an inducement or subsidy to offset these liabilities and to persuade them to take the interest.

109. In considering the hypothetical sale Miss Ellis argued that the assignor would have to sell to an assignee who he could rely upon to pay the future rent, comply with the lease covenants, not to abscond with the "endowment fund cash pot" (reverse premium), remain in existence and be scrupulous about any further onwards sale. In short, the assignee would have to be of undoubted covenant strength ("blue chip" or "AAA rated"). Miss Ellis concluded that the assignee would be the party having the necessary covenant strength that required the smallest endowment. She described this person as the least unlikely purchaser (LUP), as per Neuberger J in *Craven (Builders) Limited v Secretary of State* [2000] 1 EGLR 128. In order to induce the LUP to take an assignment of the ILI the assignor would have to offer a reverse premium that comprised an endowment fund from which to meet future rental payments, the owner's costs and VAT on the aggregate amount.

110. Miss Ellis rejected conventional valuation approaches when assessing the amount of the reverse premium saying that they should only be used to value intermediate interests with positive profit rents. She thought that Mr Beckett's single rate approach could produce the right answer where the rent payable was large although she said this was more by "luck than judgment". She also considered whether the LUP would accept a sum that was simply the

aggregate amount of the future rent payable over the term of the intermediate lease, making payments from that fund each year and investing the balance in the meantime. She rejected this idea because it might lead to over compensation of the leaseholder where the payment was large, due to the amount of interest that could be earned. She also said that it was "too inflexible to be the answer". Instead she preferred to undertake a depleting fund calculation (by means of a cash flow) to establish the initial amount of the endowment fund from which to meet future rental liabilities.

111. The endowment fund would be invested to produce an income that was sufficient to cover the assignee's outgoings and to provide an adequate return on ownership. Apart from rent the outgoings included administrative costs, accounting and taxation returns. Miss Ellis allowed for these by an annual management fee of £25 inflated at 2% per annum, the real rate of property growth determined in *Sportelli*. The interest earned on the fund was taken as the yield on 2.5% Consols on the Friday before the valuation date (this being the same as the yield used in the statutory MILI valuation formula). The yields used ranged from 4.02% (Regency Lodge) to 4.896% (Nailrile). This was a higher rate than that used by Mr Beckett or Mr Clark because she had explicitly allowed for costs and a return. The gross interest was then adjusted for corporation tax. A return to the LUP of "an absolute minimum" of £100 per annum net of tax was assumed, together with annual growth of 2%.

112. Miss Ellis conceded that her approach produced an inducement payment that substantially exceeded the aggregate rent where the negative rent was low. But Mr Rainey submitted that it was not sufficient just to say that the payment was too high. It was calculated on a rational basis and if Miss Ellis was in error then she must be shown to be so by reference to the statutory valuation hypothesis and to relevant case law, including that on the willing seller. The statutory hypothesis assumed a sale. There could not be a failure to agree. The market price might be very unfavourable to the vendor but, unless it was a ransom, that was the price. The leaseholder was not at liberty to walk away from the transaction rather than pay the amount calculated by Miss Ellis. The threat of walking away was a factor in the "higgling of the market" (as per Donaldson J in *F R Evans (Leeds) Limited v English Electric Co Limited* (1977) 36 P & CR 185 at 191) but in reality it could not happen. The value of the ILI did not depend upon whether the assignor was prepared to sell; it was a statement about what that person would have to pay as a reverse premium.

113. Mr Radevsky said that in both Albert Hall Mansions and Regency Lodge the LVT had given careful and well-reasoned judgments rejecting Miss Ellis's fund approach. These had not been shown to be wrong. The respondents' valuation approach produced a fair figure of compensation. Miss Ellis had accepted Mr Briant's valuations in the event that we accept his approach. There was no evidence to support Miss Ellis's assertion that the conventional method of compensating leaseholders led to any inadequacy of payment. Furthermore Miss Ellis did not use the reducing fund method when acting for freeholders and claimant lessees but only when acting for intermediate leaseholders. She was not sure about the origin of the Regency Lodge endowment funds, which were not supported by the valuations in her statement of case. No other surveyor used her method or would seemingly talk to her about it.

114. The result of applying the reducing fund method to Regency Lodge was to produce endowment funds that in every case far exceeded the aggregate rents payable, even before those rents had been discounted to their present value. This suggested that there was something fundamentally wrong with Miss Ellis's approach.

115. Mr Harry also criticised the "vast sum of money" produced by the reducing fund method and which the leaseholder had never lost. Miss Ellis accepted that other than losing his rental income the leaseholder saw no changes to his, or his tenant's, obligations under the ILI. So the only difference in the before and after situation was the loss of rent receivable. The LVT's method of valuing this in Regency Lodge adequately compensated the leaseholder for any losses that he suffered. Mr Harry endorsed the criticisms made of the reducing fund method by Mr Radevsky and added that Miss Ellis had accepted that it was almost impossible to imagine who the intermediate lease might be sold to. The use of her method required one to imagine a transaction that would not take place in the real world, where her hypothetical purchaser may well not exist and which led to a windfall payment to the leaseholder.

116. Mr Sefton added that the problem with the reducing fund method was that it amounted to a ransom valuation. Miss Ellis accepted that at her proposed price the vendor would be better off by not selling at all. She was wrong to conclude that the deal would nevertheless be done at that level just because of the requirement to hypothesise that a sale would actually happen.

Valuing the ILI: conclusions

117. Two features of the approach adopted by the Tribunal in *Squarepoint* are to be noted. The first is that it considered that it was the interest of the leaseholder in all the flats that fell to be valued. The second is that it valued the diminution in that interest by capitalising the gross rent lost through the grant of the new lease. The Tribunal in *Squarepoint* was dealing with an appeal in which only the appellant appeared. Here we have five appeals, encompassing a range of situations, before us and we have heard extensive evidence and argument on the part of freeholders, leaseholders and tenants. In the light of this some qualifications to the *Squarepoint* approach are in our view needed.

118. The *Squarepoint* approach is based upon what we identified in the circumstances described in paragraph 23 above as a compelling argument for saying that the proper measure of the leaseholder's loss is the capital value of the gross rent of the flat that he loses after the grant of a new lease. The Tribunal in *Squarepoint* found that it was the intermediate interest rather than the ILI that had to be valued. Whilst we have determined that it is the ILI as defined in paragraph 1 of Schedule 13 that should be valued (so that in this respect the Tribunal misstated the position), we have also found that where the hypothetical seller can be expected to have an interest in the other flats in the block as well as the ILI, so that the ILI would be sold as part of such a wider interest, and where, after the grant of a new lease, the profit rent of the intermediate lease remains positive, then the proper way to value the ILI is as a component of a sale of the whole intermediate interest. The *Squarepoint* gross rent approach generally achieves this, subject to the qualifications that we discuss below by reference to the Albert Hall Mansions and Regency Lodge appeals.

119. In Albert Hall Mansions Mr Briant uses the *Squarepoint* gross rent approach to calculate the diminution in the value of the ILI at £8,841. The same answer is obtained by using the capitalisation approach, which (in all but name) is the approach used by the LVT in *Squarepoint*. Using the capitalisation approach Mr Briant calculates the value of the ILI before the grant of the new lease at £6,158. The LVT in *Squarepoint* stopped at this point and failed to undertake the second valuation that is required, namely the valuation of the ILI after the grant of a new lease. This is represented by the capitalisation of the headrent payable until lease expiry using the same rates as the before valuation. Mr Briant calculates this in Albert Hall Mansions to be minus £2,683. The diminution in the value of the intermediate lease is therefore £6,158 minus (£2,683) which equals £8,841.

120. In this example the *Squarepoint* gross rent approach and the capitalisation approach give the same result. But that will not always be so. To illustrate this we examine the result of applying these two valuation methods to the facts of the appeal at 20 Regency Lodge. Using Mr Briant's figures, the *Squarepoint* gross rent approach gives a diminution in the value of the ILI of £2,208, whilst the capitalisation approach gives a figure of £2,246. The difference is due to the fact that, unlike Albert Hall Mansions, the headrent at 20 Regency Lodge is fixed for the remainder of the term. Mr Briant, correctly in our view, values the "after" headrent liability as a single term of 80.8 years (since there is no review of the headrent). If this term is divided into the three tranches equivalent to those used to value the (increasing) profit rent in the before valuation then the after valuation will be reduced by £38 and the diminution in value will be £2,208, the same figure that was obtained under the *Squarepoint* gross rent approach. In our opinion a fixed negative profit rent should be valued over the remainder of the term and should not be divided into notional terms that correspond with the pattern of rent reviews under the old underlease.

121. We conclude that the *Squarepoint* gross rent approach will give the same answer as the capitalisation approach where there are reviews of the headrent at the same time as rent reviews in the underleases. But as there will not always be such coincident rent reviews we prefer the capitalisation approach. It explicitly values on a before and after basis; it takes account of the intermediate lease to the extent that it is an interest in the tenant's flat; and it reflects both the rent payable and the rent receivable.

122. Miss Ellis expressed disbelief that *Squarepoint* could be correct because it takes no account of the leaseholder's profit rent. She said in her report:

> "I do not understand how such an approach can possibly be right when it means that the intermediate landlord's loss of, say, £500 per annum of income is the same, whether the current profit or the remaining obligation is £1 per annum or £499 per annum."

123. We think that Miss Ellis's concerns are misplaced with regard to the relevant calculation. It will make no difference to the *diminution* in value of the intermediate lease whether the profit rent is £1 or £499. In the former case the bulk of the diminution in value is accounted for in the after valuation which will be substantially negative and in the latter case it will be in the before valuation which will be substantially positive. But the end result, being the difference

between the two, will be the same – assuming that the same yields and YPs are used to value both the before and after cash flows and subject to the caveat expressed above about rent reviews.

124. In Albert Hall Mansions Mr Briant uses the alternative total profit rent approach, which values the whole of the intermediate lease rather than just the ILI in flat No.32. The answer, unsurprisingly, is the same. The only difference is that by including the whole of the demise the cash flows remain positive in both the before and after valuations. This accords with our conclusion that the proper way to value the diminution in the value of the ILI is as a component of the sale of the intermediate lease as a whole (see paragraph 32 above). Where such a valuation is based upon positive profit rents for the intermediate lease both before and after the grant of a new lease, as in Albert Hall Mansions, Regency Lodge and, were it not for the fact that the use of a fund approach is not in dispute, Elms Court, we consider that either the capitalisation approach or the total profit rent approach, which gives the same answer, should be used.

125. But the intermediate lease will not always have a positive profit rent after the grant of a new lease. Both Mr Beckett and Miss Ellis argue that where a purchaser is acquiring a negative income then he will need to receive a capital payment to induce him to accept the future rent liability. That being so, Mr Rainey submitted that there is no payment out of capital that must be recovered by use of a sinking fund. On the contrary there will be a reducing fund out of which the rental payments must be made. The use of a sinking fund to value a negative income is therefore redundant and the use of any dual rate YP is wrong in principle. He notes that Mr Briant accepted in cross-examination that the purpose of such a reducing fund and that of a sinking fund are not the same.

126. We consider firstly Miss Ellis's reducing fund approach to the problem. This focuses upon the viewpoint of the seller rather than upon who in the hypothetical market might be interested in the type of interest being disposed of. Miss Ellis argues that the seller will require the purchaser to be of undoubted covenant, "blue chip" or "AAA rated". She also assumes, for the purposes of her reducing fund approach, that the purchaser will require a minimum management fee of £25 pa and a minimum return, after tax, of £100 pa, both of which are increased by 2% pa. We think that the characteristics that Miss Ellis attributes to the assignee are too tightly drawn. She did not persuade us that a blue chip financial services company would be in the market for such a product as this, even though, hypothetically, the assignor might wish to dispose of his interest to an assignee of substance. She accepts that where the amount of the headrent is low then the willing seller may not insist on a sale to a corporate body of undoubted covenant because the consequences of the purchaser's failure to comply with the rental payment obligations will not be serious.

127. Miss Ellis's assumptions, taken together, produce results that are at times wholly unrealistic. In the appeals involving a small liability upon the leaseholder to pay the headrent following the grant of a new lease they produce absurd answers. It should be obvious, for instance, that a willing seller of the intermediate leasehold interest at Elms Court, where the total liability to pay future headrents (before discounting) is £275, would not be prepared to offer a reverse premium of £4,170, or over 15 times the total headrent, as suggested by Miss

Ellis. Her advocacy of this approach under these circumstances appears to us to give no weight to the need to consider the alternative options available to the willing seller during the hypothetical negotiations, one of which is to continue to pay the headrent himself.

128. The reducing fund method also produces results in the Regency Lodge appeals that are disproportionately high. The endowment funds calculated by Miss Ellis range between 3.2 and 5.5 times the gross aggregate headrents payable under the intermediate lease. Mr Briant points out that by his calculation (which was not challenged) the present value of the future headrent on 20 Regency Lodge is £450. Miss Ellis's endowment fund on this property is £9,390 or nearly 21 times this amount.

129. Miss Ellis concedes that there are problems with her approach when the headrent is low. She said:

> "…can I also point out that this problem of the fund being a lot larger than the rent payable is only applicable when the rent is small. One of the problems with any of the approaches that are under discussion here is that none of them seem to apply to all levels of rent. I know that there is a problem apparently on the face of it using a fund method when the rent is small…It is finding a solution that applies to all levels of rent that is one of the biggest problems and if anybody were to suggest that there might be more than one solution, the next problem is where do you draw the line."

130. We acknowledge the careful thought that Miss Ellis has put into the preparation of the reducing fund approach and the development of its theoretical foundations. But we do not consider that the results it produces satisfy the requirements for determining an open market value on the statutory basis. In our opinion the method does not take adequate, if any, account of the negotiating position of the willing seller and his ability to argue for the option of retaining the intermediate lease. She has failed to stand back and look at the end results to see whether they are a realistic and reasonable outcome to the required process of a hypothetical "higgling in the market" and whether they are valid across the range of factual situations that arise in practice when valuing the ILI after the grant of a new lease. In our opinion they are not and we do not favour this approach.

131. Mr Beckett's approach uses the single rate YP as a simple means of discounting, by using it as the present value of £1 per annum. In other words he uses it as a short cut to a discounted cash flow in which the capitalised value of the negative income flows represents the present value of the future rental liabilities at the chosen rate of 2.25%. That seems to us to be a logical and reasonable approach.

132. One of the conceptual problems when considering this issue is the reversal of the usual attitude to rental growth. Normally an investor welcomes the prospect of growth and reflects it in a low all risks (remunerative) yield. Where there is little prospect of such growth then the yield is increased. With a negative profit rent the position is reversed. The assignee of the intermediate lease would prefer there to be no rental growth. Certainty of his future rental liability is a paramount consideration. It provides a safer investment for which the assignee

will be prepared to accept a lower reverse premium than if the intermediate lease has reviews of the headrent payable.

133. Where the ground rent payable under the intermediate lease is fixed throughout the term (as at Regency Lodge and Elms Court) the purchaser will be prepared to accept a higher yield (discount rate) when considering how much he requires by way of a reverse premium. The rental liability at Albert Hall Mansions increases at known times and in fixed amounts. Again this merits a relatively high yield. However, at both 62 Cadogan Square and Nailrile there are rent reviews that are geared to the capital value of notional leaseholds at the time of review and the future liability is uncertain. There are three such rent reviews at Cadogan Square and two in Nailrile. In these cases it seems to us that the assignee would reasonably expect a lower yield to reflect the risk of having to pay a higher headrent of unknown amount.

134. Mr Beckett cites the uncertainty of the future level of the headrent as the reason for the yield of 2.25% when calculating the reverse premium payable at 62 Cadogan Square. This rate is the same as the risk free rate in *Sportelli* and represents, as Mr Dowding pointed out, a level of return that is guaranteed and one that gives the purchaser total security in meeting known rental liabilities. The problem at 62 Cadogan Square is that those liabilities are uncertain, although the parties agree that £45,500 is the level of the reviewed rent for the intermediate lease in 2006. Mr Rainey says that this is likely to increase to £114,671 by the time of the next rent review in 2027 (based upon the decision in *Sportelli* that property values will increase at an average rate, allowing for inflation, of 4.5% pa). The highest individual headrent for an ILI is for the flat at ground and mezzanine level, which is £13,923 from 2006 and just over £35,000 from 2027 according to Mr Rainey's growth assumptions. That is a substantial sum and we accept the need to reflect this in the choice of a relatively low discount rate.

135. In cases where there is a large, uncertain rent liability (62 Cadogan Square) we think that the appropriate discount rate to use in the single rate approach is 3.5%. This is the revised figure adopted by Mr Clark. We do not accept that the rate should be as low as the risk free rate of 2.25%. This ignores the ability of the assignor in negotiations to refuse to be ransomed and to walk away from a sale and, as Mr Dowding suggests, unduly favours the assignee. Mr Beckett has also explicitly removed the uncertainty of the 2006 rent review by capitalising the agreed rent on review. So the risk for half of the term is already accounted for. A 3.5% discount rate allows sufficient headroom for the assignee to invest in a variety of investments to meet future rental obligations and secure an adequate return, with the yield on 2.5% Consolidated Stock being approximately 4.25% at the valuation dates at 62 Cadogan Square. In our opinion there is no reason to suppose that the assignee would restrict itself to government stock as a means of funding its liabilities.

136. Although the amount of headrent involved in Nailrile is smaller than the flats at 62 Cadogan Square, it is a variable amount with rent reviews in 2007 and 2028. The parties have agreed the 2007 rent review at £1,056 per annum. We consider that it should be valued in the same way as No. 62 Cadogan Square.

137. We have determined that the ILIs in Albert Hall Mansions, Regency Lodge and, were it not for the fact that the use of a fund approach is not in dispute, Elms Court should be valued using the capitalisation approach. However, in the event that we are wrong that the proper way to value the ILI is as a component of the sale of the intermediate lease as a whole then we consider it appropriate to value those ILIs after the grant of a new lease using a single rate YP.

138. The headrent payable in Albert Hall Mansions increases in two steps from £182 to £364 per annum. We think that this presents a lower risk because it is a known and relatively small amount. In our opinion the head rent should be capitalised using a 4.5% single rate years' purchase, being the (rounded) yield on 2.5% Consolidated Stock at the valuation date.

139. In adopting a single rate YP to value 62 Cadogan Square Mr Beckett makes no adjustment for tax or other outgoings, saying that he has not done so because he sees "the rent review feature of the risk as so overwhelming as to negate the purpose of analysing those more subtle and sophisticated matters". He argues that his valuation is thereby inherently conservative. Miss Ellis takes account of tax in her reducing fund approach but agreed the alternative valuations of the other experts, should we prefer them, with no adjustment for tax. We are aware of the differences in view as to the appropriateness of making an allowance for tax. In the appeals before us the experts have made no such allowance when using the *Squarepoint*, capitalisation, total profit rent or single rate valuation approaches. We therefore make no adjustment for tax in the absence of any such evidence.

140. We conclude, therefore, that, where neither the MILI provisions nor a commutation of rent apply, an ILI should be valued after the grant of a new lease as follows:

(a) Where the reasonable assumption is that the ILI would only be sold as part of the leaseholder's interest in the block of flats and the leaseholder's profit rent will remain positive despite the loss of rent on the flat through the grant of the new lease, the diminution in the value of the ILI after the grant of that lease should be calculated by either the capitalisation or total profit rent approaches. The remunerative rate to be used is a matter of market evidence but, in our opinion, it is likely to be the same as that used to capitalise the value of the leaseholder's existing interest. The accumulative (asf) rate should be the risk-free rate of 2.25% taken in *Sportelli*. Any reversion to a higher fixed headrent should be valued as though it is an increased profit rent (albeit a negative one).

(b) Where the leaseholder's profit rent in the whole intermediate interest is negative following the grant of a new lease, the diminution in the value of the ILI should be calculated by the single rate approach. Where the headrent is either fixed or increases by fixed amounts throughout the term of the ILI we consider that the discount rate should be that of 2.5% Consolidated Stock. Where the headrent is subject to review to a substantial unknown amount based upon the capital value of a notional leasehold interest at the time of review then a lower discount rate is appropriate to reflect the increased risk. We consider that the appropriate rate will be between the risk free rate of 2.25% and that of 2.5% Consolidated Stock.

(c) In applying the single rate approach it is sufficient to assume that the assignee of the ILI is a sound covenant of good repute who can be expected to meet the future rental obligations under the headlease. It is not necessary to assume that it must be a covenant of the highest standing ('AAA' rating or blue chip). The smaller the headrent the less important becomes the status of the assignee.

(d) If we are wrong in concluding that the approach in (a) is open in law, the ILI should be valued by the single rate approach described in (b) above.

Valuing the ILI: summary of appeals

141. Applying these principles to the current appeals we find as follows:

(a) In Regency Lodge and Albert Hall Mansions the diminution in the value of the ILIs should be calculated using the capitalisation approach. The dual rates to be used have been agreed between the parties, although the asf rate should be 2.25% throughout.

(b) In Elms Court we find that the LVT was correct to reject Miss Ellis's reducing fund approach and we therefore dismiss the appeal.

(c) In 62 Cadogan Square and Nailrile the diminution in the value of the ILIs should be calculated using the single rate approach using a discount rate of 3.5%.

(d) As the alternative to the capitalisation approach we would calculate the diminution in value of the ILIs in Regency Lodge and Albert Hall Mansions by using the single rate approach using a discount rate of 4.5%.

Relativity

142. This issue is unique to the appeal in 62 Cadogan Square. Both parties challenged the decision of the LVT that the relativity, allowing for onerous ground rents (OGRs), should be 70%. The appellant said the appropriate figure, before allowing for OGRs, was 78% and the respondent said it was 69.2%. The parties agreed the allowance for OGRs for each flat, ranging from 3.5% to 5.5%.

Relativity: the case for the appellants - market evidence

143. Mr Kay reviewed the evidence of market transactions and adjusted it to arrive at leasehold vacant possession rates expressed in terms of a typical "best flat" in Cadogan Square, which he took to be a first floor flat on either the north or east side of the Square. He described this approach as the "matrix basis", the purpose of which was to analyse each transaction to arrive at a directly comparable rate per unit area. He then made a further adjustment to allow for the benefit of the Act and compared his results against the agreed freehold vacant

possession values (FHVP) to give a range of relativities. He described his evidence as being essentially the gathering of data that was then used by Mr Beckett to draw conclusions about the appropriate relativity.

144. The comparables were identified from two sources, internet databases and discussions with other valuers. The details obtained were then confirmed by reference to the Land Registry. Mr Kay identified a total of 77 transactions of which 63 were fully analysed. Fifteen of the transactions were of medium length leases that had comparable unexpired terms to the appeal properties. All of the comparables were located in Cadogan Square and all of the transactions took place within 12 months either side of the valuation date. Mr Kay only inspected two of the comparables.

145. Mr Kay made three kinds of adjustment to the comparable evidence. Firstly, he adjusted the sale price to the valuation date (November 2005) using an agreed index. Secondly, he made a series of locational adjustments depending upon which floor the comparable was on, whether it was "on" or "off" the Square and whether it was located to the north and east or to the south and west of the Square. Finally, he made several flat specific adjustments, eg whether it was modernised or unmodernised, or had a garden, balcony or private garage. He discussed these adjustments (which were expressed as percentages) at a meeting with other valuers and obtained their agreement to the quantum of the various adjustments required to bring the comparables in line with "best". He used the values for the adjustments agreed at that meeting apart from those for "off" Square which he said gave anomalous results. He increased these from minus 2.5% to minus 10% for flats that were obliquely off-Square and from minus 5% to minus 15% for flats that were entirely off-Square and on an "arm" of it.

146. Mr Kay also adjusted the comparables to allow for the benefit of the Act. He did this by deducting 25% of the marriage value at the date of the sale. The main benefit of the Act was the tenant's ability to obtain a lease extension. But a prospective purchaser of the tenant's interest would know that he could purchase a long lease in the market without having to pay four sets of costs (his own legal and valuation fees and those of the freeholder) to obtain such an extension. He would not pay 50% of the marriage value because of "the risks, delay and bewilderment that he will experience as the process proceeds". Mr Kay felt that it would be irrational for a purchaser knowingly to pay more than the FHVP value for the lease and said that the maximum that anyone would pay for the benefit of the Act was 50% of the marriage value to which the tenant was entitled.

147. Mr Kay explained the mathematics of his approach and produced a formula for the calculation of the benefit of the Act based upon his assumption that it was represented by 25% of the marriage value. The formula did not require the valuer to assume the relativity; that figure was derived from the calculation. Because the formula was time consuming Mr Kay also described a short cut version of his approach (which required either the assumption of relativity or the use of an iteration). He then explained a third approach, which he called a "rough assessment", and which relied upon the valuer simply choosing a percentage of the value of the lease to represent the benefit of the Act. Mr Kay said that 5% was appropriate for short and medium term leases and 2.5% for long-term leases (around 70 years).

148. Mr Kay considered five criticisms of his approach. Firstly, it had been said that purchasers do not always act rationally when buying short leases. He dismissed this as madness, saying that purchasers consulted their own interests. In any event any irrationality in one direction would be balanced out by irrationality in the other; the totality of market transactions would therefore not be irrational. Secondly, some critics had argued that the FHVP was changeable depending upon the relativity. But the FHVP was fixed and the relativity was a function of it, not the other way around. Thirdly, the approach was said to be circular, assuming what it set out to calculate (the relativity). That was true of the short cut and rough assessment methods but not the full mathematical model upon which Mr Kay relied. Fourthly, the ability to buy a short lease at a reduced value and then to extend the lease at a more convenient later date was considered by some to be a benefit of the Act. But generally people paid more for a flat with the assignment of a notice to extend, enabling the purchaser to proceed immediately with the purchase. Finally, there was a benefit in not having to pay the purchase price immediately. Mr Kay acknowledged this to be a potential benefit of the Act but said that it was offset by any continuing OGR and by the requirement to pay a 10% deposit on service of a notice. He also said that this factor had been accommodated within his calculations by his "conservative choice of benefit of the Act percentages".

149. The analysis of the medium term comparables produced 36 results for relativity, depending upon which of the four methods of assessing the benefit of the Act was chosen (Mr Wilson's method, described below, being taken as a separate method for this purpose) and which of 9 variants of the transaction data was preferred (with each variant presented as an average). The results, which allowed for OGRs, ranged from a maximum relativity of 87.6% to a minimum of 75.3% (the latter using Mr Wilson's approach to the benefit of the Act at 7.5%).

150. Mr Kay also analysed Mr Wilson's leasehold comparables on a floor-by-floor basis, using Mr Wilson's adjustments and producing an average capital value per unit area for each of three assumptions about the benefit of the Act. He took 5% (his own preferred rate), 7.5% (the figure used by Mr Wilson before the LVT) and 12.5% (the figure adopted by Mr Wilson before this Tribunal). He then took an average of these floor-by-floor averages to produce an overall figure of relativity which allowed for OGRs. At 7.5%, the relativity, allowing for OGRs, was 71.65% (using all of the average floor figures) or 69.92% (excluding the highest and lowest of the figures for individual floors).

Relativity: the case for the appellants - theoretical model

151. Mr Beckett described relativity as the mathematical relationship between the value of a leasehold interest in a property at any given term unexpired and the FHVP value. In the case of flats Mr Beckett said that the freehold value could only be used as a notional reference point because of the conceptual difficulties associated with flying freeholds. Consequently one should compare short and long leasehold values, the latter being at a discount to freehold value. At 62 Cadogan Square the parties agreed that the value of the unimproved long leaseholds with vacant possession was equal to 99% of the FHVP value. The ratio of short to long leasehold value represented what Mr Beckett described as the "normal" relativity. It was then necessary

to make a further adjustment to allow for OGRs. The parties agreed such adjustments for each of the six flats ranging from 3.5% to 5.5%.

152. Mr Beckett had developed a theoretical model for the calculation of normal relativity which he then compared with Mr Kay's analysis of market transactions to see whether he could "find an echo" in the sales data. He eschewed the respondents' use of graphs to undertake the comparison between short and long leaseholds. He acknowledged that he had found such graphs to be useful until recently. However, he now thought that the "graph of graphs" was virtually useless, representing as it did other people's thoughts about relativity rather than an objective assessment of relativity itself. He was critical of some of the individual graphs including those produced by Gerald Eve (derived from settlements that were based upon unidentified sales, not verifiable from the data, and a very narrow range of property, namely houses with rateable values close to, and either side of, the limits under the 1967 Act); Savills (poor methodology, based only on opinion, large variations in such opinion, illogical results); and the "suburban" graph relied upon in *Arrowdell Limited v Coniston Court (North) Hove Limited* [2007] RVR 39 (where mortgageability was the primary feature and therefore of no relevance to Cadogan Square).

153. Mr Beckett's theoretical approach was based upon the conventional method of valuing commercial leasehold interests, namely by the use of a dual rate YP. He considered that the qualitative differences between freehold and leasehold interests were reflected in the choice of the remunerative rate of interest. He said it followed "beyond question" that a leasehold investor would require a higher return than a freehold investor. He took 1.5% as representing this qualitative difference. Thus if the freehold capitalisation rate was 5.5% then he would take 7% on an equivalent leasehold to reflect the lower quality of the investment. He did not think there was any qualitative difference between a long leasehold interest and a 44-year leasehold interest.

154. The choice of remunerative rate depended upon three factors. Firstly, it had to be instinctively plausible; secondly, it had to correspond within reasonable bounds to capitalisation rates found in the real world on other kinds of investment; and finally, it had to find an echo in the real world (in evidence of transactions). Mr Beckett said that the application of these tests would enable a narrow range of capitalisation rates to be identified (in this case between 5% and 8%) and would eliminate both very low and very high yields. He considered that 5% was the minimum rate to capitalise the stream of benefits enjoyed by a tenant of a flat over the term of his lease. By taking the lowest likely rate Mr Beckett said that he was being conservative because in his model the lower the remunerative rate used the lower would be the relativity.

155. Mr Beckett described the remunerative rate as a capitalisation rate and not a yield. He said that the yield on rack rented residential properties let on assured shorthold tenancies (which had been as low as 3%) should not be used because they were not used to capitalise the value of those properties. Buy-to-let investments were a speculation on capital growth and the relationship between vacant possession value and the rent in ASTs was an artificial comparison. The vacant possession value was mainly derived from owner-occupiers where

the market had seen a dramatic re-rating over recent years. Rental values, however, had hardly changed.

156. There was also a quantitative difference between freeholds and leaseholds, with the former being interests in perpetuity and the latter being interests for only a fixed term. In order to compare the two it was necessary to provide for the recoupment of the capital outlay on a leasehold interest by means of an annual sinking fund (asf). At the end of the lease the investor would have redeemed enough capital to acquire another, equivalent leasehold interest and thus, in effect, would have made the leasehold a perpetual interest and therefore theoretically comparable with the freehold. The asf instalments had to be invested at a low, safe rate of interest in order to ensure that the original capital outlay was recovered. Mr Beckett took 2.25% as the sinking fund (accumulative) rate of interest, this being the risk free rate identified by the Tribunal in *Sportelli*.

157. Mr Beckett was uncertain whether or not to allow for tax on the asf instalments. In the model as presented in his evidence he made no such allowance and confirmed this during cross-examination and in subsequent written evidence.

158. The theory was then developed by using the dual rate YP to capitalise the annual value of the benefits and demerits of owning a lease on a flat, which Mr Beckett called £x. He said:

> "All that has to be accepted in order to draw an analogy between investment and the ownership of a leasehold flat is to accept that the capital value of a lease can be decapitalised or annualised – a proposition which seems to me to be beyond doubt at the level of principle."

The absolute value of £x did not matter and there was no need to calculate it because the assessment of relativity was an exercise in comparing £x capitalised on a dual rate basis over the number of years unexpired (leasehold) with the same £x capitalised into perpetuity. The value of £x was constant and was therefore cancelled out when determining the relativity, which thus became the ratio of the respective YPs.

159. Mr Beckett said that £x could not be equated to an adjusted AST rent. He distinguished between the rights of AST tenants and the rights of a lessee. For instance the latter had security of tenure, a known fixed rent, the power to change the flat (subject to the necessary consents) and the right to rent it out. He also considered that £x would be constant regardless of the length of the lease, subject to the general proviso that his theory of relativity only applied where the leasehold interest constituted "a form of ownership". He considered that leases of five years or less felt "more like a funny form of renting than ownership".

160. Applying the theory to the facts of 62 Cadogan Square Mr Beckett calculated the relativity by comparing the YP for 44 years at 5%, 2.25% asf and no tax (15.738) with the YP in perpetuity at 5% (20). This gave a ratio of 0.7869 or 78.69%. Mr Beckett rounded this down to 78%. He then deducted the agreed percentages in respect of OGRs and multiplied the resultant percentage by the agreed freehold vacant possession value of each flat. For example

the first floor flat at 62 Cadogan Square had an agreed freehold vacant possession value of £1,688,662 and an agreed adjustment of 3.5% for the OGR. Mr Beckett calculated the value of the current lease by taking 74.5% (78% - 3.5%) of the freehold value, ie £1,258,053.

161. Mr Beckett repeated the calculations of relativity using different remunerative rates ranging from 5% to 10% (keeping the accumulative rate constant at 2.25% and making no adjustment for tax). He plotted the results to create a series of graphs and then superimposed on it the relativities derived from Mr Kay's analysis of market transactions. Mr Beckett adopted Mr Kay's approach that produced the lowest relativity (75.3%) and which used Mr Wilson's approach to calculating the benefit of the Act (at 7.5% of the leasehold value in the Act world). He then added 4.5% to allow for the average of the OGR adjustments to the six flats at 62 Cadogan Square. This gave an adjusted (normal) relativity of 79.8%. Mr Beckett concluded that his figure of normal relativity of 78% was a doubly conservative one because it was calibrated against the lowest figure produced by any rational approach to the market evidence (75.3%) and was less than that figure when adjusted by the allowance for OGRs.

162. We asked Mr Beckett to explain how his theory could provide for the recoupment of the initial capital outlay on the leasehold interest in real terms. The conventional use of an asf only provided for the replacement of the historic cost. He accepted that it would not be possible to acquire a new 44-year lease for this historic amount. At the hearing Mr Beckett originally said that growth could be allowed for in the dual rate YP formula (which would lower the YP figure). Upon reflection he later stated that any growth in capital value would be matched in the long term by the growth in £x. This meant that each year, as £x grew, a larger sum could be set aside into the sinking fund to provide for the recoupment of the initial capital outlay in real terms. He concluded that the YP would not fall if a growth-explicit future capital value were allowed for.

163. Mr Beckett submitted further written evidence on this point. He produced a series of four cash flows illustrating how the conventional asf worked and trying to extend and adapt the concept to allow for the recoupment of capital in real terms. In his last cash flow Mr Beckett calculated what the asf rate would have to be in order to produce the correct amount of capital in real terms. The answer was approximately 4.38%. Mr Beckett suspected that the actual asf rate to adjust to a growth explicit basis was 4.25%, being the 2.25% adopted plus the assumed growth rate of 2%. He said that a higher, but certain, hypothetical growth rate implied a higher risk-free rate. He concluded that a sinking fund rate fully adjusted for whatever assumption may be made about growth resolved the model to provide fully for capital replacement.

164. Mr Beckett said that the purchaser's means was a critical feature that was missing from the attempt to adjust everything onto a growth explicit basis. He considered that the theoretical model should allow for this because, unlike an investment, occupation of a home was not a discretionary thing. The best way to incorporate this factor was to make a working assumption that whatever assumption was made about the growth in property values should also be made about the purchaser's means. At the end of a lease the purchaser would expect that his means would have risen in line with property values so that he could afford to buy a

new lease. Mr Beckett said that the inclusion of the purchaser's means in the model neutralised the effect of inflation and the growth of property values.

Relativity: the case for the appellants - submissions

165. Mr Rainey submitted that Mr Beckett's theory of relativity did not purport to be a method that was used in the market. It was a model and a means of analysis that relied upon conventional valuation methodology and applied it in a new way. It removed the problems of making explicit adjustments for the benefit of the Act when analysing evidence of transactions and of whether or not there should be a deduction for leaseholder hope value (this being excluded under the model). It also demonstrated that it was possible to produce rational and standardised graphs of relativity of a kind that had been espoused by the Tribunal in *Arrowdell*. Finally, the application of Mr Beckett's theory avoided the need to obtain detailed market evidence where this was not practical.

166. Mr Clark had accepted in principle that if a lease had a capital value then that value could be annualised. Mr Beckett had labelled that annual value £x. The existence of rent reviews was dealt with by a separate adjustment for OGRs and the effect of improvements would only have an impact when the unexpired term of the lease was short, Mr Beckett having accepted that his method did not work for leases with less than five years unexpired. Mr Beckett's assumption of a normal service charge was reasonable. His approach to future growth was logical; if capital values were assumed to grow at 2% per annum then, given that £x was the annualised value of the capital, £x would inflate at the same rate. Mr Clark expressed misgivings but did not say that the 2% growth assumption necessarily undermined Mr Beckett's approach.

167. The plausible range of capitalisation rates accepted by Mr Beckett was not large (5-8%). Mr Beckett did not compare a (higher) leasehold rate with a (lower) freehold rate because the true comparison for the purposes of determining relativity was between a medium term lease and a very long lease, not a freehold. Yields derived from AST lettings were not true capitalisation rates and should not be used in the analysis. Mr Beckett described three approaches to finding the capitalisation rate and was satisfied that his choice of 5% was reasonable and supported by the market evidence. When such evidence was plotted against Mr Beckett's theory graph it showed that his approach was well founded and further demonstrated that the Gerald Eve/John D Wood (1996) graph (the GE graph) lay outside the plausible range of relativity. The Tribunal had the benefit in this appeal of extremely strong market evidence against which to test Mr Beckett's theory. There were a large number of comparable transactions in Cadogan Square that related to architecturally uniform buildings and which enabled meaningful comparisons to be made. The amounts in issue were sufficiently high to justify the time and expense of a comprehensive analysis that would not be possible ordinarily.

168. Mr Rainey submitted that the results of Mr Kay's analysis refuted Mr Wilson's contention that the market evidence supported the GE graph. That graph produced a relativity of 64.9% (allowing for the deduction of average OGRs at 4.38%) and was up to 6.75% below

the relativity derived from Mr Wilson's own market evidence (see paragraph 150 above). That contrasted with a maximum variance of only 3.70% when the same evidence was compared against Mr Beckett's theory graph (taking the theoretical relativity as 73.62%, i.e. 78% minus the average value for OGRs). If the benefit of the Act was taken at 5% then the difference in the comparison of the market evidence with the two graphs became even more marked, with the maximum variance from the theory graph being 1.74% and from the GE graph being 8.78%. It was only if the benefit of the Act was taken at 12.5% that the variation of Mr Wilson's data from that of the GE graph was reduced to within 1% to 2%. It was highly significant that Mr Wilson had adjusted his allowance for the benefit of the Act to 12.5% in November 2007, after the decision of the LVT.

169. Mr Kay's matrix approach was reliable. He had used it consistently for short and medium term leaseholds and for determining FHVP values. In the case of the latter the matrix approach produced figures that were within 3% of the agreed compromise values which demonstrated the robustness and reliability of the method. The only adjustment made by Mr Kay but not by Mr Wilson was in respect of floor level. By making this extra adjustment Mr Kay avoided the difficulties inherent in a lack of comparables on specific floors. With only a small number of comparables any errors in analysis might be significant; using the matrix approach any such errors would tend to balance out given the much larger number of transactions to depend upon.

170. When it came to making his adjustments to the comparables for being "off" the Square Mr Kay was criticised for ignoring the views of the experienced valuers whom he had consulted. But the adjustments suggested by them were not based upon empirical data and produced anomalous results when compared with the "best" rate for an "on" Square property. In any event Mr Wilson's own adjustment for "off" Square properties was itself twice the figure suggested by the valuers.

171. Mr Kay's evidence about the condition of the comparables had been challenged on the basis that he had not inspected most of them and had relied instead upon agents' particulars. Nevertheless he was able to depend upon his general experience of inspecting flats from which he concluded that those agents were unlikely to undersell a property. Mr Wilson's own adjustments for condition had been shown to be erratic and inconsistent.

172. In *Arrowdell* the Tribunal held that it was necessary to do the best it could with the transactional evidence available, albeit that those transactions were undertaken in the Act world. Before the LVT both parties had quantified the benefit of the Act by estimating what proportion of the tenant's half of the marriage value was included in the Act world purchase price. Mr Kay and Mr Beckett assumed that the purchaser would pay half of the tenant's marriage value and had developed a rigorous mathematical model for reflecting that assumption in the calculation of relativity. Mr Wilson and Mr Clark on the other hand assumed that the purchaser would pay all of the tenant's marriage value, and sometimes more than that. This was unrealistic because the purchaser would inherit the risk and uncertainty about the timing, amount and the expense of obtaining such marriage value. Mr Beckett showed that applying Mr Wilson's adjustment of 12.5% for the benefit of the Act produced a loss to the purchaser of a medium term lease when compared to the alternative of simply buying a long

lease. It assumed irrationality and had to be wrong. The appellant's approach was supported by the case law. In *Arbib v Earl Cadogan* [2005] 3 EGLR 139 the Tribunal preferred evidence that the proportion of the marriage value paid by the purchaser in the Act world should be 25% rather than 50%. The LVT reached the same conclusion in *Henry Smith's Charity Kensington Estate Trustees v Frampton* [1985] 1 EGLR 239.

173. Mr Wilson said that 50% of the marriage value for Act rights equated to 12.5% (15% less 2.5% for OGRs) of the value of a 40-45 year lease with Act rights. He had previously said before the LVT that it equated to 7.5% (10% less 2.5% for OGRs). Mr Wilson was not able to justify his new approach, there being no discernible and consistent pattern in the empirical data to support his change of mind. Mr Wilson said that he had been persuaded over the last couple of years or so " but ultimately the evidence is not there". Mr Rainey said that Mr Wilson had accepted in cross-examination that he had changed his mind because otherwise his analysis of the comparable evidence would be inconsistent with the GE graph.

174. Mr Rainey submitted that settlement evidence was self-reinforcing and a substitute for proper analysis. It had been criticised by the Tribunal in *Arbib*. The GE graph depended upon such settlement evidence and had not been amended even though it was apparently kept under constant review. It appeared that any fresh market evidence was considered to be of poor quality if it did not conform to the graph. The graph would always prevail and would never be altered on review. Mr Rainey submitted that the GE graph had been prepared in order to "send out a message" to the market about the Grosvenor Estate's position on certain valuation matters. It should not be a first or only resort and was neither sound nor reliable. The settlement data upon which the GE graph was based comprised mainly house sales. There was a significant qualitative distinction between a leasehold house and a freehold house whereas no such distinction existed between a medium and a long leasehold interest. One of the authors of the graph, John D Wood & Co, had disowned it in no uncertain terms. It was historic and had been prepared in different market conditions.

175. Mr Beckett did not make any allowance for hope value. Mr Clark made a 5% deduction from relativity for tenant's hope value, which he said was the same as that for the freehold reversion. This was indefensible because it was the freeholder who controlled the situation in the no Act world. Mr Rainey submitted that in the no-Act world there would be no such tenant's hope value.

176. Mr Beckett should be given credit for trying to devise a rational hypothesis which could be tested against market evidence. He was the only expert to do so, despite the exhortations of the Tribunal in *Arrowdell* for experts to produce a reasoned basis for relativity. Once the theory and the resulting graph had been validated against market evidence, as it had been in this appeal, it could be applied in future without further recourse to comparables. Mr Rainey said that Mr Beckett's validated approach should be endorsed where (as often is the case) there is insufficiently reliable market evidence upon which to proceed.

Relativity: the case for the respondents - evidence

177. Mr Wilson used two approaches to calculate the value of the existing leasehold interests. Firstly, he applied the GE graph with adjustments for the OGR provisions. Secondly, he analysed sales of similar leasehold interests within Cadogan Square.

178. The normal relativity derived from the GE graph for a 44 year unexpired lease was 69.2% from which Mr Wilson deducted the agreed adjustments for OGRs. He explained that the GE graph had been compiled by Mr Ian McPherson of Gerald Eve and Mr George Pope of John D Wood and Co. He said that the data on which the graph was based was derived from three sources, all of which involved properties within the central London Grosvenor and Cadogan Estates. Firstly, an analysis of settlements from 1974 to 1996 pursuant to enfranchisement claims for both houses and flats (with the majority of settlements being in respect of the former). Secondly, from sales of leasehold interests in houses and flats that fell outside the scope of the legislation and which were used as comparable evidence during negotiations. Finally, from sales of freeholds with vacant possession which were also used as comparables during negotiations.

179. Mr Wilson acknowledged that John D Wood and Co had subsequently distanced themselves from the GE graph and that this Tribunal had been critical of it in *Cadogan Holdings Limited v Pockney* [2004] LRA/27/2003 unreported. Whilst Mr Wilson was aware of (and outlined) other graphs, he decided to use the GE graph for a number of reasons. Firstly, it was broadly consistent with WA Ellis's own schedule of relativities which compared sales of non-qualifying leaseholds with the corresponding freeholds with vacant possession. Three experienced partners in WA Ellis, all of whom were based in the Knightsbridge office, had prepared the schedule. (He acknowledged, however, that he had not been able to find the original file that described the construction of this schedule.) Secondly, experienced valuers with an extensive knowledge of the area prepared the GE graph, relying upon transactions that pre-dated the 1993 and 2002 Acts. Thirdly, he considered the other graphs to be less reliable because they were based upon opinions of value or upon post 2002 settlements or LVT determinations or were geographically remote from the appeal site.

180. Mr Wilson accepted that, to the extent that it was based upon settlements, the GE graph was susceptible to criticisms of the use of such settlements as evidence. He agreed that a settlement price was the result of a deal, a horse trade, between the parties, with the deferment rate and relativity being the most contentious issues. He did not accept that the settlement evidence underlying the GE graph was self-reinforcing by being used against tenant valuers who could not match the breadth of data that made up the graph. He said that tenant valuers were quite capable of negotiating in the face of "a battalion of settlements behind the estates valuer" and that other firms now had their own schedules of settlements in any event. He acknowledged that constant reference to a body of settlement evidence might be self-perpetuating but that in the circumstances it was the best that one could do.

181. He supported the GE graph by comparing its results with an analysis of several leasehold reform settlements that he had dealt with personally and which involved similar unexpired

terms. These included four flats at 61 Cadogan Square where negotiated settlements were reached, allowing for OGRs, of between 65.25% to 65.40%; seven flats at 36 Sloane Court West where settlements were reached, allowing for OGRs, of between 62.41% and 64.13%; and Flat 4 at 39 Cadogan Square where a normal relativity of 68% was agreed and which was adjusted by agreement to 60.25% to reflect the OGR. He gave details of a further 12 cases with similar (but slightly shorter) unexpired terms which, when adjusted to 44.1 years, showed normal relativities that averaged 70.55%.

182. Mr Wilson's second approach was to analyse sales of similar unexpired leasehold interests within Cadogan Square. He rejected Mr Kay's matrix approach which expressed all analysed sales as a capital value per square metre in terms of first floor (the best) accommodation. He had never previously come across an analysis of sales that made this adjustment. He thought it was unnecessary and said that the more adjustments that were made the more potential inaccuracies were introduced into the exercise.

183. He adjusted the comparables for a number of factors, starting with the agreed indexation of the sale price to the valuation date. He then adjusted for the length of the unexpired term by expressing the indexed sale price in terms of an unexpired term of 44.1 years using the relativities contained in the GE graph. Further adjustments were then made for the benefit of the Act at both 7.5% and 12.5%, improvements and disrepair, outside space and position. All of the comparables had similar OGRs to the appeal property and no adjustments were therefore made in respect of them. The price after these adjustments (with alternative figures given depending upon the value ascribed to the benefit of the Act) was then compared with the agreed freehold values per square metre for 62 Cadogan Square on a floor-by-floor basis.

184. Mr Wilson started by looking at the sale of the second floor flat at 62 Cadogan Square (one of the appeal properties) in October 2003. He said that he placed most weight on this transaction. Taking 7.5% for the benefit of the Act produced a value of £7,730 per m^2 or 65.33% of the freehold value. (At 12.5% for the benefit of the Act the corresponding figures were £7,313 per m^2 or 61.78%.) He concluded "this analysis sits comfortably with the 1996 [GE] graph approach." That showed a normal relativity of 69.28% for an unexpired term of 44.1 years or 65.28% when adjusted (as agreed) for OGRs.

185. Mr Wilson relied upon four other sales of second floor flats (including two sales of flat 3 at 65 Cadogan Square), which produced values of £6,395 per m^2 to £9,070 per m^2 using 7.5% for the benefit of the Act. The highest figure related to flat 5A at 61 Cadogan Square which is a mansion building where the second and third floor flats were more valuable than first floor flats. Mr Wilson said it was questionable whether this building should have been included in the analysis. He placed the least weight upon it as a comparable. Excluding number 61 the highest value (apart from number 62) was £7,428 per m^2 at 7.5% in respect of the second sale of flat 3 at number 65 in April 2006 at which time the property was described as being in pristine condition. At the time of the first sale of this flat in August 2004 (£6,395 per m^2 at 7.5%) it was described as unmodernised and in need of repair. Mr Wilson concluded that although the analyses of flat 3 at number 65 were to lesser sums than the appeal flat at number 62 they were "within an acceptable margin".

186. Mr Wilson undertook similar analyses in respect of the other floors (basement, ground, first, third and fourth). He produced five first floor comparables, three of which were at number 61 with one flat (number 5) being sold twice. They all produced figures less than the second floor flats in the same building. The other two sales, at numbers 64 and 69, indicated values close to the extended leasehold value of £13,551 per m^2. Mr Wilson said, "on the face of it, the sale prices here are over the odds". Eight comparables of third floor flats were analysed including three sales of flat 7 at number 61. Whilst the first of these, in March 2004, was in line with the GE graph approach, the two subsequent sales, in April 2005 and March 2008, were respectively above and well above what was predicted by the GE graph. The sale of flat 3 at number 11 also showed a capital value higher than expected. The two sales of flat 4 at number 69 showed an increase of 35% between April 2005 and December 2006 which may have been attributable to refurbishment works. The second sale was also above the expected value derived from the GE graph. The remaining two comparables, flat 3 at number 39 and flat 8 at number 61 were in line with and above the GE graph respectively. The analyses of the four upper (fourth floor) comparables were said to be marginally above the GE graph, whilst those of the ground and mezzanine floor flats were "of the order that one might otherwise expect".

187. Mr Wilson concluded:

> "Overall, the analyses are not wholly conclusive, but in my opinion support the 1996 [GE] graph approach in the main. When taken together, the two approaches support one another."

188. Mr Clark did not disagree with Mr Wilson's conclusions about relativity and adopted his figures in his valuations. He therefore derived the relativity of the existing leasehold value to the [notional] freehold value for each floor of number 62 by taking 69.2% less the appropriate allowance for OGRs. He then made a further deduction of 5% in respect of the tenant's hope value, a figure that was proposed by Mr Wilson. Mr Clark said that to do so was consistent with his exclusion of hope value from the freehold reversion in the subject flats.

189. Mr Wilson said that the deduction in respect of hope value was a new concept for him and was not one supported by evidence. He said that he had quantified the deduction at 5% by analysis and discussions with Mr Clark and Ms Frances Joyce, a colleague of Mr Wilson. He said that it was reasonable to take the same figure for the tenant's hope value and the freeholder's hope value.

190. Mr Clark did not accept Mr Beckett's theoretical approach to relativity. He did not agree that a dual rate YP could be applied to residential leasehold interests, and said that £x, the annual value of the lessee's bundle of rights, was not constant and was best represented by rents derived from AST lettings. He said that Mr Beckett had accepted that £x would increase in line with capital appreciation. AST rents were also potentially able to appreciate annually. Mr Clark thought that Mr Beckett's remunerative rate of 5% was too high and produced a theoretical graph that was inconsistent with Gerald Eve's settlement evidence. He said that net AST yields of between 2% to 2.5% would be more appropriate.

191. Mr Clark submitted further evidence about how Mr Beckett's theoretical model might be adjusted to allow for the recoupment of the initial capital outlay in real terms. Mr Clark's solution was to multiply the asf instalments in the dual rate YP formula by the rate of real growth (taken at 2%) compounded over the length of the unexpired term. The effect of this adjustment was to lower the YP. Mr Clark said that plotting the results on a graph revealed that the leasehold relativity never exceeded 78%, even for unexpired terms as long as 100 years. The graph was flattened by comparison with the GE graph and Mr Beckett's theoretical graph. Mr Clark thought that this result was at odds with the general expectation that at or around 100 years unexpired term the leasehold relativity rose to about 98%. For this reason he doubted that the inclusion of a growth factor was correct. Mr Clark said that Mr Beckett's adjustment of the accumulative rate to 4.38% in order to achieve the full growth-explicit replacement of the capital required to acquire a new lease lent weight to his view that Mr Beckett's general approach must be flawed. He also considered that Mr Beckett's introduction of the means of the leasehold purchaser as another variable undermined the credibility of his theoretical model.

Relativity: the case for the respondents - submissions

192. Mr Dowding submitted that Mr Beckett's theoretical model of relativity failed to satisfy the claims that Mr Beckett made for it, namely that it was an orthodox approach that applied conventional methodology; that it had predictive power; that it could be applied without needing to know the value of the annual "flow of benefits" (£x) or how that value was calculated; that it was free from contamination by the Act; and that it could be used without reference to market evidence and, in particular, without the need to adjust the comparable sales evidence for the benefit of the Act.

193. Mr Beckett's model worked by starting with the theory and then looking to see whether it found an echo in the real world of the market. He thought that it was "a policy of despair" to base the assessment of relativity upon market observation or instinct. Mr Beckett accepted that a purchaser in the market for a leasehold interest with 44 years unexpired would not use his model in practice. The reason that they would not do so was because this was a capital market that did not rely upon the capitalisation of notional annual values. The model was divorced from reality and was in no sense conventional or orthodox. It was different to the commercial market where dual rate YPs were used to capitalise income streams.

194. The model was not universally applicable. It did not work for all lengths of unexpired term. Mr Beckett thought that it would apply for terms between 15 to 70 years but not to short leases that felt "like a funny form of renting". He also said that it only applied to non-mortgage dependent markets. A different relativity applied to mortgage dependent markets based upon another, unspecified approach. There was no clear distinction between the two markets and no way of identifying the degree of mortgage dependence in any particular case. Furthermore there was apparently a different graph (not produced in evidence) for freehold interests in houses compared to virtual freeholds in flats. Mr Beckett said that there was a qualitative difference between the two.

195. Mr Dowding said that Mr Beckett's theoretical model was critically sensitive to the choice of a yield. Mr Beckett had identified three inputs into the selection of the appropriate rate. The first of these, reference to commercial yields, was deeply unsatisfactory. There was no support for a correlation between the residential owner-occupier market and the market for commercial investments. There was a wide spread of yields in the latter market and it was impossible to fix the theoretical yield for the model by reference to the notion of a single prevailing capitalisation rate. This concept also produced the improbable result that Mr Beckett's model would give different results for relativity depending upon the state of the commercial investment market at any particular valuation date. Mr Beckett described the second input into the choice of capitalisation rate as instinct. Mr Dowding rejected this as a rational approach. The third input was to analyse market transactions and to derive the yield from the relativities that emerged. In effect the yield would be determined by seeing what rate produced a graph with the best fit to the empirical data. Mr Dowding said that this approach was hopeless because it was circular. The theory was supposed to produce an answer without reference to the tainted market evidence. But by trying to "find an echo" in the transaction data Mr Beckett's theory became wholly dependent upon the type of analysis that it was meant to avoid. In any event Mr Kay's analysis produced such an enormous spread of relativities (from 65% to 117.7%) that they offered no support at all for the choice of a particular yield. Mr Beckett had recognised that such an analysis only showed what the yield was not rather than what it was. Even if it were possible to prove one or other of the theory curves from such varied results, such poof would still depend upon the correctness of Mr Kay's analysis. The respondents disputed that.

196. The Tribunal had identified three problems with the theoretical model that Mr Beckett had not addressed. Firstly, it did not allow for tax on the asf instalments. Secondly, it did not provide for the recoupment of capital in real terms; and, thirdly, it made no allowance in the rates used for the qualitative differences between a freehold and a leasehold investment. Mr Clark had shown that if such matters were factored into the calculation then the relativities would be way below Mr Beckett's figures.

197. Having concluded that no reliance could be placed safely upon Mr Beckett's theoretical model, Mr Dowding considered the use of the GE graph to determine relativities. He reviewed the background to its compilation and noted that it was now based upon a total of 1,404 settlements. The appellant accepted that the graph was an accurate representation of this settlement evidence (at least in respect of the length of unexpired term under consideration. Mr Beckett checked 142 flat settlements from Gerald Eve's schedule and concluded that they had been accurately shown on the graph). Mr Beckett accepted that the analysis of each transaction was broadly fair.

198. Mr Dowding then reviewed those criticisms of the GE graph that were still being pursued by the appellant. It was said that the graph was historic and had been drawn up in different market conditions. But it was kept under constant review and Mr Beckett's analysis of 142 post 1996 settlements showed that the graph was still valid. John D Wood and Co had now dissociated itself from the graph. But when Mr Pope, the joint creator of the graph, left that firm he took the Grosvenor Estate work with him and the bulk of the remainder of the firm's instructions would have been for tenants. John D Wood and Co might have had a vested interest in disowning the graph after that date. The appellant argued that the GE graph was

based upon houses rather than flats. But Mr Beckett had checked 142 flat settlements against the graph and found them to be in conformity with it. Although the Tribunal had criticised the use of settlement evidence there was no compelling reason for the view expressed in *Langinger v Earl Cadogan* [2001] Lands Tribunal LRA/46/2000 (unreported) that settlements underestimated the relativity. Nor was it always the case that settlements were evidence of the agreed price rather than specific evidence of relativity. In this appeal Mr Beckett had accepted that the Gerald Eve analysis was broadly fair and not self-serving. There was no evidence that there was a Delaforce effect in the scheduled settlements. That was not surprising with claims involving high value properties in prime central London. The settlements had been given serious consideration by the valuers and had been actively debated. Mr Beckett's criticism that he had only seen the settlement evidence on which the graph was based and not the full details of the comparables used in achieving those settlements was of very little weight given their number and Mr Beckett's acceptance that they were not self-serving.

199. There were seven criticisms of Mr Kay's valuation approach. Firstly, he had not valued the appeal flats but had only produced a series of average relativities for use by Mr Beckett. Secondly, his unconventional matrix approach involved adjusting every transaction to a notional first floor value even though those transactions only contained three first floor comparables, two of which related to flats at number 61, a mansion building distinguishable from the other converted houses in the Square. This technique involved very large adjustments, for instance, plus 150% to equate a fifth floor flat to first floor values. The adjustments themselves depended upon the outcome of a valuer's meeting, the specific purpose of which was not made known to the participants. Thirdly, Mr Kay had imposed an arbitrary time limit of one year either side of the valuation date when considering transactions. This meant that he had ignored relevant evidence, including the sale of the second floor appeal flat. Fourthly, the sheer scale of adjustments that the method involved illuminated one of its major problems, namely that it involved valuing one thing by reference to something almost entirely different, purely because they happened to share a Cadogan Square address. Fifthly, Mr Kay's adjustments were not based upon inspection or discussion with agents (which he dismissed as an anecdotal approach). Mr Kay had, almost entirely, referred to sales particulars. Sixthly, the matrix approach had been applied rigidly and without regard to individual variation, such as the entirely different characteristics of the mansion block at number 61. Mr Kay placed greater weight on consistency than he did upon accuracy. Lastly, Mr Kay had not exercised valuation judgment. Even where his meeting with valuation experts had produced a consensus for an adjustment he would change this if it would otherwise produce what he considered to be anomalies within the matrix.

200. Mr Wilson's approach depended upon valuation judgment and detailed investigation of the comparables, most of which he had inspected. He made no more adjustments than were necessary and therefore he did not adjust every comparable to first floor values, an approach that he described as "completely alien". Instead Mr Wilson analysed comparables on a floor-by-floor basis and having done so he was prepared to stand back and apply his valuation judgment to the results. He eschewed the use of averages favoured by Mr Kay. The outcome did not result in a consistent tone of value for each floor but Mr Wilson did not expect it to; a precise alignment of value would have been "a fudge". He therefore recognised that the market was neither wholly perfect nor wholly rational.

201. Mr Dowding contrasted the experience of the valuers who had produced the evidence of transactions. Mr Kay had no residential experience and was not in practice prior to the 1993 Act. He had no experience of Cadogan Square prior to this appeal and he had no agency colleagues with whom he could consult. The details of his evidence came from databases and from Mr Wilson. He had not discussed the transactions with the agents involved and, apart from the appeal properties, he had only inspected two of his 77 comparables. He had convened a meeting of experienced Cadogan Square valuers to learn about the local market and to inform himself about the appropriate adjustments to make. Mr Wilson, by contrast, had been in practice as a residential agent in central London before the 1993 Act and had considerable experience of Cadogan Square itself. Between 1986 and 1993 he was involved with sales of (then unenfranchisable) leases of flats in Cadogan Square. He could also consult agency colleagues at W A Ellis. He had inspected most of the comparables upon which he relied. Other than against the Cadogan Estate he acted for tenants as well as landlords. Under these circumstances Mr Dowding submitted that Mr Wilson's evidence was to be preferred when it conflicted with that of Mr Kay.

Relativity: conclusions

202. Mr Beckett seeks to develop a robust theoretical model of relativity that is supported by the evidence of market transactions. If successful the model can be used universally and objectively, avoiding the need to rely upon disputed graphs of relativity. We commend Mr Beckett's efforts to achieve this desideratum, which were thorough, thoughtful and clearly explained. However, we find that he has failed in his attempt. Mr Beckett's model relies upon the use of what he describes as conventional valuation theory, namely the use of dual rate YPs to value residential leasehold interests. As Mr Dowding points out, the use of such YPs is unconventional in the present context and several criticisms have been made of its theoretical rigour.

203. Firstly, the theory depends upon the quantitative differences between freeholds and leaseholds being negated by the use of an asf to recoup the initial capital outlay on the leasehold interest, thereby enabling the investor to acquire an equivalent leasehold at the expiry of the term. It was pointed out to Mr Beckett that conventional valuation theory only provides for the recoupment of the historic capital outlay and that this is unlikely to buy an equivalent leasehold due to the growth in real values over the length of the unexpired term. Mr Beckett argues that if the asf (accumulative) rate were increased by the rate of real growth then the model would provide completely for the replacement of capital in real terms. In order to achieve this in the present appeal the interest earned on the asf would have to be 4.38% (although Mr Beckett suspected that this rate should be 4.25%, being the risk free rate of 2.25% plus 2% real rate of growth). He concluded:

> "Even if I am wrong about the possibility of a mathematical proof, then certainly a higher, but certain, hypothetical growth rate implies a higher risk-free rate."

In our opinion the rate of real growth does not affect the risk-free rate, which was defined in *Sportelli* as:

> "The return demanded by investors for holding an asset with no risk, often proxied by the return on Government security held to redemption."

The risk free rate is not a function of the rate of growth.

204. Mr Beckett's cash flow models are an ex post facto analysis of what the asf rate would have to be (4.38%) in order to recover the initial capital outlay in real terms assuming the adoption of a dual rate YP with a 2.25% asf rate to calculate that initial outlay. He says, in effect, that 4.38% is a near miss by comparison with the rate of 4.25% which he obtains from adding the growth rate of 2% and the asf rate of 2.25%. He blames his limited mathematical ability for failing to reconcile the two numbers. In our opinion Mr Beckett's assumption that both the asf rate and the value of £x will increase at the same rate as the capital value of a lease of equivalent length does not overcome the problem of recoupment of capital in real terms and therefore undermines the theoretical rigour of his dual rate method. Mr Clark's approach to this criticism of the conventional dual rate method is the one favoured in Modern Methods of Valuation (ninth edition); a book relied upon by Mr Beckett when explaining the conventional dual rate theory. However, Mr Clark, correctly in our view, rejects its use because it produces unrealistically low relativities for long leasehold interests.

205. Secondly, it was suggested that Mr Beckett had calculated the relativity by comparing the YP of a medium term lease with the YP of a freehold in perpetuity. He said that the remunerative rate of return on a leasehold and a freehold interest should differ by 1.5%. In fact Mr Beckett compared the YP of a medium term lease with that of a long leasehold interest and therefore, he said, the remunerative rates would be the same. So if one assumes a 999-year lease as the comparator, the YP at 5% and 2.25% will be 20, which is the same as the YP single rate at 5% taken into perpetuity. (It makes no difference if tax is allowed for, given the length of the hypothetical term.) The parties agreed that the value of an unimproved leasehold interest of 134 years would be worth 99% of the value of the notional freehold (long leasehold) value. According to Mr Beckett's theoretical model this relativity should be derived by finding the ratio of the YP for 134 years at 5% and 2.25% (19.53) compared with the YP for 999 years (20), ie 97.6%. (If tax is allowed for at 30% this relativity reduces to 96.7%.). We note that Mr Beckett considered that there would be a difference of 1.5% between the remunerative rates of a comparable leasehold and freehold interest. So if the YP of a long leasehold at 5% is 20, the YP of an equivalent freehold must be 28.57 at 3.5%. So by Mr Beckett's argument the value of a 999-year lease will be only 70% of the value of the equivalent freehold; a result that we suggest is implausible.

206. Mr Beckett's model does not specify a remunerative rate but instead describes a range of between 5 - 8%. We accept Mr Dowding's criticisms of this approach in respect of the three inputs into the selection of such a rate. Mr Beckett did not satisfy us that the appropriate yield would be related to yields on commercial investments and his reliance upon relativities found from analysing market transactions to derive the appropriate rate begged the question. Mr Beckett also relied upon "instinct" to determine the remunerative rate. However, in recommending his theoretical approach he condemned the use of such "instinct":

> "It seems to follow that those who say that that theory should not play a part in the exercise of assessing Relativity are saying that there should be no theoretical basis for it

at all – that it should be based on either bare observation or instinct. I regard that as a philosophy of despair."

207. Thirdly, we do not accept that the value of £x, the annual flow of benefits, will necessarily be constant. In the no-Act world one of the benefits of a long lease is the security of tenure that it offers. That benefit is reduced on a medium (44-year) lease, which is a wasting asset. Such security must, in our opinion, be reflected in the value of £x. Unless the value of £x is constant then, upon Mr Beckett's theoretical hypothesis, it must be identified for the relativity to be calculated. Mr Beckett did not explain how this could be done.

208. In addition it is to be noted that Mr Beckett makes no allowance for tax on the asf instalments. Conventional leasehold valuation theory, which Mr Beckett is trying to replicate in the current context, favours the creation of an asf out of taxable rental income. Consequently the asf instalments are grossed up to ensure that they are sufficient to provide, after tax, for the recovery of the initial capital outlay when invested at a low, safe (and net of tax) accumulative rate of interest. In his further written evidence Mr Beckett explains his approach by reference to the means of a purchaser always being net of tax. The means of a purchaser, and whether or not an acquisition of a leasehold interest is funded from taxed income or capital, does not seem to us affect this requirement. For the purposes of theoretical analysis the dual rate theory suggests an allowance for tax, although we accept that in practice there is a range of opinion among valuers about the need to do so. In our opinion such an allowance would have given the theoretical model greater rigour.

209. Mr Clark produced a graph to show the effect of tax upon the YP and the relativity. The YP for 44 years at 5%, 2.25 % and adjusting for tax at 30% is 14.421. This gives a relativity of 72.10% compared with Mr Beckett's unadjusted figure of 78.69%. In every case the YP, and hence the relativity, will decline if tax is allowed for. The higher the tax rate the greater this effect will be.

210. We turn next to the evidence of market transactions. The parties produced an agreed combined schedule of comparable transactions. Mr Kay relied upon 15 sales. Mr Wilson relied upon 14 of these and a further 12 sales that Mr Kay did not refer to, mainly because they fell outside his self-imposed rule of ignoring any transaction that took place more than a year either side of the valuation date. Both valuers made adjustments to the transactions in respect of various factors and these were recorded in a combined table. There was little agreement between them as to the values to be attributed to each of these adjustments and in some cases the experts had markedly different views. For example, Mr Kay increased the value of a comparable by 20% where it was a rear floor flat at first floor level or above whilst Mr Wilson made no adjustment at all. These differences in approach resulted in widely divergent figures for the fully adjusted floor rates (with Act rights). The valuers were within 10% of each other's results in only 5 of the 14 jointly used comparables and in none of those 5 did they agree upon the adjustments to be made. In every case Mr Kay's analysis produced a higher figure than Mr Wilson's. The average values of the fully adjusted floor rates (with Act rights) for the 14 sales relied upon by both parties were £9,570 per m^2 (Mr Kay) and £8,089 per m^2 (Mr Wilson). There was a significant variance around these average figures. For Mr Kay the range of values around the mean was plus 45% and minus 37% and for Mr Wilson it was plus

71% and minus 29%. (The equivalent figures for all 26 of Mr Wilson's comparables were an average of £9,005 per m^2 and a range of plus 93% and minus 37%.) The other major differences between the expert valuers are Mr Kay's further adjustment to bring all of his comparables into line with first floor values, Mr Wilson's adjustment for lease length and their different approaches to the allowance to be made for the benefit of the Act.

211. The differences between the experts are pronounced and whilst we appreciate the unusual efforts that both parties have made to provide the Tribunal with a comprehensive analysis of the relevant sales transactions, we are disappointed that it was not possible to reach a greater consensus on a common approach. That being so we prefer the evidence of Mr Wilson to that of Mr Kay. Mr Wilson has residential agency experience of the central London market since before the 1993 Act, including Cadogan Square itself. He has inspected most of his comparables. Mr Kay relied heavily upon sales particulars and upon a single meeting with more experienced valuers, whose advice he disregarded where it did not conform to his approach. His analysis relies upon the matrix approach under which all comparables are expressed in terms of a "best" first floor value. We can see no advantage in making such an adjustment, which seems to us to be unnecessary and adds little to the primary information derived from the comparable sales transactions. We are aware of the Tribunal's comments in *Arbib* that valuations under the Act largely take place in a hypothetical market where the ability to analyse and apply the limited valuation data in the light of the statutory provisions is as important as market experience. But we do not consider that Mr Kay's abilities in this regard outweigh the lack of experience to which he fairly admits.

212. Mr Rainey submitted that by expressing every transaction in terms of best value any errors of analysis would tend to balance out. They may do so if such errors are random rather than systematic but the sample size is relatively small and there is some evidence that systematic errors may have been made (see paragraph 223 below). We prefer Mr Wilson's approach, which explicitly attempts to apply expert valuation judgment to the evidence on a floor-by-floor basis rather than rely upon a best first floor value. His floor-by-floor approach may not result in a consistent tone for each floor but it does reflect the volume of relevant transactions at each level and has provided us with an analysis based upon valuation judgements that are informed by Mr Wilson's experience. Mr Kay's adherence to a self-imposed time limit of one year either side of the valuation date for the selection of comparables has led to him overlook the sale of the second floor appeal flat. His matrix approach also fails to distinguish the qualitative difference between the mansion block at number 61 and the other properties in the Square.

213. We think that Mr Wilson was right to extend the temporal horizon of his analysis to include the sale of the second floor flat at number 62 in October 2003. Mr Wilson makes no adjustments to this comparable (apart from time) since it is an appeal property and therefore represents the standard by reference to which the other comparables are adjusted. It is a transaction to which we attach weight. Mr Wilson acknowledges that inaccuracies will increase the further away from the valuation date one goes and says that generally he would not consider comparable sales that took place more than 12-18 months from the valuation date. We have therefore disregarded the three comparable sales that took place well outside two years either side of the valuation date. We agree with Mr Wilson that number 61 is an atypical property within the Square since it is a purpose built mansion block and not a converted house.

We have excluded it from our consideration. This leaves 14 comparables, of which both experts analysed 8, the remaining 6 being considered by Mr Wilson alone. Two of the flats were sold twice, flat 3 on the second floor of number 65 and flat 4 on the third floor of number 69. In both cases the flat was modernised between the sales. We have disregarded the comparable at flat 3, third floor at number 11. The analysis of this transaction shows a fully adjusted floor rate of £17,354 per m^2, which is well in excess of the next highest figure (£14,748 per m^2 at flat 2, first floor at number 69) and is acknowledged by Mr Wilson to be higher than expected. The lease term is also the longest (51.68 years) of any of the comparables used by either party.

214. Before reaching our conclusions on the comparables we consider three further adjustments made by the parties. The first of these is the adjustment Mr Wilson makes in his expert report (but not in the agreed combined schedule of comparable transactions) for lease length. He expresses the sale price of comparables in terms of what it would have been had the length of lease in each case been 44.1 years. He does so by reference to the relativities of each lease length as derived from the GE graph. In our opinion that approach begs the question since the purpose of Mr Wilson's analysis is to determine whether the market transactions support the GE graph. We reject this adjustment and throughout our decision we have relied instead upon Mr Wilson's analysis as shown in the said schedule.

215. Secondly, there is the important question of the appropriate allowance to be made for the benefit of the Act. Mr Wilson took this to be 12.5% of the fully adjusted floor rate where there was an OGR or 15% where there was not. Before the LVT Mr Wilson's equivalent figures were 7.5% and 10%. Mr Wilson gave three reasons why he had changed his allowance. Firstly, he said that the removal of the residency qualification under the 2002 Act had "transformed the flat sales market in the vicinity". Secondly, he said that the market was strong with higher prices being paid for medium term leases. Thirdly, in oral evidence, he said that there were now more long-term leases available in the market. Mr Wilson explained:

> "Now, with more and more passage of time, with more cases, more leaseholds available, when analysing sales of existing leasehold interests against long leasehold comparables, the analyses threw up relativities higher than I would otherwise expect…" (Transcript, Day 4, p5)

He accepted that such expectations were based upon the results of applying the GE graph. In our opinion that admission introduces another circularity into Mr Wilson's argument insofar as he is being influenced in his choice of allowance for the benefit of the Act by the outcome of the graph that he is objectively seeking to verify. His explanation of his choice of 12.5% was unconvincing as was his rationale for making an absolute adjustment of 2.5% for OGRs. Mr Beckett showed that Mr Wilson's assumption of 12.5% produced results that meant that the purchaser paid more for a lease that he could extend than he would have to pay to buy a long lease direct.

216. Mr Kay produced a mathematical model that, in its full version, enabled the value of the benefit of the Act (which he took to be 25% of the marriage value) to be calculated without circularity, ie without assuming the relativity that it is required to determine. He applied the model to his 16 medium term comparable leases (including a paired example at number 66).

Eight of these results (50%) showed a negative marriage value. Mr Kay acknowledged that this either meant that his adjustment of the comparables gave a "best" rate per m^2 that was too high or that purchasers of the existing leases were acting irrationally by paying too much, a prospect condemned by Mr Beckett in his analysis of Mr Wilson's approach. We find no fault in the mathematics of Mr Kay's model but we do not accept his analysis that, for half of his comparables, there should be no adjustment for the benefit of the Act. Those benefits include the legal right to enfranchise or extend the lease at a time of the leaseholder's choosing. The price is fixed by the LVT in the absence of agreement and excludes the tenant's overbid whilst guaranteeing him 50% of the marriage value. There is a fixed valuation date and the tenant does not have to pay the purchase price immediately. This contrasts with the no Act world where the landlord is in an overwhelmingly strong negotiating position and the leaseholder has no certainty of being granted a new lease.

217. In our opinion these benefits will always lead to a higher price being paid for an existing leasehold interest in the Act world compared with the no Act world. We accept Mr Dowding's submission that whereas it is foreseeable that a purchaser may pay too much for the benefit of the Act (by which we mean that the price paid for the existing leasehold when added to the reversionary freehold interest exceeds the value of the unencumbered freehold interest) there are no circumstances in which that is likely to happen in the no Act world. Consequently a method for quantifying the benefit of the Act that relies upon a percentage of the marriage value will not take this possibility into account. Where there is no marriage value Mr Kay's mathematical model cannot be used. We do not accept that where there is no marriage value there is no benefit of the Act. Mr Wilson's approach overcomes this problem by adopting a flat percentage of the existing leasehold value to reflect such benefit.

218. Mr Kay acknowledges the possibility that his analysis of comparables may have produced fully adjusted rates (with rights) that are too high. We note that of the eight medium term comparables that both parties used and which we consider to be relevant, Mr Kay's adjustments produce higher fully adjusted rates in seven cases, the remaining comparable being treated the same by both parties. The most extreme example from the eight comparables is in respect of flat 4 at number 64. Mr Kay's time adjusted rate is £6,199 per m^2, which he then increases by 30% to give a fully adjusted rate of £8,059 per m^2. Mr Wilson's time adjusted rate is £6,147 per m^2, which he then increases by 5% to give a fully adjusted rate of £6,454 per m^2, ie 20% less than Mr Kay's equivalent figure. The application of Mr Kay's formula to his fully adjusted first floor rates for the eight jointly used comparables produces negative marriage values in three instances. Applying the same formula to Mr Wilson's fully adjusted rates for those comparables produces only one instance of negative marriage value (which is inevitable since both experts analyse the sale of the medium term lease at a higher rate than the agreed freehold value with vacant possession). In our opinion this analysis suggests that Mr Kay's adjustments produce fully adjusted rates that are too high and supports our general conclusion that Mr Wilson's evidence, based upon his greater experience and personal knowledge of the comparables, is to be preferred.

219. Mr Kay suggests two alternative approaches to the assessment of the benefit of the Act. He describes the first of these as a short cut version of his full mathematical model. He fairly acknowledges the obvious, and to our minds fatal, criticism that this short cut begs the question by relying upon an assumption about relativity (based upon Mr Beckett's theoretical model).

We reject this approach. Mr Kay's second alternative, which he describes as a "rough assessment", is effectively the same approach as Mr Wilson's, consisting as it does of taking a fixed percentage to represent the benefit of the Act. Again there is an element of circularity in this approach because Mr Kay relies in part upon the relativity that is found from the use of Mr Beckett's theory graph. He also refers to the GE graph. Once an approach adopts circular reasoning its value as an objective tool for determining the relativity is lost.

220. The final adjustment that we consider was made by Mr Wilson and accepted by Mr Clark. It is a deduction of 5% made in respect of the tenant's hope value. On the facts of the case we do not think that any such allowance should be made. Mr Wilson says that such a deduction is a new concept for him and that it is not supported by evidence. He discussed a figure with Mr Clark, but that, in our opinion, is an assertion and not evidence. The only justification that we were given was that it should be the same as any allowance for the freeholder's hope value. We reject that argument for the reasons given by Mr Rainey.

221. Mr Kay argues that his analysis of the comparable transactions supports Mr Beckett's theoretical graph whilst Mr Wilson says that his analysis supports the GE graph. We have already expressed our reservations about Mr Kay's matrix approach and have determined that his analysis produces adjusted rates that we think are too high. But his full mathematical model does overcome the circular reliance upon assumed relativities that all the other approaches are prone to. We have applied this model to the 13 comparables to which we give weight. In doing so we have adopted Mr Wilson's analysis of the fully adjusted rates and Mr Kay's figure of 25% of the marriage value to reflect the benefit of the Act rights. Two of the comparables produce negative marriage values (for the reason given in paragraph 218 above). The remaining 11 comparables produce relativities ranging from a low of 46.8% to a high of 85.4%. The average is 72.8%, so the data is skewed towards the upper end of the range. Such a large range means that it is possible to draw support for a wide range of relativities. We said earlier that we attach weight to the sale price of the second floor appeal flat at No.62 because it requires the minimum of adjustment. Using Mr Kay's formula to calculate the relativity that it represents produces a figure of 66.7%. This compares with Mr Wilson's analysis, making a 7.5% deduction for Act rights, of 67.0%. Mr Kay's analysis does not fully reflect the OGRs, which, if allowed for in the valuation of the existing freehold interest, would decrease the marriage value and increase the relativity. This result provides limited support for an allowance of 7.5% for Act rights (a figure which reflects OGRs).

222. Mr Kay undertook his own analysis of Mr Wilson's comparables, the results of which we have summarised in paragraph 150 above. We have reservations about Mr Kay's propensity to take an average of averages, which we consider gives a misleading degree of certitude, especially when the sample size is small and the variance of the results is significant. We also note that the figures that he uses are those contained in Mr Wilson's expert report, which we have found are incorrect in relation to their adjustment for lease length. The average lease length of the 13 comparables to which we attach weight is 43.3 years, slightly shorter than that of the appeal properties. We allow for this when drawing our conclusions about the evidence as contained in the combined schedule of transactions.

223. More generally, we have reservations about the way in which both parties have calculated their allowance for Act rights in the combined schedule of comparables by using a percentage deduction. To arrive at the fully adjusted rates the experts multiply the actual (time adjusted) sale values by a series of percentage adjustments to reflect the different factors that we have identified above, treating the deduction for the benefit of the Act as another such factor. In our opinion the value of the Act rights should be deducted from the fully adjusted rates as an end allowance. So for flat 4 at number 64 Mr Wilson makes total adjustments of plus 5% from his time adjusted sales value of £6,147 per m^2 to give a fully adjusted value (with rights) of £6,454 per m^2. He then adjusts for the benefit of the Act not by deducting 7.5% to give £5,970 per m^2, but by decreasing the sales value by 2.5% to give £5,993 per m^2. The difference here is de minimis, but is more noticeable where larger adjustments (or greater allowances for Act rights) are made. Thus Mr Kay adjusts this comparable by 30% before adjusting for Act rights. The difference between the two methods, taking 7.5% for Act rights, produces a fully adjusted rate (without rights) of £7,594 per m^2 according to Mr Kay's method and £7,455 per m^2 according to ours. The differences are greater if one then adjusts onto first floor values (in this example £13,806 and £13,555 per m^2 respectively). The principle becomes especially important where one party but not the other makes a large total adjustment, eg the fifth floor flat at number 61 where Mr Kay makes adjustments of 50% and Mr Wilson only 10%. This is an example of a systematic error; the parties have assumed in effect that if a lease without rights is worth 7.5% less than a lease with rights then a lease with rights will be worth 7.5% more than a lease without rights. That is not the case. The effect of this error is to overstate the value of the comparables when adjusted for Act rights.

224. We have dealt at length with the evidence of comparable transactions since both parties have devoted significant resources to presenting us with an unusually comprehensive and well researched set of data. But we find that it is only of limited assistance to us. There are significant differences of principle between the experts which have led to widely different interpretations of the same evidence. Our preferences have been explained but even so the results of our analysis do not reveal any consistent patterns of value or relativity. We see some advantage in the "strict" mathematical formula approach put forward by Mr Kay since it avoids the circularity of much of the analysis. It is objective in the sense that it does not rely upon relativities from other sources. However, it still makes assumptions about relativity by expressing it as a percentage of the marriage value. What that percentage should be is disputed. It ranges from 25% to 50%. There are several examples of transactions where the purchaser of the medium term lease has paid more than the agreed freehold rate with vacant possession, the kind of irrational behaviour that Mr Beckett and Mr Kay argue cannot be modelled but which evidently exists in practice and needs to be explained. The mathematical formula fails to account for these negative marriage value transactions whereas an allowance for Act rights based upon a percentage deduction of the fully adjusted rates will do so on every occasion. For this reason alone we prefer that approach. The formula also fails to take full account of OGRs. It reflects these in the value of the leasehold interest since this is derived from actual sales, but it does not do so in the evaluation of the existing freehold interest which it simply takes as the freehold vacant possession value deferred for the length of the remainder of the lease. It does not include any value for the right to receive the OGRs.

225. We place most weight upon the sale of the second floor flat at number 62. This comparable is an appeal property and is therefore not subject to numerous, and disputed, adjustments. It also avoids the systematic error that we identified in the paragraph 223 above.

Mr Kay's formula and Mr Wilson's deduction for Act rights at 7.5% (net of OGRs) give similar results in this case, although this is not generally repeated with the other comparables.

226. Mr Wilson also referred to evidence of settlements to support the GE graph. The Tribunal in *Arbib* explained the problems of relying upon such evidence. Two of those problems apply in this appeal. Firstly, settlements are usually only evidence of the price agreed and not of its component parts, and, secondly, they tend to become self-perpetuating. We do not consider the third problem, that the settlements may be affected by the Delaforce effect, is likely to arise in this case. Apart from these problems Mr Wilson's analysis is flawed due to its circular reliance upon the GE graph within the analysis itself, the same problem that we identified in his analysis of sales evidence. We place little weight upon this settlement evidence.

227. Both parties rely principally upon the relativities that are derived from graphs. We have already rejected Mr Beckett's theory graph. Mr Wilson relies upon the GE graph rather than the graph of graphs, many of the contributions to which he considers to be unreliable. The GE graph has been criticised by this Tribunal before, notably in *Pockney*. We had the benefit of a more detailed description of the provenance of the graph than was available to the Member in that appeal. In particular Mr Clark produced a letter from his firm to the RICS Working Party on Relativity that was established following this Tribunal's decision in *Arrowdell*, which explained in detail the background to the graph and which we have summarised above. We were also provided with a copy of the updated data sheets upon which the graph is based and is kept under review (albeit that seemingly it has never been changed in the light of new information). The majority of the data is derived from settlements and is therefore prey to the criticisms of the same that we outlined above. But some of it relates to sales in the no Act world, although most of these were of houses rather than flats. One advantage of the data is that it relates to similar properties to those under appeal, namely properties on the Grosvenor Belgravia and Mayfair Estates as well as the Cadogan Estate. Mr Beckett also accepted that 142 post 1996 flat settlements were correctly analysed and in conformity with the GE graph.

228. Looking at the evidence overall we agree with the comments of the Tribunal in *Arrowdell*:

> "In such circumstances, in our view, it is necessary for the tribunal to do the best it can with any evidence of transactions that can usefully be applied, even though such transactions take place in the real world rather than the no-Act world. Regard can also be had to graphs of relativity…"

In the absence of any better evidence we think it is right to rely on such transactions and graphs in this instance. Applying the GE graph to the appeal properties shows a relativity for a 44-year term, before adjusting for OGRs (the normal relativity), of 69.2%. The graph of graphs produced by Beckett and Kay (2007, first revision) shows a range of normal relativities for the same term from 62.0% to 76.5%, with a mid-point of 69.25%. That figure is broadly in line with the relativity of 67.0% calculated for the second floor flat at number 62 using Mr Kay's "strict" mathematical approach, but which would be higher if OGRs had been fully allowed for. Our analysis of this sale using Mr Wilson's figures and a deduction of 7.5% for Act rights, gives a relativity, allowing for OGRs, of 66.7%. Adding back the 4% agreed between the

parties as the agreed allowance for OGRs for the second floor (this having been agreed as an absolute figure) gives a normal relativity of 71 % and 70.7% respectively. Applying Mr Kay's formula to the 13 comparables that we think are most relevant (and using Mr Wilson's adjustments) gives an average of 66.2%, although this excludes the two comparables where there is said to be negative marriage value. This figure would be higher if fully adjusted for OGRs. The normal relativity, using the average agreed adjustment for OGRs of 4.38%, is 70.6%. Alternatively, applying an adjustment of 7.5% in respect of Act rights to these same comparables gives an average of 66.6% or 71.2% if the said two negative marriage value comparables are included. The respective figures for the normal relativity are 71% and 75.6%. Under all the circumstances we therefore determine that the appropriate normal relativity (before the agreed deductions for OGRs), should be 71%.

Conclusions

229. We summarise the general conclusions we have reached as follows:

(a) Under paragraph 7 of Schedule 13 before and after values of the ILI are required in order to ascertain its diminution in value, but this does not mean that a short-cut method of valuation such as that used in *Squarepoint* is unlawful because it does not expressly identify the before and after values (paragraph 30).

(b) If the hypothetical seller of the ILI could be expected to have an interest not just in the subject flat but also in the other flats in the block and if it could be expected also that he would only sell his interest in the block as a whole, the proper way to value the ILI is as a component of such a sale of the intermediate interest; and in this respect *Squarepoint* is to be followed (paragraphs 31 and 32).

(c) In valuing the ILI the leaseholder's landlord is to be excluded as a possible purchaser (paragraphs 33 to 37).

(d) The provisions of Schedule 13 apply even though the after value of the ILI is negative (paragraph 38).

(e) It is not the case that, if the MILI provisions apply to the before valuation of the ILI, they must also be applied to the after valuation (paragraphs 42 and 43).

(f) The requirement in paragraph 8(3)(a) of Schedule 13 that the lease "must have an expectation of possession of not more than one month" means that there must be an expectation of possession but it must not be for more than one month (paragraphs 44 and 45).

(g) The requirement in paragraph 8(3)(b) that the profit rent in respect of the lease must be not more than £5 per year means that there must be a positive profit rent and it must be less than £5 (paragraphs 46 and 47).

(h) Where the rent is subject to review the requirement in paragraph 8(3)(b) is not satisfied where the post-review profit rent attributable to the flat is or could be in excess of £5 (paragraphs 48 to 51).

(i) Compensation may be payable under paragraph 5 of Schedule 13 if, as a consequence of the lease extension, the landlord may receive less on a subsequent collective valuation and the market value of his interest after the lease extension is diminished in value for this reason (paragraphs 60 to 65).

(j) Neither paragraph 10(1) of Schedule 11 nor any other provision is to be construed as providing that the leaseholder's headrent after the lease extension is reduced to nil (paragraphs 75 to 77 and 79 to 82).

(k) The capitalisation approach is to be preferred to the *Squarepoint* gross rent approach in order to provide for situations where reviews of the rent and the headrent take place at different times (paragraphs 118 to 121).

(l) The reducing fund approach ought not to be followed since, through failure to have proper regard to the positions of the hypothetical seller and the hypothetical purchaser, it produces unrealistic results (paragraphs 126 to 130).

(m) Either the capitalisation approach or the total profit rent approach is properly to be applied where the ILI is to be valued as a component of the intermediate interest (see (b) above) and the value of the intermediate interest remains positive after the grant of the new lease (paragraph 124).

(n) When applying the capitalisation or total profit rent approaches the remunerative rate to be used is a matter of market evidence but is likely to be the same as that used to capitalise the value of the leaseholder's existing interest: the accumulative (asf) rate should be the risk-free rate of 2.25% taken in *Sportelli*; and any reversion to a higher fixed headrent should be valued as though it is an increased profit rent (paragraph 140 (a)).

(o) Where the intermediate interest has a negative value after the grant of the new lease the ILI should be valued using the single rate approach (paragraph 131).

(p) The capitalisation rate in the single rate approach should be the yield on 2.5% Consolidated Stock, but this should be adjusted downwards where necessary to reflect future uncertain rent liabilities (paragraph 140 (b)).

(q) Mr Beckett's theoretical basis for determining relativity is unsound (paragraphs 202 to 209)

(r) The transaction evidence is of limited assistance and does not reveal consistent patterns of value or relativity (paragraph 224).

(s) Relativity is best established by doing the best one can with such transaction evidence as may be available and graphs of relativity (paragraph 228).

230. We summarise the particular conclusions to which we have come in relation to the appeals before us:

(t) The remunerative rates to be applied in relation to the Regency Lodge and Albert Hall Mansions capitalisation or total profit rent valuations are those

agreed between the parties (paragraph 124). (In the former appeal the remunerative rate for 16 of the flats is agreed at 6% and for the remaining 6 flats it is 7%. In Albert Hall Mansions the remunerative rate is agreed at 7%. The asf rate should be 2.25% in both appeals.)

(u) If our conclusions at (b) and (m) are wrong and the ILI should therefore be valued using the single rate approach, the capitalisation rate to be applied in relation to Regency Lodge and Albert Hall Mansions is 4.5% (paragraphs 138 and 141).

(v) The capitalisation rate to be applied in relation to 2/12 Sloane Gardens and 62 Cadogan Square using the single rate approach is 3.5% (paragraphs 135 and 136).

(w) The deferment rate to be applied to the reversions of the Regency Lodge flats should be 5.5% (paragraph 87).

231. The only issue in the Elms Court appeal is whether the LVT was wrong to reject Miss Ellis's reducing fund approach (see paragraph 19). Our conclusion is that it was correct to reject this approach (conclusion (l) above). That appeal is therefore dismissed.

232. It is now for the parties to the other four appeals, in the light of these conclusions and the agreements that they have already reached, to put before us the valuations that they invite us to determine (including alternative valuations where they may wish to argue on appeal that we have erred in law). These valuations must be sent to the Tribunal and to the other parties within 28 days of the date of this decision. Any submissions on hope value that the parties wish to advance in relation to 62 Cadogan Square (see paragraph 88) above must be sent similarly.

Dated 22 December 2008

George Bartlett QC, President

A J Trott FRICS

Addendum

VAT: Evidence and submissions

233. We have been asked by the appellants in each appeal to clarify our decision in respect of VAT and transaction costs. The issue stated by Mr Rainey in further submissions following our interim decision is whether

> ".... where (however calculated) a reverse premium – in tax speak an 'inducement' – is paid by the hypothetical vendor of the ILI to the hypothetical purchaser, the hypothetical purchaser will require that inducement to be paid gross of conveyancing costs and gross of VAT due on the inducement."

234. This issue does not arise in the Regency Lodge or Albert Hall Mansions appeals where we have found that the proper way to value the ILI is as a component of the sale of the intermediate interest in the block as a whole. That being so there will be no negative profit rent arising and no requirement for an inducement to be paid by the hypothetical vendor. We have determined the sole issue in the Elms Court appeal by upholding the LVT's decision to reject Ms Ellis's reducing fund approach. That appeal is dismissed on that basis and there is no need for us to consider the VAT/costs issue further in respect of it.

235. The parties accept the evidence of Mr Sonneborn in respect of VAT. This may be summarised as follows:

(i) An "inducement" (referred to by us as a reverse premium) is a taxable supply by the purchaser to the leaseholder.

(ii) Such an inducement is standard rated.

(iii) The leaseholder cannot recover VAT unless it provides other services subject to the standard rate of VAT.

(iv) The purchaser must account to HM Revenue and Customs at 17.5% on whatever payment it receives.

(v) Any inducement will be liable for VAT regardless of how it is calculated.

(vi) The VAT threshold levels at the valuation dates were £56,000 in the Nailrile appeal (2004) and £60,000 in the appeal at 62 Cadogan Square (2005).

62 Cadogan Square

236. Mr Beckett said that the inducement should be calculated by capitalising the negative profit rent at a single rate years' purchase at the risk free rate of 2.25%. He did not add VAT to the resultant capital value and did not suggest that any sum should be added for transaction costs. He acknowledged that VAT might be payable but said that he had not undertaken a detailed analysis of this and other matters because:

> "... I see the rent review feature of the risk as so overwhelming as to negate the purpose of analysing those more subtle and sophisticated matters."

237. Mr Rainey submitted that the respondent had accepted that if the inducement exceeded the VAT threshold at the valuation date then VAT should be added to it. Capitalising the negative profit rent at a single rate years' purchase at 3.5% (as determined by the Tribunal) produced a figure that exceeded the VAT threshold for each of the six flats and therefore VAT had to be added at 17.5% to arrive at the total amount to be paid. Mr Beckett was not cross-examined about whether he accepted that VAT would be subsumed within the rate of 3.5%, as opposed to his adopted rate of 2.25%. The appellant's case was that the determined rate of 3.5% did not reflect or include VAT and that this should therefore be added.

238. Mr Clark did not add VAT to the reverse premium that he calculated using a single rate years' purchase at 3.5%. He was asked in cross-examination whether he thought that 3.5% was sufficiently low to allow for VAT. He said that he thought it was.

239. Mr Dowding emphasised that the respondent had not accepted that VAT was to be added to the product of the negative rental flow and the appropriate yield. Both Mr Beckett (at 2.25%) and Mr Clark (at 3.5%) had subsumed VAT within their capitalisation rate. The respondents had only accepted that, as a matter of tax law, VAT would be chargeable on a reverse premium. Mr Beckett had not undertaken the two stage process that Mr Rainey now argued was appropriate; namely capitalising the negative rental flow and then adding VAT to the end result. Instead Mr Beckett, like Mr Clark, had calculated a VAT inclusive price. Since this was a common approach by the experts Mr Beckett had not been cross-examined on the point. The notional purchaser and seller would agree an overall figure at which they were prepared to deal. The seller would not be prepared to pay VAT over and above this figure because he would be better off retaining the intermediate lease himself and saving the VAT. Mr Clark was not asked in cross-examination whether VAT ought to be added to the capitalised value of the negative profit rent. It had been the appellant's case throughout that VAT was a factor to be taken into account in fixing the capitalisation rate.

2/12 Sloane Gardens (Nailrile)

240. Ms Ellis valued the ILI using her endowment fund method and then added conveyancing costs and VAT to produce the total reverse premium payable.

241. Mr Rainey submitted that although the Tribunal had rejected Ms Ellis's approach this did not affect the need to calculate the reverse premium allowing for (ie gross of) conveyancing costs and VAT. That requirement did not depend upon the particular method for assessing the capital value of the negative profit rent. Mr Rainey invited the Tribunal to add Ms Ellis's figure of £500 for conveyancing costs to the capitalised negative profit rent at 3.5% and then to add VAT to the combined figure in order to give a total reverse premium.

242. Mr Clark produced alternative valuations based upon the calculation of an investment fund (reverse premium) using a rate of 3.5%. He stated in his expert report that:

> "I am aware that the approach of Miss Ellis is to add a management fee, transfer costs and tax to the fund, therefore increasing the size of the fund required and thus the reverse premium that the vendor would have to provide. However, I am satisfied that the fund that I have calculated of £21,100 is sufficient to cover these costs if they are valid."

243. Mr Sefton for the first respondent submitted that the only valuation method that explicitly allowed for costs and VAT was the one put forward by Miss Ellis. The Tribunal had rejected that because it took inadequate account of the fact that, at the level of premium proposed by Miss Ellis, the willing seller would be better off by keeping the ILI. Miss Ellis accepted this point in cross-examination. The appellant did not put forward an alternative valuation which capitalised the negative profit rent and then added costs and VAT. The respondent had put forward the same case as it did at 62 Cadogan Square and it was not Mr Clark's evidence that costs of VAT should be added to the reverse premium that he had calculated at 3.5%. It was not suggested to Mr Clark in cross examination that if 3.5% was the correct capitalisation rate then an insufficient allowance had been made for costs and VAT and that therefore an explicit allowance should be made on top his figure.

244. The second respondents endorsed and adopted Mr Sefton's submissions. In addition they pointed out that the negative value of the intermediate lease was well below the VAT registration limit, which the appellant accepted. That being so there was no reason to suppose that VAT would be payable in respect of a sale of the intermediate lease and no justification for adding it to the capitalised negative profit rent. As to costs, the second respondents made the additional point that at paragraph 97 of its *Sportelli* decision the Tribunal had rejected a suggestion that there should be an adjustment to the value of an interest to reflect transaction costs.

VAT: Conclusions

245. We accept that an inducement (reverse premium) will be a taxable supply by the purchaser to the leaseholder. That is not in dispute between the parties. However, Mr Dowding emphatically denies that the first respondent in 62 Cadogan Square had accepted the requirement to add VAT to the reverse premium as calculated by capitalising the negative profit rent. We do not think that the first respondent did agree to this. The concession that the respondent makes is that VAT will be chargeable on a reverse premium. However, both Mr Beckett and Mr Clark say that VAT is reflected in their capitalisation rates of 2.25% and 3.5% respectively. Mr Beckett was not asked whether he would still include VAT in the reverse premium if the negative profit rent is capitalised at 3.5%, and the appellant did not identify a "cut-off" level of yield beyond which VAT should be added separately. The principle of including VAT within the calculated reverse premium was also adopted by Mr Clark in his alternative valuations and he was not asked whether, at his rate of 3.5%, he should have allowed for VAT separately.

246. In the Nailrile appeal we have rejected Ms Ellis's reducing fund approach and prefer Mr Clark's alternative valuation that capitalises the negative profit rent at 3.5%. He argues that this figure is sufficient to allow for transfer costs and VAT.

247. We make clear, therefore, that in our view the incidence of costs and VAT should be reflected in the choice of discount rate, and we have determined this at 3.5% in both 62 Cadogan Square and Nailrile. This means that the purchaser must account for VAT out of the reverse premium that he receives rather than add the tax to it. We consider that this approach best reflects the negotiating position of the willing seller and his ability to argue for the option of retaining the intermediate lease. Furthermore, unless the reverse premium exceeds the relevant VAT threshold it is not possible to determine whether the purchaser is required to register for VAT.

Hope value

248. At paragraph 88 of our decision we said that since the House of Lords had now given its decision in *Sportelli* the parties in the 62 Cadogan Square appeal should be given the opportunity of making further submissions about hope value. We have now received such submissions from both parties.

249. Mr Rainey said that the House of Lords had confirmed the judgment of the Court of Appeal in respect of valuations made under Schedule 13 of the 1993 Act and held that hope value was excluded from the valuation of the landlord's interest. As the valuations in 62 Cadogan Square were all Schedule 13 valuations any landlord's hope value had to be excluded.

250. At paragraph 93 of his speech in *Sportelli* Lord Neuberger observed, in the context of valuations under section 9(1A) of the Leasehold Reform Act 1967, that he "was inclined to think" that any tenant's hope value should also be excluded. Mr Rainey submitted that before the legal issue could be determined as to whether tenants hope value should be excluded in Schedule 13 valuations there would have to be evidence of fact that such tenant's hope value existed. On the facts of the appeal at 62 Cadogan Square the Tribunal had found that no allowance should be made for tenant's hope value. Consequently, the legal issue did not arise for decision in this appeal.

251. Given that the Tribunal had found on the facts that no allowance for hope value should be made, Mr Dowding did not propose to address the Tribunal further on the issue unless the Tribunal considered it appropriate to decide the matter as a point of principle.

252. We have found on the facts that no allowance should be made for tenant's hope value and it is therefore unnecessary for us to consider the legal argument further in our decision on the appeal in 62 Cadogan Square.

2/12 Sloane Gardens (Nailrile): Written representations of the second respondents

253. In paragraph 13 of our interim decision we said that the tenants (the second respondents) did not appear. We have been reminded that although they did not appear at the hearing the second respondents submitted a statement of case and written representations, prepared by Mr Stephen Jourdan, in December 2006.

254. The second respondents argued that it is the general principle of interpretation of the statutes conferring rights of enfranchisement on tenants that any ambiguity should be construed in the tenant's favour. Their primary case was that the LVT was correct to hold that the diminution in the value of Nailrile's lease should be valued as a MILI both before and after the grant of the new lease. They adopted the arguments of the first respondent as set out in its statement of case and also raised two further points; firstly, that the use of the present tense in paragraph 8(2) of Schedule 13 meant that it was not necessary to ask whether the intermediate lease would also be a MILI after the grant of a new lease and, secondly, that the appellant was wrong to argue that the expression "an expectation of not more than one month" in paragraph 8(3)(a) of that Schedule could not include the situation where there was no expectation of possession at all.

255. We considered these two additional arguments at paragraphs 42 to 45 of our decision and rejected them both for the reasons there given.

256. The second respondent's secondary case was that there should be a commutation of the rent payable under the intermediate lease. We considered and rejected this argument in paragraphs 66 to 82 of our decision. The second respondent's tertiary case was that the Tribunal should have followed the *Squarepoint* approach. We have rejected this approach for the reasons given at length in paragraphs 89 to 141 of our decision, determining instead that in the Nailrile appeal the diminution in the value of the ILIs should be calculated using the single rate approach using a discount rate of 3.5%.

257. The second respondents made two further points; firstly, that Ms Ellis's reducing fund approach should be rejected and, secondly, that it was wrong to take account of future rent reviews on the application of the MILI formula. We have rejected Ms Ellis's approach and have found that the problem of rent reviews does not arise on the facts of this appeal (paragraphs 48 to 51).

258. We have considered all of the other representations of the second respondents but find no reason to qualify our decision in any respect.

Disposal

259. The current position in respect of the five appeals following this addendum is as follows:

(i) LRA/114/2006: 2/12 Sloane Gardens (Nailrile)

The parties should put before us their valuations (agreed where possible) prepared on the basis that costs and VAT are not to be added to the reverse premium calculated by capitalising the negative profit rent at 3.5%. The valuations already prepared by the first and second respondents are on that basis. Their valuations are in the sum of £205,000 (rounding the second respondent's valuation upwards from £204,570). The determination of compensation under paragraph 5 of Schedule 13 is to be the subject of a further hearing.

(ii) LRA/47/2007: Regency Lodge

In the light of our decision the parties have reached agreement on the premiums payable in respect of each of the flats that were the subject of the appeal. The valuations which have been agreed were appended to a letter to the Tribunal dated 13 January 2009 from Pemberton Greenish. In view of the volume that these constitute we do not reproduce them here.

We determine the premiums payable as set out in Appendix 1 to this decision.

(iii) LRA/89/2007: 62 Cadogan Square

The parties should put before us their valuations (agreed where possible) prepared on the basis that VAT is not to be added to the reverse premium calculated by capitalising the negative profit rents at 3.5%. Mr Clark has already prepared valuations for the respondent on this basis. Mr Beckett has added VAT to the negative value of the intermediate leaseholder's interest after the lease extensions. The determination of compensation under paragraph 5 of Schedule 13 is to be the subject of a further hearing.

(iv) LRA/90/2007: Elms Court

The appeal is dismissed and the LVT's decision dated 5 April 2007 is upheld under which the premium to the freeholder was determined in the sum of £56,414 and that to the head lessee was determined in the sum of £1,652.

(v) LRA/106/2007: Albert Hall Mansions

In the light of our decision the parties have reached agreement on the premium payable in respect of flat 32, Albert Hall Mansions. We therefore determine the premium in the amount agreed between the parties, namely £81,415 to the freeholder and £16,649 to the head lessee, making a total of £98,064.

Dated 31 March 2009

George Bartlett QC, President

A J Trott FRICS

Addendum on 2/12 Sloane Gardens

260. In paragraph 259(i) in the addendum to our decision we said that the parties should put before us their valuations (agreed where possible) prepared on the basis that costs and VAT are not to be added to the reverse premium calculated by capitalising the negative profit rent at 3.5%. This has now been done. (No question of compensation under paragraph 5 of Schedule 13 arises, as erroneously stated in paragraph 259(i).) The amounts agreed on the basis of our decision are £30,329 to the leaseholder and £174,671 to the freeholder and we determine these as the amounts payable.

Dated 22 June 2009

George Bartlett QC, President

A J Trott FRICS

Addendum on 32 Albert Hall Mansions

261. The valuation has been agreed between the parties to the appeal, and in accordance with this agreement we determine the total premium payable at £98,065, of which £81,416 is payable to the freeholders and £16,650 is payable to the leaseholder.

Dated 19 August 2009

George Bartlett QC, President

A J Trott FRICS

Appendix 1

Flat 20:	to freeholder	£7,740
	to headlessee	£2,245
	Total	£9,985
Flat 22:	to freeholder	£ 7,458
	to headlessee	£ 5,947
	Total	£13,405
Flat 27:	to freeholder	£ 9,698
	to headlessee	£114,208
	Total	£123,906
Flat 28:	to freeholder	£ 7,647
	to headlessee	£ 6,071
	Total	£13,718
Flat 30:	to freeholder	£ 10,246
	to headlessee	£119,603
	Total	£129,849
Flat 31:	to freeholder	£ 7,458
	to headlessee	£ 5,947
	Total	£13,405
Flat 40:	to freeholder	£4,770
	to headlessee	£3,631
	Total	£8,401
Flat 46:	to freeholder	£ 6,662
	to headlessee	£78,123
	Total	£84,785
Flat 50:	to freeholder	£ 8,130
	to headlessee	£ 6,601
	Total	£14,731
Flat 51:	to freeholder	£ 8,224
	to headlessee	£ 6,663
	Total	£14,887
Flat 56:	to freeholder	£ 8,319
	to headlessee	£ 6,510
	Total	£14,829
Flat 57:	to freeholder	£11,059
	to headlessee	£130,552

	Total	£141,611
Flat 58:	to freeholder	£ 8,414
	to headlessee	£ 6,571
	Total	£14,985
Flat 63:	to freeholder	£4,590
	to headlessee	£3,514
	Total	£8,104
Flat 64:	to freeholder	£ 8,025
	to headlessee	£ 6,316
	Total	£14,341
Flat 67:	to freeholder	£4,590
	to headlessee	£3,514
	Total	£8,104
Flat 79:	to freeholder	£ 9,298
	to headlessee	£107,418
	Total	£116,716
Flat 81:	to freeholder	£ 7,647
	to headlessee	£ 6,071
	Total	£13,718
Flat 84:	to freeholder	£ 7,363
	to headlessee	£ 5,886
	Total	£13,249
Flat 93:	to freeholder	£7,268
	to headlessee	£5,824
	Total	£13,092
Flat 97:	to freeholder	£7,363
	to headlessee	£ 5,885
	Total	£13,248
Flat 103:	to freeholder	£8,319
	to headlessee	£6,508
	Total	£14,827