UPPER TRIBUNAL (LANDS CHAMBER)

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TRIBUNALS, COURTS AND ENFORCEMENT ACT 2007

LEASEHOLD ENFRANCHISEMENT – Flat – extended lease – premium – apportionment of premium between freeholder and headlessee – whether no-Act assumption restricted to appeal flat – probability of receiving profit income above a threshold level – definition of net receipts – valuation treatment of initial ground rent – section 56 and Schedule 13 Leasehold Reform, Housing and Urban Development Act 1993 – appeal allowed – cross-appeal dismissed

IN THE MATTER OF AN APPEAL AGAINST A DECISION OF THE FIRST TIER TRIBUNAL (PROPERTY CHAMBER)

BETWEEN:

THE CROWN ESTATE COMMISSIONERS **Appellant**

and

WHITEHALL COURT LONDON LIMITED **Respondent**

Re: Flat 71A,
Whitehall Court,
London.
SW1A 2EL

Before: His Honour Judge Hodge QC and A J Trott FRICS

Sitting at: The Royal Courts of Justice, Strand, London WC2A 2LL
on
6-7 June 2017

Mr Stephen Jourdan QC and **Ms Cecily Crampin** (instructed by **Pemberton Greenish LLP**) for the appellant
Mr Paul Letman (instructed by **Wallace LLP**) for the respondent

The following cases are referred to in this decision:

Arnold v Britton [2015] UKSC 36, [2015] AC 1619
9 Cornwall Crescent London Ltd v LB of Kensington & Chelsea [2005] EWCA Civ 324
Hosebay Ltd v Day [2012] UKSC 41, [2012] 1 WLR 2884
Lady Fox's Executors v Commissioners of Inland Revenue [1994] 2 EGLR 185
In re Lucas and Chesterfield Gas and Water Board [1909] 1 KB 16
McHale v Earl Cadogan [2010] EWCA Civ 1471, [2011] 1 P & CR 14
Metropolitan Properties Co. Ltd. v Cordery (1980) 39 P. & C.R. 10
Nailrile Ltd v Earl Cadogan [2009] 2 EGLR 151
Pearl Assurance Plc v Shaw [1985] 1 EGLR 92
82 Portland Place (Freehold) Ltd v Howard de Walden Estates Ltd [2014] UKUT 0133(LC)
Trustees of the Sloane Stanley Estate v Mundy [2016] UKUT 223 (LC), [2016] L & TR 32
Waters v Welsh Development Agency [2004] UKHL 19, [2004] 1 WLR 13

DECISION

Introduction

1. Whitehall Court is a large Victorian mansion block. The freehold is owned by the Crown and managed by the Crown Estate Commissioners, who are the appellant. Blocks 3 and 4 ("the Building") are held under a lease ("the Headlease") made on 12 May 1987 by the Crown (as landlord) and Whitehall Court (Holdings) Limited (as tenant) for a term of 99 years and 90 days commencing on 5 January 1987 and expiring on 4 April 2086. The Building contains a large number of high value residential flats, offices and the Farmers' Club. The flats, the offices and the Farmers' Club are held on long underleases reserving a ground rent. The Headlease is held by Whitehall Court London Limited, the Respondent ("Whitehall"). One of the flats in the Building, Flat 71A, is held under an underlease by Ms Rebecca Susan Keely ("the Flat 71A Underlease"), for a term expiring on 24 March 2086, at a fixed yearly ground rent of £180, doubling to £360 on 25 March 2029, to £720 on 25 March 2050 and to £1,440 on 25 March 1971 ("the Flat 71A Ground Rent"). On 22 July 2015, a notice under section 42 of the Leasehold Reform, Housing and Urban Development Act 1993 ("the 1993 Act") was served claiming a new extended lease of Flat 71A. It proved possible to agree with Ms Keely the total amount she should pay for the extended lease, but the Crown and Whitehall were unable to agree the amounts payable to each of them under Schedule 13 so the terms of acquisition could not be agreed. The Crown did not exercise its power under Schedule 11 para 6 to agree that matter with Ms Keely; rather, it was referred to the First-Tier Tribunal ("the FTT") under section 48. It is agreed that the valuation date is 22 July 2015, and the unexpired terms, the capital values and the capitalisation and deferment rates are all agreed.

2. Ms Keely took no part in the hearing before the FTT and she has taken no part in the appeal before us because the essential issues were and are between the Crown and Whitehall. At the hearing before the FTT, the Crown and Whitehall agreed on six issues which needed to be determined in order to apportion the premium between them. In its decision dated 29 September 2016, the FTT duly determined those issues, deciding that the price to be paid for the new extended lease was £228,424 of which £217,528 was to be paid to the Crown and £10,895 to Whitehall. The Crown applied to the FTT for permission to appeal against certain of those issues, and Whitehall applied to the FTT for permission to cross-appeal against other issues. On 1 December 2016 the FTT granted permission to appeal on each of those issues. In doing so, the FTT acknowledged an omission identified by the Crown in its approach to the valuation of the headlessee's interest as a result of which it produced a corrected valuation deciding that the price to be paid for the new extended lease was £227,683 of which £220,023 was to be paid to the Crown and £7,660 to Whitehall. Subsequently, on 24 March 2017, the Upper Tribunal granted permission to Whitehall to adduce evidence on the probability issue explained below. Some of the issues have been directed to be determined by way of review, and others by way of rehearing. On the latter issues, there are reports from Mr Ed Fielding MRICS (of Savills (UK) Limited) for the Crown and from Ms Jennifer Ellis FRICS (of Langley-Taylor) for Whitehall, both of whom have given evidence before us. The Crown is represented by Mr Stephen Jourdan QC leading Ms Cecily Crampin (of counsel); and

Whitehall is represented by Mr Paul Letman (also of counsel). It was not considered necessary for us to view the Building.

The relevant statutory provisions

3. Part I of the 1993 Act addresses both the right to collective enfranchisement in the case of tenants of flats (in Chapter I) and the individual right of the tenant of a flat to acquire a new lease of his flat (in Chapter II). Section 32 provides that Schedule 6 to the 1993 Act has effect for determining the purchase price payable by a nominee purchaser in the case of collective enfranchisement while section 56 provides for the sums payable by the tenant in connection with the grant of any new lease to be determined in accordance with Schedule 13 to the 1993 Act. Schedule 13 requires assessments of the open market value of the freehold interest and the interest under the Headlease "*in the tenant's flat*" both before and after the grant of the new lease. However, a freehold or headleasehold interest in an individual flat is never sold on its own. When a statute directs the valuation of an interest which would normally be sold along with other interests, it has been held that the interest is to be valued as a component of the sale of the interests as a whole: see *Lady Fox's Executors v Commissioners of Inland Revenue* [1994] 2 EGLR 185. That principle was applied to Schedule 13 by the Lands Tribunal in its decision on five appeals heard together and reported as *Nailrile Ltd v Earl Cadogan* [2009] 2 EGLR 151 and it is common ground that that is the correct approach in the present case.

4. The aim of the valuations, then, is to identify the amount by which the open market value of the freehold interest in the Building, and the open market value of the Headlease, will each be reduced by the grant of the new lease of Flat 71A. The valuation of the diminution in value of the freehold and the valuation of the diminution in value of the Headlease are undertaken independently, but in both cases on the no-Act rights assumption set out in Schedule 13 para 3 (2) (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*". The corresponding assumption in the case of collective enfranchisement is that set out in Schedule 6 para 3 (1) (b): "*on the assumption that this Chapter and Chapter II confer no right to acquire any interest in the specified premises or to acquire any new lease (except that this shall not preclude the taking into account of a notice given under section 42 with respect to a flat contained in the specified premises where it is given by a person other than a participating tenant)*". (By section 13 (12) the "specified premises" means the property which is to be acquired under Chapter I.)

The rent payable under the Headlease

5. The rent reserved by clause 2 of the Headlease comprises:

(1) A yearly rent of £10,760, which is payable regardless of what income the headlessee receives. This the FTT called "the Trigger Rent".

(2) An additional rent of "The amount by which the Landlord's Share (as defined in the Second Schedule hereto) in any accounting year (as also so defined) exceeds £21,406". The FTT called this the "the Overage Rent" or "Clawback".

6. The "Landlords' [sic] Share" is defined in the Second Schedule as "*the proportion of the Net Receipts to which the Landlord is entitled as set out in paragraph 2 of this Schedule*". Para 2 of the Second Schedule lists a series of percentages for each year of the term rising from 60% for each of the Accounting Years 5 January 1987 to 4 January 1992, 61% for 1992-3, and then rising by 1% per year until 2002-3, when it rises by 1.5% per year for 2002-4 and then by 2% per year until it reaches 85% from 5 January 2009 onwards.

7. "Net Receipts" are defined in para 1 (b) as follows:

> *"Net Receipts" during each year of the said term (ending on the 25th day of December (hereinafter called "the Accounting Year") means the total of the following sums received by the Tenant in respect of any underlease of any part of the demised premises granted varied extended or renewed or in respect of which the rent shall have been reviewed after the commencement thereof…*

There then follows a list of five different types of payment.

8. One of the issues for this Tribunal is the correct interpretation of the definition of "Net Receipts". The FTT held that the expression included four types of payment listed in para 65 of its Decision, namely: (a) premiums received on the grant of corridor leases, namely leases which enable two adjoining flats separated by a lateral corridor to be enlarged into a single large flat incorporating the lateral corridor; (b) premiums received on the grant of deeds varying some of the office underleases to permit residential use; (c) rental or licence fee income derived from letting or licensing parts of the basement including the pavement vaults; and (d) licences permitting both structural and non-structural alterations to individual flats. These will be referred to in this decision as "Additional Payments". Until the FTT hearing, both parties appear to have treated these Additional Payments as falling within the definition of "Net Receipts" but by the end of the hearing Whitehall's position was that none of these Additional Payments did fall within that definition. The FTT ruled against Whitehall on this point and Whitehall has appealed. That appeal is to be determined by way of review.

9. The Crown points out that under clause 3 (16) (d) (ii), the headlessee covenants to "… *manage the demised premises in accordance with the principles of good estate management for the joint benefit of the Landlord and Tenant"*. It asserts that the definition of Net Receipts includes at para (v) sums that should have been received by the headlessee but were not due to a breach of that obligation.

10. At the valuation date, the total ground rents payable to the headlessee under the underleases were £15,233. These will increase to £29,814 on 25 March 2029, and increase again on 25 March 2050 and 2071. In addition, from time to time up to the valuation date, the headlessee received Additional Payments from individual underlessees in respect of various

transactions, such as the grant of new leases and the grant of licences for alterations, which were treated as part of the Net Receipts as shown in Whitehall's statements of premiums received.

11. In the FTT, it was common ground that the effect of clause 2 and Schedule 2 of and to the Headlease was that the Overage Rent was 85% of the Net Receipts in excess of £21,406. So the FTT approached the case on the basis that: *Overage Rent = (Net Receipts - £21,406) x 85%*. This made sense because, at the date of the Headlease, the total ground rents, listed in Schedule 1, added up to £21,406. On that basis, the parties were agreeing to divide between them money received by the Headlessee from the Building by way of income or capital payments in excess of the original ground rents, in agreed shares, increasing over time (no doubt to reflect the reducing value of "*the expense incurred by the Tenant in improving and repairing the buildings hereby demised*" referred to at the start of clause 2 as part of the consideration for the grant of the Headlease). The FTT referred to £21,406 as the "Threshold Rent", to the amount of the Net Receipts up to £10,760 as "the Basic Income", to the amount of the Net Receipts in excess of £10,760 but not exceeding the Threshold Rent as "the Surplus Income", and to the amount of Net Receipts in excess of the Threshold Rent as "the Profit Income".

12. However, in its Statement of Case for this appeal Whitehall claimed that the calculation required is in fact: *Overage Rent = (Net Receipts x 85%) - £21,406*. This is indeed what the reddendum in clause 2 of the Headlease actually states, although the Crown asserts that it produces a bizarre result, and is very unlikely to be what the parties intended. However, in the context of this appeal, it is said to make no practical difference, and therefore even though Whitehall has not sought or obtained permission to appeal on this point, for the purposes of this appeal the Crown is willing to apply the literal meaning of clause 2, while reserving its right to contend otherwise in other proceedings should the issue ever matter. The effect is that the Threshold Rent is £25,184 rather than £21,406.

The issues on this appeal

13. Issue 1 is the extent of the no-Act rights assumption. It is common ground that one must assume that none of the tenants of the flats in the Building have any right to participate in a collective enfranchisement under Chapter I. The issue relates to the extent of the no-Act rights assumption in relation to the rights of qualifying tenants of flats to claim a new lease of the flat under Chapter II. The Crown says that this assumption applies to the Building. Whitehall says it is limited to Flat 71A. This turns on the interpretation of the 1993 Act. The FTT determined this issue in favour of Whitehall, determining that "the 'no rights' assumption under Schedule 13 of the 1993 Act does not extend to other flats in Whitehall Court". This issue of statutory interpretation is to be determined by way of review. Whitehall accepts that if the Crown succeeds on this issue, and the no-Act rights assumption does apply to the Building, so that the true rate of erosion of ground rent income falls to be ignored, there will be a Profit Income in every year following the first increase in the ground rents payable to the headlessee on 25 March 2029 (rather than in accordance with the parties' respective cases on probability).

14. Issue 2 is the frequency with which the hypothetical purchaser of the freehold or of the Headlease would anticipate that the headlessee would receive sufficient Additional Payments to give rise to a Profit Income. The FTT accepted Mr Fielding's evidence that a purchaser would anticipate this happening once in every two years in preference to Ms Ellis's evidence that it would anticipate this happening once in every eight years. By its Order of 24 March 2017 the Tribunal gave permission for the parties to adduce additional evidence on this "probability" (or strike rate) issue, which is to be determined by way of rehearing; and the valuers addressed it in their evidence.

15. Issue 3 is the meaning and extent of "Net Receipts" for the purposes of the Second Schedule to the Headlease and, in particular, whether the Additional Payments fall to be treated as included in the Net Receipts. This gives rise to three questions. First, do Net Receipts include payments received by the headlessee in respect of transactions which would, unless permitted by the freeholder, constitute breaches of any of the covenants in the Headlease (referred to as "Covenant Breach Transactions")? Second, if not, which of the Additional Payments would be in respect of Covenant Breach Transactions? Third, if Net Receipts do not include payments in respect of Covenant Breach Transactions, would the hypothetical purchaser of either the freehold or the Headlease nonetheless envisage that they would in practice be treated as forming part of the Net Receipts? The FTT determined the first of those questions in favour of the Crown, holding that "'Net Receipts' includes all the premium income apart from any unlawful premiums charged for licences permitting non-structural alterations" so that all the anticipated future Additional Payments fell to be included in the Net Receipts. Whitehall appeals and contends that the FTT was wrong on that issue, that all of the Additional Payments are in respect of Covenant Breach Transactions, and that the hypothetical parties would envisage that none of them would be treated as forming part of the Net Receipts. This issue is to be determined by way of review.

16. Issues 4, 5 and 6 all turn on the correct valuation treatment of the Flat 71A Ground Rent.

17. Issue 4 relates to the treatment of the first £90.48 of the Flat 71A Ground Rent in the valuation. The Crown's case is that the whole of the Flat 71A Ground Rent figure forms part of the Profit Income in any Profit Income year ("PIY") because that Ground Rent is taken into account in calculating the Net Receipts. Whitehall's case is that the first £90.48 of that ground rent never forms part of the anticipated Profit Income. The FTT held in favour of Whitehall on this issue, determining "by the application of common sense" rather than of legal or valuation principles that there was no "claw back" below the Threshold Rent. The Crown appeals against that decision. This issue is to be determined by way of rehearing.

18. Issue 5 relates to the headlessee's ability to manage the Additional Payments so as to keep the Net Receipts below the Threshold Rent. The question is whether, in non-Profit Income years (ie years when it is anticipated there will not be Profit Income) the valuation should be prepared on the assumption that the purchaser of the headlease will receive, on average, only 90% of the Flat 71A Ground Rent. That was the evidence of Ms Ellis before the FTT, and the FTT accepted it, determining that "the hypothetical purchaser of the head-leasehold interest in Ms Keely's flat would assess the probability of the head-lessee not receiving its profit rent up to the trigger point at 90%". That worked in the Crown's favour, as

it reduced the value of the Headlease. Despite that, the Crown appealed against that determination because the Crown considered that it was quite inconsistent with the correct valuation approach. The Crown contended that, before the new lease was granted, the headlessee always received the whole of the Flat 71A Ground Rent, so it was wrong to include only 90% of that in non-Profit Income years. However, in its statement of case, Whitehall maintained that the FTT was right on this point, even if the Crown was right on issue 4. In its Reply, the Crown said that Whitehall was wrong on this issue but, as it worked in the Crown's favour, the Crown was content for the valuation of the Headlease to be undertaken on this erroneous basis. Despite this, Mr Fielding has not made this adjustment in his valuation, because his professional opinion is that Whitehall is wrong on this issue. Although issue 5 is now not formally in issue between the parties, it is said by the Crown that we are going to have to rule on the correct approach to the valuation, which will inevitably require considering the correct treatment of the Flat 71A Ground Rent when valuing the Headlease. It is, therefore, said to be appropriate to include it in the list of issues. It is to be determined by way of review.

19. Issue 6 also raises the issue of how to treat the Flat 71A Ground Rent when valuing the Headlease. In its original valuation of the Headlease, the FTT did not reflect at all the obligation on the Headlessee to pay Overage Rent on the first £180 pa of the Flat 71A Ground Rent in Profit Income years. The Crown says that the obligation to pay Overage Rent in respect of the Flat 71A Ground Rent in such years ought to be reflected in the value of the Headlease before the grant of the new lease of Flat 71A. As previously noted, when determining the Crown's application for permission to appeal, the FTT acknowledged that its failure to do this in its valuation was a mistake. Whitehall does not support the FTT's original valuation approach. However, it does not accept that the obligation to pay Overage Rent in respect of the first £180 of the Flat 71A Ground Rent ought to be reflected in the valuation of the Headlease before the grant of the new lease of Flat 71A. Instead, it says that one should take 15% of the lost £180 ground rent for each year where it is anticipated there will be Profit Income, capitalise that, and treat that as a deduction in valuing the Headlease after the grant of the new lease of Flat 71A. This issue is to be determined by way of rehearing.

20. A further issue (Issue 7) is said by the Crown to have emerged when Whitehall served Ms Ellis's appeal report on Monday 22 May 2017 and is therefore not an issue on which any party has appealed. In that report Ms Ellis said (at para 3.4.2) that it had only recently occurred to her that the valuations should reflect the fact that, when the ground rents increase, the headlessee receives the increased rent straight away (from 25 March 2029, 2050, and 2071) but, if there is Profit Income, the Crown will only receive Overage Rent in respect of the rent increase at a later date, after Whitehall has submitted its annual return in respect of the previous accounting year.

<u>Issue 1</u> – the physical extent of "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"

The FTT's reasoning

21. Having rehearsed the respective contentions of the parties, the FTT gave its reasons for agreeing with Whitehall's interpretation and concluding that the "no rights" assumption under Schedule 13 to the 1993 Act did not extend to other flats in the Building at paras 46 to 50 of its decision.

22. Both advocates had drawn the attention of the FTT to the Upper Tribunal decision in *The Trustees of the Sloane Stanley Estate v Mundy* [2016] UKUT 223 (LC), [2016] L & TR 32 ("*Mundy*") although they accepted that it was not entirely on point. Nevertheless the FTT agreed with Whitehall that some assistance could be drawn from the approach adopted by the Upper Tribunal in *Mundy*. In particular, at paras 10-19 the Upper Tribunal was said to have distanced itself from the previous commonly held view that the experts must value the existing lease in a "no Act world", pointing out that the experts must reflect "the real position" or, to put it another way, "the real world". The Crown was said to have rightly pointed out that in *Mundy* the Upper Tribunal was considering flats that were "outside the premises containing the tenant's flat". It was nevertheless apparent that the Upper Tribunal had considered that, in so far as possible, the valuation to be undertaken should reflect the real world and not a hypothetical construct. In the real world the ground rental income would continue to diminish and a valuation that did not reflect that reality was artificial.

23. The Crown had sought to persuade the FTT that the application of the no-Act assumption to the other flats in Whitehall Court was justified on the basis that it preserved the ground rental income and thus the Crown's Overage Rent which had been the intention when the Headlease was granted prior to the introduction of the 1993 Act. The view of the FTT was that although that might be true in so far as it went, the Crown was compensated for the loss of that income on the grant of each extended lease. Thus, in reality, the Crown would not suffer a loss if the no Act assumption was limited to the flat. When this was put to the Crown's advocate, it was recorded that she had been unable to give a reasoned response.

24. In so far as the "grammar" of the assumption was concerned, this was said to be ambiguous and capable of substantiating the two rival interpretations. In such circumstances, the FTT again agreed with Whitehall that it was reasonable to consider the intention of Schedule 13 in general and the no Act assumption in particular. The assumption was said to be made to facilitate a valuation of the landlord's interest in the particular flat. There was no obvious reason for applying the assumption to any other flat. Indeed if the assumption were applied to other flats in Whitehall Court, it was said that it might preclude their use as short lease comparables, which was unlikely to have been intended. The Crown's advocate was said

to have conceded that it was only in the unusual circumstances of the instant case that the extension of the assumption to other flats within the premises would have any practical effect. It seemed unlikely that Parliament would have had those circumstances in mind when the 1993 Act was enacted.

25. Para 3(2) (b) required the experts to assume, when valuing the diminution in value of the landlord's interest, that the lessee of the particular flat did not have the right to acquire a greater interest in that flat, either through a collective enfranchisement under Chapter I or by the grant of a new extended lease under Chapter II. In the view of the FTT, it did no more than that. Such an interpretation was said to be consistent with the scheme of the enfranchisement legislation, which was to apply the "no Act" assumption only to the subject property.

26. Consequently and for each of the above reasons, the FTT agreed with Whitehall's interpretation and concluded that the "no rights" assumption under Schedule 13 did not extend to other flats in Whitehall Court.

The Crown's contentions

27. The only physical unit referred to in the no-Act rights assumption was "*any premises containing the tenant's flat*". Therefore the natural meaning of the assumption was that Chapter I and Chapter II conferred no right to acquire any existing interest in the premises containing the tenant's flat or any right to acquire any new lease of any part of those premises. The phrase used was "*<u>any</u> new lease"* and not "*a new lease"* which was said to be consistent with an intention to refer to any new lease of any flat in the premises, and not just a new lease of the particular flat. When it was suggested to Mr Jourdan that the structure of the para 3(2) (b) assumption in the context of Schedule 13 as a whole tended to indicate that the subject of the phrase "to acquire any new lease" was the tenant's flat and not "any premises containing the tenant's flat", Mr Jourdan's response was that one could always re-arrange the language of a statutory provision to achieve a <u>*clearer*</u> result but that it could not be correct to reject a particular interpretation of a phrase merely on the basis that its meaning could have been expressed more clearly.

28. The Crown's case as to the natural meaning of the para 3(2) (b) assumption was said to be supported by Ms Ellis's chapter in *Statutory Valuations* (4thedn, 2007) (at para 4.6) and by *Woodfall* (at para 29.147A) which referred to the "no-Act world", indicating a broad rather than a narrow meaning. *Hague* (6th edn, 2014) (at para 33-04) did not say anything relevant, doing little more than repeat the wording of the statutory paragraph.

29. That interpretation was also said to be supported by considering the purpose of the assumption. The 1993 Act gave tenants powers of compulsory purchase. It was a fundamental principle of the law of compulsory purchase that the valuation must be "… estimated as it stood before the grant of the compulsory powers…. Subject to that he is entitled to be paid the full price for his lands, and any and every element of value which they possess must be taken into consideration in so far as they increase the value to him": see *In re Lucas and*

Chesterfield Gas and Water Board [1909] 1 KB 16 at pp 29-30 per Fletcher Moulton LJ, cited in *Waters v Welsh Development Agency* [2004] UKHL 19, [2004] 1 WLR 1304 at para 23 per Lord Nicholls of Birkenhead. In oral submissions, Mr Jourdan accepted that the compulsory purchase authorities were not entirely on point, being concerned with the extent of the "no-scheme" assumption. But the underlying principle was the same: that of fairness to the person whose interest was being expropriated. The "value to the owner" principle required one to inquire to what extent the particular assumption was required to ensure that the person whose interest was being acquired was fairly compensated. In the present context, the purpose of the assumption was to prevent the price for the new lease being reduced because the tenant had the right to acquire it compulsorily. The Crown submitted that the principle of fairness which underlies the *Pointe Gourde* principle applied with equal force if the ability to enfranchise other flats in the Building would depress the price payable to the freeholder. The purpose of the no-Act rights assumption was to prevent the freeholder's interest being valued on a less favourable basis.

30. It has been said of the no-Act rights assumption in Schedule 6 para 3 (1) (b) that it can be described as a "no-Act building" assumption – "an assumption that, for some unspecified reason, the rights conferred by Chapters I and II of Part I of the 1993 Act do not apply to the tenants in the building": see *82 Portland Place (Freehold) Ltd v Howard de Walden Estates Ltd* [2014] UKUT 0133(LC) (Martin Rodger QC, Deputy President, and Mr Andrew Trott FRICS) at para 13. The Crown contended that the same was true of Schedule 13 para 3(2) (b). The Crown submitted that it would be very surprising if the position was any different under the two Schedules. Both of them used similar phraseology and should be given a similar and not a different meaning. If the no-Act rights assumption was limited to the flat itself, the Crown submitted that this would produce a different result to that dictated by Schedule 6. This could not be right since one was valuing the interest in the flat as part of the building of which it formed a part. Since one was evaluating the contribution which the flat made as a component of both the freehold and the headleasehold interest as a whole, it would be inconsistent, illogical and unfair to approach a valuation under Schedule 13 any differently from a valuation under Schedule 6. Why, Mr Jourdan asked rhetorically, should Parliament have been so concerned to protect the freeholder from the effects, in valuation terms, of a collective enfranchisement claim but not from individual enfranchisement claims? Where was the logic in that?

31. As explained in *Waters* at para 55 and following, deciding the exact geographical extent of the no scheme assumption can create difficulties. In Schedule 13, Parliament had identified the extent of the assumption – it was the premises containing the tenant's flat, which was the natural unit of valuation. The interest of the freeholder in the flat, and of any headlessee in the flat, should be valued as forming part of their interest in the premises containing the flat. The valuation must therefore be undertaken free from any influence of the rights of compulsory purchase affecting those interests, whether those rights were conferred by Chapter I or by Chapter II. That ensured that the value of the freehold and any intermediate leasehold interest was estimated as it stood before the grant of compulsory powers by the 1993 Act. If the 1993 Act had not been enacted, the Crown might have agreed to join with the headlessee in granting a new long lease of Flat 71A at a peppercorn rent in substitution for the existing lease. If so, the premium payable to the Crown would have reflected the fact that future Net Receipts would include the ground rents from all the other flats and therefore, once the ground rents doubled in 2029, there would be Profit Income and Overage Rent every year. If

the FTT was right, then the effect of the 1993 Act was that the premium under Schedule 13 had to be calculated on the different, and much less favourable, basis that the ground rents from other flats would gradually diminish, so reducing the value of the Crown's entitlement to Overage Rent. The FTT had said (at para 48) that the Crown would be compensated for that on the grant of new leases of other flats, but that was said to be clearly wrong. That could only be right if the no-Act rights assumption were to be taken to apply to the whole building; but that would be inconsistent with the FTT's decision. The truth was that on the basis of the FTT's decision, the Crown would receive some £4,000 less for the flat than it would have done had the FTT decided this issue in the Crown's favour, and the Crown would not recover that sum from anyone else, and would lose it for each flat that was enfranchised.

32. At para 49 the FTT had said that applying the no-Act assumption to all the flats in the building "…might preclude their use as short lease comparables". That was said to be wrong. If Flat 71A, or the flat next to Flat 71A had sold on the open market close to the valuation date, then the sale price, subject to adjustment for the fact that it had 1993 Act rights, would be likely to be a useful comparable for the value of the existing lease of Flat 71A for the purposes of Schedule 13 para 4A. In *Mundy* at paras 100-104 and 140-147, the Tribunal had accepted Mr Fielding's evidence that it was appropriate to use the sale of the existing lease of Flat 5, 17 Cranley Gardens, with 1993 Act rights, as a comparable for the value of that lease without 1993 Act rights, with a deduction of 10% for the value of those rights.

33. The FTT had also said (at para 49) that the Crown had conceded that it was only in the unusual circumstances of the instant case that applying the assumption to all the flats in the building would have any practical effect. No such concession had been made, and it was not correct. Even if it was correct, that was no reason to construe the statutory assumption so as to produce an incorrect and unfair result. Given that the freehold and headleasehold interests in the flat had to be assessed as components of the value of those interests in the whole building, the need to treat the particular flat differently to the rest of the building would create valuation difficulties in other cases. The value of reversions on flats which had 1993 Act rights would not be the same as those that did have such rights. If the FTT was right in this case, then in deciding whether the grant of the new lease of a flat would make the overall value of the headlessee's interest negative, it would be necessary to value the headlessee's interest in the rest of the building on the basis that it was subject to enfranchiseable leases, but the headlessee's interest in the subject flat on the basis that the lease was not enfranchiseable, which would create substantial complications.

34. The FTT had said (at paras 46-47) that its view was supported by *Mundy*. However, that case was not concerned with the issue of whether the no-Act rights assumption extended only to the subject flat or to the building containing it. In fact it was common ground that the no-Act rights assumption related to the building. The way that the Tribunal described the no-Act assumption in *Mundy* (at para 15) is said to reflect that: "The assumption does not say anything about the leases of flats *outside the premises containing the tenant's flat*. Therefore, *apart from the premises containing the lessee's flat*, one reflects the real position in relation to all other leases of other properties." Since the case had been argued on the basis of that common assumption, the Tribunal had not decided the issue.

35. The FTT had said (at para 47) that: "… in so far as possible the valuation to be undertaken should reflect the real world and not a hypothetical construct". That approach had been rejected by Arden LJ in the Court of Appeal in *McHale v Earl Cadogan* [2010] EWCA Civ 1471, [2011] 1 P & CR 14 at para 33, when determining that the no-Act rights assumption applied when ascertaining the marriage value (under Schedule 6 para 4) even though it was not spelled out there. Rejecting the submission of Mr Jourdan (at para 20) that "valuation should take place on the basis of reality in the absence of contrary indication", Arden LJ said that: "… the presence of artificial assumptions necessarily displaces the presumption that the valuation is to be conducted on the basis of reality". Earlier in the same paragraph, Arden LJ had said that the result of the Court of Appeal's interpretation of Schedule 6 had the additional merits of achieving consistency with the approach in Schedule 13 and with the *Pointe Gourde* principle as well.

36. Whitehall had argued that even if the no-Act rights assumption applied to the Building, it was to be assumed (under Schedule 13 para 3(4)) that the hypothetical purchaser "could not be ignorant of the likely real attrition rate irrespective of how that comes about". As to that, the hypothetical purchaser, having made proper inquiries about the property, would know what had happened in the past, and no assumption was needed in relation to that. However, what mattered for valuation purposes was the future, not the past. The assumption directed that, for whatever reason, and whatever the position might have been in the past, Chapter I and II conferred no rights in respect of the Building and the hypothetical purchaser would negotiate the purchase price on that basis. The hypothetical purchaser was buying in circumstances where the 1993 Act did confer rights in the past, which some tenants had exercised. However, for some unspecified reason (because, for example, the 1993 Act had been repealed for the future), by the valuation date, Chapters I and II no longer conferred rights on the tenants in the block. The purchaser need not, therefore, anticipate that in the future tenants would exercise rights under Chapter I or Chapter II as they did not have those rights. With this argument, Whitehall was said to be attempting to get in by the back door what the no-Act rights assumption was intended to prevent. Whitehall could not properly introduce an assumption that was contrary to the express no-Act rights assumption in para 3 (2) (b).

Whitehall's contentions

37. Whitehall submitted that the FTT had reached the correct conclusion on this issue for the reasons that it had given. The words "any new lease" related back to "this Chapter", ie Chapter II of Part I of the 1993 Act. As "this Chapter" conferred the right to acquire a new extended lease of the subject flat, the "no rights" assumption simply required the hypothetical purchaser (and the experts) to assume that the tenant of the flat (as opposed to the tenants of other flats in Whitehall Court) did not have the right to acquire a new extended lease. The reference in para (b) to "any premises containing the tenant's flat" referred back to a collective enfranchisement claim under Chapter I, while the reference to "any new lease" was linked to the right to acquire a new lease of the tenant's flat under Chapter II. As a matter of construction, one did not need to look beyond the tenant's flat. That the reference to "any new lease" was confined to the tenant's flat was also clear from the context and, specifically, the fact that what was being valued was a portion of the superior interest in the tenant's flat.

38. Whitehall submitted that this construction was supported by the commentary in *Hague* (at para 33-04) which was said to clearly indicate that the first part of the para (b) assumption referred only to a collective enfranchisement claim whereas the reference to "any lease" related only to the tenant's flat and no other. In closing, Mr Letman submitted that his construction was also supported by the statement at para 29.147.1 of *Woodfall* that: "The statutory assumptions should be applied to reach a price for the freehold that corresponds to market reality as closely as they permit." However, the question for us is whether they do so permit.

39. Schedules 6 and 13 were said to have different structures and very different wording and the differences were actually said to support Whitehall's construction. It was said to be interesting to note the difference between the wording of the corresponding assumptions in the two schedules. The focus of the assumption in Schedule 6 was the "specified premises" and the reference to "any new lease" plainly related back to that; but the different statutory directions in Schedule 13 expressly related instead to the tenant's flat and the lease of just those premises. There was no basis in the terms of the relevant assumption in Schedule 13 for extending the reference to "any new lease" beyond the tenant's flat. Mr Letman derived support for his submissions from the observations in *Mundy* at paras 14-19.

40. Mr Letman pointed out (by reference to observations of Auld LJ in *9 Cornwall Crescent London Ltd v LB of Kensington & Chelsea* [2005] EWCA Civ 324 at para 4) that the courts have emphasised that whilst the effect of legislation such as the 1993 Act is expropriatory in nature, that is a necessary consequence of its main purpose, which was to confer benefits on tenants so that it was not appropriate to construe it strictly in favour of landlords, whose property was being subjected to compulsory acquisition, but fairly and with a view, if possible, to making it effective to confer on tenants those advantages which Parliament must have intended them to enjoy. In his reply, Mr Jourdan responded by drawing to our attention Lord Carnwath's gloss upon these observations in *Hosebay Ltd v Day* [2012] UKSC 41, [2012] 1 WLR 2884 at para 6 that: "By the same token, the court should avoid as far as possible an interpretation which has the effect of conferring rights going beyond those which Parliament intended."

41. As for the purpose of the no-Act rights assumption, Whitehall accepted that in so far as there was any difficulty or ambiguity in the terms of the no-Act rights assumption this should be taken into account. But the Crown was said to have stated the statutory purpose too widely. The principle underlying the cases on compulsory purchase was the exclusion of the effect on the value of the property which was being compulsorily acquired of the specific purchaser armed with the compulsory powers. Under Chapter I the relevant property or scheme for the purposes of the compulsory powers was the specified premises. Under Chapter II it was the tenant's flat. Nothing else was being compulsorily acquired in each case. The Crown's submission in this regard was said to be mistakenly premised on a "no-Act" assumption. The purpose of the "value to the owner" principle was to ensure that the dispossessed owner received fair compensation and no more. It did not require the scheme to go beyond the subject premises, namely the tenant's flat in relation to Chapter II rights. In addition to the observations of Fletcher Moulton referred to by Mr Jourdan, Mr Letman cited observations in *Lucas* of Vaughan Williams LJ at pp 26-7 and of Buckley LJ at p 36. The issue in *Waters* was said to relate to the extent of the scheme and to be very far from the issue in the instant case

where the subject of the statutory purchase was simply the applicant's flat; but the six pointers to the application of the principle in the speech of Lord Nicholls in the *Waters* case (at para 63) were said to provide useful guidance. In particular, at (1) that the *Pointe Gourde* principle should not be pressed too far, at (2) that a result was not fair and reasonable where it required a valuation exercise which was unreal or virtually impossible, and at (6) that when in doubt, a scheme should be identified in narrower rather than broader terms. There was said to be no justification in valuation terms for the proposition that the no rights-Act assumption should extend beyond the subject flat to leases of neighbouring flats in the same block. To exclude the real rate of attrition in relation to other flats would patently offend the second of Lord Nicholls's pointers, leading to an unreal and unfair result that artificially inflated the share of the marriage value to be received by the Crown. It would be unreal to extend the assumption beyond the tenant's flat because this was not a no-Act world.

42. Whitehall submitted that the acknowledgment in *Nailrile* that the Headlease would be sold as a whole did not require the no-Act rights assumption to extend beyond the tenant's flat given that neither the freehold nor the Headlease was being compulsorily acquired.

43. The practical effect of this interpretation was that the experts must assume that the ground rental income would continue to be eroded as the remaining short leases were extended under the 1993 Act. Although the rate of erosion was a matter of evidence, it was feasible that by the first review date the ground rental income would be less than half the Threshold Rent, with the result that after the first review date there was no guarantee that the Crown would receive the Overage Rent.

44. Mr Letman argued that the FTT had been right to say (at para 48) that the Crown was compensated for the loss of its Overage Rent on the grant of each extended lease so that the Crown would not in reality suffer a loss if the no-Act assumption was limited to the flat. If, however, he was wrong about that, it was simply the consequence of the statutory assumption in the unusual circumstances of the instant case. It was unlikely that Parliament had had the relatively unusual overage provisions of the Headlease in mind when drafting Schedule 13.

45. Further or alternatively, if the construction accepted by the FTT were held to be wrong, Whitehall sought to rely upon the declaration in para 3 (4) of Schedule 13 (the fact that sub-para (2) requires assumptions to be made as to the matters specified in paras (a) to (d) does not preclude the making of appropriate assumptions as to other matters) and submitted that for the purposes of the "before" calculation, it must be assumed that the hypothetical purchaser would not be ignorant of the likely real attrition rate in the overage irrespective of how that came about. Otherwise the "no-Act rights" assumption would be being used artificially to inflate the valuation, rather than achieving its proper purpose of ensuring that it was not unfairly deflated by the existence of the 1993 Act rights. The actual rate of attrition was a reality.

Decision and reasons

46. We do not derive any assistance in the resolution of this issue from the observations of commentators on the 1993 Act. We are satisfied that none of them is addressing the issue with which we have to grapple on this appeal. Indeed we are sure that none of them had in mind the particular, and somewhat esoteric, situation which has given rise to this issue. *Hague* (at para 27-06 (b) in relation to Schedule 6 and para 33-04 in relation to Schedule 13) does no more than repeat the wording of the relevant paragraphs. The citation from *Statutory Valuations* is concerned merely to emphasise that: "In fact none of the assumptions says that there is to be a no-Act world, but only that the Act does not apply to the house or block being enfranchised or the block where the flat whose lease is being extended is situated." It then points out that: "This point has not yet been aired at a tribunal." *Woodfall* merely refers (at para 29.147A) to the "no-Act" world that must be assumed; and (at para 29.147.1) states that: "The statutory assumptions should be applied to reach a price for the freehold that corresponds to market reality *as closely as they permit*".

47. For the same reason, we derive no real assistance from any of the case law authorities on the 1993 Act that have been cited to us. The most directly helpful of those authorities is *Mundy*. But we agree with the submission of Mr Jourdan that that case did not determine the issue we have to decide of whether the no-Act rights assumption extends only to the subject flat or to the building containing it. We accept that it was common ground in that case that the no-Act rights assumption extended to the building containing the flat; and the way that the Upper Tribunal described the no-Act assumption in *Mundy* (at para 15) reflects that: "The assumption does not say anything about the leases of flats *outside the premises containing the tenant's flat*. Therefore, *apart from the premises containing the lessee's flat*, one reflects the real position in relation to all other leases of other properties." It is against that context that one must read the immediately following sentence: "The 1993 Act will apply in accordance with its terms to other leases of other flats". We accept that since the case had been argued on the basis of that common assumption, the Tribunal did not decide the issue. We are satisfied that none of the other authorities addresses the issue which we have to determine on this appeal; and we are sure that none of them had the particular, and somewhat esoteric, situation which has given rise to this issue in mind.

48. We find that the effect of the authorities is that courts and tribunals must construe the 1993 Act fairly and with a view, if possible, to making it effective to confer on tenants those advantages which Parliament must have intended them to enjoy whilst avoiding, as far as possible, an interpretation which has the effect of conferring upon them rights which go further than Parliament had intended. The presence of artificial assumptions necessarily displaces the presumption that any valuation is to be conducted on the basis of reality; but statutory assumptions should not be pressed beyond their natural limits and should be applied to reach a price for the relevant interest that corresponds to market reality as closely as those assumptions permit.

49. In the instant appeal we bear in mind that (as is apparent from the identity of the parties to this appeal) we are primarily concerned, not with the price payable by the tenant for the grant of a new lease of the flat, but rather with the apportionment of that price between the

owners of the freehold reversion and the intermediate leasehold interest. We are also conscious that the draftsman of the 1993 Act is most unlikely to have had the particular, and somewhat esoteric, factual scenario which has given rise to this issue in mind. We accept Mr Letman's submission that it is unlikely that Parliament had had the relatively unusual overage provisions of the Headlease in mind when it enacted Schedule 13.

50. We acknowledge (as stated by Arden LJ in *McHale* at para 29) that in the absence of contrary indication, where Parliament enacts a single statute, it must be taken to intend to enact a single consistently-expressed code of provisions; but (as was also pointed out by Arden LJ at para 31) this principle of statutory interpretation can, however, be excluded by the context, such as when it is clear that two sets of provisions operate independently and in different circumstances. We should therefore focus on the issue of the true interpretation of para 3 (2) (b) of Schedule 13 of the 1993 Act as its stands, rather than in conjunction with the corresponding paragraph in Schedule 6, although we acknowledge that we should then stand back and consider whether that interpretation is consistent with the true meaning and effect of the latter provision. We note that para 3 (1) (b) of Schedule 6 contains an express exception from the no-Act rights assumption in the case of "a notice given under section 42 with respect to a flat contained in the specified premises where it is given by a person other than a participating tenant". In the light of that difference in the content of the two statutory provisions, we do not accept Mr Jourdan's submission that the No-Act rights assumption in Schedule 13 should necessarily be given a similar meaning to the corresponding assumption in Schedule 6.

51. We acknowledge that para 3 (2) (b) of Schedule 13 could have been more clearly expressed. Had it read: "… on the assumptions that Chapter I confers no right to acquire any interest in any premises containing the tenant's flat and that this Chapter confers no right to acquire any new lease of the tenant's flat" there could have been no doubt but that the FTT had reached the correct conclusion. However we accept Mr Jourdan's submission that one can always re-arrange the language of a statutory provision to achieve a <u>*clearer*</u> result and that it is not right to reject a particular interpretation of a phrase merely on the basis that its meaning could have been expressed more clearly. Nevertheless, we consider that the more natural reading of the paragraph 3 (2) (b) assumption is that adopted by the FTT. We do not agree with Mr Jourdan that the only physical unit referred to in the no-Act rights assumption is "*any premises containing the tenant's flat*". Contrary to Mr Jourdan's submission, we consider that the structure of the para 3(2) (b) assumption, in the context of Schedule 13 as a whole, tends to indicate that the subject of the phrase "to acquire any new lease" is the tenant's flat rather than "any premises containing the tenant's flat". Section 56 (which introduces Schedule 13) is directed to the grant of a new lease of the relevant flat; and Schedule 13 governs the premium payable by the tenant in respect of the grant of the new lease of the tenant's flat. Had the draftsman intended the paragraph to bear the meaning for which the Crown contends, we would have expected it to have read: "… on the assumption that Chapter I and this Chapter confer no right to acquire any interest in or any new lease of any premises containing the tenant's flat". We do not accept that the phrase in para 3 (2) (b) "*<u>any</u> new lease"* and not "*<u>a</u> new lease"* necessarily points to an intention to refer to any new lease of any flat in the premises, and not just a new lease of the particular flat. We reject the Crown's submission that the more natural reading of the para 3 (2) (b) assumption is *necessarily* that Chapter I and Chapter II confer no right to acquire any existing interest in the premises containing the tenant's flat or any right to acquire any new lease of any part of those premises. However, we

agree with the FTT that, in so far as the "grammar" (or, as we would prefer, the language) of the assumption is concerned, it is ambiguous and is capable of supporting either of the two rival interpretations.

52. For the reasons advanced by Mr Jourdan (and summarised above) we consider that the FTT was wrong to conclude (1) (at para 48) that the Crown would be compensated for a reduced Overage Rent on the grant of new leases of other flats and (2) (at para 49) that applying the no-Act assumption to all the flats in the building "…might preclude their use as short lease comparables". The former conclusion assumed an interpretation of para 3 (2) (b) which was contrary to that adopted by the FTT; and the latter conclusion ignored the capacity of expert valuers and tribunals to adjust comparable evidence to reflect the value of 1993 Act rights.

53. We have found this to be a difficult exercise in statutory construction on which our minds have wavered. This is not surprising given that we are satisfied that it is unlikely that Parliament had had the relatively unusual overage provisions of the Headlease in mind when it enacted Schedule 13. Although we consider the matter to be finely balanced, ultimately we have come to the conclusion that Mr Jourdan's submissions are to be preferred to the submissions of Mr Letman and that the Crown's construction of the no-Act rights assumption in para 3 (2) (b) is to be preferred to the interpretation adopted by the FTT. We do so essentially for two reasons.

54. First, we bear in mind the wording of the relevant assumption. Reading paragraph 3 (2) (b), the only expressed physical restriction on the extent of the no-Act rights assumption is "any premises containing the tenant's flat"; and the assumption extends to "any interest" in such premises. This suggests a wider physical area of application for the "no new lease" limb of the "no-Act rights" assumption than merely the applicant tenant's flat.

55. Secondly, we have regard to the purpose underlying the statutory assumption. The FTT said (at para 49) that: "The assumption is made to facilitate a valuation of the landlord's interest in the particular flat"; and (at para 50) that "the scheme of the enfranchisement legislation" is "to apply the 'no Act' assumption to the subject property". We consider that the former statement takes too narrow a view of the purpose underlying the statutory assumption; and the latter statement really begs the question. Both Mr Jourdan and Mr Letman were agreed that the principle underlying the assumption was that of fairness to the person whose interest (or interests) was (or were) being expropriated. Where counsel differed was as to the particular consequences of the application of that principle to the unusual circumstances of the instant case. The purpose of the no-Act rights assumption is to prevent the landlords' interests being valued on a less favourable basis because the 1993 Act confers rights of collective and individual enfranchisement. We accept the Crown's submission that the principle of fairness which underlies the *Pointe Gourde* principle applies with equal force if the ability to enfranchise other flats in the Building would depress the price payable to the freeholder.

56. We therefore hold, contrary to the decision of the FTT on this issue, that the no-Act rights assumption in para 3 (2) (b) of Schedule 13 to the 1993 Act does extend to other flats in the Building. We therefore allow the Crown's appeal on this issue.

57. We reject Whitehall's submission that even if the no-Act rights assumption applies to the Building, it is to be assumed (under Schedule 13 para 3(4)) that the hypothetical purchaser "could not be ignorant of the likely real attrition rate irrespective of how that comes about". We accept Mr Jourdan's submission that, with this argument, Whitehall was attempting to get in by the back door what the no-Act rights assumption was intended to prevent. In our view, Whitehall cannot properly invoke para 3 (4) to introduce an assumption that is contrary to the express no-Act rights assumption in para 3 (2) (b).

Issue 2 – the frequency with which the hypothetical purchaser of the freehold or the Headlease would anticipate that the headlessee would receive Additional Payments

58. This issue concerns the probability of receipt of Additional Payments in any given year. The relevant probability is that of exceeding the Threshold Rent since that is the point at which the freeholder receives Overage Rent. It is possible to receive an Additional Payment without reaching the Threshold Rent. For instance, in 2014 Whitehall received £2,500 for a licence to alter but the total net receipts that year were only £17,522, well below the Threshold Rent. Mr Fielding says it is probable that the Threshold Rent will be exceeded one year in two, while Ms Ellis says the probability is one year in eight. The FTT determined that the Threshold Rent would be achieved once every two years, although it took that rent as being £21,406 rather than £25,184.

59. We consider each type of Additional Payment in turn.

(i) Premiums received on the grant of corridor leases

60. Since the grant of the Headlease in 1987 there have been 11 corridor sales, the last of which was in 2005. Six of the sales took place between 1987 and 1990 followed by a gap of 12 years before five further sales between 2002 and 2005. The average rate of corridor sales at the valuation date was one sale every 2.59 years[1].

61. Ms Ellis identified 31 future sale opportunities to which Mr Fielding added Flats 88/88A, which he said was a live negotiation in 2015. At the historic rate of one sale every 2.59 years there would be a further 27 sales before the expiry of the Headlease, so the pool of potential corridor sales would not become exhausted.

[1] Taken over a period of 28.5 years. Mr Fielding's equivalent figure was 1:2.73 which was calculated over 30 years, i.e. it included a period after the valuation date.

62. Ms Ellis said that before a corridor sale could take place the two flats must be in common ownership and (i) market conditions must favour larger flats; or (ii) the lessee must be prepared to sacrifice value for convenience; or (iii) the lessee must simply want a larger flat. Ms Ellis said there had been a trend towards larger flats in London "over the last decade or two" but nevertheless there had been no corridor sales since 2005. She felt unable to predict the future pattern of such sales. During cross-examination Ms Ellis said that the presence of service ducts in the corridor would prevent some of the potential sales. That evidence did not appear in Ms Ellis's expert report and no examples or details were given. We do not place weight on this assertion.

63. We do not believe a hypothetical purchaser of the Headlease would simply adopt the average rate of corridor sales since the start of the headlease. In our opinion it would also be influenced by the uneven spread of the sales and the absence of any deals over the last 10 years. There is evidence that a prospective sale (Flats 88/88A) was under discussion at the valuation date but we think a purchaser would be fairly cautious and is unlikely to have assumed a corridor sale more than once in every five years, i.e. approximately half the historic average.

(ii) Changes of use

64. A premium was received in 2012 for the change of Flat 55 from office to residential use. Mr Fielding identified 11 other offices in the building which he said might be suitable for similar conversion upon payment of a premium. One of these, 1 Horseguards Avenue, had been the subject of negotiation for residential conversion since 2014. A premium of £2m had been agreed provisionally but the transaction was not completed. Ms Ellis said there was a shortage of offices "close to the heart of Government" which might explain why there had not been more applications for a change of use to residential. Mr Fielding estimated that the probability of future changes of use was once every 10 years. Ms Ellis said that it was impossible to make a prediction.

65. In our opinion Mr Fielding's estimate is reasonable and we accept it.

(iii) Basement leases and licences

66. Ms Ellis identified four basement underleases, the last of which was granted in 2003. She did not think there were any realistic further opportunities. Mr Fielding said the Crown's potential deal for the residential conversion of the offices at 1 Horseguards Avenue included taking a lease of part of the basement and vaults. This proposal would have been known at the valuation date and would have been considered likely by the market. Mr Fielding said the probability of receiving premiums from the basement was 1:20.

67. We consider this source of Additional Payments to be the most remote and we accept Ms Ellis's evidence that future opportunities would be very limited. Nevertheless there were at least preliminary negotiations in progress at the valuation date for a new lease of part of the

basement at 1 Horseguards Avenue and so we do not entirely rule out the possibility of a hypothetical purchaser making a small allowance for future incremental basement income. We determine this probability at 1:25.

(iv) Licences to alter

68. Ms Ellis said the only income received by the valuation date from a licence to alter was a fee of £2,500 which had been inadvertently included in the annual returns in 2014. She said three licences to alter had been granted in 2016 (Flats 93, 149 and 151) at premiums totalling £26,000 shared equally by the Crown and Whitehall. An application for another licence had been received in 2017 to amalgamate Flats 84 and 89 vertically, but terms had not yet been agreed. (Ms Ellis explained that very few alterations requiring a licence from Whitehall did not also require a licence from the Crown. Consequently the Crown would want a share of the premium that the underlessee was prepared to pay.) Ms Ellis recognised that premiums had been charged for leases which enabled the enlargement of flats, e.g. the amalgamation of Flats 2A and 2B into a triplex flat on the 8th to 10th floors and the grant of a lease for the expansion of the 7th floor Flat 97 into the tower above and the creation of a roof terrace. Both transactions took place in 2010.

69. Mr Fielding said there was continued demand in prime central London at the valuation date for lateral flats and that a hypothetical purchaser of the Headlease would consider it likely that premiums from licences to alter would continue to be received at a rate of one every five years.

70. Historically only one licence to alter has been included by the headlessee in the annual returns of income, and that was said to have been done inadvertently. But leases have been granted to enable the enlargement of flats and several licences to alter were granted after the valuation date and applications for licences to alter are still being made by underlessees. In our opinion Mr Fielding's estimated probability of 1:5 is reasonable for this type of opportunity.

(v) Flat reversions in 2028

71. At the valuation date three flats were held on leases which expired in 2028. Mr Fielding said that if the no-Act rights assumption applied to the Building and not just to Flat 71A (which we have held that it does) it was very likely the lessees would seek, and the headlessee would grant, lease extensions until the expiry of the Headlease in 2086. Substantial premiums would be payable for such lease extensions. If no deal was done the headlessee could sell or rent the flats at the end of the term.

72. The leases of two offices also expired in 2028 and Mr Fielding said it was possible that the headlessee would do a deal with either or both tenants to extend their leases until 2086 for a premium. Alternatively the headlessee could let the offices at an open market rent from 2028 (said by Mr Fielding to exceed £60,000 per annum).

73. Mr Fielding estimated the probability of obtaining Additional Payments from this source by assuming that voluntary deals would be done with both office tenants and with two of the three flat lessees by 2028, i.e. a probability of 4:14.

74. Ms Ellis noted that the underlessee of one of the three flats had made a claim for a new lease under the 1993 Act in October 2016. Assuming (as we have determined) a no-Act rights world, such a lease extension could only be achieved through negotiation. The desire of the underlessee to extend his lease supports Mr Fielding's estimate of probability, although we acknowledge that the claim was made after the valuation date.

75. The residential underlessees will have a strong incentive to negotiate a longer lease as the value of their existing leases begins to waste quickly. The two office leases can either be extended upon payment of a premium or relet at open market value at the expiry of the underleases. We consider that Mr Fielding's estimate of the probability of there being Additional Payments through voluntary deals for the sale or letting of the flats and offices is realistic.

Decision and reasons

76. In our opinion the probability of the five sources of Additional Payments occurring in any particular year are as follows (expressed as a decimal with 1.00 representing certainty):

(i) Corridor leases: 0.20

(ii) Changes of use: 0.10

(iii) Basement leases and licences: 0.04

(iv) Licences to alter: 0.20

(v) Flat reversions in 2028: 0.24

In his analysis Mr Fielding added the probabilities which he had assigned to each source. This gave a combined probability of 1.00 or absolute certainty that at least one of the sources would produce Profit Income in any given year. But since in each case the probability of not receiving Additional Payments from a particular source is significantly greater than the probability of receiving it, this conclusion appears suspect. To be fair to Mr Fielding he said that he had stood back and looked at the result and had concluded that it was not correct; hence instead of adopting a probability of 1.00, which would mean that every year was a PIY, he halved this probability to 0.50, i.e. a PIY every other year.

77. In response to questions from the Tribunal Mr Fielding said the sources of Additional Payments were independent of each other; i.e. if one occurred it was no more or less likely that another would occur. He also said that if any one of the events occurred it would generate sufficient Net Receipts to exceed the Threshold Rent. That being so, and assuming that the events were not mutually exclusive, i.e. if one happened one or more of the other

events could not happen, the probability of at least one of the events taking place is obtained by the formula: 1 - (A x B x C etc), where A, B and C are the probabilities of that event *not* taking place. So using the values set out above the probability of Additional Payments being received in any particular year is 0.58[2].

78. This result is similar to Mr Fielding's figure of 1:2 or 0.50 and is much higher than Ms Ellis's estimate of 1:8 or 0.125. It is also the figure adopted by the FTT and is supported by Ms Ellis's table at page 105 of bundle 2 which shows there was a PIY (after allowing for costs) in six of the last 12 years since 2004; i.e. once every two years.

79. We do not suggest that a hypothetical purchaser would be concerned with the details of probability theory but we do think it would make an assessment of the likelihood of exceeding the Threshold Rent each year by having particular regard to (i) past performance; (ii) the uneven distribution of Profit Income over time, with Additional Payments being received from multiple sources in some years but with significant periods with no payments at all; (iii) the fact that there are several different sources of income which are said to be independent of each other (although subject to changes in the market); and (iv) the future reserve of opportunities that could be exploited[3].

80. Ms Ellis's probability estimate of 1:8 reflects her view that the headlessee could manage the receipt of Additional Payments in such a way as to put pressure on the Crown to amend the 85:15 division of Profit Income in favour of the headlessee. Mr Fielding pointed out that the headlessee granted three licences to alter in 2016, so in reality the headlessee did not seem to be managing returns in the way suggested by Ms Ellis. The opportunities for Additional Payments are identified by underlessees who often approach the freeholder directly. It seems to us that the ability and/or willingness of the headlessee to manage Additional Payments may have been exaggerated. But Mr Fielding acknowledged that since Whitehall purchased the Headlease in 2014 "there has been a constant desire to alter the 85% figure to incentivise the headlessee to pursue development opportunities with more vigour." We consider this to be a factor that a hypothetical purchaser would take into account when estimating the likelihood of exceeding the Threshold Rent in any given year.

81. Given these factors and our previous analysis we are of the opinion that a PIY would occur two years in every five, i.e. a probability of 0.40 (40%). The consequence of our decision on issue 1 means that there would not be an attrition of ground rents leading up to the next review in 2029 and that every year thereafter would be a PIY.

[2] 1 - (0.80 x 0.90 x 0.96 x 0.80 x 0.76) = 0.58

[3] The above analysis assumes the probability of each event is constant regardless of how many times it occurs. But as each event takes place the chances of another event occurring is lessened because the number of potential opportunities is reduced.

Issue 3 - whether the Additional Payments fall to be treated as included in the Net Receipts

The FTT's reasoning

82. Having recited the definition of "Net Receipts" in para 1 (b) of the Second Schedule to the Headlease and rehearsed the respective contentions of the parties, the FTT gave its reasons for holding that the definition of "Net Receipts" should not be interpreted in the restrictive manner suggested by Whitehall, and for concluding that "Net Receipts" included all the premium income apart from any unlawful premiums charged for licences permitting non-structural alterations, at paras 69 to 72 of its decision.

83. The definition of "Net Receipts" was said to catch both capital and income received for the variation of any underlease. Thus any premium received on the variation of an underlease to permit a change of use or to permit structural alterations was within the contemplation of the definition. This suggested that the original parties to the Headlease had in mind receipts derived from transactions not specifically authorised under the terms of the Headlease. Equally that interpretation was reinforced by the reference to "licence franchise and concession fees" even though the Headlease did not specifically authorise the grant of licences, franchises or concessions. Standing back and looking at the paragraph as a whole, the FTT agreed with the Crown that the definition was intended to capture all net capital and rental receipts received by the headlessee in respect of Whitehall Court. Clearly the freeholder's consent would be required to a transaction such as the grant of a corridor lease or a variation permitting a change to residential use but, once given, the freeholder was entitled to the Overage Rent if the premium took the income above the Threshold Rent, as the FTT was told it inevitably would.

84. The FTT agreed with both advocates that it must have regard to the assumptions that would be made by a hypothetical purchaser when making his bid for either the freehold or the Headlease. A hypothetical purchaser would make usual enquiries of the freeholder and the headlessee. He would find, as was acknowledged by both experts, that the annual returns had always included the premiums that Whitehall now suggested were not Net Receipts. The hypothetical purchaser would also have regard to the wording of the terms of the Headlease and in particular the definition of "Net Receipts". For each of those reasons the FTT was satisfied that the hypothetical purchaser would conclude that, with one exception, the premiums and rents were indeed Net Receipts that should be taken into account in the calculation of the Trigger Rent, the Surplus Income, the Profit Income and the Overage Rent. The one exception was said to relate to any premiums received for the grant of licences for non-structural alterations permitted by the Headlease under the relevant underlease. Even if the headlessee's consent was required, it could not be unreasonably withheld and the headlessee could not lawfully charge a premium for granting it. There was no evidence before the FTT to suggest that the annual returns had ever included such premiums and the issue only arose because of Mr Fielding's evidence that there were ongoing negotiations for "reconfiguring" two flats: the extent of the proposed reconfigurations were not clear and for all the FTT knew they might have included structural alterations for which a deed of variation and subsequent consent would have been required.

(1) Do Net Receipts include payments received by the headlessee in respect of Covenant Breach Transactions?

Whitehall's contentions

85. Whitehall submitted that on a proper construction of the Headlease the FTT should have construed the Second Schedule as referring only to capital and other sums received in consideration of matters that were permitted under the terms of the Headlease. Mr Letman's argument was based on the proposition that Net Receipts could only be derived from transactions that were both permitted under the terms of the Headlease and for which the landlord was entitled to recover a rent or premium. For the proper approach to the construction of the Headlease, Whitehall cited paras 14 to 23 (inclusive) of the judgment of Lord Neuberger PSC in *Arnold v Britton* [2015] UKSC 36, [2015] AC 1619. Particular reliance was placed upon paragraph 15 and the first of the factors identified at paragraph 17, emphasising the importance of the language of the provision which is to be construed. Mr Letman also cited paras 76-7 of the judgment of Lord Hodge JSC to the effect that there must be a basis in the words used and the factual matrix for identifying a rival meaning. Construing the words of the Second Schedule in their context, in order to identify what the parties must have meant through the eyes of the reasonable reader, Whitehall submitted that the contracting parties could not have meant that the freeholder would be entitled to take into account, and include in Net Receipts, premiums or other income from sources, such as the grant of underleases, that were prohibited and were not therefore permitted under the Headlease. This was not (as suggested by the FTT) a restrictive interpretation of the Headlease but simply respected its terms. Sums received for permissions or transactions outside the purview of the detailed provisions of the Headlease could not fall within the scope of Net Receipts.

86. If an underlease that was not permitted or contemplated by the Headlease (such as the lease of part of a corridor) was to be granted Whitehall would require the consent of the Crown (outside of the Headlease) and the Crown would undoubtedly require the payment of a premium. It could not then be right, or within the contemplation of the parties, that having agreed on a payment for consent from the Crown, Whitehall's receipt should then be included in the Net Receipts and subject to an 85% Overage Rent. However, that would be the inevitable result of the FTT's interpretation.

87. Whitehall further submitted that the reference to "licence franchise and concession fees" was not properly a point against its interpretation. It was said to be quite plain that para (b) (i) of the Second Schedule had adopted a "torrential" style of drafting designed simply to capture all forms of rent or payments in the nature of rent including mesne profits, thereby ensuring that the application of some different label to such income did not cause it to fall outside the scope of Net Receipts. That was said to be very different from including within the scope of Net Receipts premium payments or income received in respect of actions otherwise prohibited under the Headlease.

88. In summary, therefore, Whitehall submitted that the premiums and rents referred to at para 65 of the FTT's decision should not have been held to be Net Receipts, and that such income should therefore have been disregarded by the FTT in its assessment of the strike rate for the purposes of calculating the Surplus Income, the Profit Income, and the Overage Rent. The FTT relied upon its erroneous interpretation of Net Receipts in deciding that the hypothetical purchaser would conclude (with the one exception mentioned) that the premiums and rents referred to at para 65 of its decision should be regarded as Net Receipts (so as to be taken into account in the calculation of the Overage Rent). It is said that the FTT thereby erred in law by taking into account a mistaken and irrelevant consideration. Whitehall invited us to hold that, when properly construed, those premiums and rents should not be taken into account.

89. In the course of his reply, Mr Letman submitted that the terms of paragraph 1 (b) of the Second Schedule supported Whitehall's contentions. Sub-paragraph (i) was directed to sums in the nature of rent whilst sub-paragraph (ii) was directed to capital sums and could only extend to dealings contemplated by the Headlease itself. As reasonable persons, the parties to any separate negotiation outside the purview of the Headlease could not be taken to have contemplated that the headlessee's share of any premium should go into the "pot" for the purposes of determining the Net Receipts.

The Crown's contentions

90. Clause 3(16)(b) of the Headlease was a covenant by the headlessee "*not to … part with or share the possession of or grant any licence in respect of the demised premises or any part thereof*" except by way of a permitted underlease. Therefore the headlessee could not grant a licence, franchise or concession, as each of those transactions would constitute a breach of clause 3(16) (b). Despite that, the definition of Net Receipts specifically included income from granting licences, franchises or concessions. From that, it was quite clear that the parties intended that money paid to the headlessee in respect of Covenant Breach Transactions should be included in the Net Receipts. The draftsman of para 1 (b) (i) of the Second Schedule might have adopted a "torrential" style of drafting, but the whole purpose of that drafting technique was not to miss anything out. The draftsman had tried to pick everything up; and the torrent included payments in respect of transactions prohibited by the terms of the Headlease.

91. It was not surprising that the parties should have agreed that payments received for Covenant Breach Transactions should be included in Net Receipts. It would have been obvious to reasonable parties in 1987 that, over a term of nearly 100 years, there were bound to be occasions when the headlessee would enter into transactions which were, strictly speaking, in breach of one of its many covenants in the Headlease. Over the term of the Headlease, the prospect of strict compliance would be "vanishingly small". In that situation, the freeholder would have two choices. He could elect to treat the transaction as unlawful, and require it to be reversed, by threatening and, if necessary, bringing forfeiture proceedings, or claiming an injunction. In that case, it would be unlikely that the headlessee would be able to retain any payment made for the transaction; but if he was able to, it would be very surprising if he was not required to treat it as forming part of the Net Receipts.

92. If, however, the freeholder were to waive the breach, then the transaction would be a lawful one: see *Metropolitan Properties Co. Ltd. v Cordery* (1980) 39 P. & C.R. 10 (holding that where a landlord waives a breach of covenant against subletting, the property is to be treated as "lawfully sublet" for the purposes of s.137 (1) of the Rent Act 1977). As Templeman LJ pithily put it (at p 19): "Having waived the breach of covenant, they [the landlords] cannot now claim that Miss Cordery's subtenancy is unlawful." It would not be open to the headlessee, in those circumstances, to rely on its own breach of covenant to say that it could keep the payment; and it would have to treat the transaction as permitted and account for the payment as forming part of the Net Receipts. That would be so whether the waiver was in advance of the transaction or afterwards.

93. It would always be open to the freeholder and the headlessee to agree, in respect of a particular payment, that it was to be apportioned in a way which excluded the proportion paid to the headlessee from the Net Receipts. Absent any such agreement, any sum received by the headlessee of the nature identified in the definition of Net Receipts would fall to be included in Net Receipts, even if the transaction was one which was, strictly, a Covenant Breach Transaction. So if the headlessee granted a licence in breach of clause 3(16), he would have to include the licence fees in his account of Net Receipts.

Decision and reasons

94. On this issue we prefer the submissions of the Crown (as summarised above) to those advanced by Whitehall. We reject Whitehall's submission that sums received for permissions or transactions outside the purview of the detailed provisions of the Headlease do not fall within the scope of Net Receipts. We prefer the Crown's submission that the parties to the Headlease clearly intended that money paid to the headlessee in respect of Covenant Breach Transactions should be included in the Net Receipts. The draftsman of para 1 (b) (i) of the Second Schedule might have adopted a "torrential" style of drafting; but the whole purpose of that drafting technique was not to miss anything out. The draftsman had tried to pick everything up; and the torrent included payments in respect of transactions prohibited by the terms of the Headlease.

95. For the reasons stated at paras 91-93 above, with which we agree, and absent any specific agreement between the parties to the contrary, we consider that any sum received by the headlessee of the nature identified in the definition of Net Receipts would fall to be included in the Net Receipts, even if the transaction was one which was, strictly, a Covenant Breach Transaction.

96. Accordingly, we accept the reasoning of the FTT at paras 69 and 70 of its decision. However, we would not accept the validity of the exception in respect of unlawful premiums charged for licences permitting non-structural alterations. If (as the FTT held) the definition of "Net Receipts" was intended to capture all net capital and rental receipts received by the headlessee in respect of the Building, including receipts derived from transactions not specifically authorised under the terms of the Headlease, we can see no logical justification for excepting premiums for the grant of licences which the headlessee could not lawfully

charge. Subject to this minor qualification, we would uphold the decision of the FTT on this issue and dismiss Whitehall's cross-appeal.

(2) Which of the Additional Payments are in respect of Covenant Breach Transactions

Whitehall's contentions

97. Whitehall pointed out that by clause 3 (11) (a) of the Headlease the Building was to be used (to the extent so used at the date thereof) as private residential flats each in one occupation or as a club or as offices and for ancillary storage. The permitted user of each part of the Building was specified in the First Schedule to the Headlease; and the permitted user of each part of the Building was fixed as at the date of the Headlease. Whitehall contended that Clause 3(16) (c) of the Headlease restricted any underletting to "any one individual residential flat or office unit". Consequently the Headlease did not permit the grant of a lease of a lateral corridor or storage area; and any premium received for the grant of such a lease would not be a Net Receipt. Likewise a lease of two flats, with or without a part of the corridor. A premium for permission to rearrange or reconfigure a flat internally would not be a Net Receipt because it was the price of a licence under the lease and not a grant or variation of such a lease. Similarly, by clause 3 (14) there was a complete prohibition on structural alterations with the result that a licence authorising structural alterations was not within the contemplation of the Headlease; and any premium received for such a licence would not be a Net Receipt. Licence fees for changes that were visible externally or were structural, such as for a new extractor fan or a widened balcony door, could not be a Net Receipt because they were simply not permitted under the Headlease. The premiums received for lease extensions for the three flats that had leases that were due to expire well before the expiry of the Headlease were likely to be the result of claims under the 1993 Act and so were outside the definition (as decided by an Expert Determination by Mr Jonathan Gaunt QC dated 4 June 2010).

The Crown's contentions

98. The Crown contended that the phrase in parenthesis in Clause 3 (11) (a) of the Headlease "(to the extent so used at the date hereof)" should be understood as relating to the manner of use within each of the categories and should not be interpreted as requiring each part of the building to be used for exactly the same use as it was at the date of the Headlease. That would be an extremely restrictive covenant which would have needed to be spelled out, rather than referred to in passing in a bracketed phrase. It would also be inconsistent with the proviso. The Crown accepted that if part of the Building was designated for a particular use, it would be a breach of covenant for it to be used for some other use.

99. If a tenant held a lease of one flat (X) and a lease of an adjoining flat (Y), occupying the two together as a single residence, and he wished to create a new flat incorporating the two flats and the lateral corridor separating them, he would require a new lease which would include the two flats and the corridor, and permission to make the alterations needed to create the new flat. For the headlessee to grant permission to make those alterations and to grant an underlease of the new enlarged flat would not be a breach of covenant. As the alterations

would involve the making or blocking of openings and the removal of walls, the freeholder's consent would be needed under clause 3(14), but consent could not be unreasonably withheld. The newly enlarged flat would be used as a private residential flat, so there would be no breach of clause 3(11) (a). Nor would the new lease be a breach of clause 3(16) (c) as the underlease would be of one individual flat. The parties would structure the transaction by way of the grant of a single lease of the enlarged flat (incorporating the former corridor).

100. In oral submissions, the Crown accepted (correcting para 70 of its skeleton argument) that the variation of an underlease of a part of the Building to remove a covenant obliging the underlessee to use that part as offices, and instead to permit it to be used as a private residential flat in one occupation, would constitute a breach of clause 3(11) (a) of the Headlease.

101. It would not be a breach of clause 3(11) (a) or clause 3(16) (c) to grant an underlease of part of the basement provided that the use fell within clause 3(11) (a).

102. The grant of a licence for alterations would not breach clause 3(14) provided it fell within the scope of permitted alterations under that clause. The grant of a licence which was contemplated by an underlease would not constitute a variation of the underlease, but the grant of a licence for a transaction where the licence was not contemplated by the underlease would constitute the variation of the underlease: *Pearl Assurance Plc v Shaw* [1985] 1 EGLR 92.

Decision and reasons

103. In the light of our decision on the first sub-issue, this particular sub-issue does not strictly arise for determination. Since it also raises pure issues of law and construction, we can deal with it quite shortly. Insofar as there is any disagreement between Whitehall and the Crown as to which Additional Payments are in respect of Covenant Breach Transactions, we prefer the submissions of the Crown, for the reasons advanced by Mr Jourdan (and recited above).

(3) If Net Receipts do not include payments in respect of Covenant Breach Transactions, would the hypothetical parties nonetheless envisage that they would in practice be treated as forming part of the Net Receipts?

Whitehall's contentions

104. Given the prohibitions under the Headlease in respect of changes of use or the carrying out of structural alterations, Whitehall submitted that it would be entirely circular to rely upon past returns which may have included such payments where, on the true interpretation of the Headlease, such payments should be excluded from the Net Receipts. The hypothetical purchaser should be taken to be properly informed and advised as to the true interpretation

and meaning of Net Receipts. He would therefore approach the matter on the basis of the correct interpretation of the Headlease; and he would not be a slave to the previous history.

The Crown's contentions

105. The Crown submitted that the hypothetical purchaser (whether of the freehold or the Headlease) was prudent and well informed and would therefore know how Additional Payments had been treated in the past. He would be correctly advised by his solicitor as to the interpretation of the Headlease; but he would be likely to take the view that, even if Additional Payments were strictly not Net Receipts, it was likely that in the future they would be treated as such, as they had been in the past.

Decision and reasons

106. Once again, in the light of our decision on the first sub-issue, this particular sub-issue does not strictly arise for determination. In our view, the true answer is somewhere between the two positions advanced by the Crown and by Whitehall. The hypothetical purchaser (whether of the freehold or the Headlease) would be likely to form a view, on the basis of legal advice, as to the scope and extent of the likely Net Receipts under the Headlease. To the extent that Additional Payments should properly be taken to fall outside the scope of Net Receipts, he would attach some hope value to their continued receipt. The extent of that hope value would very much depend upon the strength of the market for the relevant asset at the relevant valuation date.

Issues 4, 5 and 6 – the treatment of the Flat 71A Ground Rent in the valuation

Overview

107. The dispute about the diminution in the value of the freehold and headleasehold interests is essentially a disagreement between the experts about how to treat the current ground rent of £180 payable by the underlessee to the headlessee. The ground rent will no longer be paid once a new lease of Flat 71A has been granted which means the value of the freehold and headleasehold interests will be reduced. But by how much?

108. The effect of losing £180 each year depends upon whether or not the year in question is a PIY, i.e. a year where the net receipts exceed £25,184, and the probability of this happening was determined in issue 2 above at 0.40. If it is a PIY the loss of £180 will mean a reduction in the Profit Income by the same amount. Profit Income is divided 85% to the freeholder (Overage Rent) and 15% to the headlessee; so in a PIY the freeholder's income is reduced by £180 x 0.85 = £153 and the headlessee's income by £180 x 0.15 = £27.

109. In a non-PIY the whole of the £180 forms part of the headlessee's Surplus Income; so upon the grant of a new lease the freeholder's income is unaffected (since its Basic Income is protected) and the headlessee's income is reduced by £180.

110. As the probability of a PIY is 0.40 the average annual loss to the freeholder and the headlessee will be £61.20 and £118.80 respectively, i.e. a total loss per annum of £180[4].

111. The capitalised value of these losses depends upon what happens at the next rent review in 2029. If, as we have found, the no-Act rights assumption applies to the Building and not just Flat 71A, the experts agree that every year from 2029 will be a PIY and therefore from that date onward the freeholder will lose £153 and the headlessee will lose £27.

112. Looked at in this way the valuation problem seems to us to be easily resolved. Mr Fielding agrees with the principle of how these figures are calculated but Ms Ellis does not. She focuses instead upon the obligation of the headlessee to pay the Basic Income to the freeholder every year, regardless of whether or not it is a PIY. Ms Ellis therefore apportions the ground rent of £180 between a contribution to the Basic Income (£90.48) with the balance (£89.52) forming part of the Surplus Income, all of which is retained by the headlessee. This apportionment is agreed between the parties (although its significance is not) and is calculated as the ratio of the Trigger Rent (£10,760) to 85% of the Threshold Rent (£21,406)[5].

113. Ms Ellis says that the ground rent from Flat 71A (at least until review) will never contribute anything to the Profit Income; such income consists of Net Receipts other than rent. But she then faces the problem after the grant of the new lease that in a PIY the Profit Income will be reduced by £180 which is, of course, the amount of the ground rent from Flat 71A. Both experts adopt a "before and after" valuation approach to the assessment of the diminution in the value of the freehold and headleasehold interests. In her "after" valuation Ms Ellis values the loss to the headlessee in a PIY of £27 of Profit Income. For such income to be lost it must have existed before the grant of the new lease. It does not seem to us that she has resolved this difficulty and, with great respect to her diligent and detailed evidence, we think Ms Ellis is wrong, not least because her analysis relies upon an annual loss after the grant of the new lease of £189.02. The loss cannot exceed the ground rent of £180, as Mr Jourdan explained in his closing submissions.

114. Ms Ellis's overestimation of the loss would have been greater had she not made a reduction of 10% in non-PIY to what she calls the theoretical profit rent of £89.52[6]. The Crown has accepted this adjustment because it is in their interest to do so, but it has consistently said that it thinks it is wrong. So do we. Ms Ellis says that the headlessee would

[4] Freeholder: (£153 x 0.40) + (£0 x 0.60) = £61.20; Headlessee: (£27 x 0.40) + (£180 x 0.60) = £118.80

[5] In our opinion it was wrong for the parties to use this historic ratio. At the valuation date it would be more realistic to use a ratio which reflected the rental income that the purchaser of the headlease would expect to receive in future, based upon the rent received in recent years, i.e. about £16,000, rather than the rent receivable at the commencement of the headlease (£21,406). However as nothing turns on this in our valuations we do not consider the matter further.

[6] Ground rent receivable less contribution to Basic Income; i.e. £180 - £90.48 = £89.52. If Ms Ellis had not discounted the theoretical profit rent by 10% the annual loss after the grant of the new lease would increase to £193.57.

carefully manage the Net Receipts (including costs) in order to avoid reaching the Threshold Rent (£25,184), even to the extent of under recovering Surplus Income by 10%. The ostensible reason is to apply pressure to the freeholder to concede a larger share of the Profit Income to the headlessee, thereby incentivising it to seek further and more regular opportunities to generate Additional Payments. But apart from the fact that the underlessee would pay 100% and not 90% of the ground rent of £180, Ms Ellis's reasoning makes no practical sense. The headlessee would not, in our opinion, forgo 10% of Surplus Income (to which it is fully entitled) just to deny the freeholder 85% (and itself 15%) of Profit Income. If it wanted to put pressure on the freeholder as suggested it would make more sense for Whitehall to try and make a little Profit Income in order to maximise its Surplus Income whilst denying the Crown any *meaningful* Overage Rent.

115. Under clause 3(16)(d)(ii) of the Headlease the headlessee covenants to "manage the demised premises in accordance with the principles of good estate management for the joint benefit of the Landlord [Crown] and Tenant [WCL]". Mr Jourdan submits that Ms Ellis's suggested strategy would be in breach of this covenant. Mr Letman argues that "good estate management" is about day to day management of the Building and does not apply to strategic issues concerning the amount and timing of Additional Payments. We consider this expression should be given a broader meaning and the headlessee's policy of deliberately denying the freeholder Profit Income as a ploy to force it to concede a larger share of such income to the headlessee would not, in our view, benefit the freeholder (Crown).

116. Issue 5 is whether, in a non-PIY, the valuation should be prepared on the assumption that the purchaser of the headlease will receive 90% of the Flat 71A Ground Rent. The FTT agreed with Ms Ellis's approach which it said at para 80 was "more consistent with reality". Although this is not an issue which is formally in dispute between the parties (since the Crown are prepared to accept Ms Ellis's position) we consider it appropriate to determine it to ensure the correct valuation treatment of the ground rent. For the reasons we have given above we determine that 100% of the Flat 71A Ground Rent would be receivable in both non-PIY and PIY.

The diminution in the value of the freehold interest in Flat 71A

117. The value of the freehold interest in Flat 71A before the grant of the new lease comprises two elements: (i) the capitalised value of the contribution the flat makes to the Basic Income and Profit Income receivable during the term of the Headlease and (ii) the present value of the reversion at the end of the Headlease. The value of the freehold interest after the grant of the new lease consists solely of the present value of the reversion at the end of the extended lease. The parties agree the present values of the before and after freehold reversions but disagree about the value of the term income to the freeholder.

118. The dispute is in part due to the difference between the experts about the frequency of PIYs. We have determined the probability of a PIY at 0.40 (see issue 2 above). The remaining dispute is about how the initial ground rent of £180 should be treated and the timing of the receipts. In his closing submissions Mr Jourdan presented a reconciliation

statement showing that there was no difference in the experts' freehold valuation approaches if consistent assumptions were adopted about the probability and timing of receipts. We find this statement useful to illustrate the differences in principle (rather than detail) between the experts and unless stated otherwise we refer to it in the following analysis.

119. Both experts agreed to use the tier method of valuation (also known as the "layer" or "hardcore" method) whereby the initial tier (or tranche) of income and each incremental tier following a rent review is valued separately for the remaining length of the lease term. In the "before" valuation of the freeholder's interest the experts agreed the valuation of the second, third and fourth tiers of income following each rent review. They also agreed that the value of the Basic Income to the freeholder would be the same before and after the grant of the new lease and that this did not contribute to the diminution in value of the freehold interest. But whereas Ms Ellis took this to be the value of the first tier income, Mr Fielding added a further amount[7] for the freeholder's share of the Profit Rent in PIYs in his "before" valuation. Ms Ellis showed the same figure as "potential overage rent lost" in her "after" valuation. Although the experts obtain the same answer for the diminution in the value of the freehold, we prefer Mr Fielding's approach because it identifies as part of the "before" valuation the capital value of the Profit Income which is subsequently lost upon the grant of the new lease.

120. Ms Ellis criticised Mr Fielding's approach because she thought it involved double counting. In his "before" valuation Mr Fielding capitalised the £90.48 that the parties agreed was Flat 71A's contribution to the Basic Income and, in PIYs, also capitalised £153, being Flat 71A's contribution to the freeholder's Overage Rent. Ms Ellis said that the total of £243.48 could not be right as it exceeded the total ground rent of £180. Mr Fielding said that neither the freeholder nor the headlessee would notionally apportion the ground rent in the way suggested by the FTT. He had done so because it was necessary to undertake a before and after valuation, but it made no difference to the result since the Basic Income was always payable by the headlessee regardless of whether or not ground rent was receivable from the underlessee of Flat 71A. The right of the freeholder to receive £90.48 as Basic Income in respect of this flat has nothing to do with the £180 payable by the underlessee to the headlessee and is not part of it. But it is part of the value of the freeholder's interest and so was properly shown in both the before and after valuations. We accept that there has not been double-counting in Mr Fielding's approach.

The diminution in the value of the headleasehold interest in Flat 71A

121. Before the grant of the new lease the headlessee receives all the ground rent (£180) from the underlessee but in PIYs it pays the freeholder 85% (£153) of this amount as Overage Rent. In every year the headlessee pays the freeholder the Basic Income, £90.48 of which is apportioned to Flat 71A. After the grant of the new lease the headlessee receives no ground rent, loses its 15% of Profit Income in PIYs and continues to pay the freeholder the Basic Income.

[7] £180 x 0.85 = £153

122. Mr Jourdan's reconciliation statement shows that, given common assumptions, the experts agree upon the "before" value of the headlessee's second, third and fourth tiers of income (reflecting the future rent reviews). The experts differ in how to treat the valuation of the initial ground rent. Ms Ellis calculates a theoretical profit rent of £89.52 which she capitalises for the remainder of the headlease term. She excludes the value of Profit Income to the headlessee (£27) in PIYs because she believes the whole of the ground rent is accounted for in the Basic Income and Surplus Income. But Ms Ellis contradicts herself by including the value of such Profit Income as a loss in her "after" valuation. By doing so she tacitly acknowledges that in PIYs the ground rent of £180 constitutes Profit Income. Since that income is lost upon the grant of the new lease the ground rent must also have constituted Profit Income in PIYs before the grant of the new lease. By not including the value of the headlessee's Profit Income in her "before" valuation Ms Ellis exaggerates the loss in her "after" valuation.

123. Mr Fielding's "before" valuation of the headleasehold interest includes £27 (15%) of the ground rent as Profit Income in PIYs which is then lost on the grant of the new lease. We think that approach is correct.

124. Issue 6 is concerned with the failure of the FTT to allow in its valuation for the headlessee's obligation to pay the freeholder 85% of any Profit Income resulting from the receipt of the £180 initial ground rent. The FTT issued a corrected valuation when it granted permission to appeal. In view of our analysis above we think this amendment was correctly made in principle but we note that the FTT deducted the value of the obligation in the hands of the freeholder (using a single rate years' purchase) rather than as a cost to the headlessee (which should be valued using a dual rate years' purchase).

Issue 7 – should the valuation reflect the delay of nine months between the ground rents on review doubling and the freeholder receiving Overage Rent in respect of the increased ground rents?

125. Ms Ellis first raised this issue in her expert report dated 19 May 2017. It was not raised before the FTT. She said the valuation of the freehold interest should reflect the fact the freeholder would receive its Overage Rent following future ground rent reviews a year after the headlessee received its share of the Profit Income. She justified this approach by the need for accuracy. Mr Fielding did not deal with this issue in his expert report because Ms Ellis did not raise it until after his report was filed.

126. Ms Ellis denied that hers was an over-sophisticated approach which a hypothetical purchaser of the freehold would not adopt. Mr Letman submitted that Ms Ellis's approach was correct on the facts and it was no answer for the Crown to say that she had only just appreciated the point. It was necessary to defer the receipt of the freeholder's Overage Rent by an extra year compared to the headlessee.

127. If it is necessary to be accurate in the timing of some cash flows it seems to us that a hypothetical purchaser would have to be accurate in respect of them all. When it was put to

Ms Ellis that the rent under the headlease is payable quarterly in advance but that she nevertheless valued it as though it was payable annually in arrears, she replied that this was "not a valuation convention". The most conventional of all valuation tools is "Parry's Valuation and Investment Tables" which is now in its 13th edition. "Parry's" contains quarterly in advance valuation tables and their use in practice is recognised although not common. It seems to us that Ms Ellis identified this issue very late in the day and took it into account without proper consideration of whether the timing of other cash flows should also be considered.

128. In our opinion a hypothetical purchaser would be far more concerned about the probable frequency of exceeding the Threshold Rent and obtaining Additional Payments than it would be about the precise timing of the increased rent at distant reviews. The valuation effect of the latter would be de minimis by comparison and we do not consider that a hypothetical purchaser of the freehold interest would take such valuation nuances into account.

Determination

129. We determine the seven issues in this appeal as follows:

130. *Issue 1*: The no-Act rights assumption in paragraph 3 (2) (b) of Schedule 13 to the 1993 Act extends to other flats in the Building and is not restricted to Flat 71A. Appeal allowed.

131. *Issue 2*: The Threshold Rent will be exceeded in two years in every five (a probability of 40%) until 2029 and thereafter every year. Cross appeal allowed in part.

132. *Issue 3*: Net Receipts include payments received by the headlessee in respect of Covenant Breach Transactions. Cross-appeal dismissed.

133. *Issue 4*: The valuation of the freehold and headleasehold interests should be undertaken on the basis that the Flat71A Ground Rent forms part of the Profit Income in PIYs. Appeal allowed.

134. *Issue 5*: The hypothetical purchaser of the Headlease would assume that in non-PIYs it would receive all of the Flat 71A Ground Rent and in PIYs it would receive 15% of the Flat 71A Ground Rent. Appeal allowed.

135. *Issue 6*: The valuation of the tier 1 income in the before valuation of the headleasehold interest should reflect the liability of the headlessee to pay Overage Rent to the freeholder throughout the term of the headlease. Appeal allowed.

136. *Issue 7*: The hypothetical freehold purchaser would not make an allowance for the deferral of receipt of Profit Income for a year after it had been received by the headlessee. This issue was not the subject of appeal or cross-appeal.

137. We understand that the determination of the above issues will enable the parties to complete the calculation and apportionment of the premium payable under Schedule 13 to the 1993 Act. We expressly grant permission to the parties to apply if there is any disagreement about the amount of the premium or its apportionment arising from our decision.

Dated 20 July 2017

David R. Hodge

His Honour Judge Hodge QC

A J Trott FRICS