THE LEASEHOLDERS CHARITY

A REPORT ON THE SI 2020/632 AND THE IMPACT OF THE NEW RIGHT TO ADD TWO STOREYS OF FLATS TO MANY EXISTING BLOCKS OF FLATS WITHOUT PLANNING PERMISSION

An analysis of the SI2020/632 Impact Assessment and a review of its impact on existing leaseholders

Executive Summary

The government has introduced a new Statutory Instrument SI2020/632 which provides for the use of automatic Permitted Development (PD) rights to add up to two storeys of flats on many existing blocks. The SI comes into force on 1st August 2020.

The costs and uncertainty of seeking to obtain full Planning Permission (PP) are removed subject to the limitations set out in the SI.

According to the government Impact Assessment (IA) this right will apply to the sites above 1,457,948 existing leasehold flats.

The IA concludes that it expects that approximately 800 new homes will be added under the SI per year with a total of 8,120 new homes over a 10-year period.

The IE asserts a total benefit to the economy of £492 million

This report sets out the problems with the SI.

- It provided no compensation for existing leaseholders impacted by the effects of any new development that takes place
- The IA costs the potential benefits but provides no costings for potential detriments

We estimate those detriments to existing leaseholders will be:

- Those leaseholders living under any new development will face a loss in value of their homes and inconvenience we estimate to be worth £200 million
- Over 1.2 million existing leasehold homes will face increased costs of collective enfranchisement. We estimate this potential cost as being between £21 billion and £41.9 billion. These costs equate to the equivalent of between£11,970 and£28,742 per flat

Sir Peter Bottomley speaking in Parliament criticised the bill as a huge windfall for third party freeholders while adding only a small number of new homes. He then placed an EDM calling for the SI to be annulled

That an humble Address be presented to Her Majesty, praying that the Town and Country Planning (Permitted Development and Miscellaneous Amendments) (England) (Coronavirus) Regulations 2020 (S.I., 2020, No. 632), dated 23 June 2020, a copy of which was laid before this House on 24 June 2020, be annulled.

https://edm.parliament.uk/early-day-motion/57218/town-and-country-planning

Introduction

The Statutory Instrument 2020/632 was laid before Parliament on 24th June[1]

It provides for the addition of up to two additional floors of flats under Permitted Development. By adopting this approach, it in most cases is considered to save developers:

- The costs associated with planning permission and the rights to object provided as part of the planning rights
- The delays associated with planning permission

The potential costs and benefits are set out in the Impact Assessment (IA) produced by the government[2]

This paper sets out the information in that assessment and provides an analysis of that report and the costs the report has failed to properly consider.

Background

The standard model of ownership for leasehold blocks of flats in England and Wales are now almost unique in using leasehold tenure.

Under this system the flat owner purchases a lease for up to 999 years. This obliges the leaseholder to pay a ground rent and their share of the service charges

The leases then sit under the ownership of a freehold, which is deemed to own the building. The freeholder has the right to issue service charges which must be paid by the leaseholders under the terms of their lease to maintain the building.

Some sites are collectively owned by the leaseholders, but most sites have a third-party freeholder. This freeholder's primary income is the ground rent.

The methodology for calculating the value of the freeholds of blocks of leasehold flats is predominantly a function of the ground rent income. The sector had used a valuation model of 15-20 times the ground rent rates but that multiple has increased in recent years.[1] The valuation of these freeholders is normally considered to represent between 1% - 5% of the total asset value of the building

For shorter leases under 80 years something marriage value applies as the asset gradually reverts to the freeholder at the end of the lease. This would add to the cost and in any collective enfranchisement. The landlord had often argued for an increased value based on potential development opportunities but this potential increased valuation would be at the discretion of the Tribunal.

[1] http://www.legislation.gov.uk/uksi/2020/632/made
[2] http://www.legislation.gov.uk/ukia/2020/43/pdfs/ukia_20200043_en.pdf

The new SI and the supporting IA will add substantially to the enfranchisement value, because of the automatic PD rights it gives subject to the conditions set out in the SI.

Impact Assessment Data and Methodology

1) The SI states (page 1) that the net present value of the project is £440.5 million, with a reduction in costs to business as a result of not needing to apply for planning permission adding further savings of £51.2 million.
2) The rationale for the 800 new homes per year starts with a number of tables using data from the English Housing Survey. The tables start with the gross number of flats in the market and eliminates by various criteria as follows:

Table number	Criteria	Total number of homes
Table 1	Number of flats above three stories and below 30 meters	2,809,168
Table 2	Number of flats in scope once conservation areas removed reduces to:	2,580,754
Table 4	Number of flats adjusted to include only "freestanding" blocks reduces to:	2,023,212
Table 5	Number of flats adjusted for age to include only post 1948 and pre-2018 reduces to:	**1,457,948**

Table 5 gives the number of new flats that could be added:

Block height	**Total Existing Flats within the criteria**	**Adding one floor to a block**	**Adding two floors to a block**
Existing 3 story	873,541	291,180	582,361
Existing 4 story	335,087	83,772	167,543
Existing 5 story	113,228	22,646	45,291
Existing 6 story	72,694	12,116	24,231
Existing 7 story	39,967	5,710	11,419
Existing 8 story	23,432	2,929	*
Total number of theoretical new flats	**1,457,948**	**418,353**	**830,845**

The figure here should be 2,929 but this was omitted in the IA. The correct total should therefore be* **833,774.

The AI then attempts to use proxies to establish the likely number of new homes which are likely to be added based on "new addresses in the last three years (were) created on existing residential sites".

Table 7 then asserts that the "best estimate" of the likely uptake under the SI will be less than 10% of the figure set out in table 5, i.e. 81,000 new homes.

The AI uses a further proxy to predict a reduced number from their "best estimate" above. This is based on: "The uptake best estimate (8k) is staggered for each of the ten years based on the uptake growth rates of the office-to-residential permitted development right."

It assumes that between 0% and 1.59% of these new homes will be built during years 1 to 10.

This then produces an expected final figure over that 10-year period of 8,120 homes as per table 9.

Potential errors and missing costs in the IA

There seems considerable risk of error in the assumptions made between the starting figure of between 418,353 and 830,845 new homes, as set out in table 5, and the conclusion of 8,120 new homes as set out in table 9.

Detriment to the sites where development occurs

The IA accepts that there will be detriment to existing leaseholders, but makes no attempt to calculate a cost.

At page 19 the IA states as a non-costed "benefit":

"There is greater potential to spread building maintenance costs over more units and to use building upwards as an opportunity to simultaneously retrofit other parts of the building (e.g. save on cost of scaffolding). This is a benefit enjoyed by the freeholder and – where servicing costs are shared with the occupiers – may benefit all those in the building in terms of improved building quality (if other improvements undertaken at the same time) and/or lower maintenance charges."

This seems speculative. There is no evidence presented in the IA that there is any cost reduction per unit in larger blocks. Additionally, the potential to coincide the development of new floors with other works is likely to occur on a small sub-set of sites.

There is no obligation to improve the build quality of the existing flats and no motivation under PD to ensure that any new flats are even of equal standard to the existing development. It could be equally argued there is a risk of increased costs if the freeholder seeks to include elements of the development related costs into the service charge. There may also be loss of parts of the common areas.

On page 20 the IA states:

"There may be reductions in the value of existing dwellings in the building, particularly top floor dwellings/penthouses if new dwellings are built above them, resulting in a loss of their 'exclusivity' and they may suffer from increased noise from residents above. This will be a cost that offsets some of the [Land Value Uplift] LVU gained. Of course, in this circumstance a new penthouse would be built on top and we would expect the current penthouse owner to take part in negotiations over the works and as part of any development package may agree to "swap" the existing penthouse for the new one to be created by the development."

The IA appears to misunderstand leasehold law on this point. The leaseholder has no right to negotiate to be part of the LVU or have any right to "swap" flats in circumstances where they are not part owners of the freehold.

As we know, the vast bulk of leasehold sites have a third-party freeholder. Unreleased data from the DCLG 2014 work to estimate the size of the leasehold sector suggests that 83% of the market has third party freehold ownership, i.e. that only 17% of leaseholders are likely to own a share of the freehold and therefore to benefit from the SI.

"Construction works may carry short term costs for residents living below such as noise, dust and access disruption, and possible disruption from relocation while the works are carried out."

The IA accepts there is detriment to the existing leaseholders during any development phase, including the fact that the freeholder may seek to require leaseholders to be relocated during the building works. The SI mandates only that the developer should provide to the Local Authority their proposals to mitigate "any adverse impact of noise, dust, vibration and traffic".

LKP costed leaseholder impact model

If we take 83% of the proportion of leasehold properties with a third-party freeholder, and the 8,120 homes estimated to be added by this project over the 10-year period, it can be assumed that leaseholder-controlled sites may obtain 17% of both the net present value gains of £440.5 million and reduced planning related costs under PD of £51.2 million.

The remaining 83%, i.e. £408 million will pass to third party ground rent investor landlords who generally own less than 1-5% of the asset value of the building.

The potential direct detriment on those 83% of sites owned by third party freeholds is as follows:

Issue	Costing methodology	Cost to Leaseholder
Loss in value top floor flats	Reduction in value estimated at 3-7% (5% used) Office for National Statistics average flat value for 2020 of £226,382 Either 1 or 2 floors added, assumed average no of additions is 1.5 floors Hence 8,120 new flats affect (8,120 x 2/3) existing flats 83% 3rd party freeholder	**£50,857,471**
Loss in value other floors	Reduction in value estimated at 1% ONS average flat value for 2020 of £226,382 Assumed an average of 3 floors below the top floor 83% 3rd party freeholder	**£66,441,753**
Inconvenience costs of living under a development site for up to 3 years permitted for building works	Inevitably such costs can only be a guestimate but if a conservative figure of £3,000 per flat were used Assumptions consistent with the above	**£80,875,200**
Total		**£198,174,424**

Indirect Detriment

The IA explains that the freeholders will obtain an uplift in value of the freehold resulting from the SI, whether or not additional homes are provided. The IA states:

"Land value uplift will bring benefits to freeholders of eligible and feasible buildings even if they do not act on the right simply because the building will gain the in-principle permission for building upwards development." Page 15 para 2.

"Freehold owners of eligible blocks of flats will benefit from any land value uplifts to their properties due to having planning permission through the permitted development right even if they do not actually extend upwards." Page 23 'Wider impacts' para 2.

LKP costed leaseholder impact model

The SI will have a major impact on enfranchisement costs for sites wishing to collectively buy their freehold, particularly given the IA assertion that benefit would accrue to all "eligible and feasible buildings even if they do not act on the right".

Methodology for calculating the uplift in freehold value

The IA therefore shows that for all the 1,457,948 flats within the constraints per table 5, the freehold is now subject to this uplift in value.

The number of potential new flats set out in table 6 is: lower bound 418,353; upper bound 833,774.

We assume 83% ownership by third party freeholders (see above) this equates to the valuation impact applying to 1.21 million homes

We use the IA NPV benefit £440.5 million and savings of £51.2 million spread across 8,120 homes. This gives a benefit of £60,544 per new flat.

Applying this to the upper and lower bounds of possible new flats per table, this gives the formula

Number of potential new homes x NPV uplift

This gives an increase attributable to third party held freehold assets of between £21.0 billion to £41.9 billion (using corrected table 5).

<u>Conclusions</u>

The IA states that the net benefit of the SI is £440.5 million plus £51.5 million. This gain would be attributable among the leaseholders in the minority (approximately 17%) of sites where they own a share of the freehold. For the bulk of sites where there is a third-party freeholder 100% of that benefit will pass to the freeholder, even though they may only own between 1% and 5% of the investment in the building.

The detriment to the leaseholders in the 83% of blocks with a third-party freeholder in the impacted blocks are not costed in the IA.

We calculate that detriment at approximately £200 million for the approximately 27,000 flats that would be impacted by the 8,120 new homes

The indirect detriment. would apply to the much wider group of over 1.21 million leaseholders. We have calculated this detriment to be in the range of £21.0 billion to £41.9 billion in terms of higher enfranchisement costs.

This suggests a potential negative impact per flat for the 1.2 million flats held by third party freeholders may result in an £11,970- £28,742 increase per flat in enfranchisement costs.

The IA appears to make the incorrect assumption that the benefits from the SI would pass to the leaseholders rather that the freeholder. If fact the benefits will in the main not fall to the leaseholder but the third-party freeholder who will also gain from the increased enfranchisement valuation that will now be able to be applied.

Esther McVey MP when she was Housing Minister met the APPG on Leasehold and Commonhold reform. She expressed her clear belief that the result of this proposal, to add up to two floors to existing leasehold blocks, was intended to benefit the existing leaseholders.

The SI now passes that benefit to the freeholder, to the direct and indirect detriment of the leaseholders.

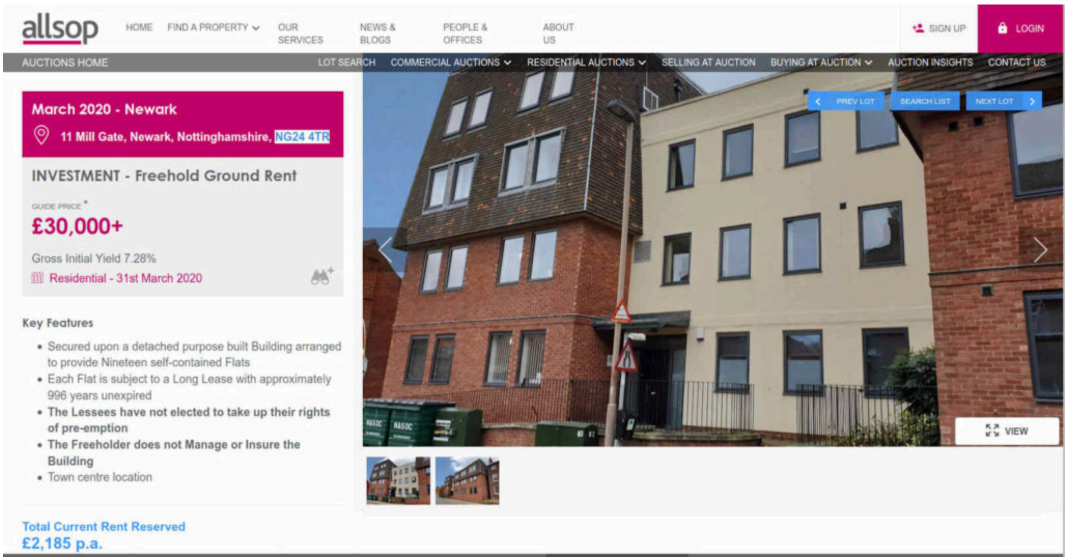
In other countries such as Sweden where such development is permitted there are formalised systems to provide compensation to the owners of existing flats. The income from the new flats is used to benefit the overall site and the monies used to ensure the upkeep of the overall building. This SI makes no provision for any compensation and passes all the benefit to the third-party freeholder.

An example of how PD may impact values

In March this year we gave details of an auction sale in the constituency of the current MHCLG Secretary of State.

https://www.leaseholdknowledge.com/robert-jenrick-why-give-freeholders-such-a-whopping-planning-windfall-over-two-new-storeys-rule-like-this-site-in-newark/

The sale was for the freehold of a block of flats. It attracted a guide price at the time of £30,000 but sold for less.



This sale offered an annual return of 7.28% based just on the ground rent incomes

This block may now qualify to add two more floors under this PD scheme. This might allow 8 new flats.

If the leaseholder now applied to collectively enfranchise the landlord is likely to demand the price he paid for the gr income rights in March 2020 plus the new DP development potential under the SI.

Notes

Almost all the figures used in making this assessment come from the govenment IA and other government sources such as the ONS for average sale price per flat as at April 2020[3]

The figures derived by LKP are as follows:

We have asserted that 83% of leasehold sites are likely to owned by third party freeholders. This figure is based on 2014 unpublished DCLG data and anecdotal input from the sector.

We have used on average 1.5 floors are added on sites per the SI on those sites where development occurs.

We have assumed a 5% decrement in the value of existing top floor flats where new floors will be added. These initial figures have been provided by a number of estate agents.

We have assumed a 1% decrement in the value on lower floors where new floors added. This figure has been set at a very conservative level as there is no clear body of evidence of what the decrement might be.

We have assumed a net detriment of £3,000 per flat for those who would be required to live under the new development for what may be up to 3 years.

In the absence of any calculations in the IE on the average height of the blocks where 8,120 flats will be added we have inferred that on average of 4 floors from the date in table 6.

We have not added a supplement for the potential benefit to existing leasehold homes with PD above them as there is no clear evidence such gains exist. It might be argued the costs for existing leaseholders could rise.

We have assumed the calculation of the NPV benefit of £491.7 million for the 8,120 equates to the profit that the freeholder would gain from such development.

We have assumed that third party freeholders will look to apply increased valuations to their assets as per the IA which accepts the increase will apply even where no development occurs.

[3] https://www.gov.uk/government/publications/uk-houe-price-index-england-march-2020/uk-house-price-index-england-march-2020