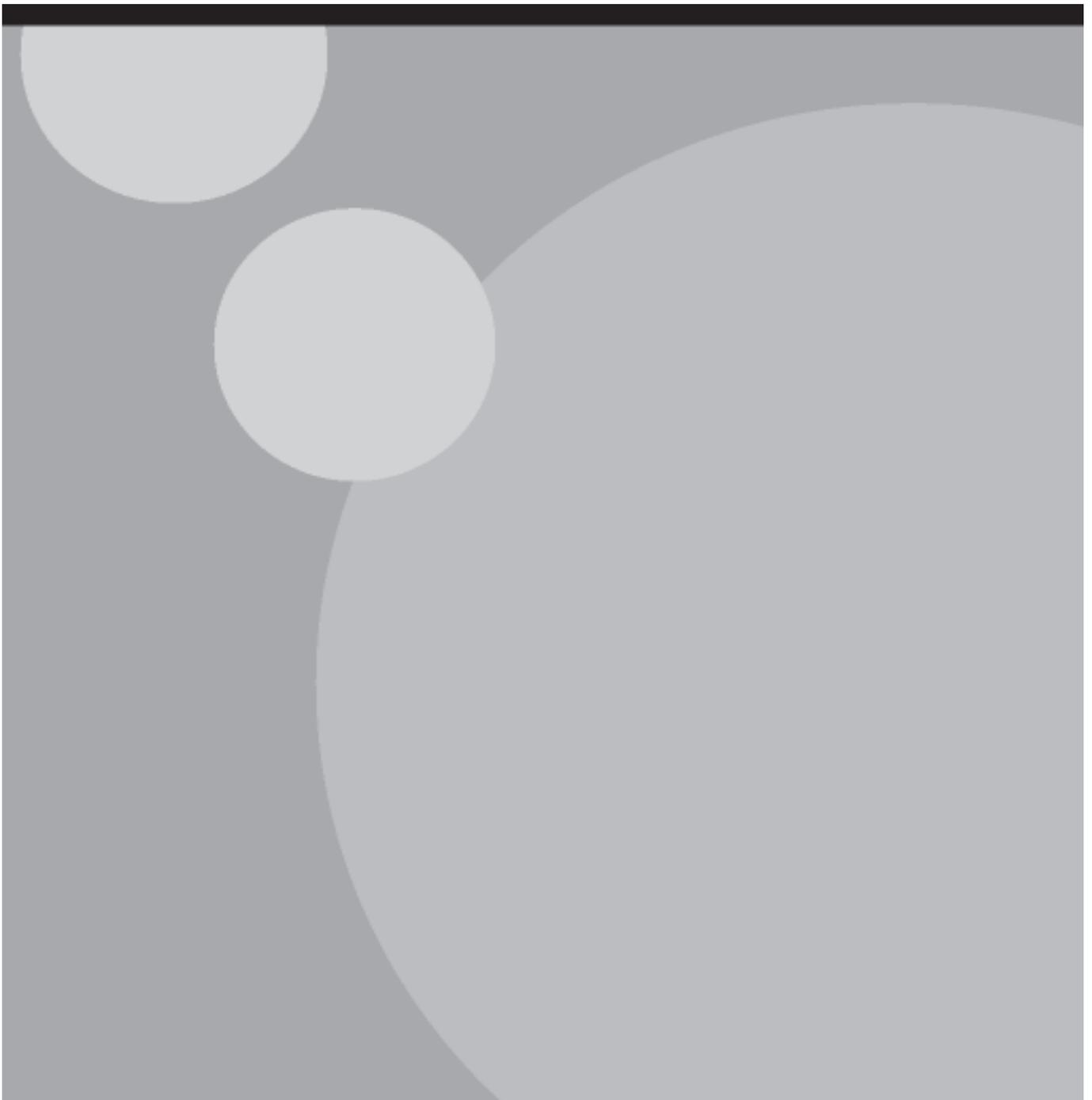


# Capitalisation directions (excluding equal pay) 2010-11: Policy and procedures

**A guidance note**



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# 1. Introduction and general policy

## 1.1. Introduction

- 1.1.1. The legislation implementing the prudential capital finance system, the *Local Government Act 2003* (“the 2003 Act”), preserved the Secretary of State’s power to issue capitalisation directions. The relevant provision, section 16(2)(b), replaced the similar measure under the former system (section 40(6) of the *Local Government and Housing Act 1989*).
- 1.1.2. The effect of a direction is that specified revenue expenditure becomes treated as capital expenditure, so that instead of having to be charged to revenue, it may be funded from capital sources (e.g. borrowing or capital receipts), thereby increasing an authority’s financial flexibility.
- 1.1.3. This guidance note sets out the procedures for the issue of capitalisation directions by the Secretary of State for 2010-11. The guidance for capitalisation categories has been slightly revised since 2009-10, and is set out at Section 2.
- 1.1.4. Please note that this guidance is separate from the guidance issued for equal pay. Capitalisation directions in respect of equal pay back-pay continue to be subject to a separate process. Decisions on the total amount available for capitalisation will be informed by the total demand for capitalisation and macroeconomic considerations.
- 1.1.5. This guidance on non equal-pay capitalisation supersedes that issued by the Department for Communities and Local Government on 23 March 2009.

## 1.2. General policy

- 1.2.1. Capitalisation is a relaxation of the normal accounting requirement that long term borrowing or capital receipts should only be used to finance capital expenditure. The *Local Government Act 2003* allows the Secretary of State to issue capitalisation directions to local authorities, which permits specified items of expenditure that would normally be classified as revenue, to be treated as capital expenditure. For that reason, it is appropriate that capitalisation directions are considered against strict criteria, and that the Government should be able to monitor closely and control the degree and use of directions.
- 1.2.2. From the viewpoint of local authorities, capitalisation runs counter to the principles of prudent financial management. It can never permanently solve financial difficulties, but simply postpones the need to deal with them. For example, the debt incurred to meet revenue costs will have to be serviced from revenue resources over many years. And using capital resources for revenue expenditure tends to reduce long-term investment in capital assets. All these issues should be strongly considered before making an application for a capitalisation direction.

## 1.3. Conditions

- 1.3.1. Ministers have discretion under Section 20 of the Local Government Act 2003 to impose other conditions – for example, that the capitalised expenditure is to be met out of capital receipts rather than by external borrowing. That section also confers power to revoke and vary directions already issued.

## 2. Capitalisation (excluding equal pay)

### 2.1. General capitalisation criteria and basic policy

- 2.1.1. In view of the considerations set out in Section 1 above, capitalisation is only likely to be agreed where an extremely strong case can be made. The tests outlined below are designed to examine the justification for it. Generally, capitalisation should be sought only for costs which are due largely to factors beyond the local authority's control. It should not be requested for routine or discretionary schemes, no matter how beneficial the long-term effects. The fact that a scheme may produce future revenue savings is not considered relevant. Virtually all worthwhile projects will have significant initial revenue costs as well as ongoing ones and these must all be properly budgeted for as part of the planning process, without any expectation of reliance on capitalisation.
- 2.1.2. It should be noted that capitalisation is generally only appropriate for **one-off payments** (such as statutory redundancy costs), rather than indefinitely continuing payments (such as ongoing salaries). It would be most imprudent for an authority to keep borrowing to meet the latter. This does not, however, prevent an authority from submitting a series of applications for directions e.g. where a programme of redundancy is implemented in phases over more than one financial year.
- 2.1.3. Capitalisation is only likely to be granted where a local authority is placed in an unavoidable situation. Applications for the funding of planned schemes are likely to be refused because local authorities should not embark on projects without budgeting appropriately.
- 2.1.4. The Government is prepared to consider applications in 2010-11 for capitalisation of the impairment charge in respect of potential losses of investments in Icelandic banks. Any such applications will be assessed against the **exceptional financial difficulties criteria** (see section 2.4).
- 2.1.5. It may be helpful to consider the following examples of costs for which capitalisation has been refused in previous years:
- lost interest on investments made in Icelandic Banks
  - consultancy fees
  - publicity and public consultation costs
  - costs of tenants' ballots on proposed large-scale voluntary transfers of housing
  - legal costs arising from contractual disputes
  - development and procurement costs of capital projects and PFI schemes
  - costs of re-engineering administrative processes
  - workforce efficiency training; and
  - concessionary fares.

- 2.1.6. Local authorities are referred to the document *Invitations to councils in England*, published by the Department on 26 October 2006, and in particular paragraph 3.2 (v) which states that in relation to transitional costs arising from local government restructuring “the use of capital resources to meet revenue costs will not be permitted”. This document is available online at:

[www.communities.gov.uk/publications/localgovernment/invitationall](http://www.communities.gov.uk/publications/localgovernment/invitationall)

In short, capitalisation is not available to finance any revenue costs incurred on any local government restructuring resulting from a proposal submitted by a council in response to the above invitation. It is requested that local authorities indicate their involvement in the restructuring process where relevant.

## 2.2. Application procedure

### Background to the 'Two Gate' system

- 2.2.1. Applications will normally be subject to a two-stage process. Those meeting the policy criteria for capitalisation will initially receive confirmation of that fact in a “minded to” letter (Gate 1). The second stage is when all applications which pass the Gate 1 stage will be considered simultaneously to determine the actual amounts which may be capitalised by each authority (Gate 2). Applications assessed against the exceptional financial difficulties and late applications criteria will not be subject to the ‘Two Gate’ process - see paragraphs 2.4.6 - 2.4.9 and 2.8.1 respectively.
- 2.2.2. Applications should only be submitted for the financial year in which the expenditure is to be incurred. **The deadline for applications to be submitted for 2010-11 non-equal pay capitalisation is 29 October 2010. Applications submitted after this date will be assessed according to the policy on late applications at 2.8.1 below.**
- 2.2.3. Applications received by that date (except those to be assessed against the exceptional financial difficulties criteria) will be considered using the 'Two Gate' process as follows:

#### Gate 1 Stage

- 2.2.4. Applications will initially be considered against the criteria for non-equal pay capitalisation. Applicants will be sent a letter (normally within 15 working days of receipt of the application) confirming which, if any, of the specified items of expenditure appear to be in accordance with those criteria.
- 2.2.5. Where expenditure is confirmed to meet the non-equal pay capitalisation criteria, no formal capitalisation direction will be issued at that stage and no guarantee will be offered of the amount of any direction eventually issued. Such applications will however qualify for the Gate 2 assessment.

## Gate 2 Stage

- 2.2.6. After 19 November 2010, final decisions will be taken on all applications which authorities have submitted by 29 October 2010 and which have passed Gate 1.
- 2.2.7. The overall total that authorities are seeking to capitalise will be considered in the light of the level of capitalisation already approved for applications, in respect of the implication of capitalisation across the board. It will be necessary for the Secretary of State to decide whether the total expenditure can be capitalised in the financial year without any unacceptable macroeconomic impact. If the Secretary of State is satisfied that it can, directions may be issued to each applicant for the full amount of the expenditure which met the policy criteria for capitalisation at Gate 1 (subject to any changes in circumstances).
- 2.2.8. If, however, it appears that there could be an adverse impact, a lower overall level of capitalisation may be identified which the Secretary of State considers to be manageable. The total of directions issued will need to be kept within this figure. Consideration will be given at that stage to a method of distributing between applicants the amount available. The approach adopted could be influenced by the scale of the reduction needed.
- 2.2.9. It is intended that formal capitalisation directions will be issued by **17 December 2010**. A list of applications will be published on the Department's website on that date indicating under which category each authority's application was made and the amount for which a direction was given.

## 2.3. Information required

- 2.3.1. In order to consider applications as fairly as possible, the Department is seeking a range of information. Annexed to this document are checklists to assist the application process in relation to pension fund and redundancy payments. Applications may be made by email to the following address:  
**capitalisation@communities.gsi.gov.uk**
- 2.3.2. All applications for non-equal pay capitalisation will be acknowledged by the Department by email within 14 days of receipt. Applicant authorities who do not receive an acknowledgement email within 14 working days after submitting should contact the Department to confirm that the application has been received. Authorities should consider sending applications both electronically and in hard copy, or, if in hard copy only, by registered post.
- 2.3.3. Applications should present all the required information as fully as possible, in the order given on the checklist. Failure to do so may result in consideration of the application being delayed whilst the Department seeks clarification and, where clarification is not forthcoming, the application not being considered. The Department expressly reserves the right to seek further information where this may be required. **It is the authority's responsibility to ensure that all the relevant information is submitted, including any additional information which it wishes to be taken into account.**

- 2.3.4. Local authorities are reminded of their duty to supply the Secretary of State with such information as he may request in relation to the issuing of capitalisation directions. There is however no guarantee that supplying the information will lead to a direction being issued.
- 2.3.5. Applications that are for non equal pay costs should confirm that the direction will not be used to fund equal pay costs.

## 2.4. Assessment of applications

- 2.4.1. All applications (excluding Commutation Losses & Contaminated Land), will be considered against the affordability test set out below. A final figure or detailed estimate is required in order to process the application. Both the Affordability Test and the Exceptional Difficulties Test will be applied to applications under exceptional difficulties, see below.
- 2.4.2. Applications should indicate whether they relate to the General Fund, where the costs relate to non-housing expenditure, or Housing Revenue Account for housing expenditure; they will be assessed separately.

### **Affordability Test**

- 2.4.3. Capitalisation is meant to help authorities to deal with costs that would otherwise be unaffordable. To assess affordability in a consistent way across authorities, the following test will normally be applied:

**The costs to be capitalised must exceed *both*:**

**(a) 5% of available reserves; *and***

**(b) 0.25% of budgeted expenditure for the year in which the expenditure is incurred.**

- 2.4.4. General Fund available reserves are the total unallocated and other earmarked reserves as predicted for 31 March 2011, as supplied to the Department on the Revenue Account Budget Estimate, (a combined total of lines 915 and 916). Applications may include updated figures to those in the Revenue Account Budget Estimate, but will need to indicate the reason for the difference.
- 2.4.5. Budgeted expenditure is Revenue Expenditure (on a non-FRS 17 basis) calculated from the figures supplied to the Department on the Revenue Account Budget Estimate. The calculation is Revenue Expenditure plus appropriation to/from pensions reserve (line 795).

## Exceptional Difficulties Test

- 2.4.6. This test assesses whether capitalisation is necessary to help an authority manage **exceptional financial difficulties**. The following three conditions must normally be met. Authorities will need to demonstrate clearly how their application meets these conditions:
- (a) **the capitalised expenditure is unavoidable (for example, because it relates to statutory duties or contractual or other commitments)**
  - (b) **the authority could not meet the expenditure out of revenue resources without there being an unacceptable adverse impact on those who use or pay for its services; and**
  - (c) **there is no alternative way of ensuring that the expenditure could be met.**
- 2.4.7. **Evidence will be required that the financial difficulties are of an extreme nature.** Relevant factors might include, for example, significant or longstanding underperformance by the authority, or actual or imminent use by the Government of its statutory intervention powers.
- 2.4.8. The relevant Government Office and Regional Improvement and Efficiency Partnership may be asked for its views, and further information such as a financial diagnostic may be required to support the application to ensure the causes of the financial difficulties are clear and are being addressed. Capitalisation would need to be part of a package of measures to get the authority back onto a sound financial footing. Capitalisation by itself could make the situation worse rather than better by prolonging and extending the problem.
- 2.4.9. In these circumstances, a decision on an authority's capitalisation request may be made outside the normal timetable and may not be subject to any end of year reduction. The 'Two Gate' system described in section 2.2 will not apply.
- 2.4.10. A list of information needed for Pension and Statutory Redundancy applications can be found at Annex A and Annex B. These annexes may be used as templates. For applications to be assessed against the exceptional financial difficulties criteria, there is no specific template - please refer to paragraphs 2.4.3 to 2.4.9.

## 2.5. Redundancy costs

- 2.5.1. The *Affordability Test* will normally be applied.
- 2.5.2. It is unlikely that the Secretary of State would grant a capitalisation direction for anything other than *statutory* redundancy costs. This means that **a direction is unlikely to be issued for enhanced costs. Nor is a capitalisation direction likely to include the lump sum element of the pension payment arising from compensatory added years, or any payments the authority makes into its**

## **pension fund in order to eliminate deficits resulting from premature retirements.**

- 2.5.3. Statutory redundancy costs are those costs required and calculated in accordance with Part 11 of the Employment Rights Act 1996 (see in particular section 162).
- 2.5.4. Applications for capitalisation of lump-sum payments into pension funds will normally be considered against the tests in section 2.6 below. Applications will be assessed separately (in terms of the affordability test) and in accordance with that section (but they may be made at the same time as related redundancy cost applications).

## **2.6. Payments into pension funds**

- 2.6.1. In respect of an application for the capitalisation of a lump-sum payment into a pension fund to remedy a deficit, the cause of the deficit will need to be explained and the application will need to be accompanied by the LGPS Pension Fund's last triennial actuarial valuation report and latest Funding Strategy Statement.
- 2.6.2. The *Affordability Test* will normally be applied.
- 2.6.3. The following conditions will also usually apply:
  - (a) capitalisation is unlikely to be allowed unless the council is able to demonstrate that it has taken all the steps allowed under the Local Government Pension Scheme, including 'spreading' and 'stepping' options
  - (b) capitalisation is unlikely to be allowed if the funding difficulties arise from a decision by the council itself either to make provision over a shorter period than is recommended by its fund's actuary, or to exceed a limit on early retirements agreed as part of the actuarial valuation inputs; and
  - (c) in addition, any directions issued are likely to require the capitalised payment into the fund to be met only out of **capital receipts** and not by borrowing.
- 2.6.4. Advice issued by the Department in connection with the Local Government Pension Scheme and associated legislation can be accessed online in the 'available documents' section at: [www.clg.heywood.co.uk](http://www.clg.heywood.co.uk).

## 2.7. Other categories

2.7.1. There are also some other schemes for capitalisation, linked to the implementation of specific Government policies, details of which are issued separately by the sponsoring policy divisions. Special criteria will apply and the tests and procedures outlined above may not always be relevant, or may be modified. The schemes include those relating to:

- commutation losses (separate guidance is available on the Department's website)
- contaminated land inspections (see paragraph 2.10.2 below).

## 2.8. Late applications

2.8.1. Under exceptional circumstances, applications for the current financial year received after the closing date of 29 October 2010 will be considered on or after 17 December 2010. The 'Two Gate' system described in paragraph 2.2 will not apply and a final decision will be issued as soon as possible after 17 December. In considering such cases, account will be taken of the level of capitalisation which has already been reached. Strong weighting will be given to macroeconomic considerations and the impact of issuing further directions.

## 2.9. Returns to Communities and Local Government

2.9.1. The capitalisation direction letter contains a requirement that local authorities inform the Department of how much of their allocation was used in the relevant financial year. These returns enable the Department to monitor the operation of the system and to enable any unused allocations to be made available for the next cycle of capitalisation applications. Local authorities should therefore inform the Department, at the address below, no later than **15 July 2011**. There is no template form for returns, an email or hard copy return will suffice.

2.9.2. Where local authorities notify the Department before the end of the financial year in which the expenditure was incurred that they have not used the full amount of their direction, the Department will issue a revised capitalisation direction for the appropriate amount.

## 2.10. Contacts

- 2.10.1. Except as indicated below, queries and applications in respect of capitalisation requests (excluding equal pay) should normally be directed to the Communities and Local Government Capital Finance and Reserves Team as follows:

**Sarah Blackman**

Capital Finance and Reserves Team  
Communities and Local Government  
Zone 5/J3  
Eland House  
Bressenden Place  
London  
SW1E 5DU

Tel: 0303 444 1765 Fax: 0303 444 3294  
Email: [capitalisation@communities.gsi.gov.uk](mailto:capitalisation@communities.gsi.gov.uk)

- 2.10.2. Further information on the capitalisation of contaminated land inspection costs should be directed to the Contaminated Land Team as follows:

**Natalie Holehouse**

Contaminated Land Team  
Defra  
Area 3C  
Nobel House  
17 Smith Square  
London  
SW1P 3JR

Tel: 020 7238 5280 Fax: 020 7238 4929  
Email: [natalie.holehouse@defra.gsi.gov.uk](mailto:natalie.holehouse@defra.gsi.gov.uk)

# Annex A

## Information required in support of capitalisation requests in respect of pension fund costs

APPLICATIONS FOR 2010-11 ONLY - COSTS MUST BE INCURRED IN THIS FINANCIAL YEAR.

**Name of Authority:**

**Name of official:**

**Address:**

**Telephone number:**

**Email:**

**Local Government Pension Scheme to which the authority contributes:**

**Financial year in which costs are to be incurred:**

**Figure which your local authority is applying to capitalise?**

**Is the amount claimed the final figure or an estimate?**

Final figure  Estimate

**Is the Authority subject to the Government's intervention powers?**

Yes  No

If yes, please provide further details here:

**Is the Authority part of the local government restructuring process?**

Yes  No

If yes, please provide further details here:

**Description of application:** (Continue on a separate page if necessary)

**Will the direction be used to fund equal pay costs?** Yes  No

**Has the authority pursued ALL the steps allowed under the LGPS as outlined in the Guidance including “spreading” and “stepping” options (set out in ODPM’s letter of 10 September 2004)?**

Yes  No

If no, please provide details of why not:

**Have the funding difficulties arisen from a decision by the authority itself either to make provision over a shorter period than is recommended by its fund actuary, or to exceed a limit in early retirements agreed as part of the actuarial valuation inputs**

Yes  No

If yes, please explain and provide details below:

**Total unallocated and other earmarked revenue reserves predicted for 31 March 2011**, as submitted on the CLG Revenue Account Budget Estimate (a combined total of lines 915 and 916): £

<b>Application figure</b>	<b>Total Revenue Reserves</b>	<b>Total costs as %</b>	<b>5% = £</b>	<b>Costs exceed 5%?</b>
(office use only)				

**Please indicate the reason for any difference between the revenue reserves figures in the application and the RA return.**

**Revenue Expenditure for 2010-11, as predicted at 1 April 2010, as submitted on the CLG Revenue Account Budget Estimate: (line 795): £**

<b>Application figure</b>	<b>Revenue Expenditure</b>	<b>Total costs as %</b>	<b>0.25% = £</b>	<b>Costs exceed 0.25%?</b>
(office use only)				

**Please indicate the reason for any difference between the revenue expenditure figures in the application and the RA return.**

**Please confirm that the costs cannot be funded from revenue resources without there being an unacceptable adverse impact on those who use or pay for its services?**

Yes  No

If no, then subtract that from the amount to be capitalised.

**Do you agree that the capitalised payment will be funded by capital receipts and not by borrowing?**

Yes  No

**Is the application accompanied by the LGPS Pension Fund's last actuarial valuation report and the Pension Fund's Funding Strategy Statement? (The Department will need both these documents in order to assess the application by the deadline of 29 October 2010). If there will be a delay in obtaining these documents, please inform us as soon as possible).**

Yes  No

**Please include any further information which you consider relevant to your application.**

**Requests for capitalisation (excluding equal pay) should be submitted to Communities and Local Government no later than 29 October 2010.**

**OFFICE USE ONLY**

**Do LGWPP support the request?**

YES [  ] NO [  ]

# Annex B

## Information required in support of capitalisation requests in respect of redundancy costs

APPLICATIONS FOR 2010-11 ONLY - COSTS MUST BE INCURRED IN THIS FINANCIAL YEAR.

**Name of Authority:**

**Name and position of official:**

**Address:**

**Telephone number:**

**Email:**

**Financial year in which costs are to be incurred:**

**Figure which your Local Authority is applying to capitalise:**

**Have you excluded discretionary or pension strain costs?**

Yes  No

**Is the application figure the final figure or an estimate?**

Final figure  Estimate

**Description of application:** (Continue on another sheet if necessary)

**Is the Authority subject to the Government's intervention powers?**

Yes  No

If yes, please provide further details here:

**Is the Authority part of the local government restructuring process?**

Yes  No

If yes, please provide further details here:

**Will the direction be used to fund equal pay costs?** Yes  No

**Are the costs statutory? i.e. is the claim for statutory costs only?**

(Any discretionary costs should be deducted from the final total)

Yes  No

**Do the costs include “strain on fund” costs?**

(“Strain on fund” payments means those payments the Authority would make into its pension fund in order to eliminate any deficits resulting from premature retirements, and should be subject of a separate application)

Yes  No

**Total unallocated and other earmarked revenue reserves predicted for 31 March 2011**, as submitted on the CLG Revenue Account Budget Estimate (a combined total of lines 915 and 916): £

Application figure	Total Revenue Reserves	Total costs as %	5% = £	Costs exceed 5%?
(office use only)				

**Please indicate the reason for any difference between the revenue reserves figures in the application and the RA return.**

**Revenue Expenditure for 2010-11, as predicted at 1 April 2010**, as submitted on the CLG Revenue Account Budget Estimate: (line 795): £

Application Figure	Revenue Expenditure	Total costs as %	0.25% = £	Costs exceed 0.25%?
(office use only)				

**Please indicate the reason for any difference between the revenue expenditure figures in the application and the RA return.**

**Please include any further information which you consider relevant to your application.**

**Requests for capitalisation (excluding equal pay) should be submitted to Communities and Local Government no later than 29 October 2010.**