Capitalisation directions (excluding equal pay) 2011-12: policy and procedures

Guidance note

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March 2011
Department for Communities and Local Government

Department for Communities and Local Government
Eland House
Bressenden Place
London
SW1E 5DU
Telephone: 030 3444 0000
Website: www.communities.gov.uk

If you require this publication in an alternative format please email alternativeformats@communities.gsi.gov.uk

DCLG Publications
Tel: 030 0123 1124
Fax: 030 0123 1125

Email: product@communities.gsi.gov.uk
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1. Introduction and general policy

1.1. Introduction

1.1.1. **This guidance note sets out the procedures for the issue of capitalisation directions by the Secretary of State for 2011-12**. There is £300m of capitalisation available in 2011-12 to support local authorities who wish to deliver efficiency savings early through organisational restructuring. In order that authorities are clear ahead of the financial year how the process will work, the guidance is being issued earlier than in previous years.

1.1.2. While capitalisation will provide important support in 2011-12 to help authorities manage organisational restructuring, it cannot meet all of these costs. It will be for authorities to assess how they best manage costs overall from their own resources - including, as appropriate, from reserves.

1.2. What is capitalisation?

1.2.1. **Capitalisation is the means by which the Government, exceptionally, permits local authorities to treat revenue costs as capital costs. It is a relaxation of the accounting convention that revenue costs should be met from revenue resources**.

1.2.2. Permission is given through **capitalisation directions**, which the Secretary of State has the power to issue under section 16(2)(b) of the Local Government Act 2003.

1.2.3. **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.

1.2.4. 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.

1.3. Why is capitalisation controlled?

1.3.1. Since capitalisation is a relaxation of the normal accounting requirement that long-term borrowing or capital receipts should only be used to finance capital expenditure, **it has always been subject to an application process, with applications assessed against strict criteria.**

1.3.2. The Government's top priority is to reduce the budget deficit. **Regardless of whether the capitalised expenditure is funded through borrowing or the use of receipts (e.g. from asset sales), capitalisation scores as revenue expenditure in the national accounts. It therefore impacts directly on the deficit reduction programme**. Given these macro-economic considerations, it is all the more important that capitalisation is strictly controlled, and that the Government is able to monitor closely and control the degree and use of directions.

1.3.3. **It is also important to note that, 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 carefully considered before making an application for a capitalisation direction.

1.4. How has the guidance changed since 2010-11?

1.4.1. **The capitalisation categories and criteria have been revised since 2010-11. This is set out in Section 2 of the guidance**. In particular, authorities are asked to note the changes made to the affordability test (paragraphs 2.5.3. to 2.5.5.) and with regard to applying for payments into pension funds (Section 2.7.). As set out in that section, authorities will not be able to apply this year for pension costs under the 'standard' categories; they will only be able to do so for consideration against the exceptional financial difficulties criteria.

1.4.2. **Please note that this guidance does not cover equal pay capitalisation**. Decisions have not yet been taken on equal pay capitalisation policy for 2011-12.

1.4.3. This guidance on non equal-pay capitalisation supersedes that issued by the Department for Communities and Local Government in July 2010.

1.5. Reserves

1.5.1. **As set out in Section 2.5. of the guidance, consideration of the level of reserves will be a key part of the assessment process.** As has been the case in previous years, the Government will look at the total reserves for each authority (excluding schools reserves), including both "earmarked" and unallocated reserves, since earmarking of reserves in itself does not exclude use for other purposes.

1.5.2. Within the statutory and regulatory framework, it is for local authorities to assess what the appropriate level of reserves should be, taking into account all of the relevant factors. These factors are best assessed at the local level, and in the context of both the budget for a particular year, and medium term financial planning.

1.5.3. As the Secretary of State said in his statement in November 2010, Ministers believe that it is sensible - as part of wider financial planning - for authorities to consider drawing on their reserves to help them manage transformational change, where it is appropriate to do so. An authority might decide that a prudent and managed approach to using reserves would be appropriate to help to manage the costs of internal restructuring.

2. Applying for capitalisation

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.

2.1.2. 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.

2.1.3. 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.

2.1.4. Capitalisation is only likely to be granted where a local authority is placed in an unavoidable situation. Applications for the funding of planned schemes other than organisational restructuring are likely to be refused because local authorities should not embark on projects without budgeting appropriately. It should also be noted that applications should only be submitted for the financial year in which the expenditure is to be incurred.

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 Private Finance Initiative schemes
- costs of re-engineering administrative processes
- workforce efficiency training and
- concessionary fares

2.2. The timetable

2.2.1. Given the request from authorities to have clarity as early as possible in the financial year, the main application deadline is being brought forward. While there will be a limited second process later in the financial year (see below), **the main application deadline for applications to be submitted for 2011-12 non-equal pay capitalisation is 12 May 2011. All authorities who are applying to capitalise statutory redundancy costs should apply by that deadline.**

2.2.2. The majority of the capitalisation limit for 2011-12 will be allocated in this main process. The precise amount will be determined by the Secretary of State once all the applications have been assessed, and in light of the total amount applied for which meets the criteria.

2.2.3. **It is intended that formal capitalisation directions from this main process will be issued as early as possible in July 2011**. A summary list of applications will be published on the Department's website, indicating the category under which each application was made and the amount for which a direction was given.

2.2.4. **In order to ensure that all the available capitalisation is used, authorities who receive directions in this main process will be asked to confirm to the Department by 7 October 2011 that they intend to use the direction in its entirety**. This will allow for any capitalisation not used to be made available in the limited second process in October. **The deadline for applications to be submitted for this second process will be 28 October 2011.**

2.2.5. **Given the limited amount which will be available in this second process, authorities will only be able to apply at that stage on the grounds of *exceptional financial difficulties*** (see paragraphs 2.5.6. to 2.5.9.). This is in order to ensure that the remaining small amount of capitalisation available is given to those authorities most in need.

2.2.6. Unless there is a strong need to do otherwise (eg because the authority is facing immediate exceptional financial difficulties), applications submitted after the deadline for the first process and by the deadline for the second process will be considered as part of the second process.

2.2.7. **It is intended that formal capitalisation directions from this limited second process will be issued in December 2011**. As with the main process, a summary list of applications will be published on the Department's website, including the amount for which a direction was given.

2.2.8. Applications received after the second deadline will be considered in line with the policy on **late applications** (see paragraphs 2.8.1.- 2.8.2.).

2.3. The 'Two Gate' system

2.3.1. **Applications in the main process will normally be subject to a two-stage process**. Those meeting the policy criteria 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).

2.3.2. Applications assessed against the exceptional financial difficulties test – including all applications made in the limited second process (see above) - will not be subject to the 'two gate' process: see paragraphs 2.5.6.-2.5.9. The two gate process will also not apply to late applications – see paragraphs 2.8.1-2.8.2.

Gate 1 stage

2.3.3. **Applications will be considered against the criteria for non-equal pay capitalisation**. Applicants will be sent a letter confirming which, if any, of the specified items of expenditure appear to be in accordance with those criteria.

2.3.4. **Where the Department confirms that expenditure meets the 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

2.3.5. **The overall total that authorities are seeking to capitalise will be considered in the light of the total level of capitalisation available, and in respect of the implications of capitalisation across the board**. If the Secretary of State is satisfied that the total amount meeting the criteria can be capitalised, directions may be issued to each applicant for the full amount of the expenditure which met the criteria at Gate 1 (subject to any changes in circumstances).

2.3.6. **If, however, the total amount meeting the criteria is greater than the total level of capitalisation available, consideration will be given at that stage to the method of distributing between applicants the amount available**. The approach adopted may be influenced by the scale of the reduction needed. As well as considering a possible pro-rata scaling back of directions, the Secretary of State will also consider whether it might be appropriate to adopt a sliding scale approach, based on an assessment of the level of need.

2.4. Information required

2.4.1. In order to consider applications as fairly as possible, the Department is seeking a range of information. Annexed to this document is a checklist to assist the application process in relation to statutory redundancy payments. **Please note**

that applicants for statutory redundancy costs will be asked to provide extracts from their budget papers/ relevant council documents on the expected number of posts which will be made redundant, and the expected level of costs.

2.4.2. Authorities should consider sending applications both electronically and in hard copy, or, if in hard copy only, by registered post. Applications by email should be sent to the following address: **capitalisation@communities.gsi.gov.uk**

2.4.3. All applications 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.

2.4.4. 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.

2.4.5. The Department expressly reserves the right to seek further information where this may be required. There is however no guarantee that supplying the information will lead to a direction being issued. **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.**

2.4.6. Applications should confirm that the direction will not be used to fund equal pay costs.

2.5. Assessment of applications

2.5.1. **All applications 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**.

2.5.2. Applications should indicate whether they relate to the General Fund, where the costs relate to non-housing expenditure, or the Housing Revenue Account for housing expenditure; they will be assessed separately.

Affordability Test

2.5.3. Capitalisation is meant to help authorities 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) 10% of available reserves; *and*

(b) 0.5% of budgeted expenditure for the year in which the expenditure is incurred.

2.5.4. General Fund available reserves are the total unallocated and other earmarked reserves as predicted for 31 March 2012, as supplied to the Department on the Revenue Account Budget Estimate (a combined total of lines 915 and 916).

2.5.5. Budgeted expenditure is Revenue Expenditure (on a non-IAS 19 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

2.5.6. 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.

2.5.7. **Evidence will be required that the financial difficulties are of an extreme nature.** Relevant factors might include, for example, actual or imminent use by the Government of its statutory intervention powers. 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.

2.5.8. In these circumstances, a decision on an authority's capitalisation request may be made outside the normal timetable. The 'Two Gate' system described in section 2.3. will not apply.

2.5.9. **There is no specific template for applications against the exceptional financial difficulties criteria.**

2.6. Redundancy costs

2.6.1. The **Affordability Test** will normally be applied.

2.6.2. 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.**

2.6.3. 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).

2.6.4. **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.**

2.7. Payments into pension funds

2.7.1. **Any applications made for capitalisation of lump-sum payments into pension funds will be considered against the exceptional difficulties test (see section 2.5.6. to 2.5.9. above).** Applications will be assessed separately and in accordance with that section (but they may be made at the same time as related redundancy cost applications). **As with other exceptional difficulties applications, there is no standard template.**

2.7.2. 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 the latest Funding Strategy Statement.

2.7.3. 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.

2.7.4. 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.

2.8. Late applications

2.8.1. **Under exceptional circumstances, applications for the current financial year received after the closing date for the second process of 28 October 2011**

will be considered after December 2011. The 'Two Gate' system described in paragraph 2.2. will not apply.

2.8.2. All such applications will be considered against the exceptional difficulties test, and, in considering applications, 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 the Department

2.9.1. **As set out above (paragraph 2.2.4.), authorities receiving capitalisation directions in the main process will be asked to let the Department know by 7 October 2011 that they intend to use the direction in its entirety**. This is to ensure that any capitalisation that is not intended to be used will be made available to other authorities in the limited second process.

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

2.9.3. **All direction letters issued, whether in the main or the second process, will contain a requirement that local authorities inform the Department of how much of their allocation was subsequently used in the financial year**. These returns enable the Department to monitor the operation of the system. Authorities should therefore inform the Department, at the address below, no later than **12 July 2012**. There is no template form: an email or hard copy return will suffice.

2.10. Contacts

2.10.1. Queries and applications in respect of capitalisation requests (excluding equal pay) should be directed to the Department for Communities and Local Government Capital Finance and Reserves Team as follows:

Sarah Blackman
Capital Finance and Reserves Team
Department for 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

Annex A

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

APPLICATIONS FOR 2011-12 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 included budget papers/ relevant council documents setting out the number of redundancies and the costs? (This is required to process the application.)

Yes ☐ No ☐

Is the application figure the final figure or an estimate?
Final figure ☐ Estimate ☐

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 ☐

Have you excluded pension fund "strain on" 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. If applied for, these should be subject of a separate application, and should only be applied for on the grounds of exceptional financial difficulties.)

Yes ☐ No ☐

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:

Can you confirm the direction will not be used to fund equal pay costs?
Yes ☐ No ☐

Total unallocated and other earmarked revenue reserves predicted for 31 March 2012, as submitted on the DCLG Revenue Account Budget Estimate (a combined total of lines 915 and 916)**: £**

Application Figure	Total Revenue Reserves	Total costs as %	10% = £	Costs exceed 10%?
(office use only)				

Revenue Expenditure for 2011-12, as predicted at 1 April 2011, as submitted on the DCLG Revenue Account Budget Estimate (line 795): **£**

Application Figure	Revenue Expenditure	Total costs as %	0.5% = £	Costs exceed 0.5%?
(office use only)				

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

Requests to capitalise statutory redundancy costs should be submitted to the Department for Communities and Local Government no later than <u>12 May 2011.</u>

Department for Communities and Local Government

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