

CAPITALISATION DIRECTIONS: POLICY AND PROCEDURES

A guidance note by the Department for Communities and Local Government

INTRODUCTION

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), was a direct replacement for the similar measure under the former system (section 40(6) of the *Local Government and Housing Act 1989*).
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 borrowed money or capital receipts, thereby increasing an authority's financial flexibility.
3. This note sets out revised procedures for the issue of capitalisation directions, which have immediate effect. The previous guidance on capitalisation (issued by the Office of the Deputy Prime Minister on 13 December 2004) is superseded.

GENERAL POLICY

4. At the national economic level, capitalisation raises concerns by facilitating practice which breaches the Chancellor's "Golden Rule" - that long-term borrowing should be used only to finance capital expenditure. Under the prudential system, which abolished the routine need for Government borrowing approval, capitalisation removes the only formal obstacle to borrowing for a revenue purpose (subject, of course, to its affordability in accordance with the principles of the new system). Using capital receipts instead of borrowing is equally problematic, since pressure is put on the Golden Rule when revenue expenditure is met from any source other than revenue income.
5. From the viewpoint of authorities themselves, 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. Debt incurred to meet revenue costs will have to be serviced out of revenue resources over many years. And using capital resources for revenue expenditure tends to reduce long-term investment in the capital assets needed to create and maintain sustainable communities.
6. Accordingly, applications for capitalisation directions have always been considered against strict criteria. Despite that, the value of directions requested and issued in recent years has been rising, with a consequent increase in the threat to the Golden Rule.
7. Ministers have concluded that additional safeguards must be adopted to contain that risk. In order to implement these safeguards, the Department for Communities and Local Government (DCLG) is introducing a new system for processing applications, as explained below.

THE “TWO GATE” SYSTEM FOR PROCESSING APPLICATIONS

8. The essence of the new system is that applications will normally be subject to a two-stage process. Those meeting the policy criteria for capitalisation will initially receive only confirmation of that fact in a “minded to” letter (Gate 1). There will be a second stage when all such applications will be considered simultaneously to determine the actual amounts which may be capitalised by each authority (Gate 2).

Target date for applications - 15 December

9. In principle, applications may be submitted at any time (for contact points, see paragraphs 43 to 45 below). However, authorities are strongly encouraged to submit applications to arrive by 15 December in the financial year in which the expenditure is to be incurred. Applications received by that date will be considered using a “two gate” process as follows:

Gate 1

10. Applications will initially be considered against the criteria for capitalisation (as set out below in paragraphs 18 to 38). 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 the capitalisation criteria.

11. Where expenditure is confirmed to meet 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

12. After 30 December, final decisions will be taken on all the current year’s applications which authorities have made by 15 December and which have passed Gate 1.

13. The overall total of the amounts which authorities are seeking to capitalise will be considered in the light of the implications for the Golden Rule (paragraph 4 above). 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 national economic 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 or in the policy criteria since then).

14. 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.

15. It is proposed that formal capitalisation directions will be issued by 31 January.

Late applications

16. Applications for the current financial year received after the closing date of 15 December will be considered on or after 31 January. The “two gate” system will not apply

and a final decision will be issued as soon as possible after 31 January. In considering such cases, account will be taken of the level of capitalisation which has already been reached and the potential threat to the Golden Rule presented by the issuing of a further direction. It is possible that a small proportion of headroom will be earmarked for such late applications relating to that financial year.

Monitoring

17. In order to assist monitoring of the annual level of capitalisation, directions will include a condition that the authority informs DCLG by 15 July in the following financial year how much expenditure has actually been capitalised by virtue of the direction. This would enable the Secretary of State to take account of any unused amounts in the previous year's directions when considering applications for the current year and could permit a higher level of capitalisation in the current year.

GENERAL CAPITALISATION CRITERIA

Basic policy

18. In view of the considerations set out in paragraphs 4 and 5 above, capitalisation should be resorted to only where a strong case is made and the tests outlined below are designed to examine the justification for it.

19. It should be noted that capitalisation is generally only appropriate for **one-off payments** (such as 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, for example, where a programme of redundancy is implemented in phases over more than one financial year.

Assessment of applications

20. Applications will be considered against the three tests set out in paragraphs 21 to 27 below. The normal requirement is that:

All applications must pass the *Affordability Test* (paragraph 21) and either the *Exceptional Difficulties Test* (paragraph 23) or the *Cost-Cutting Test* (paragraph 25)

Affordability Test

21. 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.

22. That test will be based on the reserves and budget figures for the General Fund (exclusive of the HRA) where the costs relate to non-housing expenditure; and where the costs fall within the Housing Revenue Account (HRA), the reserves and budget figures will be those for the HRA only.

Exceptional Difficulties Test

23. This test assesses whether capitalisation is necessary to help an authority manage **exceptional financial difficulties**. The following three conditions must normally be met.

(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.

(c) There is no alternative way of ensuring that the expenditure could be met.

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

Cost-Cutting Test

25. This test assesses whether capitalisation can be justified by reference to the future revenue savings it will generate. The following condition must normally be met.

The capitalised expenditure must relate to measures with a *demonstrable* cost-cutting effect.

26. The only obvious example of expenditure meeting this test is that relating to *statutory redundancy payments*, where the savings on salaries arise automatically and can be quantified with certainty.

27. Most other measures expected to cut costs will not easily pass this test, since the timing and size of any savings will be insufficiently predictable. The initial development and procurement costs of capital projects and PFI schemes are unlikely to qualify and authorities are advised to budget for this revenue expenditure, without expecting to rely on capitalisation directions. Other costs for which capitalisation has recently been refused include those of: re-engineering administrative processes; consultancy; public consultations; legal costs arising from disputes with contractors.

SPECIAL CAPITALISATION CRITERIA

28. For certain kinds of costs, capitalisation has been allowed in recent years subject to additional special criteria and the main categories are set out below. **Applications under these categories will normally be subject to the arrangements set out in paragraphs 8 to 17 above.**

Redundancy costs

29. The *Affordability Test* (paragraph 21) and the *Cost-Cutting Test* (paragraph 25) will normally be applied.

30. 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. Applications for capitalisation of lump-sum payments into pension funds will normally be considered only against the tests in paragraph 31 below. For the latter, applications should be separate and in accordance with that paragraph (but they may be made at the same time as related redundancy cost applications).

Payments into pension funds

31. 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 actuarial valuation report.

32. The *Affordability Test* (paragraph 21) will normally be applied.

33. 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 (LGPS), 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.

(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.

34. Advice and associated legislation issued by the DCLG in connection with the LGPS can be accessed online in the 'available documents' section at:

<http://www.xoq83.dial.pipex.com>

Equal pay awards

35. In relation to equal pay awards, the only kind of expenditure for which a capitalisation direction is likely to be given is that incurred on lump-sum payments to present or former Council employees in respect of complaints relating to *past pay levels* under the *Equal Pay Act 1970*; a capitalisation direction is unlikely to be granted in relation to *ongoing salary increases*.

36. Applications should state what proportion of the authority's total expenditure on equal pay awards it is proposed to capitalise. They should also state how much, if any, of the capitalised expenditure could be funded from capital receipts, if a direction were to be issued. If the expenditure relates to negotiated *ex gratia* payments, rather than amounts

awarded by a court or tribunal, the application will need to confirm that this option is expected to reduce the cost to the authority.

37. The *Affordability Test* (paragraph 21) and *Exceptional Difficulties Test* (paragraph 23) will normally be applied.

Other categories

38. 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 has been issued by DCLG today. The weblink is: <http://www.local.communities.gov.uk/finance/capital/data/comm0607.pdf>)
- Contaminated land inspections (see paragraph 44 below)

APPLICATION PROCEDURE

Information required

39. Initial applications should be kept concise and may be made by e-mail, but additional information may be requested later.

40. All applications should state:

- (a) exactly how much expenditure the authority is requesting to be capitalised;
- (b) when it would be incurred.

41. They should also provide sufficient information to show that the relevant tests are met, including the figures for the *Affordability Test* (paragraph 21), which should be consistent with those provided to DCLG in the authority's Revenue Accounts Budget Estimates Returns.

Conditions

42. Ministers have wide discretion under section 20 of the 2003 Act 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.

Contacts

43. Except as indicated below, queries and applications should normally be directed to the DCLG Capital Team as follows:

Sabrina Swain
Capital Finance and Analysis Division
DCLG
5/J3 Eland House, Bressenden Place, London SW1E 5DU
Tel: 020 8944 4232 Fax: 020 8944 4239
Email: Sabrina.Swain@communities.gsi.gov.uk

44. For the capitalisation of contaminated land inspection costs, the contact is:

Trevor Jones
Contaminated Land Branch
Defra/LEQ
Zone 7/D10 Ashdown House, 123 Victoria Street, London SW1E 6DE
Tel: 020 7082 8566 Fax: 020 7082 8567
Email: trevor.jones@defra.gsi.gov.uk

45. For certain other special schemes, authorities will have been notified of separate contact points.

Department for Communities and Local Government
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5/J3 Eland House, Bressenden Place, London SW1E 5DU

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