NEWCASTLE MUNICIPALITY

FUNDING & RESERVES POLICY

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1. PREAMBLE

The funding and reserves policy is aimed at ensuring that the municipality has sufficient and cost-effective funding in order to achieve its objectives through the implementation of its operating and capital budgets.

This policy aims to set guidelines towards ensuring financial viability over both the short- and long-term which includes reserves requirements.

2. POLICY OBJECTIVES

2.1 The objectives of the policy are to:

2.1.1 Ensure that the Medium Term Expenditure Framework (annual budget) of the municipality is appropriately funded.

2.1.2 Ensure that cash resources and reserves are maintained at the required levels to avoid future year unfunded liabilities.

2.1.3 To achieve financial sustainability with acceptable levels of service delivery to the community.

3. SCOPE OF THE POLICY

This policy shall apply to the Council, Exco, Finance Portfolio Committee, Budget Steering Committee, Accounting Officer, Strategic Executive Directors and all staff of the municipal council. It is, however, specifically applicable to the council and all officials who have a formal, administrative duty to prepare, manage and control the municipal's budget and expenditure.

4. APPLICABLE LEGISLATIVE

4.1 The legislative framework governing borrowings are:

4.1.1 Local Government Municipal Finance Management Act, Act 56 of 2003; and

4.1.2 Local Government Municipal Budget and Reporting Regulation, Regulation 393, published under Government Gazette 32141, 17 April 2009.

5. FUNDING OF ANNUAL BUDGET

5.1 An annual budget may only be funded from:

(a) cash backed accumulated funds from previous years surpluses and reserves not committed for any other purpose;

(b) borrowed funds but only for capital expenditure; and/or

(c) Grant Finding.

5.2 Realistic anticipated revenue projections must take into account:

(a) projected revenue for the current year based on collection levels to date.

(b) actual revenue collected in previous financial years.

5.3 Capital expenditure may only be incurred on a capital project only if:

(a) the funding for the project has been appropriated in the capital budget.

(b) the total cost for the project has been approved by Council.

(c) the future budgetary implications and projected cost covering all financial year until the project is operational has been considered.

(d) the implications of the capital budget on municipal tax and tariff increases.

(e) the sources of funding are available and have not been committed for other purposes.

6. CASH MANAGEMENT

6.1 The availability of cash is one of the most important requirements for working capital management and must be closely monitored to ensure a minimum days cash on hand of forty five (45) days for its daily operations.

6.2 Changes in the municipal environment that may have an impact on the municipal cash flow position include:

(a) changes in revenue levels as a result of consumption patterns (water restrictions, load shedding etc.);

(b) reduced growth as a result of economic conditions;

(c) increase in non-payment rate as a result of economic conditions;

(d) implementation of electricity industry pricing policy (inclining block tariffs).

(e) increased debt levels.

6.3 Surplus cash not immediately required for operational purposes is invested in terms of the municipality's investment policy to maximize the return on investment.

7. DEBT MANAGEMENT

7.1 Debt is managed in terms of the municipal credit control and debt collection policy and the writing off of bad debts and impairments of debtors policy.

7.2 The provision for revenue that will not be collected are budgeted as an expense and is based on the projected annual non-payment rate for each service.

8. OPERATING BUDGET

8.1 The operating budget provides funding to departments for their medium term expenditure as planned. The municipality categorises services rendered to the community according to its revenue generating capabilities.

(a) trading services – services that generate surpluses that can be used for cross subsidization to fund other services.

(b) economic services – services that break even with no surpluses.

(c) rates and general services – services that are funded by rates, surpluses generated by trading services, and/or other revenues generated such as fines, interest received, grants and subsidies etc.

8.2 The operating budget is funded from the following main sources of revenue:

(a) property rates.

(b) surpluses generated from service charges.

(c) government grants and subsidies.

(d) other revenue, fines, interest received etc.

(e) cash backed accumulated surpluses from previous years not committed for any other purposes.

8.3 The following guiding principles apply when compiling the operating budget:

(a) the annual budget must be balanced.

(b) growth parameters must be realistic taking into account the current economic conditions.

(c) tariff adjustments must be realistic, taking into consideration the general inflation, affordability, bulk increases and the demand according to the approved Integrated Development Plan (IDP).

(d) Revenue from government grants and subsidies must be in line with allocations gazette in the Division of Revenue Act and provincial gazettes.

(e) Revenue from public contributions, donations or any other grants may only be included in the budget if there are acceptable documentation that guarantees the funds such as:
  - (i) signed service level agreement;
  - (ii) contract or written confirmation; or
  - (iii) any other legally binding document.

(f) Property rates are levied according to the Municipal Property Rates Act, and property rates policy based on land and improvement values. The budget is compiled using the latest approved valuation and supplementary roll, consistent with current and past trends. Property rates tariffs and rebates are determined annually as part of the tariff setting process.

(g) Property rates rebates, exemptions and reductions are budgeted either as revenue foregone or a grant as per directive in MFMA Budget Circular 51 depending on the conditions thereof.

(h) Projected revenue from service charges must be realistic based on current and past trends with expected growth considering the current economic conditions. The following factors must be considered for each service:
  - (i) Metered services comprise of electricity and water:
    - the consumption trends for the previous financial years;
    - envisaged water restrictions or load shedding when applicable; and
    - actual revenue collected in previous financial years.
  - (ii) Refuse removal services:
    - the actual number of erven receiving the service per category; and
    - actual revenue collected in previous financial years.
  - (iii) Sewerage services:
    - the actual number of erven receiving the service and the consumption trends per category; and
    - actual revenue collected in previous financial years.

(i) Rebates, exemptions or reductions for service charges are budgeted either as revenue foregone or as a grant as per directive in MFMA Budget Circular 51 depending on the conditions thereof.

(j) Other projected income is charged in terms of the approved sundry tariffs and fines considering the past trends and expected growth for each category.

(k) Provision for revenue that will not be collected is made against the expenditure item bad debt and based on actual collection levels for the previous financial year and the projected annual non-payment rate.

(l) Interest received from actual long-term and or short-term investments are based on the amount reasonably expected to be earned on cash amounts available during the year according to the expected interest rate trends. The actual amount allocated for interest on investments is contributed to the capital replacement reserve.

(m) Transfers from the accumulated surplus to fund operating expenditure will only be allowed for specific once-off projects and with no recurring operating expenditure resulting thereof.

(n) Transfers from the accumulated surplus to offset the increased depreciation charges as a result of the implementation of GRAP 17 will be phased out over a number of years.

(o) A detailed salary budget is compiled on an annual basis. All funded positions are budgeted for in total and new and/or funded vacant positions are budgeted for six (6) months only of the total package considering the recruitment process. As a guiding principle the salary budget should not constitute more than 35% of annual operating expenditure.

(p) Depreciation charges are fully budgeted for according to the asset register and to limit the impact of the implementation of GRAP 17 a transfer from the accumulated surplus is made. However the annual cash flow requirement for the repayment of borrowings must fully be taken into consideration with the setting of tariffs.

(q) To ensure the health of municipal assets, sufficient provision must be made for the maintenance of existing and infrastructure assets based on affordable levels, resulting that maintenance budgets are normally lower than the recommended levels. Therefore the mere reduction of maintenance budgets to balance annual budgets must carefully be considered. As a guiding principle repair and maintenance should constitute between 5 and 8% of total operating expenditure and should annually be increased incrementally until the required targets are achieved.

(r) Individual expenditure line items are to be revised each year when compiling the budget to ensure proper control over expenditure. Increases for these line items must be linked to the average inflation rate and macro-economic indicators unless a signed agreement or contract stipulates otherwise.

9. CAPITAL BUDGET

9.1 The capital budget provides funding for the municipality's capital programme based on the needs and objectives as identified by the community through the Integrated Development Plan and provides for the eradication of infrastructural backlogs, renewal and upgrading of existing infrastructure, new developments and enlargement of bulk infrastructure.

9.2 Provisions on the capital budget will be limited to availability of sources of funding and affordability. The main sources of funding for capital expenditure are:

(a) accumulated cash back internal reserves;
(b) borrowings;
(c) government grants and subsidies; and
(d) public donations and contributions,

9.3 The following guiding principles applies when considering sources of funding for the capital budget:

(a) Government grants and subsidies:
   (i) only gazette allocations or transfers as reflected in the Division of Revenue act or allocations as per provincial gazettes may be used to fund projects;
   (ii) the conditions of the specific grant must be taken into consideration when allocated to a specific project; and
   (iii) government grants and subsidies allocated to specific capital projects are provided for on the relevant department's operating budget to the extent the conditions will be met during the financial year.

(b) In the case of public contributions, donations and/or other grants, such capital projects may only be included in the annual budget if the funding is guaranteed by means of:
   (i) signed service level agreement;
   (ii) contract or written confirmation; and/or
   (iii) any other legally binding document.

(c) Public donations, contributions and other grants are provided for on the relevant department's operating budget to the extent the conditions will be met during the financial year.

(d) The borrowing requirements as contained in the borrowing policy are used as a basis to determine the affordability of external loans over the Medium Term Income and Expenditure Framework. The ratios to be considered to take up additional borrowings:

(i) long-term credit rating of BBB;

(ii) interest cost to total expenditure to not exceed 8%;

(iii) long-term debt to revenue (excluding grants) not to exceed 50%;

(iv) payment rate of above 95%;

(v) percentages of capital charges to operating expenditure less than 18%.

(e) Allocations to capital projects from cash back internal reserves will be based on the available funding for each ring-fenced reserve according to the conditions of each reserve as follows:

(i) infrastructure projects to service new developments and the revenue is received through the sale of erven must be allocated to the capital reserve for services ;

(ii) capital projects of a smaller nature such as office equipment, furniture, plant and equipment etc. must be allocated to the capital reserve from revenue which is funding from the revenue budget for that specific year. A general principle is that these types of capital expenditure should not exceed more than 1% of total operating expenditure;

(iii) capital projects to replace and/or upgrade existing assets will be allocated to the capital replacement reserve;

(iv) capital projects to upgrade bulk services will be allocated to the capital bulk contributions reserve for each service.

9.4 All capital projects have an effect on future operating budget therefore the following cost factors should be considered before approval:

(a) additional personnel cost to staff new facilities once operational;

(b) additional contracted services, that is, security, cleaning etc.

(c) additional general expenditure, that is, services cost, stationery, telephones, material etc.

(d) additional other capital requirements to the operate facility, that is, vehicles, plant and equipment, furniture and office equipment etc.

(e) additional costs to maintain the assets;

(f) additional interest and redemption in the case of borrowings;

(g) additional depreciation charges;

(h) additional revenue generation. The impact of expenditure items must be offset by additional revenue generated to determine the real impact on tariffs.

10. RESERVES

10.1 All reserves are "*ring fenced*" as internal reserves within the accumulated surplus, except for provisions as allowed by the General Recognized Accounting Practices (GRAP).

10.2 The following ring fenced reserves exist:

(a) Capital reserve for new developments

This reserve is used to fund capital expenditure to service new developments. Each development is ring fenced within this reserve. The valuer determines the price for the erven to be sold and the revenue generated through the sale of erven is then allocated to the specific development. This reserve must be cash backed to ensure the availability of cash to fund the capital expenditure required to service the erven.

(b) Capital replacement reserve

Funding for capital budgets of future financial years are generated through a combination of methods. Once a municipality has reached its maximum gearing ability no further borrowings can be taken up. This necessitates that the municipality also invests in a capital replacement reserve, however, it must be cash backed.

This reserve once fully established will enable the municipality to provide internal funding for its capital replacement and renewal programme.

In the past the cash generated from depreciation was used for the redemption payments on borrowings only. The increased asset value as a result of GRAP 17 has resulted that the depreciation charges increased drastically which was not supported by cash.

To limit the tariff increases a non-cash contribution was made from the depreciation reserve to offset the depreciation charge.

Depreciation is a method to generate future cash. Therefore it is anticipated to annually incrementally decrease the offset depreciation charge from the depreciation reserve with 2% until the depreciation is fully funded from cash through tariff setting.

Other contributions to the capital replacement reserve through the operating budget are:

(i) interest received on investments;

(ii) surface rentals from mines as identified from time to time; and

This reserve must be cash backed to ensure the availability of cash to fund the municipal capital programme.

(c) Bulk capital contribution reserves

This reserve is to supplement capital expenditure for the necessary expansions and upgrading of bulk infrastructure due to new developments. Revenue generated through bulk services contributions are allocated to this reserve for each applicable service. This reserve must also be cash backed.

11. PROVISIONS

A provision is recognised when the municipality has a present obligation as a result of a past event and it is probable, more likely than not, that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

Provisions are revised annually and those estimates to be settled within the next twelve (12) months are treated as current liabilities.

The municipality has the following provisions:

(a) Leave provision

Liabilities for annual leave are recognised as they accrue to employees. An annual provision is made from the operating budget to the leave provision. Due to the fact that not all leave balances are redeemed for cash, only 75% of the leave provision is cash backed.

(b) Landfill rehabilitation provision

The landfill site rehabilitation provision is created for the current operational site at the future estimated time of closure. The value of the provision is based on the expected future cost to rehabilitate the landfill site. This provision must be cash backed to ensure availability of cash for rehabilitation on closure.

(c) Long services awards

Municipal employees are awarded leave days according to years in service at year end. Due to the fact that not all long service leave balances are redeemed for cash, only 75% of the long service leave provision is cash backed.

(d) Post employment medical care benefits

The municipality provides post retirement medical care benefits by subsidizing the medical aid contributions to retired employees and their legitimate spouses. The entitlement to post retirement medical benefits is based on employees remaining in service up to retirement age and the completion of a minimum service period. The expected cost of these benefits is accrued over a period of employment. This provision must be cash backed to ensure the availability of cash for the payment of medical aid payments.

12. OTHER ITEMS TO BE CASH BACKED

(a) Donations, public contributions, unspent grant funding

Revenue received from conditional grants, donations and funding is recognised as revenue to the extent that the municipality has complied with any of the criteria, conditions or obligations embodied in the agreement. Unspent amounts in relation to donations, public contributions and unspent grant funding are therefore retained in cash and are not available to fund any other items on the operating or capital budget other than that for which it was intended for.

(b) Consumer deposits

Consumer deposits are partial security for a future payment of an account. Deposits are considered a liability as the deposit is utilised on the account once the service is terminated. Therefore the funds are owed to consumers and can therefore not be utilised to fund the operating or capital budget.
Consumer deposits should be retained in cash. Due to the fact that it is not likely to redeem all of the consumer deposits at once, only 75% are cash backed.

13. IMPLEMENTATION AND REVIEW OF THIS POLICY

13.1 The Accounting Officer shall be responsible for the implementation and administration of this policy with the assistance of the Strategic Executive Director for Financial Services Department once approved by Council.

13.2 In terms of section 17(1) (e) of the Municipal Finance Management Act, 2003 this policy shall be reviewed on annual basis to ensure that it complies with changes in applicable legislation, regulations and any other directive issued by National Treasury.and tabled to Council for approval as part of the budget process.

13.3 This policy must be read in-conjunction with the Budget and Borrowing Policies; Local Government Municipal Finance Management Act, Act 56 of 2003; and Local Government Municipal Budget and Reporting Regulation, Regulation 393, published under Government Gazette 32141, 17 April 2009.