LIDSTONE & COMPANY
BARRISTERS AND SOLICITORS

MEMORANDUM **Privileged and Confidential**

TO:	Twyla Graff, CAO
FROM:	Don Lidstone, Q.C.
DATE:	October 16, 2014
RE:	Water Agreement
FILE:	10047-108

1.0 PURPOSE OF MEMO

In this memorandum of law we are summarizing our written and verbal advice from July 2014 to date in regard to the need for elector approval of the water agreement with the City of Nanaimo in light of the *Municipal Liabilities Regulation.*

2.0 BACKGROUND

The requirement for approval is found in section 175(2) of the *Community Charter.* This section expressly provides for a general rule that a municipality must obtain elector approval for a liability under an agreement if the term is greater than five years. This requirement, however, is subject to section 175(4)(c) which empowers Cabinet to prescribe exceptions. There are a number of exceptions to the general rule, each operating independently (that is, Council need only comply with one exception if Council determines as a matter of public policy that the approval of the electors is not required). Of course, despite the exceptions Council may voluntarily elect to seek the approval of the electors or to hold a plebiscite to obtain the opinion of the electors. As well, elector approval or petition would be required for each local service area in the future if Council elects to proceed with accepting water under the agreement.

Under the authority of section 175(4)(c) of the *Community Charter,* Cabinet has enacted sections 6, 7, 8 and 9 of the *Municipal Liabilities Regulation,* which sections provide for four independent grounds for the exemption from the requirement for elector approval.

3.0 APPROVAL-FREE ZONE

3.1 SECTION 7 OF MUNICIPAL LIABILITIES REGULATION

As we determined in early August prior to consideration of the agreement by the

City of Nanaimo Council, we are of the opinion that the District of Lantzville satisfies the requirements of section 7 of the *Municipal Liabilities Regulation*, such that the approval of the electors is not required as a condition precedent to the validity of the agreement. Section 7 is commonly referred to as the "assent-free zone". Section 7 provides as follows:

> **Approval-free liability zone**
>
> 7 Approval of the electors is not required under section 175 (2) *[liabilities under agreements]* or section 180 (1) *[loan authorization bylaws]* of the *Community Charter* if
>
> (a) at the time it proposes to incur the liability,
>
> (i) the annual cost of servicing the aggregate liabilities of the municipality for the year, as determined in accordance with section 3 of this regulation,
>
> does not exceed
>
> (ii) 5% of the annual calculation revenue of the municipality for the previous year, as determined in accordance with sections 4 and 5 of this regulation, and
>
> (b) incurring the liability would not cause the annual cost referred to in paragraph (a) (i) to exceed the limit established by paragraph (a) (ii).

We commenced our analysis with the proposition that the making of the agreement itself does not cause the District to incur a liability, in that none of the financial clauses are triggered unless Council at some future date passes a resolution that it is ready to accept water under the agreement and delivers a copy of the resolution to the City of Nanaimo: in this regard section 2.3 of the agreement says that Lantzville has no financial liability to Nanaimo under the agreement until the Commencement Date which is defined as when Lantzville delivers the Council resolution after completion *to Council's satisfaction* of the water system owned and operated by Lantzville to serve premises in Lantzville. This was a major change from previous drafts of the agreement that were prepared by Nanaimo.

Despite the fact that *making of the agreement itself* does not cause the District to incur a liability, we have assumed that Council may at some future date elect to trigger the opportunity to receive water from Nanaimo under the agreement, and that certain liabilities would at that point be incurred under the agreement. By the time Council elects to proceed, if it so

elects, it is possible that the District will have the benefit of infrastructure grants and larger reserves. However, to look at the worst case scenario we have reviewed the agreement in the context of the District's 2013 financial statements and the 2014 financial plan (without infrastructure grants or increased reserves, even though the agreement triggers no liabilities at this time) to confirm that if Council were to pass a resolution now to trigger financial liability to Nanaimo under the agreement, the liability would be covered by section 7 of the *Municipal Liabilities Regulation.* The District's finance officer has independently calculated the effects of applying section 7 and has come to the same conclusion.

In arriving at this conclusion, we have carefully reviewed section 7 and made the calculations in accordance with the plain language of the regulation.

3.2 Borrowing from Reserves

We have reviewed ss. 3 and 7 of the regulation and it is our view that money and interest repayable to a capital reserve fund under s. 189(4.2) of the *Community Charter* is not included as a liability in determining a municipality's debt servicing capacity under s. 7 of the *Regulation.* We have reviewed the *Municipal LGDE Help Manual* published by the Province which provides guidance on financial reporting requirements for local governments and it appears from that manual that reserve funds are treated as a form of equity or surplus. The following excerpts ***(in bold italics)*** from the Manual make reference to reserve funds:

> "Restricted Revenue (Line m)
>
> These are assets and/or revenues that are subject to restrictions through either legislation or agreement. These restrictions limit the use of the assets or revenues to specific purposes not relating the local government's general operating obligations. The restrictions are usually external to the local government (but may also be internal in some cases). PS 3100 provides more detail on Restricted Assets and Revenues. ***This does not include most reserve funds established under Part 6 - Division 4 of the Community Charter, which are considered a form of equity.***
>
> Restricted cash inflows should not be recognized as revenue until the period in which the resources are used for their specified purposes. A cash inflow received before this criterion has been met should be reported as a liability."[1]

---

[1] *Municipal LGDE Help Manual* (BC Ministry of Community, Sport and Cultural Development), December 2013, at p. 18.

"Reserve Fund (Line af)

This is all reserve fund balances under Part 6, Division 4 of the Community Charter (except sinking funds, MFA reserve funds and DCC funds, which are all classified as restricted revenue under the liabilities portion of the Statement of Financial Position --- see Line m in Schedule A2). Reserve funds are broken down into three categories: water reserves, sewer reserves, and other reserves. Do not include ***Reserve Accounts as these are merely a form of appropriated surplus*** (usually established by council resolution). Also, do not include trust funds that are merely administered by the local government (e.g. Cemetery Trusts) or MFA sinking funds because these are outside the reporting entity of the local government (PS 1300)."[2]

"Total Surplus / (Deficit) (Line ai)

This is the sum of Operating Fund, ***Reserve Fund,*** Capital Fund and Equity in Tangible Capital Assets (lines ae to ah - Schedule A2). ***This amount must equal Accumulated Surplus /*** (Deficit) (Schedule A2 - Line ad)."[3]

These references do not make specific reference to funds and interest owed from one reserve fund to another under s. 189(4.2); however, we have also reviewed section 6 of the *LGDE Help Manual* with respect to reporting liabilities and calculating debt servicing capacity and there is no reference to reserve funds or amounts owing under s. 189(4.2) being included as part of these calculations.

We have concluded that transferring funds from one reserve fund to another will not affect the debt servicing capacity of a municipality as the municipality in effect is using money it already has and any interest payable under s. 189(4.2)(b) will be equivalent to the interest it would have earned if it had remained in the originating reserve fund.

3.3 The Time Council Proposes to Incur the Liability

For the purposes of section 7, the critical time for Council's calculation to occur is "the time it proposes to incur the liability" under section 7(a). Since that time is some year in the future when the infrastructure is "ready" and after which Council elects to notify Nanaimo, it is not possible to determine now what the annual cost of servicing the aggregate liabilities will be for that future year or

---

[2] *Municipal LGDE Help Manual* (BC Ministry of Community, Sport and Cultural Development), December 2013, at p. 28.

[3] *Municipal LGDE Help Manual* (BC Ministry of Community, Sport and Cultural Development), December 2013, at p. 29.

what the annual calculation revenue will be for the prior year. However, as stated, we have completed the calculation as if the liability were to be incurred now, for the purposes of determining that the agreement falls under the assent-free zone. We note that Council can improve this financial snapshot by building reserves and applying for infrastructure grants between now and the Commencement Date.

3.4 INCURRING THE LIABILITY

Section 7 (b) of the regulation says that approval of the electors is not required if incurring the liability would not cause the annual cost referred to in section 7 (a) (i) to exceed the limit established by section 7 (a) (ii). The question arises whether the reference to "liability" means the gross total financial quantum of the liability under the entire agreement, or the annual cost of servicing the liability. On a plain language construction of section 7, noting the context of the provision within the regulation taken as a whole, we think the Province intended the reference to "liability" to be a reference to the annual cost of servicing the liabilities under the agreement: if this annual cost of servicing the liabilities under the agreement PLUS the annual cost of servicing the aggregate liabilities of the municipality for the year does not exceed 5% of the annual calculation revenue for the previous year, approval of the electors is not required.

In our opinion, section 7(b) provides [by incorporation by reference to section 7(a)(i)] that *incurring* the liability under the agreement would not cause the *annual costs of servicing* to exceed the 5% limit. In other words, it is the *annual costs of servicing* as impacted by the new liability cost of servicing that must not exceed 5%. Otherwise, the Province would have enacted a regulation that provides that the liability under the agreement will not cause the aggregate liabilities of the municipality to exceed a prescribed amount. This is clearly reinforced by the Ministry's phrasing of the liability calculation form that is required to be completed by municipalities.

3.5 S. 7 CONCLUSIONS

We have reviewed the agreement in the context of the District's 2013 financial statements and the 2014 financial plan (without infrastructure grants or increased reserves) to confirm that if Council were to pass a resolution now to trigger financial liability to Nanaimo under the agreement, the liability would be covered by section 7 of the *Municipal Liabilities Regulation.* Based on the information available to us, we also think that by the time the District in fact incurs the liabilities under the agreement the financial position of the District under section 7 will be even stronger.

4.0 CAPITAL LIABILITIES

Under the authority of section 175(4)(c) of the *Community Charter*, section 6 of the *Municipal Liabilities Regulation* expressly states that approval of the electors is not required under section 175(2) unless the liability is of a capital nature or is a loan guarantee. This exemption operates independently of section 7 of the regulation, as they each stand on their own as separate exemption authorities.

The question is whether the liability to purchase water from Nanaimo is a liability of a capital nature. The purchase of water is for redistribution to residents and businesses in the District. Water consumers will pay the District various connection and user fees and charges for the water which the District is flowing through to the users, and the infrastructure connection will be funded by borrowing internally from a reserve and repaid by the fees and charges. The District's own infrastructure that it pays for separately, not by payment to Nanaimo, will carry the water within its boundaries, and Nanaimo's infrastructure already exists and is paid for. As part of the fee for the water, Nanaimo calculated that the equivalent of its development cost charge would serve as a proxy for the District's use of the Nanaimo's infrastructure, but this does not constitute a capital outlay or acquisition. As well, in addition to paying for all water infrastructure in its boundaries the District is paying for its own connection and metering (but in neither case to Nanaimo under the Nanaimo agreement). Accordingly, despite the references to development cost charges and "capital buy-ins" by non-lawyers and non-accountants during the development of the water agreement, the District is not incurring a capital liability under the agreement (subject to section 14.1 which is discussed below).

Under section 1(2) of the Regulation, the Generally Accepted Accounting Principles, and therefore the Public Sector Accounting Board rules, apply to interpretation of this matter. Under the PSAB standards, this is not a capital transaction. It is not purchasing infrastructure from Nanaimo, it is purchasing water for (basically immediate) resale. The definition of a tangible capital asset under PSAB standards is as follows:

> (a) **Tangible capital assets** are non-financial assets having physical substance that:
>
> (i) are held for use in the production or supply of goods and services, for rental to others, for administrative purposes or for the development, construction, maintenance or repair of other tangible capital assets;
>
> (ii) have useful economic lives extending beyond an accounting period;
>
> (iii) are to be used on a continuing basis; and

(iv) are not for sale in the ordinary course of operations.

According to Bill Cox, C.A., a partner of BDO Dunwoody LLP, the water purchase fails to meet any of the components of the definition. In his view, accordingly, the fees paid to Nanaimo for bulk water under the agreement are not in respect of a capital liability and so the agreement is exempt from elector approval under section 6 of the Regulation.

We think the construction of the Lantzville Water System, including the connection of the Lantzville Water System to the Nanaimo Water System, constitutes a condition precedent to the agreement and not the incurring of a liability under the agreement. There is no obligation under the agreement to incur this liability - it is a discretionary election for a future Council, not a liability.

The outstanding issue, then, is the interpretation of section 14.1. In regard to whether this section creates a contractual capital liability beyond five years, we have several comments:

1. this is also a discretionary election for a future Council, not a liability under an agreement;

2. it was the express intention of the parties as agreed in meetings with Nanaimo and as recorded by you in your notes and in an email message to the City that if the agreement were to be triggered this section would not create ongoing capital liabilities, but that by consensus of the parties the section would protect Nanaimo for five years (due to the fact that connection charges under the agreement were frozen at 2011 levels until the first five years of the Term have passed, the rationale being that after five years the higher City of Nanaimo DCC rate which would cover all capital impacts of the Lantzville water system would start to apply) - accordingly, since the capital liability is limited to five years the elector approval requirement is not applicable;

3. there is no certain amount required by section 14.1 and no certain date, but this section is driven by *the extent* to which the District wishes to grow or otherwise impose new capital obligations on the City of Nanaimo and so the District for practical purposes can budget zero for this section;

4. the *making of the agreement* itself does not cause the District to incur a capital liability, in that none of the financial clauses including

section 14.1 are triggered unless Council at some future date passes a resolution that it is ready to accept water under the agreement and delivers a copy of the resolution to the City of Nanaimo: in this regard section 2.3 of the agreement says that Lantzville has no financial liability to Nanaimo under the agreement until the Commencement Date which is defined as when Lantzville delivers the Council resolution after completion *to Council's satisfaction* of the water system owned and operated by Lantzville to serve premises in Lantzville;

5. in any event, at the September 29, 2014 in camera meeting, I informed Council that I would take steps to remove or clarify section 14.1 since it fails to expressly reflect the agreement described in paragraph 1 above.

5.0 CONCLUSION

In conclusion, it is our opinion that the making of the agreement did not require the approval of the electors. Council may in its discretion voluntarily conduct an elector approval process or plebiscite, and in any event will have to get elector or owner approval for each local service area that it establishes in relation to each local area that may receive water in the future.