ENDEAVOR
CHARTERED ACCOUNTANTS

TIM L. ELL, B. Mgmt., C.A. *
JEFF M. FAUPEL, B. Mgmt., C.A.*
MONICA N. BACH. B. Mgmt., C.A.*

302-2nd Avenue W.
Box 2110, Hanna,
Alberta T0J 1P0
Phone: (403) 854-4421
Fax: (403) 854-2023

5015 Victoria Avenue
Box 720, Coronation,
Alberta T0C 1C0
Phone: (403) 578-4014
Fax: (403) 578-3561

INSPECTION REPORT

KNEEHILL REGIONAL WATER SERVICES COMMISSION

* denotes operating as a professional corporation.

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1. CREATION OF THE COMMISSION

a) Kneehill Regional Water Services Commission

The Commission was formed and was filed under the Regulations Act of Alberta Regulation 224/2003 on July 10, 2003 as contained in Appendix A indicating that Kneehill County, Municipal District of Rocky View No.44, Village of Acme, Village of Beiseker, Village of Carbon, Village of Irricana and Village of Linden were to members of the commission.

Appendix A also contains the Commission By-Law 1-2003 "being a by-law respecting the appointment of a board of directors and chairman, governing the fees to be charged by the Commission and the governance of administration of the Commission" signed by the Chairman and Secretary/Treasurer on August 11, 2003 and by Minister Boutilier on September 30, 2003.

2. DESIGN AND CONSTRUCTION OF CAPITAL PROJECT

a) Transmission Line Preliminary Design Report

Water issues had been well studied among the communities contained within the Kneehill County and the MD of Rocky View since the mid 1990's. Water quality issues, failing infrastructures, increasing population and other issues within a number of communities was a catalyst to attempts to structure intra-municipal arrangements and agreements in efforts to stabilize these water issues in efforts to find affordable solutions to these water problems.

In November, 2003 Stantec Consulting Ltd. prepared the Regional Water Transmission Line Preliminary Design Report for the Commission. The report includes detailed information on existing facilities, system water demands, system alignment, pipeline materials, system hydraulics, system components, construction issues, environmental overview, geotechnical overview, project design and construction schedule, project costs and conclusions and recommendations. This report was a significant underlying document for departments of the Alberta Government to approve the project, to provide grant funding for the project and provide further debt limit approvals for debt funding of the project. Given the size and complexity of this report, the Table of Contents, List of Tables and List of Figures has been reproduced and contained in Appendix B for reference.

b) Alberta Municipal Affairs Enables the Project

A time line of documents contained in Appendix C indicate the following :

- On November 19, 2002 Minister of Transportation Ed Stelmach advised Robert Jackson of the Village of Acme that the Government of Alberta has chosen to nominate the Kneehill Regional Water Line Project for Infrastructure Canada-Alberta Program (ICAP);
- On March 10, 2003 the Kneehill Regional Water Committee provided to Christina Parkins, Municipal Services, Alberta Municipal Affairs a breakdown of costs, operating budget, letters of support from each municipal forming the commission indicating approximately $29.4 million capital costs inclusive of GST for the project, anticipated grant funding of $19 million with an anticipated debenture financing need of $10.4 million;
- On July 11, 2003 Infrastructure Canada-Alberta Program advises Kneehill Regional Water Line-2002 has been approved;
- Pursuant to section 602.28 of the Municipal Government Act, Ministerial Order No. L:094/03 dated August 4, 2003 signed by Guy Boutilier, Minister of Municipal Affairs, authorizing the Commission to borrow <u>up to $11,000,000</u> to complete construction of a regional water transmission line;

- Pursuant to section 602.28 of the Municipal Government Act, Ministerial Order No. L:158/04 dated October 3, 2004 signed by Guy Boutilier, Minister of Municipal Affairs, rescinding Ministerial Order No. L:094/03, authorizing the Commission to borrow up to $15,000,000 to complete construction of a regional water transmission line.

As indicated in Appendix D, extracts of certain sections from the Municipal Government Act, section 602.28 indicates "no commission may make a borrowing if the borrowing will cause the commission to exceed its debt limit, unless the borrowing is approved by the Minister".

c) Water Supply Agreement Key to Project

Appendix E contains a copy of the Water Supply Agreement between the Commission and the Town of Drumheller signed June 15, 2004. Attached to this agreement is a copy of the License to Divert Water allowing the Commission to divert from the Red Deer River, through the works of the Town of Drumheller, 2,350,000 cubic metres of water annually. Key to this agreement is Schedule "C" on page 22, where it was determined that the Capital Contribution for the amount of water required in the agreement for the Commission was $2,400,000 and that the Commission was to pay on January 1, 2005 $1,200,000 as its first payment and the final payment of $1,200,000 by December 31, 2005.

d) Construction of the Project

Appendix F contains an analysis of the Capital Costs of the project as well as the grant and debt funding. This analysis was prepared from the audited financial statements of the Commission contained in Appendix G and Appendix H. This analysis clearly shows that the Transmission Line Project capital costs of $31,372,925 plus the Water Supply Contribution Agreement capital contribution agreement amounts to the Town Drumheller of $2,400,000 for a total project investment of $33,772,925 where more than offset by grants and debenture debt funding totaling $34,033,315. The facts support that the project was over-funded by $260,390. The project was substantially complete in September, 2005 with only a minor flow through of capital costs occurring in 2006.

During my examination of documents at the Commission, it was discovered that no comprehensive cost accounting evaluation was being performed by the manager of the Commission nor the Secretary/Treasurer of the Commission. Administration was totally unaware of the fact that the project was actually overfunded. In fact, the office manager, on direct testimony given by the Chairman of the Commission and other members of the Commission, were advised that the reason that they were having financial shortfalls was due primarily to escalating project construction costs. The analysis contained in Appendix F clearly shows that this is not the case.

Further, while Appendix F shows that the $2,400,000 for the Water Supply Contribution Agreement to the Town of Drumheller was fully funded, the Commission decided only to pay $600,000 of the final $1,200,000 on July 27, 2006 to the Town of Drumheller that was due on December 31, 2005. Information contained in Appendix E indicated that the Commission felt that the Town of Drumheller should recover the balance of the agreement over time through the water rate. This decision by the Commission was in complete violation of the aforementioned agreement. When I spoke with officials at the Town of Drumheller indication was made that the Town at no time ever agreed to this substantial change in the Agreement with the Commission. This fact was also verified in personal interviews with the Chairman of the Commission.

Accordingly, not only were the capital costs over-funded by $260,390 but the Commission had not paid the Town of Drumheller the additional $600,000 to finalize the agreement thus the Commission technically should have had $860,390 in surplus resources available to the organization.

Appendix K contains a copy of Bylaw #2003-03 authorizing the Commission to borrow up to $3,000,000 for short term obligations at the Alberta Treasury Branch on October 23, 2003. Contained in Appendix K is a "Commitment Letter" from the Alberta Treasury Branches to the Commission indicating this $3,000,000 facility continues to be available to the organization.

Given the fact above, one begins to question the responsibility of the decision not to pay the Town of Drumheller the remaining contact amount of $600,000. Whether the organization had somehow absorbed the surplus capital funding amounts on hand, evaluated to be $860,390, or not, the Commission had the ability to pay the amounts owed to the Town of Drumheller from credit facilities that were known to administration, the Chairman and all other members of the Commission.

3) POST CONSTRUCTION OPERATING ACTIVITIES

a) Period Ended December 31, 2005

i) Operating Activities Four Months Ended December 31, 2005

The 2005 results for the first four months of operations are contained as comparative figures in the December 31, 2006 audited financial statements in Appendix H. The Statement of Operations for 2005 shows an unexpected deficiency in operations of $276,786. I use the term "unexpected" for the following reasons:

1. 602.2(3) of the MGA, as reproduced in Appendix D, that Commissions formed operate on a income producing basis;
2. By-law 1-2003 contain in Appendix A 7.2(c) indicates that the budget prepared pursuant to the Act will set out the "estimated revenue requirements to <u>meet</u> the expenditures of the Commission and the rates and fees to be charged to Members and Customers of the Commission".

Section 602.2(1) of the MGA, as reproduced in Appendix D, dictates that an operating budget must include the estimated amount of expenses and transfers as detailed in the provision. Section 602.(2) of the MGA, as reproduced in Appendix D, dictates that an operating budget must include the estimated amount of all revenues and transfers as detailed in the provision. Section 602.2(3), as detailed above, dictates that revenues must at least be equal to expenditures.

Appendix L is an analysis of the 4 months of operating result and the appendix also contains an extract of the administration prepared 2005 budget determinations. A review of this analysis reveals the following facts:

1. Virtually no sales volume exists for the Kneehill County nor Municipal District of Rocky View No.44;
2. The budgeted sales volume for the other municipal participants was projected fairly accurately;
3. No costs of water were included in the Commissions prepared budget;
4. No maintenance fees were included in the Commissions prepared budget;
5. No operating supplies, repairs and maintenance nor utilities were included in the Commission prepared budget;

6. No long term interest expected of $210,261 nor the expected principal repayment amount of $87,687 was included in the Commission prepared budget;
7. Most administrative expenditures were contemplated in the Commissions prepared budget;
8. No interest revenue was included in the Commissions prepared budget;
9. Amortization of deferred water capital contributions, deferred capital asset contributions nor amortization of capital assets was included in the Commission prepared budget;
10. Given the current cost structure and with the water rate set at $2.45 per cubic meter, the breakeven volume would be 1,487,746, 13.15 times the existing level of water delivery, an impossibility.
11. While the audited Statement of Operations shows a current period deficit of $276,785.91, it appears the cash flow loss equivalent is ($306,829.07).

ii) 2005 Administration Prepared Budget

Based on the above prepared analysis the contracted Manager and the Secretary/Treasurer are in direct violation of the Commission By-Law 1-2003 in the negligent preparation of the 2005 budget given the magnitude of the missing budgeted expenditures as detailed above. Further, the Chairman and the members of the Commission are in violation of section 602.2(1) of the MGA in accepting a budget that they knew or should have known was severely deficient given the magnitude of missing expected operating expenditures, indicated above, that should have been included in the operating budget. Had the variety of expenditures been complete, major adjustments to the water rate or transfers from participating commission members would been required to be in compliance with section 602.2(3) of the MGA and By-law 1-2003 section 7.2(c).

iii) Municipal Water Consumption

Appendix M is a reproduction of Section 3 "System Water Demands" extract from the Stantec Consulting Ltd. Regional Water Transmission Line Preliminary Design Report. As discussed earlier, this report was the basis under which the transmission line was designed. The engineered design was based on system water demand information contained in Section 3 analyzing the per capital water demands, both for urban and rural municipal participants to the project. Table 3.7 the "System Design Flow Summary" showing specific user information anticipated for both urban municipal participants and the rural municipalities.

Based on extensive meetings and interviews with all municipal participants it was determined, through testimony given, that the Municipal District of Rocky View No.44 was given a water allocation of approximately 19%, the Kneehill County was given a water allocation of approximately 36% with the remainder of approximately 45% shared amongst the Village municipal participants. By inference, this means, that perhaps as high as 19% of the system cost design relates to the MD of Rocky View and 36% of the system cost design relates to Kneehill County.

Accordingly, 55% of the capital costs of $33.77 million as well as the related debt of $12.15 million relate to rural municipalities which, based on the 2005 audited financial statements contained in Appendix H and the related analysis in Appendix L delivery virtually no volume to the system.

This very issue became the subject of intense discussion and interviews with the municipal representatives of the MD of Rocky View, Kneehill County, the Chairman, the representatives of the other municipal participants and administration. The following represents the determined results of these discussions and interviews:

1. It was known to administration that there will be little development of volume from the MD of Rocky View and Kneehill County municipal participants with the exception of the Kneehill County water project that would delivery volume in certain future years but the volume would be fractional compared to the "System Water Demands" table previously discussed;
2. Administration felt, that given both the MD of Rocky View's and Kneehill's County's clear indication that they would only pay debenture payments amounts based on water consumption, that administration had no alternative than to try to find other alternatives to raising revenue, realizing that few alternatives truly existed;
3. The representative of Kneehill County indicated that there was a clear understanding among the commission members that Kneehill County's participation was in substance "name only" and that little support would be derived financially from the County until water volumes were delivered to the rural participants of the Kneehill County. This, despite having approximately 36% of the allocated volume of the system as previously evaluated.
4. The representative of the Municipal District of Rocky View No.44 viewed the relationship as only having value once volumes could be derived from the system, again, despite having an approximate 19% allocation of the volume of the system.
5. Most of the representatives of the Villages fully understood that the above mentioned municipalities would contribute little to the actual costs involved in the Commission given that they were not deriving any water volume to their municipal constituents. They further were fully aware, from the very outset of the formation of the Commission, that if the water rates was set at a level, based on the Village volumes of consumption alone, that the water rate would be unaffordable to their individual Village system and Village constituents. For this reason the water rate of $2.45/cu remained unchanged for years despite the mounting cash flow losses and operating deficits.

6. Certain representatives of Villages intimated to me their concern that they felt they could not challenge or force a vote at the Commission to effect change to any of the financial structure of the Commission as they were afraid of reprisal from the MD of Rocky View or the Kneehill County as it related to intra-municipal grants for recreation or other matters as a consequence of such a challenge.
7. The Chairman of the Commission was under the impression, based on, influenced by and convinced on information provided by the administration, that the financial problems of the Commission were purely related to cost overruns of the capital project requiring additional Alberta Government support to solve their financial situation.

Accordingly, based on this information provided and obtained:

- The administration knew or should have known that the information provided to Stantec Consulting Ltd. for "System Water Demands" for rural municipalities was not representative of the water flows reasonably achievable for sale by the Commission;
- The representatives of the Municipal District of Rocky View No.44 and the Kneehill County knew or should have known that the information provided to Stantec Consulting Ltd. for "System Water Demands" for rural municipalities was not representative of the water flows reasonably achievable for sale by the Commission.

With approximately 55% of the allocated water volume allocated to Rocky View and Kneehill, with the system designed based on volumes for these municipalities along with the financial debt structure based on this capital costs and with these municipalities not contributing financially representing this 55% based capital structure, it becomes readily apparent that from the outset of delivery of the first cubic meter of water, the system and the Commission would be in financial duress and Commission without change would not be financial feasible as a going concern.

iv) 2006 Ministerial Reaction to the 2005 Financial Results

Appendix N contains a letter to the Chairman of the Commission dated June 26, 2006 from Rob Renner, Minister of Municipal Affairs along with a copy of Ministerial Order No.L:123/06. This Ministerial Order was to allow a recovery period of 4 (four) years being 2006 through 2009 of the 2005 deficit in operations instead of the standard 3 (three) years as mandated under section 602.21 of the MGA. Accordingly, the deficit of $276,786 was to be recovered from 2006 to 2009 by inclusion of $276,786/4= $69,197 of additional budget expenditure in accordance with 602.2(1)(f) of the MGA and that revenues in accordance with section 602.2(3) would have to be obtained to at least cover the expenditures as determined in these annual budgets.

It will be shown subsequently in this report that administration, the Chairman and the Commission members interpreted this Ministerial Order to mean that they could incur unlimited deficits through the years 2006 to 2009 and that they had to have a balanced budget by 2010!

b) Year Ended December 31, 2006

i) Operating Activities Ended December 31, 2006

Appendix O provides an analysis of the 2006 operating result as well as contains an extract of the administration prepared 2006 budget. A review of this analysis reveals the following facts:

1. As in the prior year nominal sales volume exists for the Kneehill County and no sales occurred with the Municipal District of Rocky View No.44;
2. The budgeted sales volume for the other municipal participants was projected fairly accurately;

3. The budget contained an unusual payment from the Municipal District of Rocky View, relating to a two year payment agreement as contained in Appendix P, relating to amounts received during the "Balzac Development" deliberations. These amounts were not operational payments in nature and, accordingly, should have been outside of operational revenues for financial statement purposes and for purposes of the operational analysis;
4. The Commission was much more accurate in their 2006 budget on their projection of water sales that the prior year;
5. While the Commission had improved on their budgeting of direct costs, the administration was still having problems predicting utility expenditures;
6. The Commission continued in 2006 to understate the budget administrative expenditures. Between direct costs and administrative costs, the budget was understated by approximately $105,000;
7. The budget did not include any cash-flow provision for the repayment of principal on debentures of $278,831;
8. The budget did not contain any provision required under Ministerial Order L:123/06 for the recovery of the 2005 operational deficit of ($193,258) before amortization charges or ($276,786) after amortization charges or the cash flow deficit loss of ($306,829) as determined in Appendix L over the approved period of four years which in essence required the inclusion in expenses under section 602.1(1)(f) of the MGA.

ii) 2006 Administration Prepared Budget

As in the evaluation of the 2005 administration prepared budget, based on the above prepared analysis the contracted Manager and the Secretary/Treasurer are in direct violation of the Commission By-Law 1-2003 in the negligent preparation of the 2006 budget given the magnitude of the missing budgeted expenditures as detailed above. Further, the Chairman and the members of the Commission are in violation of section 602.2(1) of the MGA in accepting a budget that they knew or should have known was severely deficient given the magnitude of missing expected operating expenditures, indicated above, that should have been included in the operating budget. Had the variety of expenditures been complete, major adjustments to the water rate or transfers from participating commission members would been required to be in compliance with section 602.2(3) of the MGA and By-Law 1-2003 section 7.2(c). The following are the direct matters the above conclusions are based on:

- Inclusion of a non-operational grant for $240,000 when only $130,000, as per agreement, actually received, thus overstating revenue by $110,000 which would a created a deficit budget that would have been in contravention of section 602.2(3) of the MGA;
- Failed to included no less than ¼ of the 2005 operating deficit that was required under Ministerial Order L:123/06 issued July 5, 2006 which would have created an increase in the deficit budget that would have been in contravention of section 602.2(3) of the MGA;
- Failed to include the known and expected principal payments on debentures for 2006 of $278,831 which would have created an increase deficit budget that would have been in contravention of section 602.2(3) of the MGA.
- Failed to balance the annual budget as required under section 602.2(3) of the MGA and By-Law 1-2003 section 7.2(c).

iii) 2006 Audited Financial Statements and Audit Findings/Management Letter

Appendix H contains a copy of the 2006 audited financial statement and audit finding/management. A copy of these documents along with the audited Financial Information Return for the Commission for this year end would had been sent to Alberta Municipal Affairs. The following comments are germane to the review of these documents:

1. The audited financial statements, in particular the statement of operations did not disclose the unaudited budget information. Given that the primary users of the information are the municipal commission members and Alberta Municipal Affairs, the comparison of actual to budget comparison would have been useful in the circumstances to evaluate the continuing deterioration of financial and cash flows results;
2. The notes to the financial statements did not disclose the requirements of Ministerial Order No.L:123/06 nor did the notes to the financial statements disclose the need for the organization to recover the current operating deficit required in accordance with section 602.2 of the MGA;
3. The statement of operations included the payment of $130,000 received from the Municipal District of Rocky View as "Water sales to commission members" when in actual fact this material revenue should have been separately disclosed in relation to this contract agreement payment at least as an other separately described revenue;
4. The auditor expressed concern regarding the accuracy of the bank reconciliations prepared and thus the accuracy of the financial records and the fact that billings and collections for water sales was not always done in a timely manner. Discussions with commission members indicated that most of the time they little internal accounting information concerning the accurate revenue and expense operations of the Commission on a regular basis;
5. The auditor and the audit findings/management letter should have called attention to the Commission's non-compliance with Ministerial Order L:123/06, the fact that the Commission was not in compliance with section 602.2 of the MGA and the fact that during the Commission's 2007 budget preparation that not only will they have to include the recovery of 2/4 of the 2005 deficit that will also have to include for recovery under section 602.21(1) 1/3 of the 2006. While the auditors comment on the requirement to prepare a three year plan under Bylaw 1-2003 was

absolutely correct, the firm failed to direct action at the continued financial and cash flow demise that was occurring.

iv) Conclusions Regarding The Year Ended December 31, 2006

1. The Commission continued to hemorrhage cash incurring an estimated income deficit of \$439,560 and a cash flow deficit for the 2006 year of \$381,836 as determined in Appendix O evaluation and the audited financial statements contained in Appendix H;
2. The auditor continued to express concern over a number of Commission corporate governance issues that shows a number of continued weaknesses in accounting and internal controls at the Commission;
3. The Chairman and members of the Commissions continued to disregard the recommendations of their auditor in not insisting that the manager and Secretary/Treasurer make the necessary modifications in the accounting and internal controls at the Commission to improve their weaknesses as described;
4. The administration, the Chairman and the members of the Commission continued to show disregard for the required financial provisions of the Municipal Government Act and By-Law 1-2003 as described in this report during the 2006 operating period;
5. The administration, the Chairman and the members of the Board completely disregarded Ministerial Order No. L:123/06 whether intentionally or through misunderstanding of the reading of the order;
6. It was evident that no evaluations were initiated by the manager or the Secretary/Treasurer, similar to that prepared and contained in Appendix O, to clearly show that given the current water volumes of 420,000 cubic meters to the villages, the current sales price of \$2.45/cu.m. and the current costs of the Commission that a break-even volume of approximately 865,000

cubic meters, nearly double of actual, would be required. Further, no evaluation was presented to show that if the MD of Rocky View and Kneehill County had provided their 55% allocation share of water volume of relational sales that this would likely represent the volume needed to break-even;

7. The administration, the Chairman and members of the Commission continued to believe that their financial difficulties arose from capital cost over-runs resulting in higher than expected capital principal and interest payments and that the solution was to find new water volume outside of the water volumes projected in the engineered design of the project.

c) Year Ended December 31, 2007

i) Operating Activities Ended December 31, 2007

Appendix Q provides an analysis of the 2007 operating result as well as contains an extract of the administration prepared 2007 budget. A review of this analysis reveals the following facts:

1. As in the prior years nominal sales volume exists for the Kneehill County and no sales occurred with the Municipal District of Rocky View No.44;
2. The budgeted sales volume for the other municipal participants was projected fairly accurately but actual volumes dropping sharply from budget expectations;
3. The Commission was much more accurate in their 2007 budget on their projection of water sales and cost of sales that the prior year;
4. The Commission had vastly improved on their budgeting of direct costs and administrative expenses;
5. For the first time since commencement of operations the budget included provision for principal debt repayments of $228,831;

6. The budget did not contain any provision required under Ministerial Order L:123/06 for the recovery of the 2005 operational deficit of ($193,258) before amortization charges or ($276,786) after amortization charges or the cash flow deficit loss of ($306,829) as determined in Appendix L over the approved period of four years which in essence required the inclusion in expenses under section 602.1(1)(f) of the MGA;
7. The budget did not contain any provision required under section 602.21 of the MGA for the recovery of the 2006 operational deficit of ($103,006) before amortization charges or ($439,560) after amortization charges or the cash flow deficit loss of ($381,837) as determined in Appendix O over the period of three years which in essence required the inclusion in expenses under section 602.1(1)(f) of the MGA;
8. A deficit budget, as created by administration and approved by the Chairman and members of the Commission, is specifically not allowed under section 602.2(3) of the MGA.

ii) 2007 Administration Prepared Budget

Significant improvement in the preparation of the annual budget occurred in the preparation of the 2007 budget as a much superior effort had occurred to identify the expected revenues and expenditures and ensure a reasoned budget determination had been formulated. However, the contracted Manager and the Secretary/Treasurer are in direct violation of the Commission By-Law 1-2003 in the negligent preparation of the 2007 budget given the magnitude of the missing budgeted expenditures as detailed above. Further, the Chairman and the members of the Commission are in violation of section 602.2(1) of the MGA in accepting a budget that they knew or should have known was severely deficient given the magnitude of missing expected operating expenditures, indicated above, that should have been included in the operating budget. Had the variety of expenditures been complete, major adjustments to the water rate or transfers from participating commission members would been required to be in compliance with section 602.2(3) of the MGA and By-Law 1-2003 section 7.2(c). The following are the direct matters the above conclusions are based on:

- Failed to included no less than ¼ of the 2005 operating deficit that was required under Ministerial Order L:123/06 issued July 5, 2006 which would have created an increase in the deficit budget that would have been in contravention of section 602.2(3) of the MGA;
- Failed to included no less than 1/3 of the 2006 operating deficit that was required under section 602.21 of the MGA which would have created an increase in the deficit budget that would have been in contravention of section 602.2(3) of the MGA;
- Failed to balance the annual budget as required under section 602.2(3) of the MGA and By-Law 1-2003 section 7.2(c).

iii) 2007 Audited Financial Statements and Audit Findings/Management Letter

Appendix I contains a copy of the 2007 audited financial statement and audit finding/management. A copy of these documents along with the audited Financial Information Return for the Commission for this year end would had been sent to Alberta Municipal Affairs. The following comments are germane to the review of these documents:

1. The audited financial statements, in particular the statement of operations did not disclose the unaudited budget information. As previously indicated, given that the primary users of the information are the municipal commission members and Alberta Municipal Affairs, the comparison of actual to budget comparison would have been useful in the circumstances to evaluate the continuing deterioration of financial and cash flows results;
2. The notes to the financial statements did not disclose the requirements of Ministerial Order No.L:123/06 relating to the 2005 operating deficit, did not disclose that the Commission was not reactive to the requirements of section 602.21 of the MGA to recover 1/3 per year of the 2006

deficit nor did the notes to the financial statements disclose the need for the organization to recover the current operating deficit required in accordance with section 602.2 of the MGA;

3. The statement of operations continued to include the payment of $130,000 received from the Municipal District of Rocky View in the current year as "Water sales to commission members" when in actual fact this material revenue should have been separately disclosed in relation to this contract agreement payment at least as an other separately described revenue and would not to reoccur;
4. The financial statements continued to show the decision by the Chairman and members of the Commission not to pay the Town of Drumheller the contractual amount in arrears of $600,000 despite having the credit facility to do so;
5. The auditor clearly indicated to administration, to the Chairman and the members of the Commission that an independent solution to their continued deficits had to be obtained given that it was clear from correspondence from the Alberta Government that no further funds would be forthcoming and further given the results of the rejection of the Balzac project to the Commission.

iv) Alternatives for Water Rates Document

Contained in Appendix R is a working document created by the manager of the Commission to present to the Chairman and the members of Commission in September, 2007. The manager indicated in interviews that this document was meant to mobilize the members of Commission to critically review the options as the manager admitted he began to realize the situation could not continue. An examination of the document clearly indicated that it was not supported with direct analysis of financial results since operations began, break-even analysis or any other sophisticated evaluations that would typically be involved in such a critical review.

A critical review of the scenario's presented shows certain fundamental flaws in the information presented. Firstly, there are expenses that increase directly with increases in volume and certain expenses that within a relevant range vary little with volume. The cost of water alone, approximately \$.60 per cubic meter would represent an expense increase of 50,000 x \$.60=\$30,000 for each year shown in the managers evaluation, ignoring the effect of other variable expenses that would be affected. Secondly, such a critical evaluation of alternatives should have had a comprehensive cash flow projection by year, with all assumptions noted for reasonableness, with clear details of all variable and fixed expenses expected itemed with expected volumes so that the reader evaluating the proposals could determine the accuracy and reasonableness of the determinations. As it stands most of the financial information presented is mostly conjecture, a best guess without any foundation.

The manager did however attempt in scenario #5 an alternative to the very root of the deficit problem of the Commission. In this information the manager suggested that the rural municipalities would be responsible for 46% of the debenture debt, <u>being \$430,100 annually</u>. Based on the financial evaluation performed in this inspection, had this alternative scenario been pursued there would not have been any further financial difficulties.

It is my understanding that there was insufficient political will for this process to find alternatives so this particular examination collapsed.

v) Conclusions Regarding The Year Ended December 31, 2007

1. The Commission continued to absorb cash incurring an estimated income deficit of $515,861 and a cash flow deficit for the 2007 year of $581,970 as determined in Appendix Q evaluation and the audited financial statements contained in Appendix I;
2. The auditor reverted their concern from concerns over Commission corporate governance issues to that of the Commission's deteriorating financial condition;
3. The administration, the Chairman and the members of the Commission continued to show disregard for the required financial provisions of the Municipal Government Act and By-Law 1-2003 as described in this report during the 2007 operating period;
4. The administration, the Chairman and the members of the Board completely disregarded Ministerial Order No. L:123/06 whether intentionally or through misunderstanding of the reading of the order and rejected the requirements of section 602.21 of the MGA to recover 1/3 per year of the 2006 operating deficit;
5. It was evident that no evaluations were initiated by the manager or the Secretary/Treasurer, similar to that prepared and contained in Appendix Q, to clearly show that given the current water volumes of 391,454 cubic meters to the villages, the current sales price of $2.45/cu.m. and the current costs of the Commission that a break-even volume of approximately 904,000 cubic meters, more than double of actual, would be required. Further, no evaluation was presented to show that if the MD of Rocky View and Kneehill County had provided their 55% allocation share of water volume of relational sales that this would likely represent the volume needed to break-even;
6. The administration, the Chairman and members of the Commission continued to believe that their financial difficulties arose from capital cost over-runs resulting in higher than expected

capital principal and interest payments and that the solution was to find new water volume outside of the water volumes projected in the engineered design of the project. For the first time, however, information was presented to the Commission members as contained in Appendix R forcing the members to face the problem but it appears the process was rejected.

d) Year Ended December 31, 2008

i) Operating Activities Ended December 31, 2008

Appendix S provides an analysis of the 2008 operating result as well as contains an extract of the administration prepared 2008 budget. A review of this analysis reveals the following facts:

1. As in the prior years nominal sales volume exists for the Kneehill County and no sales occurred with the Municipal District of Rocky View No.44;
2. The 2008 budget operational revenues and operational expenditures was the most accurately prepared operational budget prepared since commencement of operations, with the exception of the deficit recovery items;
3. The budget did not contain any provision required under Ministerial Order L:123/06 for the recovery of the 2005 operational deficit of ($193,258) before amortization charges or ($276,786) after amortization charges or the cash flow deficit loss of ($306,829) as determined in Appendix L over the approved period of four years which in essence required the inclusion in expenses under section 602.1(1)(f) of the MGA;
4. The budget did not contain any provision required under section 602.21 of the MGA for the recovery of the 2006 operational deficit of ($103,006) before amortization charges or ($439,560) after amortization charges or the cash flow deficit loss of ($381,837) as determined

in Appendix O over the period of three years which in essence required the inclusion in expenses under section 602.1(1)(f) of the MGA;

5. The budget did not contain any provision required under section 602.21 of the MGA for the recovery of the 2007 operational deficit of ($188,115) before amortization charges or ($515,861) after amortization charges or the cash flow deficit loss of ($581,970) as determined in Appendix Q over the period of three years which in essence required the inclusion in expenses under section 602.1(1)(f) of the MGA;
6. A deficit budget, as created by administration and approved by the Chairman and members of the Commission, is specifically not allowed under section 602.2(3) of the MGA.

ii) 2008 Administration Prepared Budget

As in the prior year significant improvement in the preparation of the annual budget occurred in the preparation of the 2008 budget. However, the contracted Manager and the Secretary/Treasurer continue to be in direct violation of the Commission By-Law 1-2003 in the negligent preparation of the 2008 budget given the magnitude of the missing budgeted expenditures as detailed above. Further, the Chairman and the members of the Commission are in violation of section 602.2(1) of the MGA in accepting a budget that they knew or should have known was severely deficient given the magnitude of missing expected prior year deficit recovery expenditures, indicated above, that should have been included in the operating budget. Had the variety of deficit recovery expenditures been complete, major adjustments to the water rate or transfers from participating commission members would been required to be in compliance with section 602.2(3) of the MGA and By-Law 1-2003 section 7.2(c). The following are the direct matters the above conclusions are based on:

- Failed to included no less than ¼ of the 2005 operating deficit that was required under Ministerial Order L:123/06 issued July 5, 2006 which would have created an increase in the deficit budget that would have been in contravention of section 602.2(3) of the MGA;
- Failed to included no less than 1/3 of the 2006 operating deficit that was required under section 602.21 of the MGA which would have created an increase in the deficit budget that would have been in contravention of section 602.2(3) of the MGA;
- Failed to included no less than 1/3 of the 2007 operating deficit that was required under section 602.21 of the MGA which would have created an increase in the deficit budget that would have been in contravention of section 602.2(3) of the MGA;
- Failed to balance the annual budget as required under section 602.2(3) of the MGA and By-Law 1-2003 section 7.2(c).

Appendix T describes what would have been the effect on the water rate, excluding any other type of fiscal reaction that the Commission may have undertaken, had the Commission adjusted the water rate in accordance with section 602.2 of the MGA. As you can see, the water rate would have risen steadily from $2.45 in 2005 to an introductory rate of $3.42 for the 2009 year. Raising the water rate to such levels would not likely have occurred as rate would have likely had a volume reducing impact given the level. It is highly likely that insisting on municipal grant contributions to the Commission or other fiscal reactions would have had to occur when compared to water rate increases exclusively to correct the fiscal imbalance.

iii) 2008 Audited Financial Statements and Audit Findings/Management Letter

Appendix J contains a copy of the 2008 audited financial statement and audit finding/management. A copy of these documents along with the audited Financial Information Return for the Commission for this year end would had been sent to Alberta Municipal Affairs. The following comments are germane to the review of these documents:

1. As in prior years the audited financial statements, in particular the statement of operations did not disclose the unaudited budget information. As previously indicated, given that the primary users of the information are the municipal commission members and Alberta Municipal Affairs, the comparison of actual to budget comparison would have been useful in the circumstances to evaluate the continuing deterioration of financial and cash flows results;
2. The notes to the financial statements did not disclose the requirements of Ministerial Order No.L:123/06 relating to the 2005 operating deficit, did not disclose that the Commission was not reactive to the requirements of section 602.21 of the MGA to recover 1/3 per year of the 2006 deficit nor did the notes to the financial statements disclose the need for the organization to recover the current operating deficit required in accordance with section 602.2 of the MGA. The note should have also indicate that the Commission was not reactive to the requirements of section 602.21 of the MGA to recover 1/3 per year of the 2007 deficit nor did the notes to the financial statements disclose the need for the organization to recover the current operating deficit required in accordance with section 602.2 of the MGA.;
3. The statement of operations continued to include the payment of $130,000 received from the Municipal District of Rocky View in the prior year as "Water sales to commission members" when in actual fact this material revenue should have been separately disclosed in relation to this contract agreement payment at least as an other separately described revenue and would not to reoccur. This had a result of distorting the comparative sale of water information;
4. The financial statements continued to show the decision by the Chairman and members of the Commission not to pay the Town of Drumheller the contractual amount in arrears of $600,000 despite having the credit facility to do so;

5. The auditor clearly indicated to administration, to the Chairman and the members of the Commission their continued concern over fiscal matters and once again mentioned concern over accounting and internal controls as bank reconciliations were not completed correctly indicating a renewed concern over corporate governance matters.

iv) Conclusions Regarding The Year Ended December 31, 2008

1. The Commission continued massive deficit spending incurring an estimated income deficit of \$505,861 and a cash flow deficit for the 2008 year of \$443,403 as determined in Appendix S evaluation and the audited financial statements contained in Appendix J;
2. The auditor continued documenting their concern over the Commission's deteriorating financial condition as well as reiterated a part theme over certain governance concerns with the internal and accounting controls at the Commission;
3. The administration, the Chairman and the members of the Commission continued to show disregard for the required financial provisions of the Municipal Government Act and By-Law 1-2003 as described in this report during the 2008 operating period;
4. The administration, the Chairman and the members of the Board completely disregarded Ministerial Order No. L:123/06 whether intentionally or through misunderstanding of the reading of the order, rejected the requirements of section 602.21 of the MGA to recover 1/3 per year of the 2006 operating deficit and rejected the requirements of section 602.21 of the MGA to recover 1/3 per year of the 2007 operating deficit;
7. It was evident that no evaluations were initiated by the manager or the Secretary/Treasurer, similar to that prepared and contained in Appendix S, to clearly show that given the current water volumes of 411,053 cubic meters to the villages, the current sales price of \$2.45/cu.m.

and the current costs of the Commission that a break-even volume of approximately 746,000 cubic meters, more than one and a half times that of actual, would be required. Further, no evaluation was presented to show that if the MD of Rocky View and Kneehill County had provided their 55% allocation share of water volume of relational sales that this would likely represent the volume needed to break-even;

8. The administration, the Chairman and members of the Commission continued to operate in a state of denial choosing not to react to the myriad of financial challenges facing the commission.

4) CONCLUSIONS AND RECOMMENDATIONS

a) Accumulated Deficit

The apparent objectives of the urban municipal participants of the Commission were to solve water quality issues, have a stable reliable source of quality water, meet the needs of growing populations, create an affordable solution in an intra-municipal situation and other objectives. It appears that the rural municipal participants key objectives were to support the urban municipal participants within their boundary's, secure a water allocation within the water supply management system as a right for their participation for future use and for Kneehill County to obtain a quality source of water for their future distribution system network to its rural farm community. The water supply system was engineered, designed and constructed within an assumed framework of water delivery of approximately 45% allocation to urban participants and 55% allocation to the rural participants of the Commission. No one could have know, but for the municipal participants themselves, that despite the design report contained in Appendix M containing intensive livestock water demand information and other rural water demand information, that this system would highly likely not be available for volume within the system!!

It was known within the membership that the rural municipal participants were going to deliver very little volume to the system in the short run and near term periods. I verily believe that the rural municipal participants believed that supporting their urban municipalities was the right thing to do given the objectives of the communities and the water issues evident within the communities. They were, however, very careful in how they would support the Commission. In Appendix C, the letters of support from the Municipal District of Rocky View No.44 and Kneehill County include the following statement; "The terms include borrowing of funds from AMFC over a twenty-five year term at an interest rate not to exceed 8% that the cost of borrowing for principal and interest be included in the per cubic meter water service fee levied on its members of the commission and that the annual operating costs be paid on the metered use of water". The membership was aware that the intent of the rural municipal participants was to only pay payments on the servicing of the debenture only once they delivered volume to the system. This despite the rural municipal participants controlling 55% of the water allocation within the system and despite the fact that the cost of the system was directly related to their controlled water allocation.

It is readily apparent that the contract manager had poor financial evaluation skills given his inability to create a complete, accurate and appropriate financial budget for the Commission for 2005 and 2006. Had the contract manager had the necessary skills and had the members of the Commission demanded a proper cash-flow and income projection based on the above indicated facts, it would have been determined immediately that the Commission would have been in cash flow and financial difficulty. Based on approximately 400,000 cubic meters of delivered volume in a system with an annual diversion license (see Appendix E) of 2,350,000 cubic meters, representing 17% of the total system capacity, and the fact that the rural municipalities refused to contribute to the payment of the debenture debt, there was no way that the system could be self-sustaining from a cash flow perspective and the Commission's financial fate of hemorrhaging cash and deficits was its destiny.

i) Examination of Options

Option #1 – Increase Volume

Appendix U presents a determination of the estimated volume increase, by year of operation, that would have been required to eliminate the deficit. This option would require a decision by the members of the Commission on the division of the existing approximate $1,200,000 deficit.

Based on this analysis, sale volume would have to increase by approximately 50% in order for the Commission to have financially sustainable operations.

Based on information provided by the Commission members, there is virtually no likelihood that volumes could increase to this level in the near term.

Option #2 – Increase in Water Price

Appendix U provides an evaluation of the four year period ending December 31, 2008 indicating that, based on this evaluation, sales price of water would have had to increase to an average of $3.60 per cubic meter in order to break even for the period. This analysis assumes that no reduction in volume would have occurred to achieve break-even with such large increase in price. It would be highly probable that this assumption would be violated as many of the Commission members have already indicated that their communities are significantly curtailing and conserving water and reducing volumes.

Appendix T, as previously mentioned, also examines what the price of water would have been had the Ministerial Order been followed and subsequent deficits been budgeted for recovery as required under the Municipal Government Act. In this analysis, it shows the pricing rising to $3.42 by the end of 2008 had these regulations been followed. This analysis also assumes that had the pricing as noted been implemented, volume would not have been influenced.

It is highly probable that this level of price change could be a valid solution to the Commission given the reaction of the individual consumers of the Commission.

Option #3 – Reduction of Debt

What would debt have to be reduced to in order that the operations of the Commission, as currently occurring and constituted, would have to be for the Commission to be sustainable? Appendix U contains an evaluation of the debt reduction necessary to achieve a balanced budget. It appears that approximately 45% of the existing debt, being $5,100,000, plus the working capital deficit of approximately $1,145,000 would have to be eliminated for the Commission to be financially sustainable.

Option #3a – Debt Reduced by Alberta Government Grant

Appendix U presents the option that assuming no change in the price structure of water, the Alberta Government would grant the Commission $6,245,000 to solve its financial crisis. While this option has obvious appeal to the Commission members, it would ignore those member municipalities having direct or indirect responsibility for this very financial crisis arising.

Option #3b – Debt Reduced by Local Government Contributions

Appendix U presents a number of alternative calculations where the local government members of the Commission each had to satisfy the reduction of debt of $6,245,000 with the calculations based on equalized assessment, water allocation or evenly across each municipality.

The issue is whether each municipal participant has contributed to this crisis or whether certain municipalities have contributed more to the financial crisis than others. If you argue that each municipal Commission member have contributed to the financial crisis, then it would reasonable to likely conclude that the debt, under these considerations, should be divided based on water allocation percentages. To use equalized assessment would unduly penalize municipalities with large assessment basis. Using an equal percentage would unduly penalize small municipal participants and thus would not be a fair methodology in the circumstances.

Option #3c – Debt Reduced by MD of Rocky View & Kneehill County

An argument can be presented that the urban participants of the Commission have no direct responsibility relating to the annual operating and accumulating deficits as the primary reason for these deficit's occurring was the rural municipalities not providing any substantive water volume in relation to their water allocation. Information contained in Appendix V clearly shows that had these rural municipal Commission members either provided their 55% of the net water sales volume or had contributed 55% toward the annual payments of the debt debentures, there would be not Income Statement accumulated deficits over the years nor any Cash Flow deficits accumulated for the year. The Appendix V also shows that had these municipalities contributed in this way there would have been a possibility of reducing the cost of water from the $2.45 per cubic meter to as low as $2.13 per cubic meter in 2006 to $2.28 per cubic meter in 2008.

If this argument would be accepted, the $6,245,000 debt would be the exclusive responsibility of the rural municipalities.

Option #4 – Recover Accumulated Deficit Over Future Years

Perhaps a combination of Options 1, 2 and 3 could be formulated to determine an action plan of price adjustments in compliance with the MGA along with local government grants annually to achieve annual balanced budgets, achieve regular debt reduction and achieve recovery of accumulated deficits.

Appendix W includes a letter received from the Commission and the new Chairman presenting a plan to recover the "Accumulated Deficit" of $1,200,000 over a ten (10) year period, increase water billing rate to $3.00 per cubic meter and any yearly operational deficit to be recovered annually based on the members water allocation percentage. I commend the Chairman and other members of the Commission in their efforts to achieve a solution to this financial crisis. I am concerned over the period requested, concerned that the Village's are accepting 45% of the accumulated deficit that it could be argued they did not create, concerned that the Village's are accepting 45% of annual deficits that clearly if the rural municipalities are not contributing their 55% allocation share of debt repayments that they are forcing the Village to accept responsibility for the rural municipal members shortfalls and concerned that the Village's may be accepting such a proposal under duress a concern intimated to me in personal interviews.

b) Corporate Governance

Considerable discussion has been documented in this report concerning administration and the Chairman involving corporate governance issues. As a consequence, had the contract manager not resigned, this report would have called for the dismissal of the contract manager. Further, before any new manager is employed, the Commission should determine whether there is any valid reason to replace this position or whether a CAO of a participating municipal organization to the Commission could fulfill this role.

Further, I commend the organization in appointing a new Chairman to the Commission. I believe that it was time, during this period of examination and renewal, to have a new leader to focus on how to resolve this current financial crisis. The former Chairman should be recognized for his service and his effort given the difficult issues and times facing the Commission.

Finally, the auditor over the last number of years, has documented a number of internal and accounting controls and matters that effect the regular duties performed by your contract Secretary/Treasurer. The Chairman and the members of the Commission should demand that all services be performed in accordance with the By-laws of the organization and the Municipal Government Act.

c) Final Recommendations

There is little doubt that had the Village's involved in this Commission presented this water supply system that was to only involve their water usage volumes alone, the project would not have been approved or supported by the Alberta Government. Other alternatives to their water issues would have had to be determined and examined.

If it concluded that the Municipal District of Rocky View No.44 and Kneehill County's decision not to annually contribute in net water volume based on their 55% water allocation share nor to be responsible for their 55% share of the debenture debt is not appropriate and lead exclusively to the direct financial deficits of the Commission, then these rural municipalities and them alone should be held responsible for the financial demise of the Commission. If such is the case and these municipalities refuse to accept this responsibility in the formulation of the corrective financial planning and decisions, then the Minister, within his power, should consider dissolving the Commission back to an "Authority" thereby making each municipal participate responsible for their respective share of the Tangible Capital Assets and related indebtedness of the former Commission.

Report Signed:

Report Prepared By: Tim L. Ell CA

Report Finalized: January 17, 2010