WASTEWATER INTERIM REPORT NO. 1

CITY OF SAN DIEGO OFFICIALS' FAILURE TO DISCLOSE MATERIAL FACTS IN CONNECTION WITH THE OFFER AND SALE OF WASTEWATER BONDS AND RELATED IMPROPER ACTIVITY

REPORT OF THE

SAN DIEGO CITY ATTORNEY

MICHAEL J. AGUIRRE

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO

1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
TELEPHONE: (619) 236-6220

15 SEPTEMBER 2005

I.

INTRODUCTION

This Wastewater Interim Report No. 1 of the San Diego City Attorney demonstrates that San Diego City officials set wastewater rates that resulted in more than $120 million in overcharges to San Diego City residents during the seven-year period from 1998 to 2004.[1] The City's Metropolitan Wastewater Department (City Wastewater Department) included the inflated wastewater rates in bills mailed and sent to San Diego City ratepayers. When City officials set the proper rates in 2004, residential wastewater rates dropped about 25%.[2] The United States Securities and Exchange Commission (SEC) and the United States Grand Jury for the Southern District of California (Grand Jury) are investigating decisions by San Diego City officials related to the residential rate overcharges.[3]

Through its Wastewater Department the City owns and operates the Wastewater System, which consists of the Municipal System (City of San Diego) and the Metropolitan System (15 participating agencies located within the County of San Diego).[4] The Metropolitan System was designed to provide sufficient capacity to accommodate a population of 2.6 million. As presently designed, the Metropolitan System provides advanced primary treatment of sewage at its Point Loma Wastewater Treatment Plant and tertiary treatment of sewage at its North City Water Reclamation Plant.[5]

---

[1] Statements made in this Wastewater Interim Report No. 1 of the San Diego City Attorney reflect the opinion of the City Attorney and are not intended nor constitute any admissions by the City of San Diego in the lawsuit known by *Shames v. The City of San Diego*, San Diego Superior Court, Case No. GIC831539.

[2] Residential wastewater rates dropped from $3.62 to $2.56 per hundred cubic feet. 8 June 2004 Notice to City of San Diego Property Owners Regarding Water and Sewer Fees and Charges p. 2.

[3] 25 August 2005 US Grand Jury Subpoena requiring the City of San Diego to produce to the wastewater related writings; 30 June 2005 SEC Subpoena requiring the City of San Diego to produce wastewater related writings.

[4] The participating cities are Chula Vista, Coronado, Del Mar, El Cajon, Imperial Beach, La Mesa, Lemon Grove, National City, and Poway; the participating districts are Alpine-Sanitation District, Otay Water District, Padre Dam Municipal Waster District, Spring Valley Sanitation District, and Winter Gardens Sewer Maintenance District. Official Statement $315, 410,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1999A and Series 1999B, March 1, 1999 p. 21.

[5] Id. at p. 15.

The City Wastewater Department treats the wastewater from the City of San Diego and the 15 other cities and districts (called Participating Agencies)[6] from a 450 square-mile area with a population in excess of 2.2 million. An average of 180 million gallons of wastewater is treated every day of the year.[7] The Municipal System (City of San Diego) comprises approximately 2,544 miles of trunk and collector mains, 82 sewer pump stations, and 14 storm water interceptor pump stations serving more than 250,000 customer accounts. Eighty-two percent (82%) of these accounts are single-family dwellings; 12% are multi-family dwellings, and the remaining 6% are commercial and industrial customers. On average these accounts generate 138 million gallons per day (MGD) of wastewater that the Municipal System conveys to the Metropolitan System for treatment and disposal.[8]

II.

WASTEWATER SYSTEM CAPITAL IMPROVEMENTS PROGRAM

In July 1988, the City of San Diego was sued by the federal government and State of California for alleged violations of the Clean Water Act in connection with the City's operation of the Wastewater System. The City, as a result of the legal proceeding, was required to make substantial capital improvements to the Wastewater System. Thus, in 1993, the City embarked on a major capital improvement program for its Wastewater System.

These capital improvements included an upgrade and expansion of the digester facility, the chemical feed, headworks, odor control, and grit removal systems, and the construction of a new maintenance building at the Point Loma Plant.[9] The capital improvements included a pump station, force main, and associated sewer pipelines to convey wastewater at the South Bay Conveyance System and the construction of the South Bay Water Reclamation Plant, the Mission Valley Water Reclamation Plant, and the South Bay Wastewater Treatment Plant. Further, the plan called for new interceptor lines and pump stations, major interceptors in North and South San Diego, a centrate treatment facility, and an environmental monitoring and technical services laboratory, repairs and upgrades at the Point Loma Plant, the replacement of deteriorated concrete sewer collector lines, and rehabilitation of sewer pumping stations.[10]

These capital improvements were paid for in part by federal and state grants and loans of over $300 million.

---

[6] City of San Diego Metropolitan Wastewater Department website.

[7] Id.

[8] Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1999A and Series 1999B, March 1, 1999 p. 15.

[9] Id. at pp. 27-29.

[10] Id.

III.

CONDITIONAL FEDERAL AND STATE LOANS AND GRANTS FOR SAN DIEGO CAPITAL IMPROVEMENTS

To help pay for the capital improvements to the Wastewater System the City of San Diego applied for and received federal Environmental Protection Agency (EPA) grant funds under the Clean Water Act and loan funds from the State of California.[11] As a condition of receiving these loan and grant funds, the City of San Diego agreed to adopt a user-based system for charging wastewater rates.[12]

In essence the City agreed to enforce federal and state conservation policies that require wastewater rates to be based on the ratepayer's actual use of the wastewater system. This was expressly required of the City in order to receive the grants and loans. Under the user-based formula, the more a wastewater ratepayer used the system the higher the total charge to the ratepayer.[13] A 1991 letter from State Water Resources Control Board (State Water Control Board) approved the City's participation in the loan program.[14] This participation triggered the specific conditions of the loan program in addition to EPA regulations.[15]

These federal and state user-based rate schemes were designed to encourage conservation and avoid waste. The City applied for or received over $368 million in loans and grants from federal and California state sources to pay for capital improvements to the Wastewater System.[16]

/ / /

/ / /

/ / /

---

[11] Id. at p 22.

[12] Id. at pp. 22-23.

[13] Id. at pp. 22-23.

[14] Letter from SWRCB, Ronald Blair, to City of San Diego, dated September 18, 1991.

[15] Page 4, Section 17 of the loan contract between SWRCB and the City of San Diego requiring compliance with Section 204 (b) (1) of the Clean Water Act and the related Code of Federal Regulations, 40 CFR § 35.929-2 and 40 CFR §35.2140.

[16] 16 March 2004 memorandum from Richard Enriquez to Dennis Kahilie re: Grants Loans Info; 14 November 2002 Attorney-Client Memorandum from Mary Vattimo and Kelly J. Salt to the Honorable Mayor and City Council.

IV.

26 NOVEMBER 2003 NOTICE OF FAILURE TO IMPLEMENT WASTEWATER USER CHARGE

On 26 November 2003 the State Water Resources Control Board notified the City of San Diego that it had not implemented the user rate system that was previously promised in 1991. Ronald R. Blair, a Sanitary Engineer Associate for the State Water Control Board, wrote in a 26 November 2003 letter to San Diego City Manager Michael T. Uberuaga that he [Mr. Blair] "was unable to find any documentation indicating that the City implemented their wastewater revenue program approved by [the State Water Resources Control Board] on September 17, 1991."[17]

Mr. Blair reiterated in the 26 November 2003 letter that the City had received the capital improvement loans and grants on the express condition that the City adopts a wastewater rate user-based system:

> Implementation and maintenance of the wastewater user charge system is a condition of both federal Clean Water Grants and state SRF loans. The wastewater user charge system must conform to the requirements of Clean Water Grants regulations for the useful life of the grant funded facilities. The user charge system must also conform to the requirements contained in SRF loan contracts until the loans are discharged. [Note: the grant requirements and loan requirements are the same except for the termination date.] In addition, your agency must maintain records necessary to document compliance with these requirements. [Emphasis added.]

The City had not complied with the express conditions and did not have the records necessary to show such compliance. Mr. Blair's 26 November 2003 letter brought to an end the 7-year effort by City officials to delay the implementation of a user-based system.

V.

WASTEWATER SYSTEM REVISED IN 1998 TO PROVIDE FOR USER BASED RATES NOT ADOPTED FOR SAN DIEGO UNTIL 2004

State authorities had, previous to November 2003, found the City to be out of compliance with the user-based system for setting wastewater rates. In 1994, State Water official Ron Blair discovered during an inspection in San Diego that the City's Wastewater Department had not implemented a user-based rate system as required under federal and state laws. Mr. Blair had visited San Diego to inspect and audit the City's compliance with the Federal and State user-based billing requirements. Mr. Blair discovered the City had not adopted a user-based rate system for the Participating Agencies during his inspections:

---

[17] Letter from SWRCB, Ronald Blair, to City of San Diego, dated Nov. 26, 2003.

In addition, the City must adopt the following charges to bring its wastewater user charge system into compliance with the requirements of the existing and past Clean Water Grants.

a. The City must modify their agreements with all the participating agencies to include for BOD and TSS content as well as flow discharge into City facilities.

b. The City must include septage discharges into their rate ordinance/resolution. The City is accepting discharges from septage haulers. However, I was unable to find any mention of septage haulers in the City rate codes.

c. The City must develop forecast unit costs, including markups, for wastewater flow, BOD removal and TSS removal. These unit costs should be based on the prior year's costs and forecast increases. The forecast unit costs must be transmitted to all participating agencies as soon as possible each year to allow them to implement any needed rate adjustments prior to the start of the next fiscal year.

Please provide the information requested in Items 103, above and a timetable for compliance with items a-c by November 1, 1994.[18]

Between 1994 and 1998, San Diego City officials developed a user-based rate system for the Participating Agencies. However, they failed to adopt a user-based system for the City of San Diego. Thus, in 1998, the City entered into a joint agreement, known as the "Regional Wastewater Disposal Agreement" with the Participating Agencies which included a cost for "organics." This agreement purportedly resolved the State water officials' concerns. In a 30 September 1998 letter from Mr. Blair to San Diego City officials, Mr. Blair wrote:

I have reviewed the executed contract, submitted with your letter of August 31, 1998, between the City of San Diego (City) and the 15 Participating Agencies for treatment and disposal of wastewater in the City's Metropolitan Sewerage System.

The contract as submitted by the City appears to comply with requirements of the Water Resources Control Board's Revenue Regulations.[19]

Thus, by 1998, the user cost of removing organics was factored into billing for the Participating Agencies. However, the City failed to adopt for the City of San Diego a user-based

[18] Blair letter to City of San Diego, City Manager, Jack McGrory, dated September 30, 1994.

[19] Blair letter to City of San Diego, Ms. Hedy Griffiths, Supervising Management Analyst, Agency Contracts, dated September 30 1998.

rate system for organics in 1998 when it implemented one for the Participating Agencies. The City's failure to so act was recorded in the 23 November 2003 letter from Mr. Blair to City officials:

> While reviewing the files for the above referenced projects, I was unable to find any documentation indicating the City implemented their wastewater revenue program approved by this office on September 17, 1991.
>
> Implementation and maintenance of the wastewater user charge system is a condition of both federal Clean Water Grants and state SRF loans… [Note the grant and loan requirements are the same except for the termination date.] In addition your agency must maintain records necessary to document compliance with these requirements.
>
> Please submit a copy of the City ordinance (or resolution) adopting the wastewater rate system that was previously approved. The rate system must generate sufficient revenue to fund the annual operation and maintenance of the wastewater facilities and charges must be based on each user's (or user group's) proportionate contribution to total flow, BOD (or COD) and TSS loadings.[20]

As developed infra, the result of the failure by city officials to adopt a user-based rate system for organics resulted in substantially higher rates for residents and lower rates for certain commercial users of the system.

VI.

CITY OFFICIALS ENGAGE IN DILATORY TACTICS TO AVOID USER-BASED RATES FOR ORGANICS

City of San Diego officials engaged in a series of dilatory tactics to avoid implementing a user-based system that included organics over a 7-year period, from 1998 to 2004. Dennis Kahlie, the City's Utilities Finance Administrator, detailed the pertinent facts in a document entitled "Salient Points Sewer Cost of Service Compliance Issue, November 11, 2002:"

- The municipal billing structure was not brought into compliance with SWRCB requirements in 1997 because of concerns about the adverse impact of so doing on certain large volume dischargers of organics in a then-soft economy. SWRCB (State Water Control Board) did not take issue with this situation because it was under the mistaken impression that the PA (Participating Agencies) billing structure it had approved was applicable to the City's municipal users as well.

[20] Blair letter to City of San Diego, Mr. Michael Uberuaga, City Manager, dated November 26, 2003.

- In the fall of 1999, pursuant to a request by then-council member Kehoe, who was concerned that residential ratepayers might be subsidizing other sewer users, the manager was directed to prepare, with the assistance of a mayor-appointed stakeholders' group, a cost of service study which would address both user and capacity charge equity issues and set the stage for the structural changes which would bring the municipal billing structures into compliance with SWRCB [Water Control Board] requirements.

- In October 2002, then-City Attorney Casey Gwinn issued an opinion regarding the City's obligation to comply with the Water Control Board's billing requirements. This opinion indicates that the City would suffer significant exposure to litigation if it failed to comply with federal and state loan and grant guidelines and recommends that the City bring its sewer rates and charges into compliance with those guidelines.

The 14 May 1998 Sewer Cost of Service Report prepared by PinnacleOne-Chester Engineers, the City's retained expert, informed City officials of the continuing failure to implement a user-based rate system that included organic removal charges:

> The City's current system bills sewer customers within the City on their flow and suspended solids contributions to the system. However, the organic strength of the sewage is not factored into sewer bills for City customers. Participating Agencies in the Metropolitan sewer system are billed on the basis of flow, suspended solids and organic strength.
> . . . .
> Changes are made so that costs are allocated within the City to individual customers classes so that the revenue generated by each user class is in proportion to the customer's demand on the system. Annual revenue requirements for the Metro wastewater system and the City's Municipal . . . wastewater system through 2003 were provided by the City for use in determining rates that would be charged to users that reflect their contributions to flow, suspended solids and organic strength.[21]

Again, in January 2002, City officials were informed of the fact that the City was not in compliance with the user-rate-based system. A 15 January 2002 draft cost-of-service study by City-retained experts Black and Veatch also informed City officials of the continuing need to include an organics charge in order for the city to comply with the user-based rate requirement. On 29 January 2002, the San Diego City Council voted in closed session not to release this sewer rate study. (Councilmember Donna Frye provided a timeline to the City Attorney's office detailing these events.) The vote was 6-2, with Councilmembers Donna Frye and George Stevens voting to release the report and Councilmember Scott Peters absent.[22]

---

[21] City of San Diego Sewer Cost of Service Report, PinnacleOne 14 May 1998, p. 1.

[22] Closed Session Report of 29 January 2002.

At a 14 May 2002 City Council meeting former Mayor Dick Murphy said the City Council had not discussed a sewer cost of service study. The former Mayor inaccurately stated that the only discussion had been an informal one. In fact, as set forth above, the Mayor voted against releasing the cost of service study at a closed session on 29 January 2002 . On 18 November 2002, Ms. Frye wrote a letter to City Attorney Gwinn in which she raised questions about the legality of scheduling closed session meetings to discuss wastewater rates.[23]

The above sequence of events was described by large wastewater discharger, International Specialty Products Inc. representative David McKinley in a 2003 letter:

> Our goal is to maintain the status quo by preventing the COD charge issue from moving forward. Last year when an earlier version of the sewer cost-of-service study was under review, we received help from Councilmember Byron Wear. He championed the issue, and persuaded all Council Members except Donna Frye to vote in closed session to table the study indefinitely, along with COD charges. So we have a history of council support.
>
> This year, possible ways to prevent the adoption of COD charges are to request the City Manager directly to delete COD charges from the cost-of-service study, to ask the Mayor to so direct the City Manager, to ask Councilmember Frye to so direct the City Manager, or to ask assistance from Jim Madaffer in tabling the study, (chair of the Natural Resources and Culture Committee). We could also ask help from any of the other council Members who voted with Wear last year, including Scott Peters, Brian Maienschein, Ralph Inzunza and Toni Atkins.[24]

Moreover, documents related to the 1998 PinnacleOne report dating from as far back as 1999 paint a similar picture of delay regarding the implementation of a legal rate structure. Internal memoranda and letters from the City Attorney's office were not presented, though prepared for the benefit of Councilmember Christine Kehoe, were not finalized. These letters and documents were not finalized.[25] Instead, Ms. Kehoe was orally briefed and promised that the City manager would take further action.

/ / /

/ / /

---

[23] Letter from Councilmember Donna Frye to City Attorney Casey Gwinn, dated 18 November 2002.

[24] Letter from David McKinley, Manager, Environmental, Safety & Health for ISP, Inc., to Larry Dolson, Business Representative, Operating Engineers Local 501, dated 4 August 2003.

[25] Draft memoranda and letter dated "November" from City Attorney to Kehoe.

VII.

MISREPRESENTATIONS AND OMISSIONS OF MATERIAL FACTS FROM THE BOND OFFERING DOCUMENTS

As noted, the requirements associated with the federal grants and state loans date back, at a minimum, to the 1991 participation of the City with the State Revolving Loan program and the SWRCB.[26] These grants and loans are subject to the requirements user charge system described in the loan contract and the federal regulations associated with the acceptance of federal grant money.[27] Despite the mandates of the loan contracts and federal regulations, as well as notice of the need to comply by adding organics contained in the SWRCB letter of November 1994[28] and specific statement of noncompliance in the PinnacleOne study (1998), the City did not fully disclose the same in its 1999 sewer bond offering. Specifically in contrast to the requirement of organics described in the 1998 PinnacleOne study, the City's 1999 bond offering states:

> As another condition of its past receipt of receipt of federal grants, the State Board, as the delegate of the EPA, must approve the sewer service charge structures of the City and Participating Agencies. Such service charge structures require the recovery of annual operations… from users of the system in a proportionate manner according to the customer's level of use. Such factors as volume, infiltration/inflow, delivery flow rate, and strength of sewage are to be considered for determining proportionate use…. *The City's rate structure has been reviewed by the State Board and no grant funds or costs under grant funded programs have been disallowed based on the nature of the rate structures.* [Emphasis added.] [29]
>
> …
>
> The City believes that is in compliance with all federal and state laws relating to the Wastewater System.[30]

Instead of advising the bond market of the lack of an organic component and thus the noncompliance of the sewer rate system, the 1999 bond disclosure glosses over the obvious non-compliance.

---

[26] The federal grants are jointly administered by the EPA and the SWRCB, but primary responsibility is with the SWRCB.

[27] See letter from SWRCB, Ronald Blair to City of San Diego, dated September 18, 1991.

[28] Blair letter to City of San Diego, City Manager, Jack McGrory, dated September 30, 1994.

[29] Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, series 1999A and Series 1999B dated March 1, 1999, page 22-23.

[30] Public Facilities Financing Authority if the City of San Diego, sewer Bonds, series 1999A and Series 1999B, Dated March 1, 1999, page 22-23.

Similarly, the language used by the City in its inchoate 2003 bond offerings parroted the same language used in the 1999 Sewer Bond offerings: *The City's rate structure has been reviewed by the State Board and no grant funds or costs under grant funded programs have been disallowed based on the nature of the rate structures.* [Emphasis added.][31]

Further evidencing the City's awareness and lack of candor in its Sewer Bond disclosures is reflected in the communications between council members and the City Attorney. For example on November 15, 1999, the City Attorney, Casey Gwinn, was advised that "As you noted, the Cost-of-Service Report and Ms. Kehoe's memo present significant issues on the City's sewer rate structure."[32] The context and relevant time of this memo implies the discussion of the Cost of Service Report relates to the 1998 PinnacleOne Study.

The City's public facilities financing documents required the City to disclose any noncompliance of its sewer rate structure with the user-based requirements. The noncompliance of the actual rates charged was a risk to the bond financing because the loan and grants allowed for the State of California to make the City immediately repay the grants and loans received. Also the City was at risk for a lawsuit by those affected by the noncompliance of the sewer rate billing system.

Likewise, subsequent bond disclosures, though more specific regarding potential non-compliance, did not prompt the City to act upon the need to comply with the loan and grants. Thus, simultaneously there was a continuing subsidizing of high organic dischargers at the expense of lower organic discharges within the City.

VIII.

THE DUTY TO DISCLOSE MATERIAL FACTS

In Interim Report No. 2 of the City Attorney Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials, the legal standards were set forth regarding the duty of public officials and public bodies to disclose material facts in their offering materials. It is instructive to review those standards as they pertain to the disclosures made by the City with respect to the Wastewater System.

Securities & Exchange Rule 10(b)-5 prohibits the making of material false statements and the omission of facts needed to make statements not misleading:

---

[31] Preliminary Official Statement, dated August 26, 2003, Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, series 2003A and Series 2003B page 27.

[32] November 15, 1999 Memo from Deputy City Attorney, Ted Bromfield, to City Attorney Casey Gwinn.

Rule 10b-5 -- Employment of Manipulative and Deceptive Devices

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

a. To employ any device, scheme, or artifice to defraud,

b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[33] [Emphasis added.]

The United States Securities & Exchange Commission [SEC] has brought enforcement cases against public officials and public bodies relying upon Rule 10(b)-5 and other antifraud provisions of federal securities law.

A critical SEC enforcement action involved Orange County. *In re County of Orange, California; Orange County Flood Control District and County of Orange, California Board of Supervisors*, Securities Act Release No. 7260, Exchange Act Release No. 36760, A.P. File No. 3-8937 (January 24, 1996), *Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors*, Exchange Act Release No. 36761 (January 24, 1996); *SEC v. Robert L. Citron and Matthew R. Raabe*, Civ. Action No. SACV 96-74 GLT (C.D. Cal.), Litigation Release No. 14792 (January 24, 1996) (complaint), *SEC v. Robert L. Citron and Matthew R. Raabe*, Litigation Release No. 14913 (May 17, 1996) (settled final orders). As detailed below, the application of the SEC enforcement action against Orange County officials was brought to the attention of San Diego City officials. City of San Diego officials, the Mayor and Council were told they could not authorize disclosure that the official knows to be false nor could they authorize disclosure while recklessly disregarding facts.[34]

Other relevant cases brought by the SEC against public entities and officials include the Boston cases (*In the Matter of the Massachusetts Turnpike Authority and James J. Kerasiotes*, Securities Act Release No. 8260, A.P. File No. 3-11198 (July 31, 2003); *SEC v. Robert D. Gersh, Boston Municipal Securities, Inc., and Devonshire Escrow and Transfer Corp.*, Civ. Action No. 95-12580 (RCL) (D. Mass.), Litigation Release No. 14742 (November 30, 1995) (complaint); *SEC v. Robert D. Gersh, Boston Municipal Securities, Inc., and Devonshire Escrow and Transfer Corp.*, Litigation Release No. 15310 (March 31, 1997) (settled final order); the Pennsylvania case (Injunctive proceedings *SEC v. David W. McConnell*, Civ. Action No. 00CV-

[33] 13 FR 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951.

[34] 6 November 2001 Closed Session Report and 29 October 2001 letter from Brian Cave L.L.P.

2261 (E.D. Penn.), Litigation Release No. 16534, AAE Release No. 1254 (May 2, 2000); the San Antonio case, *SEC v. San Antonio Municipal Utility District No. 1, et al.*, Civ. Action No. H-77-1868 (S.D. Tex.), Litigation Release No. 8195 (November 18, 1977) (settled final order); the State of Washington cases, *SEC v. Whatcom County Water District No. 13, et al.*, Civ. Action No. C77-103, (W.D. Wash.), Litigation Release No. 7810 (March 7, 1977) (complaint); *SEC v. Whatcom County Water District No. 13, et al.***,** Litigation Release No. 7592 (May 10, 1977) (settled final order); *SEC v. Washington County Utility District, et al.*, Civ. Action No. 2-77-15 (E.D. Tenn.), Litigation Release No. 7782 (February 15, 1977) (complaint), *SEC v. Washington County Utility District, et al.*, Litigation Release No. 7868 (April 14, 1977) (default entered).

Additional cases have been brought by the SEC: *SEC v. Reclamation District No. 2090, et al.*, Civ. Action No. 76-1231-SAW (N.D. Cal.), Litigation Release No. 7460 (June 22, 1976) (complaint); *SEC v. Reclamation District No. 2090, et al.*, Litigation Release No. 7551 (September 8, 1976) (settled final order); *In re Newport-Mesa Unified School District*, Securities Act Release No. 7589, A. P. File No. 3-9738 (September 29, 1998); *In re City of Moorhead, Mississippi*, Securities Act Release No. 7585, Exchange Act Release No. 40478, A.P. File No. 3-9724 (September 24, 1998); Securities Act Release No. 7616, Exchange Act Release No. 40770, A.P. File No. 3-9724 (December 10, 1998); *In re City of Carthage, MS., et al.*, Securities Act Release No. 40194, A. P. File No. 3-9650 (July 13, 1998) (administrative cease and desist proceedings against 38 municipalities and settled administrative orders); *In re County of Nevada, City of Ione, Wasco Public Financing Authority, Virginia Horler and William McKay*, Securities Act Release No. 7503, Exchange Act Release No. 39612, A.P. File No. 3-9542 (February 2, 1998).

Additional cases brought by the SEC against government bodies and public officials include: enforcement actions have been brought against officials in Miami, Florida *(In the Matter of the City of Miami, Florida, Cesar Odio and Manohar Surana*, Securities Act Release No. 7741, Exchange Act Release No. 41896, A.P. File No. 3-10022); *In re County of Nevada*, Securities Act Release No. 7535, A.P. File No. 3-9542 (May 5, 1998); *In re Wasco Public Financing Authority*, Securities Act Release No. 7536, A.P. File No. 3-9542 (May 5, 1998); *In re City of Ione*, Securities Act Release No. 7537, A.P. File No. 3-9542 (May 5, 1998); *In re City of Syracuse, New York, Warren D. Simpson, and Edward D. Polgreen*, Securities Act Release No. 7460, Exchange Act Release No. 39149, AAE Release No. 970, A.P. File No. 3-9452 (September 30, 1997); *In re Maricopa County*, Securities Act Release No. 7345, Exchange Act Release No. 37748, A.P. File No. 3-9118 (September 30, 1996); *In re Maricopa County*, Securities Act Release No. 7354, Exchange Act Release No. 37779, A.P. File No. 3-9118 (October 3, 1996).

Cases that have focused on public officials brought by the SEC also include: *SEC v. Larry K. O'Dell*, Civ. Action No. 98-948-CIV-ORL-18A (M.D. Fla.), Litigation Release No. 15858 (August 24, 1998) (settled final order).

/ / /

/ / /

IX.

MATERIALITY

The United States Supreme Court has found that for information to be material there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available. *TCS Industries, Inc. v. Northway, Inc.,* 426 U.S. 438, 449 (1976). [Emphasis added.]

For financial statements, misstatements or omissions of facts are material when:

> [T]he magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.[35]

In addition to the Rule 10(b)-5 prohibitions, Exchange Act Rule 15c2-12 prohibits the underwriting of municipal securities unless the underwriters have reasonably determined that the issuers for whom they are providing underwriting services have undertaken to provide the marketplace with certain required on-going information.[36] The participating underwriter must determine that the contractual undertaking meets the standards of the rule.[37] Rule 15c2-12 creates a duty to update annually the financial information and operating data that are set forth in the final official statement. The anti-fraud provisions should be viewed as the standard of care for the preparation of the annual disclosures required by Rule 15c2-12.[38] When a municipal issuer releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions.[39]

/ / /

/ / /

/ / /

/ / /

---

[35] Statement on Auditing Standard no. 47, Audit Risk and Materiality in Conducting an Audit (AU 312.10). (Exhibit 70.)

[36] Exchange Act Release No. 34,961 (Nov. 10, 1994).

[37] Fippinger, Robert A., *The Securities Law of Public Finance*, 6:5.1 (6-42).

[38] Fippinger, Robert A., *The Securities Law of Public Finance*, 6:5.2 (6-44).

[39] Fippinger, Robert A., *The Securities Law of Public Finance*, 6:5.2 (6-45); Release No. 33-7049 (9 March 1994).

X.

SAN DIEGO WASTEWATER BOND ISSUANCES AND CONTINUING DISCLOSURE REPORTS---1995 TO 2003

During the period 1995 to 2003, the City issued or proposed to be issued bonds to finance capital improvements for both the Municipal Wastewater System and the Metropolitan Wastewater System.

In December 1995, the City caused to be issued its $350,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1995 (the "1995 Bonds"). In March 1997, the City caused to be issued its $250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B [the "1997 Bonds"]. In March 1999, the City caused to be issued its $315,410,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1999A and Series 1999B [the "1999 Bonds" and collectively with the 1995 Bonds and the 1997 Bonds, the "Sewer Bonds"]. Proceeds of the Sewer Bonds were applied, among other things, to the design, engineering, land acquisition, and construction costs of certain capital improvements for both the Municipal and the Metropolitan Wastewater Systems.

In addition, the City prepared to issue its $505,550,000 aggregate principle amount of Public Facilities Financing Authority of the City of San Diego Subordinated Sewer Revenue Bonds, Series 2003A and 2003B (the "2003 Bonds") to pay for certain capital improvements for both the Municipal and Metropolitan Wastewater Systems. However, upon learning that certain information in the City's audited financial statements for the year ending June 30, 2003 were incorrect, the City withdrew the 2003 financing from the market place.

During the period 1995-2003, the City filed its Annual Reports for the Sewer Bonds. The Annual Reports were designed to provide to investors certain financial information and operating data, including audited financial statements for the Sewer Revenue Fund and other tabular information. On March 26, 2004, the City filed its Annual Report for the Fiscal Year ended June 30, 2003, covering the Sewer Bonds. But the 2004 Annual Report, in addition to the information required by the Annual Reports, included information under the caption "Supplemental Information Regarding Certain Sewer Rates" which contained, among other things, "important information regarding the state of the City's sewer rate structure and its possible non-compliance with state law and the terms of federal and state grants and loan conditions."

Relevant for our purposes is the City's disclosures pertaining to the regulatory requirements applicable to the Wastewater System. In particular, the following disclosure was prepared for the City's aborted 2003 Sewer Bond offering. The disclosure in the 2003 Sewer Bond offering, pages 25 through 27, were substantially the same as that prepared for the 1995, 1997, and 1999 Sewer Bond offerings:

> Among other grant-related requirements are guidelines which must be followed concerning planning methodologies, design criteria, construction activities, and the operation, maintenance and financing of facilities. As another condition of its

> past receipt of federal grants, the State Board, as delegate of the EPA, must approve the sewer service charge structures of the City and its Participating Agencies. Such service charge structures require the recovery of annual operations, maintenance and replacement costs from users of the system in a proportionate manner according to the customer's level of use. Such factors as volume, infiltration/inflow, delivery flow rate, and strength of sewage are to be considered for determining proportionate use. Sewer service charge rates for all retail users are reviewed periodically and established at a level necessary to generate sufficient revenues to recover the annual operations, maintenance and replacement costs. Sewer service charge rates for users are established to recognize the volume and strength characteristics of wastewater contributed to the Wastewater System. The City's rate structure has been reviewed by the State Board and no grant funds or costs under granted funded programs have been disallowed based on the nature of the rate structures.

As noted, the requirements associated with the federal grants and state loans date back, at a minimum, to the 1991 participation of the City with the State Revolving Loan program and the SWRC. These grants and loans are subject to the requirement of a user-charge system as described in the loan contract and the federal regulations associated with the acceptance of federal grant money.[40] Despite the mandates of the loan contracts and federal regulations, as well as the notice contained in the SWRCB letter of November 1994[41] to comply by adding organics and a specific statement of noncompliance in the PinnacleOne study (1998), the City did not fully disclose the same in its 1999 sewer bond offering. In contrast to the requirement of organics described in the 1998 PinnacleOne study, the City' s 1999 bond offering affirmatively states . . . "[t]*he City's rate structure has been reviewed by the State Board and no grant funds or costs under grant funded programs have been disallowed based on the nature of the rate structures*." [Emphasis added.] Moreover, the City affirmatively stated, "the City believes that it is in compliance with all federal and state laws relating to the Wastewater System."[42]

In addition, the 2003 Sewer Bond offering included the information about Proposition 218, the so called "Right to Vote on Taxes Act." [The disclosure for Proposition 218 was substantially similar in each of the bond offerings.] Proposition 218 added Articles XIIIC and XIIID to the State Constitution, which contain a number of provisions affecting the ability of the local governments to levy and collect both existing and future taxes, assessments, fees and charges. Proposition 218 required, among other things, that by July 1, 1997, all property-related fees and charges, including those which have been in existence since prior to the passage of Proposition 218 in November 1996, would be required to meet the following substantive standards:

---

[40] See letter from SWRCB, Ronald Blair to City of San Diego, dated September 18, 1991.

[41] Blair letter to City of San Diego, City Manager Jack McGrory, dated September 30, 1994.

[42] Public Facilities Financing Authority of the City of San Diego, Sewer Bonds, series 1999A and Series 1999B, dated March 1, 1999, page 22-23.

> Revenues derived from the fee or charge cannot exceed the funds required to provide the property-related service.
>
> The amount of a fee or charge imposed upon any parcel or person as an incident of property ownership must not exceed the proportional cost of the service attributable to the parcel.

There was and is a continuing debate regarding whether Proposition 218 applies to sewer rates and charges. But the City's disclosures on the matter are misleading to say the least. "Without conceding that its sewer rates and charges are subject to Article XIIID, *the City believes that its rates comply with the foregoing standards*." Instead of advising the bond market of the lack of an organic component and thus the noncompliance of the sewer rate system, the Sewer Bond disclosures gloss over the obvious issue of non-compliance.

The City's lack of candor in its Sewer Bond disclosures is further reflected in the communications between Council Members and the City Attorney. For example, on November 15, 1999, the City Attorney, Casey Gwinn, was advised: "As you noted, the Cost-of-Service Report and Ms. Kehoe's memo present significant issues on the City's sewer rate structure."[43] The context and relevant time of this memo imply the discussion of the Cost of Service Report relates to the 1998 PinnacleOne Study. Similarly, various internal memoranda between the City Attorney's Office and the Mayor and City Council showed recognition that the Cost of Service Report called for a sewer rate change in order to comply with SWRCB requirements. [E.g., December 22, 1999, memorandum to file from Ted Bromfield describing Ms. Kehoe's request for a legal opinion on whether the Cost of Service Report showed a violation of Proposition 218. That memorandum resulted in a request for the City Manager to update the Cost of Service Report.][44]

It was not until the City's March 26, 2004 Annual Report ("2004 Report") that the City finally divulged the full extent of the City's non-compliant rate structure and the corresponding financial risk to bondholders. Under the caption "Supplemental Information Regarding Certain Sewer Rates" the City for the first time fully sets forth matters related to its rate structure. In contrast to its earlier statement that the ". . . City's rate structure has been reviewed by the State Board and no grant funds or costs under grant programs have been disallowed based on the nature of the rate structure" the City now disclosed that, "Currently, the Wastewater System's retail user-charge system has not been approved and could be found not to be in compliance with these requirements [i.e., the proportionality requirements]." Moreover, the City's disclosure provides, for the first time, a warning to investors that failure of the City to bring the Wastewater user-charge system into compliance could result in the repayment of Clean Water grants and the

---

[43] November 15, 1999 Memo from Deputy City Attorney Ted Bromfield to City Attorney Casey Gwinn.

[44] December 22, 1999 memorandum from Bromfield to File, referencing Bromfield's December 22, 1999 email to George Loveland. That email requests that the Manager provide a time frame to Ms. Kehoe for an update on the Cost of Service Report.

repayment of State Water Board loans. The cost to the Wastewater System could be $266 million. Until the 2004 Annual Report, this had never been disclosed to bond investors.

Bond investors should have been told about the City's non-compliant rate structure, the possible risk of forfeiture, and the potential exposure to the City. City officials who issue investment bonds have ultimate authority to approve the issuance of securities and related disclosure documents, and they have responsibilities under the federal securities laws as well.[45]

On 6 November 2001, the Mayor and City Council, in writing and orally during a briefing by its outside securities law experts were informed of their duties under the federal securities law.[46] The Mayor and City Council were reminded that the County Board of Supervisors in neighboring Orange County had been found to have violated federal securities laws in connection with bond offerings in 1996.

The federal securities law standard under which the Mayor and Council were to conform their conduct was provided in writing:

> In authorizing the issuance of securities and related disclosure documents, a public official may not authorize disclosure that the official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading. When, for example, a public official has knowledge of facts bringing into question the issuer's ability to repay the securities, it is reckless for that official to approve disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts. In this matter, such steps could have included becoming familiar with the disclosure documents and questioning the issuer's officials, employees or other agents about the disclosure of those facts.[47]

Despite being informed of their clear duty to disclose the material facts about the non-compliance of the wastewater system's rate structure and the risk of forfeiture arising therefrom, the City Council failed to take reasonable steps to ensure proper disclosure in the Sewer Bond offerings.

/ / /

/ / /

---

[45] Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors, Exchange Act Release No. 36761 (January 24, 1996).

[46] 6 November 2001 Closed Session Report and 29 October 2001 letter from Brian Cave L.L.P.

[47] 6 November 2001 Closed Session Report and 29 October 2001 letter from Brian Cave L.L.P.

XI.

NEED TO CORRECT OVERCHARGES TO RESIDENTS AND UNDERCHARGES TO COMMERCIAL AND INDUSTRIAL DISCHARGERS OF ORGANICS

The non-compliant sewer rate structure allowed some commercial and industrial sewer rate payers to underpay for sewer service. At the same time, however, this non-compliant system caused single and multiple family residences to overpay for sewer services. Single and multiple family residences are 96% of the City sewer rate payers. This class of users overpaid by approximately $20 million per year from 1998 to 2004. At the same time, some commercial and industrial dischargers underpaid by that same $20 million amount. The City Attorney recommends that the City institute a program that will provide refunds or credits to single and multiple family sewer customers and also charge commercial and industrial dischargers who underpaid. The exact damage figure will be subject to expert calculations but is estimated to be $20 million per year from 1998 to 2004.

The following table, compiled by San Diego Metropolitan Wastewater personnel using data currently available, estimates the amount of average daily flow and total pounds per day of the top ten MWWD customers discharging organics (COD) into the wastewater system:[48]

HIGH COD DISCHARGERS, BY TOTAL LBS/DAY

IU #	Industry Name	Avg Daily Flow (gpd)	Avg Analysis mg/L	Discharge lbs /Day
11-0441	ISP Alginates, Inc. (and CP Kelco) C-800	1287953	4234	45479
11-0441	ISP Alginates, Inc. C-420	38600	17906	5764
11-0016	Naval Station San Diego(total all connections)	710537	762	3663
08-0018	NAS North Island	825665	514	3162
12-0154	Heinz Frozen Foods	95800	3423	2735
10-0018	Coca-Cola Bottling Company of San Diego	97990	3335	2725
02-0112	UCSD (total all connections)	707000	367	2162
02-0332	Pall Filtration and Separations Group, Inc	38250	5675	1810

[48] Calculations by Metropolitan Wastewater Department, September 2005.

09-0001	Steiner Corp dba Alsco (Laundry)	72380	2586	1717
03-0900	KOCH Membrane Systems	110089	1570	1442
11-0444	Kelco Biopolymers Plant	100000	1639	1306

The new rate structure added significantly to the monthly costs of the biggest dischargers of organics (COD). The following table, compiled by San Diego Metropolitan Wastewater personnel using data currently available, demonstrates the estimated effect on monthly service charges under the new rate structure:[49]

Estimated effect on monthly sewer service charges when including organics in the rate structure for large organics dischargers
(Navy and UCSD not included because of multiple connections and a low strength/high flow waste stream)

Industry Name	**Before rate change**	**After rate change**	**% change**
ISP Alginates, Inc.	$74,000	$146,000	+98
Naval Station San Diego (total all connections) NAS North Island			
Heinz Frozen Foods	$15,000	$27,000	+81
Coca-Cola Bottling Company of San Diego	$21,000	$36,000	+69
UCSD (total all connections)			
Pall Filtration and Separations Group, Inc.	$8,800	$7,300	-16
Steiner Corp dba Alsco (Laundry)	$16,000	$20,000	+25
KOCH Membrane Systems	$14,000	$20,000	+42
Kelco Biopolymers Plant	$157,000	$311,000	+98

Clearly, the biggest beneficiaries of the unlawful rate structure were Kelco and ISP Alginates, Inc., two companies involved in the processing of kelp. Under the old rate structure, the two companies were able to avoid paying the City approximately $226,000/month or $2,712,000 annually.

XII.

CONCLUSION

The San Diego City Attorney concludes in this Wastewater Interim Report No. 1 there is substantial evidence consistent with a finding that City officials did attempt to conceal, and did

[49] Calculations by Metropolitan Wastewater Department, September 2005.

conceal, material information regarding the wastewater system's noncompliant rate structure and the potential risk of forfeiture of Federal grants and State loans.

Moreover, the City Attorney concludes, with respect to federal securities law, there is substantial evidence consistent with a finding that members of the City Council and other City officials acted knowingly or recklessly to approve related disclosures to investors without taking steps to prevent the dissemination of materially false or misleading information. In this matter, such steps should have included becoming familiar with the disclosure documents and questioning City officials, employees, or other agents about the disclosure of material facts, and withholding approval of offering documents until such time that those documents reflected all material information accurately. City officials and members of the City Council did not disclose the fact that the City was not in compliance with the user-based rate requirements for the wastewater system, contrary to California State and federal laws.

By_____
Michael J. Aguirre
City Attorney