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NORTH COAST RIVERS ALLIANCE

November 23, 2010

The Honorable John Garamendi
House of Representatives
2459 Rayburn HOB
Washington, D.C. 20515

Re: **Request SEC Investigation of Westlands Water District for Misrepresentations and Omitted Statements in the Sale of Bonds to Finance the Preliminary Phase of the Peripheral Canal**

Dear Congressman Garamendi:

We seek your help to request the Securities Exchange Commission to investigate whether Westlands Water District (Westlands) engaged in material misrepresentations and omissions in connection with the offer and sale of certain municipal securities, including those issued by the

Westlands and the San Luis & Delta Mendota Water Authority (Authority). The specific securities in question involved a $50 million Revenue Notes, Series 2009A, CUSIP 798544AM4, issued in March 2009.[1]

How could the largest irrigation district in the United States with declining revenues, highly leveraged debt, an uncertain water supply, and few actual water rights, borrow $50 million in a bond market still reeling from the credit collapse of 2008?[2] Add to this Wall Street mystery, the fact that the borrowing was to quietly finance the early phase and highly uncertain phase of California's most controversial public works project--- the "Peripheral Canal" -- a massive project previously defeated by the state's voters in 1982.[3]

Except for a vague reference to a water "conveyance" facility, investors were never told about the history of controversy of the project to be financed. Nor were they informed that this offering was being sold more than one year and a half before even a draft of the new Peripheral Canal project proposal was finalized, any of the required federal, state, and local permits had been approved, or the lands/right of ways purchased upon which the proposed facilities could be built. Investors solicited to purchase these securities should have been informed of the uncertainties and controversy surrounding these notes and that the project's future was uncertain where Westlands proposed use of these funds for the early phase of the Peripheral Canal. Like the subprime mortgage crisis of 2008, the derivatives-driven bankruptcy of Orange County California in December 1994,[4] and the California energy crisis of 2001, the complexity of circumstances surrounding this offering appears to have been used to mask its true risks for both private investors and taxpayers.

The bond offering relied heavily on Westlands misleading statements that the borrowing was secured by the districts revenues based on federal "water entitlements." The offering, as well as rating service information made available to investors used language that confused "water rights" with "water entitlements."

"Public entities that issue securities are primarily liable for the content of their disclosure documents and are subject to proscriptions under the federal securities laws against false and misleading information in their disclosure documents."[5]

Westlands and the Authority were aware that water entitlements are not "water rights," and that Westlands did not actually own the rights to 1.15 million acre feet of federal Central Valley Project (CVP) water contracts. Yet this claim in the offering served as the very foundation for the Westlands' assets and revenues and, thus constituted the security for the borrowing.

Based on these facts, an investigation is needed to answer fundamental questions and ascertain whether federal law has been violated:

1. Did Westlands Water District intentionally mislead investors by confusing “water entitlements” (contracts for CVP water) with CVP water rights in fact owned by the public?

2. Did Westlands intentionally mislead investors to believe that part of its borrowing was secured by illusory CVP “water rights” instead of inferior CVP water contracts? Specifically, did Westlands mislead investors into believing the borrowing was secured by 1.15 million-acre feet of water rights it did not own?

3. Did Westlands mislead investors by asserting that the federal CVP long term water contract renewal at full contract amounts was likely?[6]

4. Should Westlands have informed investors that its “potential” to sell federally subsidized agricultural water to Southern California and the San Francisco Bay area “at a higher price” was dependent on uncertain legislation still pending before Congress?[7]

5. Should Westlands have told investors that the transfer of 1.15 million acre feet of water rights currently owned by the public to Westlands would constitute the largest privatization of federally owned water rights in the history of the nation?

Background

Westlands Water District (Westlands) is the largest irrigation district in the United States. The district is a quasi-public agency with a highly concentrated private corporate ownership. Nine directors control Westlands, which is one of the strongest proponents of a Peripheral Canal-type isolated water conveyance system for moving Sacramento River water around the San Francisco Bay Delta to the San Joaquin Valley and beyond. The California Delta Habitat Conservation and Conveyance Program (DHCCP) is expected to announce a plan for a massive publicly financed Peripheral Canal-type plan as early as November 2010.

The $50 million offering that is the subject of this request for investigation is being used to finance the initial studies and engineering development costs of this new Peripheral Canal proposal. In March of 2009, Westlands anchored the $50 million dollar offering of Revenue Notes, Series 2009A , to finance the California Delta Habitat Conservation and Conveyance Program (DHCCP) under the auspices of the San Luis & Delta-Mendota Water Authority in California. To quote the FitchRatings report on the bond offering:

> "Financial strength is derived from the obligor's, the Westlands Water District (WWD, or the district), credit quality (revenue bonds rated 'A' by Fitch Ratings), based on satisfactory historical financial operations and high commodity value."

> "The DHCCP consists of joint efforts by agencies of the federal government, the state of California, and local agencies to fund and plan habitat conservation and water supply activities in the Sacramento San Joaquin River Delta/San Francisco Bay Estuary (the Bay Delta); including Bay Delta water conveyance options. The cost of the DHCCP project is currently uncertain but is expected to be substantial. The current issuance will finance the CVP portion of development costs pursuant to a memorandum of agreement. The ultimate source of funding for such a massive undertaking remains to be determined." [8]

The DHCCP likely will announce the draft plan for the San Francisco Bay-San Joaquin Delta in late November 2010. This bond offering, however, took place one and a half years prior to the expected release date of the *draft* DHCCP for compliance with the endangered species act. It is widely expected that the proposed DHCCP will embrace the Westlands-backed Peripheral Canal-type option. Cost estimates for the canal or tunnel alone are over $10 billion, with urban water users in Southern California, Santa Clara and Alameda counties slated to pay the majority of the bill for a project that will primarily benefit would-be agricultural water merchants (primarily Westlands).

<u>The Facts</u>

1. Westlands Water District's General Manager has publicly conceded that Westlands does not have "water rights" to water delivered pursuant to CVP contracts: "The contractors who receive Central Valley Project Act water do not hold water rights. Those rights are held by the United States [for the benefit of the contractors.]"[9]

2. "Water entitlements" are not the same as "water rights." Westlands holds interim CVP water contracts, where Westlands has junior contracts for supplemental water up to 1.15 million acre-feet of water a year. Even these contracts are not guaranteed, despite Westlands claims to the contrary. Now and at the time the bonds were issued, Westlands holds interim water contracts, which are subject to the discretion of the Secretary of Interior and balancing other Congressional directives. These water contracts are also subject to the state and federal laws, which have in the past limited water deliveries. Westlands water contract allocations are also subject to the Bureau of Reclamation's CVP allocation formulas designed to account for various weather conditions.

3. The rating agency and Westlands may have misled potential investors in the $50 million offering by confusing "water contracts" or "water entitlements" with "water rights." The

documents misrepresented one of the six key bond rating rationales by claiming it can sell water "entitlements" (contracts), but such sale is not assured under existing federal law. Westlands allows the impression that the revenues of intermittent interim water contracts will be enough to securitize $50 million dollars of debt:

> "The value of the WWD's entitlement to a substantial amount of water (1.15 million acre feet) offers financial flexibility, as it can be marketed for municipal and industrial uses at a higher price if the water is not sold for agricultural purposes."[10]

This statement is speculative in that in that Westlands' entitlements to water are not certain, as explained above. This is not a legal and certain right and it misrepresents Westlands' capabilities by implying that the full amount of this supplemental contract water could be marketed under existing law.

The rating agency documents describing Westlands' bond offering baits investors with a misleading claim about Westlands "potential" for becoming a major water wholesaler to Southern California and the San Francisco Bay area:

> "…The WWD potentially has the ability to sell and transfer water rights outside the district should agriculture cease to be economic, as the demand for water in Southern California and the San Francisco Bay area by users with connectivity to the CVP is very high."[11]

However, Westlands failed to inform investors that such "a potential" to sell its contract water "at a higher price" would require regulatory approvals and could only be sold for a short time period until the term of the interim contract expires. At the time of the bond offering, and currently, these water rights are owned by the public and such long term sales are not guaranteed.

4. Westlands also potentially mislead investors into believing that its previous heavily leveraged borrowing would be secured by (1) CVP water rights it did not own and, (2) likely inflated real property values:

> "The district's high leverage position is somewhat offset by **<u>the value of water rights</u>** and real property held by the district, which is not included in fixed assets. The net long-term debt outstanding includes those obligations incurred for water rights acquisition as well as debt for land purchased. At the end of fiscal 2008, the district's water rights net of accumulated depreciation totaled $102.5 million, and real property held was valued at $105.7 million."[12] [Emphasis added.]

These figures in the offering do not appear justified based on actual values of the primarily water entitlements (not water rights) held by Westlands.

<u>The Law</u>

SEC Rule 10b-5 states that 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:

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

2. 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

3. To engage in any act, practice, or course of business this operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Investors and other third parties are entitled to objective information and data free from bias and inconsistency, regardless whether such bias and inconstancy is deliberate. Therefore, financial accounting relies on certain standards or guides that are called "Generally Accepted Accounting Principles" (GAAP).

Conclusion

Investors who purchased the $50 million in revenue notes should have been fully informed that their funds were to be used in a risky scheme to privatize 1.15 million acre feet of federally owned water rights and the building of the massive and controversial Peripheral Canal water conveyance system around the San Francisco Bay Delta. Tax-exempt bonds are now being used to develop a conveyance system using phantom water rights as collateral. The appearance that the bonds would likely be rolled over or remarketed in 2014 also is unlikely,[13] despite the fact that this was a key ratings driver for the debt.[14] More broadly, a default on these bonds would not only harm bondholders, but could also have the potential to disrupt municipal bond debt.[15] This risk was recently recognized in a study reported on in the New York Times.[16] This planning project now has an anticipated shortfall of approximately $100 million. Additional debt and obligation will be needed to complete the studies.[17] Taking action to ensure adequate disclosure of the risks to bond investors is at the heart of our financial system. Last, but vitally important, the undue risks associated with leveraging the sale of inflated amounts of water likely will put increased bias and pressure on federal and state regulators to either bail out these bond holders or skew environmental and water policy. We urge you to seek this investigation and to enforce the disclosure laws before additional debt is issued.[18]

Thank you for your assistance,

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Sierra Club California

Steven L. Evans
Conservation Director
Friends of the River

Conner Everts
Executive Director
Southern California Watershed Alliance

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Byron Leydecker
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Bruce Tokar Co-Founder
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Frank Egger, President
North Coast Rivers Alliance

ENDNOTES

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[1] See http://emma.msrb.org/SecurityView/SecurityDetails.aspx?cusip=798544AM4 (Official Statement). http://emma.msrb.org/MS279708-MS278527-MD564986.pdf

[2] These are revenue notes that rely on the use of what is known as joint powers authorities—a coalition of public and/or private entities that pool resources for project where they can avoid voter approval of the bonds by obtaining a majority vote of the entity's board. [See California Government Code Division 7 Chapter 5 [6500-6599.3].

[3] In 1982, California voters defeated the Peripheral Canal (a trench to carry water around the Sacramento-San Joaquin Delta for export south), voting by a 3-2 margin in favor of Proposition 9 (a veto referendum on the Legislature's SB 200 package of statewide facilities and related requirements).

[4] See Municipal Bond Participants: Public Officials and Obligated Persons Public Officials Report under Section 21(a) of the Exchange Act *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), available at:
http://www.sec.gov/info/municipal/mbonds/publicof.htm#PO1 (SEC investigation report involving material misrepresentations and omissions in connection with the offer and sale of certain municipal securities issued by the County of Orange, California).

[5] Ibid. See March 1994 Release; 1989 Release, supra note 5, at 18,199-10 and n.84; see also In re CitiSource, Inc. Securities Litigation, 694 F. Supp. 1069, 1072-75 (S.D.N.Y. 1988); Draney v. Wilson, Morton, Assaf & McElligot, 597 F. Supp. 528, 531 (D. Ariz. 1983).

[6] See http://emma.msrb.org/MS279708-MS278527-MC564986.pdf . "The District now expects the long-term Water Contracts to be renewed during the term of the IRD, and in any event before February 10, 2010." D-7. The long-term water contracts were not renewed. Currently, Westlands is still operating under interim contracts with the Bureau of Reclamation.

[7] See S. 1759 Senator Dianne Feinstein's Water Transfer Facilitation Act of 2009 pending before the Senate.

[8] FitchRatings Report, San Luis and Delta Mendota Water Authority, California: Delta Habitat Conservation and Conveyance Program Development Project. March 12, 2009, p. 2.

[9] Tom Birmingham, General Manager, Westlands Water District, Testimony Before the Assembly Water, Parks and Wildlife Committee, May 11, 2010. See http://www.vimeo.com/11771367

[10] FitchRatings Report, San Luis and Delta Mendota Water Authority, California: Delta Habitat Conservation and Conveyance Program Development Project. March 12, 2009, p. 2
(*"There is concentration among the WWD's water purchasers. But offsetting this risk somewhat is the value of cash crops farmed in the district (about $1.3 billion in fiscal 2008) and the absence of alternative/equivalent supplies or infrastructure to deliver water. In addition, the WWD potentially has the ability to sell and transfer water rights outside the district should agriculture cease to be economic, as the demand for water in Southern California and the San Francisco Bay area by users with connectivity to the CVP is very high."*).
"The inherent value in the district's extensive water entitlements through its role as the contractor with the federally owned Central Valley Project (CVP) is a credit strength. Offsetting credit considerations are the risk of the availability of CVP water, its increasing costs, high revenue concentration resulting from the small number of customers/land owners of the WWD, and future capital needs, potentially substantial, to secure future CVP water deliveries." [pp1-2 Credit Summary]

[11] FitchRatings Report, San Luis and Delta Mendota Water Authority, California: Delta Habitat Conservation and Conveyance Program Development Project. March 12, 2009, p. 2.

[12] Ibid. p. 6.

[13] See Del Puerto Water District Benefit Assessment Evaluation California Proposition 218 Engineer's Report Summers Engineering January 2010. In order to pay back the principle instead of only the interest, a 340% water rate increase was sought by the District to avoid a projected deficit of $4,382,280.

"In addition to the forecasted operational budget, the District also has a principle debt obligation due in March of 2014 to fund its share of the Delta Habitat Conservation and Conveyance Program. This $150 million effort, which is being cost-shared equally between State and Federal Contractors, will select and design a preferred Delta conveyance alternative for South-of-the-Delta water supplies. Del Puerto's share of this program is $3,692,405. The annual interest-only obligation currently associated with this debt is being paid as a component of the District's SLDMWA dues. While it is anticipated that the Contractors will be able to "roll" this principle obligation into a construction bond in 2014, no such opportunity currently exists. Due to this uncertainty, the District believes it is prudent to fiscally prepare to meet this debt obligation." P16.

[14] Ibid. FitchRatings. *"Key rating drivers are the ability to remarket the notes upon maturity in 2014, the WWD's ability to levy and collect increased land assessments, and ultimate costs attributable to the WWD and authority associated with the expected construction of the DHCCP"*. [pp1-2 Credit Summary]

[15] *The Muni-Bond Debt Bomb* by Steven Malanga Wallstreet Journal JULY 31, 2010

New Risks Emerge in Munis Debtholders Are Left Steamed as Some Cities Forgo Repayment Promises, M. Corkery Wallstreet Journal 11-10-2010

[16] See Leurig, Sharlene, Ceres Analysis, *The Ripple Effect: Water Risk in the Municipal Bond Market, A Ceres Report*, October 2010, available at: http://www.ceres.org/Document.Doc?id=625; see also

Water Scarcity a Bond Risk, Study Warns (New York Time, October 20, 2010), available at: http://www.nytimes.com/2010/10/21/business/21water.html.

[17] San Luis & Delta-Mendota Water Authority Minutes – Delta Habitat Conservation and Conveyance Committee/Special Board Of Directors Meeting Workshop June 24, 2010.

"*Executive Nelson reviewed additional funding needs to complete the development of the DHCCP. Nelson reviewed the most recent budget and indicated that the program continues to track around $100 million over budget. Nelson indicated that our share of the original $140 million commitment will likely provide sufficient cash flow through December 2010. We will need to have additional funding available by then to allow continuation of the project without delays. Nelson reported that we had initiated discussions with Dave Houston and Bond Counsel Doug Brown to secure funding and that we were looking at bonds that would mature 3/1/14 (date of maturity of original DHCCP bond financing). The expectation is the payments through maturation would be interest only and that the bond would be refinanced as part of* *the financing for the construction of the project. Nelson reported that the Direct Funding Agreement 1st Amendment with DWR had been executed. Rathmann indicated that she was working on a draft Activity Agreement amendment to accommodate the increased funding."*

[18] First Amendment to the Agreement for Funding Between the Department of Water Resources and the San Luis& Delta Mendota Water Authority for the Costs of Environmental Analysis, Planning and Design of Delta Conservation Measures, Including Delta Conveyance Options. 6-13-2010.
 DHCCP Workshop Minutes (7-28-10) "*Nelson reported that we had initiated discussions with Dave Houston and Bond Counsel Doug Brown to secure funding and that we were looking at bonds that would mature 3-1-14 (date of maturity of original DHCCP bond financing). The expectation is the payments through maturation would be interest only and that the bond would be refinanced as part of the financing for the construction of the project*." "Nelson reminded the Committee that although our original funding commitments would cash flow the project through the end of the year, we will need to commit to additional funding through the approval of Task Orders, probably by the beginning of October."