

January 14, 2016

The Honorable District Board
South San Luis Obispo County Sanitation District
P.O. Box 339
Oceano, CA 93475

Mr. John Clemons III, CPO and Acting District Administrator
South San Luis Obispo County Sanitation District (DISTRICT)
1600 Aloha Place
Oceano, CA 93475

EXECUTIVE SUMMARY

Our goal as we conducted our investigative review of the Past Management Practices of the “Wallace Years,” was to be fair and objective and let the evidence gathered speak for itself. This approach was endorsed by District Management and the current Board of Directors. We are mindful that there are different viewpoints about the success or failure of the operation of the District during the “Wallace Years.” However, we have strived to represent all viewpoints that were relevant to the goals of our review.

At the beginning of our Past Management Practices review, we sought out all of the available South San Luis Obispo County Sanitation District (“District”) accounting/financial records for the periods 2004 to 2013, which were stored at the Oceano Wastewater Treatment Plant (“WWTP”) or available through other witnesses or government agencies. However, we believe that in order to fairly evaluate the management practices during the 27-year career of John Wallace, we sought to also include in our review, the District’s accounting/financial records for the period 1986 to 2004, which were unorganized and found in different areas of the District. In piecing the historical financial records together, we were able to gain a broader and a more balanced historical perspective.

The volume of records that we received and reviewed from the District, The Central Coast Regional Water Quality Control Board (“Water Board”) and cooperating witnesses were substantial and well beyond our projections as set forth in our submitted Work Plan. Further, in our opinion, the accounting/financial records of the District were unorganized and had suffered from years of mismanagement by the previous District Administrator. This is in no way

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reflective of the current administration at the District, but an observation on past management practices and the transition from the previous administration.

We were able to locate and conduct interviews of over thirty individuals (Appendix B to report), including; past and present Operators at the Oceano WWTP, former and current District Board Members, former District Counsel, former District Administrators, District Engineers, former Chief Plant Operators, affected citizens of the participating cities of Oceano, Arroyo Grande and Grover Beach, past and present Outside Auditors, the San Luis Obispo County Auditor, and Water Board officials. We are pleased to report that, except for one witness, we received responses and cooperation from all those witnesses that we could locate. All of the interviewees voluntarily met with us, and there was no promise of confidentiality regarding the interviewee's statements.

From the beginning of our Past Management Review, Mr. Wallace has been cooperative and has responded to our questions or request for documents. We also interviewed Mr. Wallace, although he required his personal attorney and a "financial expert" in government finance to be part of our interview. But, because Mr. Wallace insisted on being present during our interviews with his employees, current and former, we did not conduct the interview with Heather Billing, Tom Zehnder or others from the Wallace Group that were involved in the finances of the District. We did send and receive emails with Christine Burkett through Mr. Wallace that was related to the billings of the Wallace Group.

As detailed in our report, our Past Management Practices Review revealed that during the years 1986 to approximately 2004, John Wallace performed without incident as the District Administrator of the District in executing the financial and managerial duties of his office. There were no documented employee issues at the District that we were aware of, and the Audited Financial Statement for the Fiscal Year Ending in 2004 showed \$8.9 million in cash and cash equivalents on the Balance Sheet. The financial statements of the District at this point were simple and easy to follow. The monthly payments from the District to Wallace & Associates were in the \$3,000 to \$5,000 range.

We noted in the District's Audited Financial Statements that the year 2000 was the end of the "Chuck Ellison Era" and the beginning of the "Jeff Appleton Era" as the District Chief Plant Operator (CPO).

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John Wyckoff, Vice President of the Engineering firm of Kennedy/Jenks, from the original engineering company that consulted on the building of the Oceano WWTP, commented in his 2005 Report to the District that the Oceano Plant, “has evidenced an exceptional record of meeting water pollution control needs...and at a minimum cost to the District rate payers.” (Kennedy/Jenks 2005 Report).

However, as our Past Management Review for the period 2004 to 2013 revealed, there were growing operational, financial and personnel issues at the District that culminated in 2011 with the investigations by the San Luis Obispo Grand Jury, the Central Coast Regional Water Quality Control Board (“Water Board”) and the legal proceedings against the District and John Wallace by former District employees.

Our review showed that starting as early as 1986, there were institutional weaknesses in the District that would disrupt continuity in the process of evaluating and monitoring the performance of the District Administrator and the financial affairs of the District as follows:

There was a designed turnover of District Board Members on a yearly basis who are all *elected officials* from Arroyo Grande, Grover Beach and OCSD (participating agencies).

The 1986 Contract (a three-page document) between the District and John L. Wallace and Associates had no performance standards or provisions for accountability, and was apparently not renewed until July 2011, twenty-five years later. Even though Wallace and Associates changed its name and company structure in 2004, the District did not amend the 1986 contract. Written performance evaluations of the District Administrator or District Engineer by the Board of Directors were not performed yearly and there was no transparency as to the Board’s evaluations of Wallace to the Rate Payers.

There was no Purchasing and Construction Policy related to expenditures in place at the District and it wasn’t until 1999 that the Board passed a resolution setting forth the policies and procedures for the Expenditure of District funds. The Board approved projects related to Administrative and Operational work at the District, which could have been accomplished by qualified employees at the WWTP at no cost to the District.

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However, the rationale, as expressed by one long-serving Board member was that the Plant Superintendent and the part-time secretary were not competent to perform the administrative duties such as: Staff Reports, Board Packets and Budget Reports, so this work was directed to the Wallace Group by the Board. This was apparently the case beginning in or about 2001 until 2012 just before John Wallace retired. The fact that the Board deemed the Plant Superintendent to be incompetent is one thing, but to keep him on in that position for over 10-years when the appropriate business decision would've been to bring in a qualified Superintendent and a full-time secretary.

There was no "contract" between the participating agencies and the District regarding the collection and payment of fees by the participating agencies. This was the only source of operating "revenue" that the District based their operating budget and expansion fund upon. In fact, we were told by a former Board Member that the local business practices were "rural" and business in the area was often done on a "handshake."

There was an apparent conflict of interest where the wife of the District's long-serving legal counsel was employed by the Wallace Group in their HR Department and was involved in the sensitive personnel issues that were ongoing at the District between John Wallace and the employees of the District.

In or about 2001, Jeff Appleton, the Plant Superintendent (CPO) stated that the jobs that had been traditionally performed by the CPO and the District Bookkeeper/Secretary had been taken over by John Wallace and assigned to the Wallace Group. The evidence we gathered tends to support Appleton's statement that many of the administrative projects such as: Board Packets, Staff Reports, Yearly Budget Reports traditionally performed by the CPO-Plant Superintendent and the in-house secretary/bookkeeper were taken over by the Wallace Group and charged in their billings to the District. Our interviews of former Board members confirmed that these events occurred with the approval of the Board of Directors.

However, current District Management has reversed this trend and these same administrative functions are now being performed at the District by the Plant Superintendent and the Plant Secretary/Bookkeeper, not by outside contractors.

Our Past Management Practices Review revealed that Wallace assumed control over all aspects of the financial affairs of the District including the approval of the Wallace Group invoices that were presented to the District for payment. The trend

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in billings by the Wallace Group grew steadily from \$3,600 and 81 hours per month in 1999 to over 600 hours and \$70,000 per month by the end of 2010. During this time the Wallace Group received over \$6 million dollars for Administrative Fees, Engineering Fees, and Major Budget Item projects. During this same period of time, there was also a trend where Expenses exceeded Revenue by a substantial amount in every year.

We also noted a trend in the number of Major Budget Item Projects (MBI) beginning with seven (7) MBI projects in 2003 to twenty-eight (28) MBI projects in 2011 where the Wallace Group received fees. There was also an increase in the number of Wallace Group employees charging time to Administrative, Engineering, and MBI Projects to the District.

The analysis of the District's "Board Packets" for the period 2004 to 2013, which were posted to the District's Website, showed that Staff Reports were included in the "Board Packets" and was prepared by John Wallace acting as the District Administrator. The Staff Reports provided an explanation of Major Budget Item projects proposed at that time. There was a constant reference in the Staff Reports to "District Staff" performing work on MBI projects, which we confirmed through two former Board Members, that reference was actually to the Wallace Group employees. This is further confirmed in our analysis of the Wallace Group billings related to the MBI projects.

However, we question whether this practice was in conformance with the District's Policy on "Expenditure of District Funds." The District's policy related to the "Expenditure of District Funds" gives dollar levels for the approval process related to when the Board of Directors were required to authorize services. It would appear that the Board's actions approved MBI Projects for the Wallace Group without the proscribed bidding process for projects that exceeded the \$25,000 thresholds for MBI project(s).

We also learned that over fifty-six (56) boxes of the operating, personnel and business records of the District were stored at the Wallace Group offices, and that there are missing or unaccounted for assets, such as the CAD drawings and GIS analysis paid for by the District. Further, there was no formal inventory of the District's records at the District as required in the District's Operating Manual (O&M).

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We found that there was a steady depletion of the District's "Reserves," which were critical to the longevity of the Oceano WWTP. The use of "Reserve" funds for Operational expenses was contrary to District guidelines in Resolution 24 enacted in 1966 and further confirmed by the District's outside auditor in their report to the Board of Directors in the 2011-2012 Audit.

The critical issue of "Redundancy" of the "FFR" and the "2nd Clarifier" as detailed in 2005 Kennedy Jenks Report were not adequately addressed by the Wallace administration or the Board of Directors and the cost of the construction has increased from \$4-6 million in 2005 to \$12 million (present dollars 2015).

There were apparent conflicts of interest in assigning administrative, engineering, and MBI work by Wallace as the District Administrator to the Wallace Group thereby bypassing or duplicating the duties of the CPO, bookkeeper and the Operators at the Oceano WWTP. The fact that the Board of Directors sanctioned all or some of these actions, in our opinion does not eliminate the conflict. In our opinion, the obvious resolution to the lack of confidence that the Board of Directors had regarding the District Superintendent would have been to replace him with a person who had their confidence.

Finally, there was potential Malfeasance in office in the solicitation of payments by Wallace for the Wallace Group while acting in the capacity as the District Administrator for the District. Malfeasance is a public official's performance of an act that is contrary to law. Because potential violations of law are investigated and processed by law enforcement officials, we suggest that this report be provided to law enforcement officials for their determination.

In conclusion, the ending of the "Wallace Era" certainly distracted from his early successes, but as Wallace retired as the District Administrator/Engineer at the beginning of 2013, the District reserves had been depleted to the level where the critical "redundancy" issues, outstanding since at least 2005, cannot be resolved without seeking outside funding. In the meantime, if the WWTP experiences a failure of the main operating components of the WWTP and there is a resulting sewage spill into the area, as in December 2010, the fines and penalties will be severe.

In evaluating the **Past Management Practices**, the question to be answered is; Is the District better off today after 27 years under the administration of John Wallace? The fact is that the WWTP is 27 years older, but the critical issues

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regarding “redundancy” still remain even after several reports issued by Kennedy Jenks Consulting beginning in 2005. The other question to ask is; Did the Board of Directors manage the District Administrator? Did complacency or personal relations set in even though there were warning signs of increasing payments to the Wallace Group, decreasing reserves, increasing personnel issues with plant employees, and increasing plant violations?

The findings and conclusions in our report are not inconsistent with the findings of the 2011 San Luis Obispo County Grand Jury, the 2011 Water Quality Control Board’s investigation, and the 2012 Audit by the San Luis Obispo County Auditor-Controller. Having said that, our findings were determined independently and are substantially different in depth of analysis and investigative efforts.

I did not redact the identities from the report of those individuals that I interviewed, and I did not promise or suggest to those individuals that their conversations would be held in confidence. However, there may be other legal concerns or information that we are not privy to or aware of so it is our suggestion that the District’s legal counsel consider this issue.

Respectfully submitted,

Carl R. Knudson
Knudson & Associates

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INTRODUCTION

Our methodology for our Past Management Practices Review was predicated upon a “look back” to prior year’s management in order to establish a benchmark and reference point for comparison to the “Wallace Years” (1986-2013). We also used the same methodology in a “look forward” to the Management Practices that were instituted after the “Wallace Years” (2013-2014), which then provides a contrast between management practices in three distinctive eras.

Government sector operations like the District are unique, and one has to appreciate the differences between government-funded operations and operations funded in the private business sector. The hierarchy in both cases is similar in the sense that there is a Board of Directors, but the shareholders of the District are the “rate payers” of the Tri-County participating cities of; Arroyo Grande, Grover Beach and Oceano (OCSD) and thus they cannot exert the same instant influence as shareholders in the private sector. Therefore, the Board of Directors of the District, representatives of the participating cities (Member Agencies), are the voice of the “rate payers.” In the past few years, the “rate payers” have become more of a “voice” and have expressed their concerns on the management of the District.

We are mindful that there are different viewpoints about the success or failure of the management and operation of the District during the Wallace Years, and that there are obvious “political” factions between the Tri-County participating agencies. Unfortunately the political climate at the District Board is still at “toxic” levels and in our view; this climate has slowed or impeded the progress of the current management of the District as it attempts to move forward. Rick Sweet, the District Administrator recently resigned and there is a discussion at the Board as to who will be hired to take his place.

A Brief Background of Pertinent Facts

The Sewer System Management Plan (SSMP)(2014) states:

“The District provides wastewater treatment to a combined population of just under 40,000 residents and is governed by a three member body, known as the Board of Directors. The members of the Board of Directors each serve a ***one year term***, unless directed otherwise by the Member Agencies. The Board of

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Directors includes one representative from each of the Member Agencies. The Board of Directors makes policy decisions with *advice from District Staff and District Administrator*.

Daily District management of the WWTP and collection system is carried out by the Plant Superintendent (emphasis added). The Plant Superintendent reports directly to the District Administrator **and** the District Board of Directors. The Plant Superintendent **and** District Administrator are jointly responsible for the implementation of the SSMP. The Plant Superintendent is also the designated staff member who is responsible for all wastewater collection operations and it is his operator's license that is legally required in order to operate the Oceano WWTP (DISTRICT Website)."

The Oceano WWTP became operational in 1965 and was historically run by a full time crew of five operators, a Lab Technician, a bookkeeper/secretary and a Chief Plant Operator ("CPO"). Chuck Ellison (former CPO, 1980-1999) and Paul Karp (former District Administrator 1980's and 2013) indicated that during their time at the Oceano WWTP prior to Wallace, there was a part-time District Administrator, and Engineers were consulted as needed. In the 1980's, the plant was re-designed as a Biological Treatment Plant and the FFR (Fixed Film Reactor) was the centerpiece of the technology. The Oceano WWTP has no capacity for overflow or a "pond" where wastewater can be diverted. Therefore, any disruption in the water treatment process can become critical in a matter of hours.

The personnel at the plant are reasonably compensated in comparison to other local government jobs, and many of the District "Operators" began their careers as operators-in-training, but rose through the ranks to become the plant CPO (aka Superintendent), and enjoy a more than 20-year career. According to Chuck Ellison, the former CPO, the plant, during his tenure, was self-sufficient and rarely went outside its ranks when repairs were needed. Millions of dollars in improvements were made to the plant through the judicious use of the "Reserve" fund. The District used a "pay as you go" approach to making improvements. Ellison stated that during his tenure as CPO, John Wallace was not at the plant a lot and was not required to do so. The operators possessed the skills where outside

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consultants were rarely needed or used. Ellison retired in 1999 and started a business (Fluid Resources Management) with John Wallace.

John Wallace (“Wallace”) became the District Administrator in 1986. According to the Wallace Web Site, two years before in 1984, Wallace & Associates was started in his garage as a one-person home based business. Paul Karp, the District Administrator prior to Wallace, stated that it was the intention of the Board to employ Wallace as a temporary replacement, until they could find a full-time District Administrator.

The original 1986 contract with Wallace & Associates was a three-page document that spelled out the duties of the District Administrator (Exhibit 1, copy of 1986 contract). In reading the contract it is unclear whether the “Contract” designated Wallace and Associates as the Engineer. Later in 2004, Wallace & Associates became “Wallace Group,” but there is no indication that a new contract between the Wallace Group and the District was prepared and signed by the two parties.

In reading the 1986 contract, there were no provisions addressing performance or accountability issues. One Board Member likened the Tri-County area as “rural,” not as sophisticated as big-city operations, and that many business transactions in the area were done on a handshake. This also seems to be the case with a handshake agreement with the three cities that provide the primary revenue source to the District.

In reviewing the District Budget Proposals for 1995 to 2005 we found some evidence as to what was intended by the 1986 contract. The Budget Proposals prepared by the plant administration and adopted by the District Board of Directors showed the accounting code “7077” for “Engineering” as providing for “miscellaneous engineering services.” The same Budget Proposals listed the accounting code for the District Administration “7076” specifically named “John L. Wallace and Associates.” (Source, Budget Proposals 1995 to 2005). We noted that in the same Budget Proposals the reports included a budget item for Engineering ranging from \$35,000 to \$45,000 per year.

Except for the change in rates charged by Wallace, this 1986 contract was apparently not updated or amended until 2011, some 25 years later and after the Grand Jury investigation of the District had begun (Exhibit 2, copy of 2011 contracts).

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We also noted on the “Audited Financial Statements” that a designation was not included for a plant engineer, but only a designation for the “District Administrator.”

A review of the District Personnel Manual (February 2005) noted at section “7000 District Administration/District Counsel,” “The District Administrator and District Counsel are both contract positions and are governed by their respective service contracts.”

According to the Wallace Group Website, “In 2002, Wallace Group acquired Swanson International, an innovative wastewater treatment design company. Wallace Group is now an industry leader in the design and use of Advanced Integrated Pond Systems (AIPS) and other environmentally sustainable technologies for wastewater treatment.” The Wallace Website states further,

“Over the years, the company has expanded to include services in Civil & Transportation Engineering, Construction Management, Landscape Architecture, Mechanical Engineering, Planning, Public Works Administration, Right-of-Way Services, Surveying/GIS Solutions, and Water Resources and employs over 50 people. The people of Wallace Group are at the heart of our success. As professionals and as contributing members of the communities we serve, we will continue to approach our work with integrity, quality and a dedication to service.”

According to Mr. Wallace’s resume and based upon our research, during the intervening years, John Wallace and the Wallace Group increased its business association with other cities and municipalities by providing administrative or engineering services at: Avila Beach, Nipomo, Oceano, Cambria, Cayucos, Los Osos, Templeton, San Simeon, San Miguel, Heritage Ranch, Arroyo Grande, Pismo Beach and Atascadero. Wallace also started Fluid Resources Management with Chuck Ellison in 2000, the former CPO and in 2009; Wallace was bought out by Chuck Ellison.

Jeff Appleton, former District CPO, testified (at a Water Quality Board hearing) that when he began to disagree with Wallace over the construction of the Chlorine Contact Chamber, he was gradually pushed aside and some of the overtime that had been granted to him over the years was stopped, it really made it hard for him to make ends meet after that (Exhibit 3, copy of Appleton Testimony).

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In a recent conversation with Mr. Wallace (11/12/2015), Mr. Wallace recalled that Mr. Appleton was very critical of the Chlorine Contact Chamber project and that Appleton refused to participate at all as the Superintendent of the WWTP on this project.

Appleton, during his interview with our investigation, stated that he was eliminated from preparing the Bi-Weekly Board Packets and the Yearly Budget Reports, which were taken over by the Wallace Group. In that period of time, the evidence shows that Wallace was also in control of the financial responsibilities of the District, and was the sole authority for transferring LAIF funds to the District operational account until September 2011 (Exhibit 4, LAIF transfer notices). We have reviewed LAIF transfer documents for the period August 2005 to September 2011, but we have included only a sampling of these documents due to the volume of paper.

In 2009, the District Laboratory Technician, Disa Thorenson retired and a new Laboratory Technician, Davina Douglas (a Grade IV operator) was hired to replace Thorenson.

In December 2010, the well-documented sewage spill occurred. One District Board member characterized it as a “leak.”

In 2011, the grand jury began an investigation based upon complaints from citizens, local newspaper articles and editorials alleging mismanagement and other problems at the District (Exhibit 5, Grand Jury Report).

In 2011, the Water Quality Board began their investigation of the December 2010 sewage spill.

In 2011, the new contracts between the District and Wallace required new billing transparency and changed the authority to transfer funds from the LAIF account to the District Board Members.

In February 2013, Wallace retired as District Administrator and Engineer.

In March of 2013, Paul Karp was brought in as District Administrator, with John Clemons III, Plant Superintendent, and Shannon Sweeney, Engineer.

In 2014, the Board brought in Rick Sweet, as the District Administrator.

REVIEW OF PAST MANAGEMENT PRACTICES

As detailed in our RFP response to the District, and as further detailed in our work plan to: “Review documents, interview past and present employees, interview former contract administrators and consultants; and to analyze and present professional analysis of the following for the period 2004 to February 2013:

Financial, Line item evaluations of expenditures, review of agency audits, identify malfeasance; identify practices that are not consistent with best management practices.

Operation, Evaluate past practices associated with plant operations, evaluate contracts for engineering, purchasing and capital projects to ascertain whether they are consistent with standard practices.”

One of our first priorities was to visit the District Offices to document, evaluate and isolate those vital business/accounting records that would form the foundation for our review of the Financial and Operational history of the District for the period 2004 to 2013. In our experience, the success of any investigative review is reliant upon obtainable and reliable records.

At the outset, we were greatly assisted by Rick Sweet, District Administrator, Amy Simpson, Secretary/Bookkeeper and John Clemons, CPO who allowed us full access to the District offices, the District computer system and the “Sea Train” container located at the front of the property. Rick Sweet has since resigned and John Clemons is now the acting District Administrator.

We have also been provided with computer flash drives by Amy Simpson that held the District’s accounting QuickBooks records for the period 2008 to 2013, and other business records that we requested.

FINANCIAL ANALYSIS

In this section of our report, we focused on expenditures at the District during the period 2004 to 2013 and the process by which the District controlled and accounted for the expenditures of District funds. We also considered the approval process for the expenditure of District funds to determine whether the expenditures were in compliance with the District’s Resolutions regarding the Policies and Procedures for the Expenditure of District Funds most recently updated in Resolution 2010-274.

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District Revenue

However, we thought it appropriate to briefly review the “revenue” side of the District’s finances.

The District receives revenue from the participating agencies: OCSD, Grover Beach and Arroyo Grande who collect the fees from the “rate payers” who live in the cities of OCSD, Grover Beach and Arroyo Grande. Each of the cities issues a monthly check to the District that covers monthly sewer charges and connection fees. The participating agencies charged a fee to the District for the collection services they provided.

As we began our project earlier this year, we learned that the District was concerned that one of the participating cities was increasing their collection fees, which seemed to be especially unwarranted. The issue then surface that there was no contract between the District and the participating agencies and this collection arrangement had never been memorialized in a contract. In our contact with Sabrina Spears, the former secretary/bookkeeper at the District, she recalled that there was no problem in the relationship with the participating agencies and the collection of fees that were charged, and it was never an issue.

In our review of the past accountant’s work papers we noted that reconciliations were performed between the Districts accounting records and the County financial records where the District funds were deposited. However, there was no reconciliation with the participating agencies collection records and the funds paid and received at the District. This seems to be another “hand shake” business relationship that existed in the District.

District Expenditures

We started our review of the District’s expenditures by selecting certain areas for a “Line Item Review” and analysis such as:

Trend analysis of Cash & Cash Equivalents

Trend analysis of Revenue to Expenses

Trend analysis of Expenditures to the Wallace Group

Analysis of Expenditures for Plant Chemicals and

Analysis of Expenditures for Legal Expenses

In performing our Line Item Review and analysis of expenditures, we used several sources of information such as; The Districts QuickBooks accounting data for the period 2008 to 2013, The District’s Audited Financial Statements for the period 1998 to 2014, The District’s Audit Files for the period 2004 to 2011, a computer

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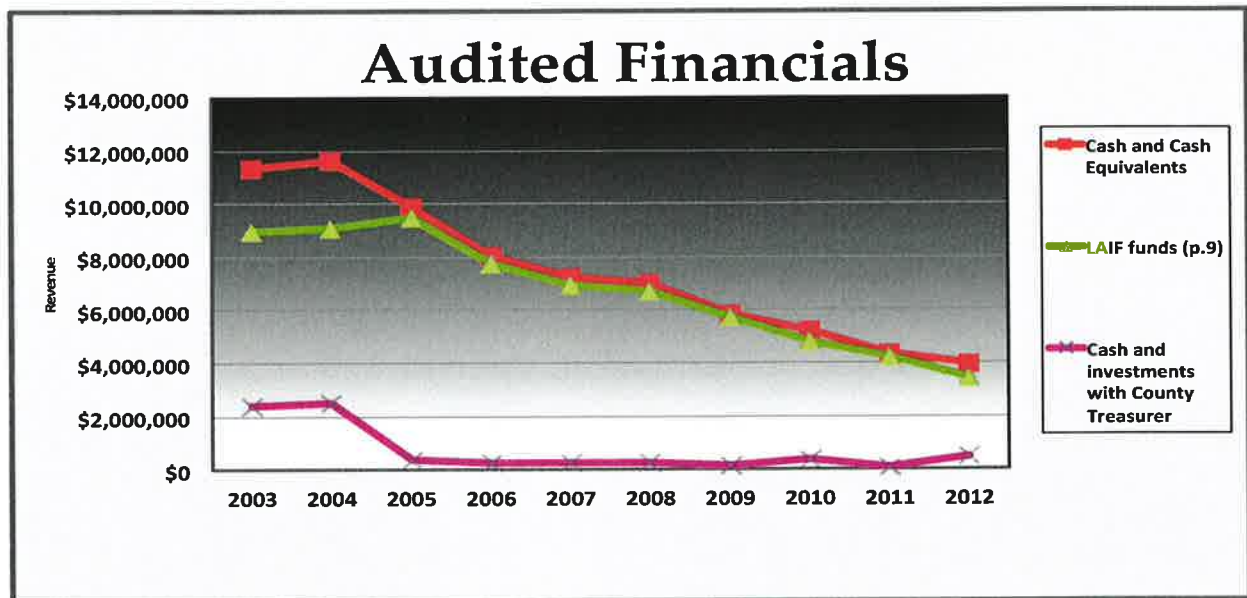
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file “Matt Haber” retrieved from the District’s server, Several binders of MBI (Major Budget Items) reports for the period 2000 to 2013, The Wallace Group (and Wallace Associates) billing statements for the period 1999 to 2013, The District’s Bi-weekly Board Meeting Agenda packets for the period 2004 to 2013 (District Website 2010 to 2013) and The District’s Yearly Budget Reports for the period 1995 to 2013.

The first chart we prepared focused on Cash and Cash Equivalents. Our analysis for the period 2003 to 2012 was based upon the District’s Audited Financials because we believe that they are the most reliable accounting of the District’s finances since they were prepared at or near the time that the District’s transactions occurred. We also compared the District’s QuickBooks data to the Audited Financial Statements and found that in every year from 2008 to 2012, the QuickBooks accounting data for revenue and expenses was substantially lower than the data listed on the Audited Financial Statements.

Cash & Cash Equivalents

As shown below, there was a sharp decline in cash and cash equivalents of about \$7 million during the ten-year period ending in 2012, the last full year before John Wallace retired as District Administrator.

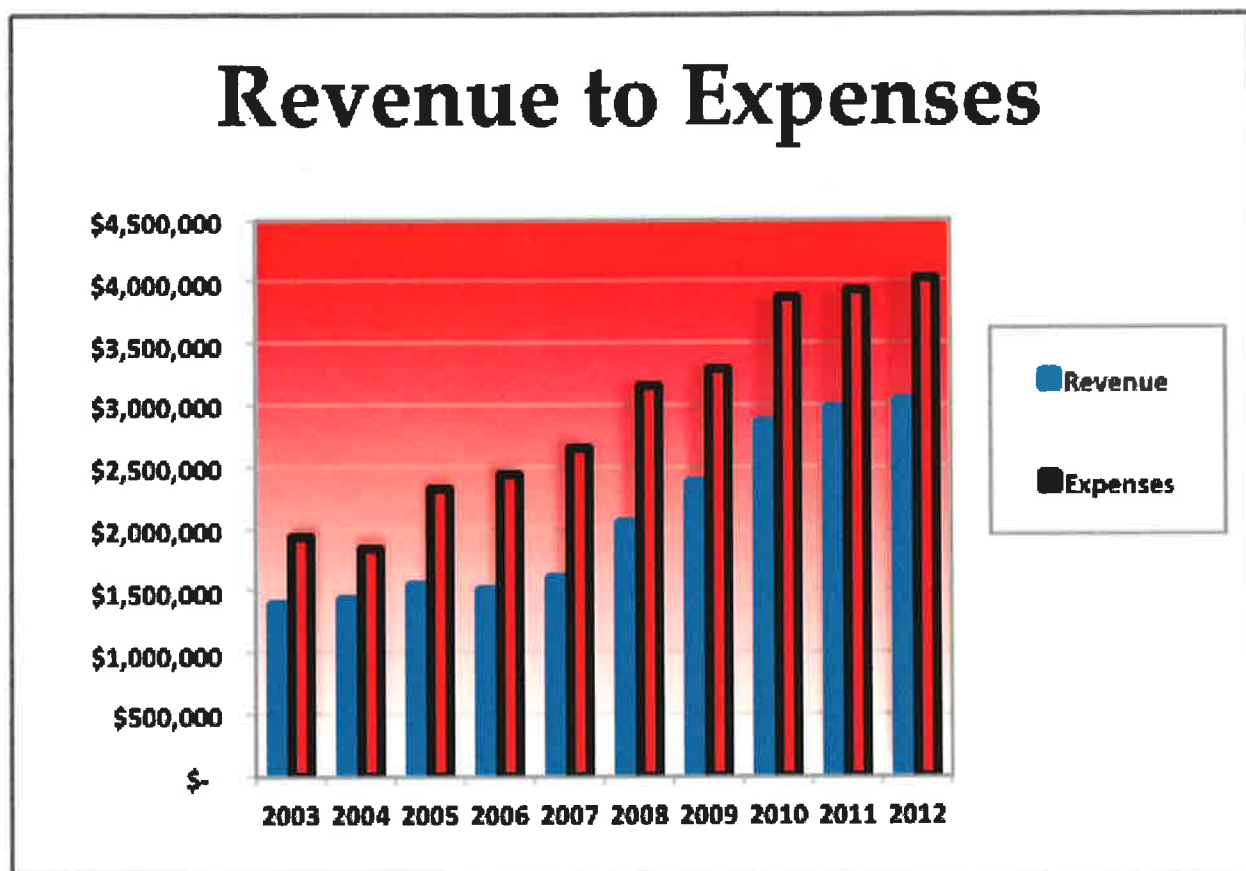


Revenue to Expenses

The next chart that we created from the District Audited Financial Statements was a comparison between revenue and expenses. As shown by the chart below,

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expenses grew steadily every year and exceeded revenue by a substantial margin in each and every year from 2003 to 2012.



Wallace Group Billing History

As part of our “Line Item Review of Expenses” we selected District payments made to the Wallace Group for Administrative, Engineering and other MBI payments. Based upon our review of the Wallace billing statements and after our conversation with Sabrina Spears, it was apparent that the Wallace billing statements served as the source document or the basis for payments made to the Wallace Group. We learned that from the Wallace billing statements, a warrant request was prepared by the District bookkeeper, which was then attached to the bi-weekly Board Packets for the District Board of Director’s approval.

Certain categories of information from the billing statements were then entered into the District’s accounting system by the District bookkeeper. Beginning in August 2008, the District began using the QuickBooks accounting software for the District’s finances. We noted that Sabrina Spears received assistance from the Wallace Group in categorizing the Wallace billings (admin, engineering and MBI

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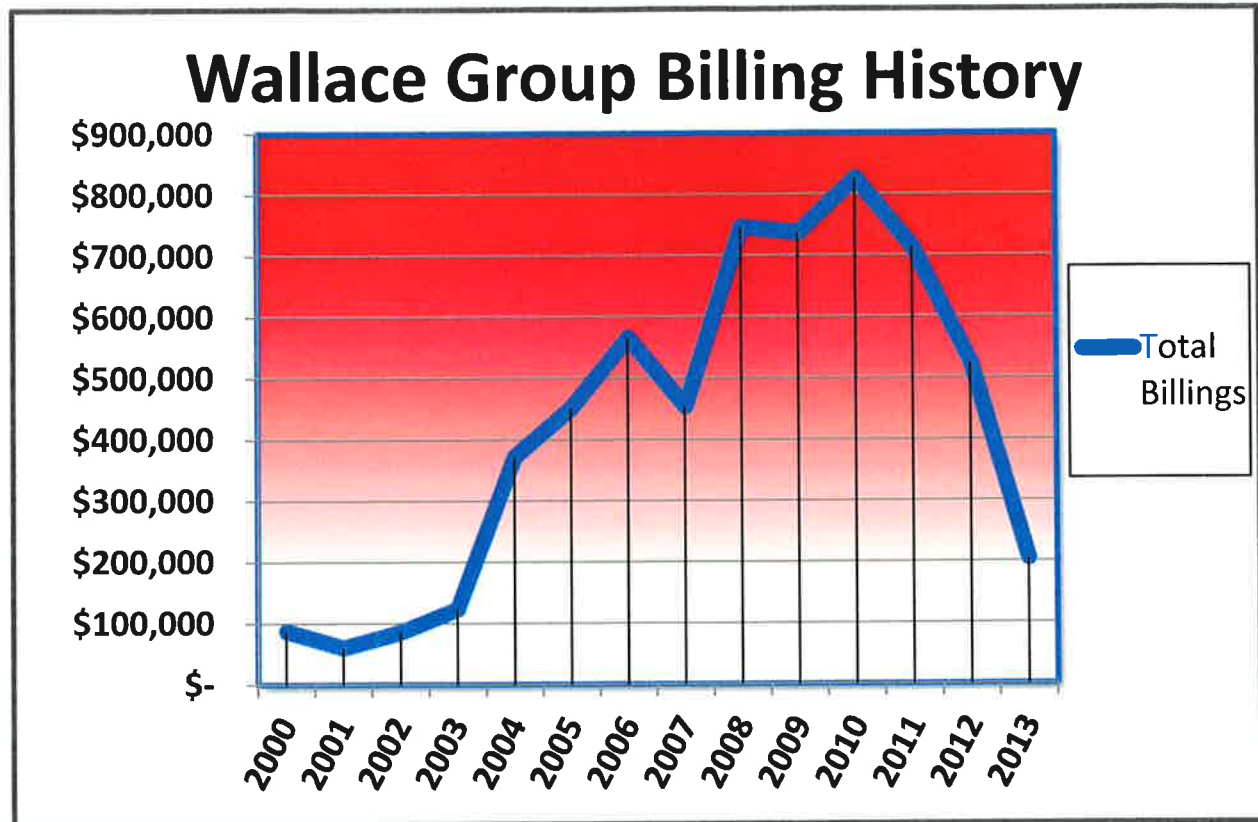
projects) to the District's accounting system (Exhibit 6, 2009 Memo to Sabrina from Jill (McPeck)).

We were advised by the current administration that there was no electronic accounting software retained by the District prior to August 2008. We therefore reconstructed the District's accounting of the Wallace billings prior to 2008 by analyzing the monthly billing statements for the period 1999 to August 2008 which were stored at the District. We then prepared a summary spreadsheet of the District's payments to the Wallace Group for the period 2000 to June of 2013 that revealed that the District paid the Wallace Group \$6.2 million during that period.

As shown below our "trend analysis," of the yearly billings by the Wallace Group starting in 2000 showed modest increases, but after 2001 there was a dramatic increase in their billings that peaked in the 2009-2010 period. Our analysis showed that after the Grand Jury investigation began in 2011 and after the rewriting of the Wallace contracts in July 2011, the monthly billings decreased substantially until the retirement of Wallace in 2013.

Although we reviewed all of the Wallace billing statements for the period 1999 to 2013, we have selected a sampling of the billing statements ending in December for the years 1999 to 2012, and the final billing statement dated May 2013. This sampling allowed us to demonstrate the trends and anomalies we observed regarding the billings. We believe this sampling is representative of all of the Wallace Group billing statements for the period 1999 to June 2013. We have only included a few of these billing statements as exhibits due to the sheer volume of paper. Our in depth review of the selected monthly billing statements of the Wallace Group are detailed here:

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Analysis

We obtained the Wallace Group (“Wallace”) monthly billing statements from the District for the periods 1999 to May of 2013. A review of the monthly billing statements up to 2010 from Wallace showed that they were addressed to Sabrina Spears at the District. Each one of the billing statements had an “Approved by” notation at the bottom of billing statements for “Administrative” services and for “Engineering” services. It appears that Mr. Wallace’s initials were written in the “Approved by” area on the document.

We interviewed “key” employees and members of the Board of Directors regarding the bills submitted to the District by the Wallace Group.

Ms. Sabrina Spears (1986 to 2010) who was the secretary/bookkeeper at the District advised us that she would prepare a “Warrant Request” based upon the Wallace billing statements, but she did not question any of information contained in the billing statements because “Wallace was in charge.” Mrs. Spears stated that Jill McPeck, a Wallace Group employee, would send her a summary of the

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Wallace billings and broken down by Administrative, Engineering and Major Budget Items.

Jeff Appleton (1986 to 2011), who was the Superintendent (CPO) at the District during the period 2000 to 2010, stated that he never reviewed a Wallace billing statement and was never asked by Wallace to review any of the billings as it related to work performed at the WWTP by the Wallace Group employees. In fact, during his tenure, Appleton stated that he only heard one or two board members actually talk about the monies being paid to the Wallace Group.

Appleton was shown copies of the Wallace Group billings for the periods March 2004, June 2008 and December 2009 and was asked to review the charges for Administrative Services. Appleton observed that the Wallace Group was now performing many of the duties that had historically been performed by District employees. Appleton pointed out that the District employees were still drawing their normal salary and there was no savings to the District by the Wallace Group taking over their administrative duties.

Bob Barlogio (2010 & 2011 to 2013), who was the CPO from 2010 (two months) and 2011 to 2013, stated that he did not review the Wallace Group billings and wasn't sure that it was his duty to check them. Further, Mr. Barlogio stated that he wasn't going to step on anyone's toes by questioning Wallace's bills to the District. It was the opinion of Mr. Barlogio that Wallace's motive for having so many of the Wallace Group working at the District was money and that the Wallace Group people added little value to the operation of the plant.

In fact, there were several instances where he had issues with Heather Billing, a Wallace Group employee, who was constantly editing and re-writing his reports to the District. Billing was not asked by him to do any of this and he finally told her to stop duplicating his work. In another situation, Billing was giving classes on the Operators Manual to the Operators at the plant, but it was clear to him that she had no idea what she was doing and the Operators also told him that she didn't know what she was doing.

There was another Wallace Group employee "Kate" who was trying to develop SOP's, but this person had no experience in WWTP so those SOP's were not well received by the operators.

Bill Nicolls, Board Member (2008-2012) told us, as the Chairman of the District Board of Directors, he reviewed the billing invoices of Wallace and would ask questions about categories of billings and how much was being spent on MBI

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projects. He didn't challenge Wallace on the detail or have Wallace provide proof of the work that was done. He knew the Wallace people and visited the plant, and knew that the work was being done. It was a great savings by having the Wallace Group do the work where it was appropriate since they charged a lot less than other companies in the area.

Tony Ferrara, Board Member (2000 to 2014), told us that the Chairman of the Board reviewed all of Wallace's billings and was satisfied that the work billed was completed and approved by the Board. Mr. Ferrara also stated that the Board approved all of the MBI projects and all of the work that the Wallace Group performed at the District. Mr. Ferrara stated that if anyone wanted to blame how much the Wallace Group made at the District, they could blame it on the Board of Directors.

Mathew Guerrero, Board Member (2012 to present) told us that he had become concerned about the amount the District was paying to the Wallace Group and was told that Bill Nicolls reviewed and would go over the billings at the plant, but he was not sure what that meant.

Laurie Angelo, Board Member (2011-2013) told us that she was on the DISTRICT Board with Bill Nicolls and Tony Ferrara around 2011. During that time, she had questioned Wallace on his billings and the amount of money he was spending while he was the Engineer and the District Manager. She had asked Wallace to provide receipts and evidence to justify the amounts he was charging the District, but his response was that the support was in the files at the plant and he basically gave her the run a round. When she tried to press Wallace to provide the backup to his billings, she was voted down by Nicolls and Ferrara. Mrs. Angelo voted "no" when Wallace's new contracts came up for a vote in 2011.

Debbie Peterson, Board Member (2013) told us that before she became a Board Member, she had spoken with local citizens and other Board Members regarding how much the District was paying the Wallace Group. Once she was on the Board her concerns about the Wallace billings and how much District money had been paid to the Wallace group over the years concerned her even more.

Based upon how badly the plant was running, she didn't believe that the District's money had been wisely spent on improvements; rather the District's monies were being spent on enormous legal fees as a result of the mismanagement of the

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District by Wallace. Ms. Peterson had reviewed a substantial amount of the District's finances and had constructed several analyses of payments to the Wallace Group, and payments made to the attorneys who were defending Wallace and the District on the personnel actions and the 2010 sewage spill.

Jim Hill, Board Chairman and Mayor of Arroyo Grande (2007- 2011, 2015 to present) commented that when he was on the Board in 2010 (OCSD) he had expressed his concerns about Wallace's billings and the fact that it appeared to be a conflict of interest where Wallace as the District Administrator was approving Engineering work that was being done by the Wallace Group. Mr. Hill provided emails dated December 2010 and February 2011 where he had expressed his concerns on the conflict, because he believed that there was no pretense of competitive bidding on some of the Engineering work that the Wallace Group had performed for the District. (Exhibit 7 and 8, Copy of emails). Further description of the 2010 Board Meeting is found at page 52 of this report and related Exhibit 30.

As detailed below, in our analysis of the Wallace billings, we looked for trends related to the billing process, and anomalies regarding the number of hours charged and the amount of funds that were charged:

Billing Statements

The billing statement for Wallace & Associates for the period December 1999 (Exhibit 9) consisted of 6 pages and the total amounts for Administrative and Engineering services was \$3,622.66. Total hours charged for the month was; 45.25 for administrative services, and 35.75 for engineering services for a combined total of **81 hours**. The detail describing the charges consisted of a two or three word description with no identification of the 7 Wallace employees who charged time on the Wallace bills. On an annual basis total costs to the District would be \$43,471.92.

The charges for the "Administrative" work were identified as Principal, Associate Engineer, Secretary and Operational Manger. The charges for the "Engineering" work were identified as; Associate Engineer, Secretary, Senior Planner, Associate Planner and Operations Manager. Hourly rates were from \$20 to \$50 per hour.

At the bottom of each of the invoices for Administrative and Engineering billings was written "**Approved by John L. Wallace.**"

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The billing statements for Wallace & Associates for December 2000 (Exhibit 10) consisted of six pages and the total amounts for Administrative and Engineering services were \$5,625.93. Total hours charged for the month was; 50.25 for administrative services and 69.50 for engineering services for a total of 119.75 hours billed to the District. The detail describing the charges consisted of a two or three word description with no identification of the actual person doing the work.

The charges for the “Administrative” work were identified as Principal, Associate Engineer, Secretary and Operational Manger. The charges for the “Engineering” work were identified as: Principal, Senior Engineer, Associate Engineer, Secretary, Senior Planner, and Operations Manager. Hourly rates were from \$20 to \$50 per hour. Total annual costs to the District would be \$67,511.16 at those rates.

At the bottom of the invoices for Administrative and Engineering work was written **“Approved by John L. Wallace.”**

The billing statements for Wallace & Associates for December 2001(Exhibit 11) consisted of seven pages and the total amounts for Administrative and Engineering services were \$6,501.56. Total hours charged for the month was; 31.00 for administrative services, and 117.50 for engineering services for a combined total of 148.50 hours. The detail describing the charges consisted of a two or three word description with no identification of the actual name of the 12 Wallace people doing the work.

The charges for the “Administrative” work were identified as Principal, Engineering Associate III, and Clerical. We noted that the charges for “Clerical” were described as; Agenda/Staff Report, Board Mtg, Agenda Prep. and Staff Services.

The charges for the “Engineering” work were identified as; Principal, Civil Engineer, Senior Civil Engineer, Operations Manager, Operator III, Engineering Associate II, Engineering Associate III, Systems Supervisor and Field Inspector I (Inspection).

We noted that the “Operator III” identified on the Wallace billing is a term of art in the Waste Water Quality Board approval of “Operators” licensing. We have been advised by the WWQB that using a roman numeral for the level III means it is related to Waste Water operations. If you used a “3” instead of a III the designation from the WWQB would be for a water treatment facility, not a Waste Water treatment facility like Oceano. There is a clear distinction made by the WWQB and the licensing process is noticeably different. Since the Wallace billing didn’t

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identify a person associated with the charges for “Operator III” we could not determine whether Wallace was charging for the services of the Operator III at the WWTP who was an employee of the WWTP and not an employee of the Wallace Group. Hourly rates were from \$20 to \$50 per hour.

The District Budget for 2001 showed that the District Bookkeeper’s beginning monthly salary was \$3,064 or a little over \$19 per hour (160 hours in an average work month); and the Plant Superintendent was \$5,002 per month or \$31 per hour)

The bills for Administrative and Engineering work were “Approved by John L. Wallace.”

The billing statements for Wallace & Associates for December 2002 (Exhibit 12) consisted of seven pages and the total amounts for Administrative and Engineering services were \$5,781.36. Total hours charged for the month was; 34.50 for administrative services, and 102.00 for engineering services for a combined total of 136.50 hours. The detail describing the charges consisted of a two or three word description with no identification of the 10 Wallace people doing the work.

The charges for the “Administrative” work were identified as Principal, Engineering Associate IV, Financial Analyst I, and Clerical II.

The charges for the “Engineering” work were identified as Principal, Senior Operating Consultant, Associate Planner II, Engineering Associate IV, Financial Analyst I and Field Inspector I (Office). Hourly rates were from \$20 to \$50 per hour. The detail describing the charges consisted of a two or five word description with no identification of the actual 10 Wallace Group people doing the work. Total costs to the District on an annual basis would be \$69,376.32.

The bills for Administrative and Engineering work were “Approved by John L. Wallace.”

The billing statements for Wallace & Associates for December 2003 (Exhibit 13) consisted of eleven pages and the total amounts for Administrative and Engineering services were \$12,855.52. Total hours charged for the month was; 39.50 for administrative services, and 160.25 for engineering services for a total of 199.75 hours billed to the District. We noted that there was not a summary of hours worked on the Engineering billing schedule; rather it was broken down by particular MBI projects, which made the process of auditing the documents more time consuming and tracking more difficult. Total annual costs to the District on an annual basis would be \$154,266.24,

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The detail describing the charges consisted of a two or three word description with no identification of the actual person doing the work.

The charges for the “Administrative” work were identified as’ Principal, Senior Operations Consultant, Engineering Associate IV, and Clerical III.

The charges for the “Engineering” work were identified as Principal, Senior Operating Consultant, Associate Planner II, Engineering Associate I and IV, Financial Analyst I and Field Inspector I and III (Inspection and Office), Director of Surveying, Director of Planning. Hourly rates were from **\$35 to \$90** per hour an increase from the previous year where the highest billing rate range was from \$20 to \$50 per hour. The detail describing the charges consisted of a two or five word description with no identification of the actual 16 Wallace Group people doing the work.

The bills for Administrative and Engineering work were “Approved by John L. Wallace.”

The billing statements for the Wallace Group for December 2004 (Exhibit 14) increased substantially to twenty-two pages and the total amounts for Administrative and Engineering services were \$46,319.65, which were more than triple the costs in December 2003. Total hours charged for the month was; 155 for administrative services, and 430.50 for engineering services for a combined total of 585 hours, which was more than triple from the previous year. We noted that the Engineering billing schedule was broken down by **twenty MBI projects.**

The charges for the “Administrative” work were identified as Director of Marketing Engineering, Principal, Senior Financial Analyst, GIS Specialist, Engineering Associate I and IV, and Administrative Assistant I and II. The hourly rates ranged from \$35 to \$90 per hour.

The charges for the “Engineering” work were identified as Principal, Senior Operating Consultant, Associate Planner II, Engineering Associate I and IV, Financial Analyst I and Field Inspector I and III (Inspection and Office), Director of Surveying, Director of Planning.

The detail describing the charges consisted of a two or five word description with no identification of the actual 18 Wallace Group people doing the work.

The bills for Administrative and Engineering work were “Approved by John L. Wallace.”

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The billing statements for the Wallace Group for December 2005 (Exhibit 15) consisted of twenty pages and the total amounts for Administrative and Engineering services were \$50,841.84, Total hours charged for the month was; 57 hours for administrative services, and 363.25 for engineering services for a combined total of 420 hours. We noted that the Engineering billing schedule was broken down by **twenty-two MBI projects**, but did not provide a total of hours worked.

The charges for the “Administrative” work were identified as Principal, Director of Mechanical Engineering, and Project Analyst I. The hourly rates ranged from \$60 to \$98 per hour. We noted that the “Principal” was performing “Brd Mtg, Agenda Prep, Staff Service” at \$98 per hour and the “Director Mechanical Engineering” was charging for “Board packages at \$97.75 per hour. We noted that historically, the Wallace Group billed clerical work at \$20 per hour. Further, the past and present District Superintendent’s both stated that these duties were performed by District employees and would have been part of their salary.

The charges for the “Engineering” work were identified as Principal, Project Analyst I, Director of Mechanical Engineering, Engineering Associate II and III, Project Analyst, Engineering Inspector (Office), Senior Mechanical Engr I, Associate Planner, Supervising Planner, Construction Manager, Administrative Assistant III, Senior Civil Engineer II and Director of Surveying. The hourly rates charged ranged from \$46.75 to \$98 per hour with the predominant amount closer to the \$90 per hour range.

The detail describing the charges consisted of a two or five word description with no identification of the actual 14 Wallace Group people doing the work.

The bills for Administrative and Engineering work were “Approved by John L. Wallace.”

The billing statements for the Wallace Group for December 2006 (Exhibit 16) consisted of twenty pages and the total amounts for Administrative and Engineering services were \$42,553.18, Total hours charged for the month was; 55 hours for administrative services, and 364.75 for engineering services for a combined total of 419 hours. We noted that the Engineering billing schedule was broken down by **thirteen MBI projects**, but did not provide a total of hours worked.

The charges for the “Administrative” work were identified as Principal, Director of Mechanical Engineering, and Project Analyst III. The hourly rates ranged from

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\$46.75 to \$98 per hour. We noted that the “Principal” was performing “Brd Mtg, Agenda Prep, Staff Srvc” at \$98 per hour and the “Director Mechanical Engineering” was charging for “District Admin” at \$97.75 per hour. We noted that historically, the Wallace Group billed administrative-clerical work at \$20 per hour.

The bills for Administrative and Engineering work were “Approved by John L. Wallace.”

The billing statements for the Wallace Group for December 2008 (Exhibit 17) consisted of thirty-two pages and the total amounts for Administrative and Engineering services were \$55,707.95, Total hours charged for the month was; 56 hours for administrative services, and 534 hours for engineering services for a combined total of 590 hours. We noted that the Engineering billing schedule was broken down by at least twenty-six MBI projects, but did not provide a total of hours worked.

The detail describing the charges consisted of a two or five word description to sentences with the actual identification of the 14 Wallace Group people doing the work.

The charges for the “Administrative” work were identified as Principal, Project Analyst II, Director of Mechanical Engineering, Senior Mechanical Engineer II and Admin Assistant III. The hourly rates ranged from \$46.75 to \$98 per hour, but the predominant amount charged was over \$90 per hour.

The charges for the “Engineering “ work were identified as Principal, Director of Water Resources, Engineering Associate III, Senior Mechanical Engineer I and II, Admin Assistant I and III, Resident Engineer, Construction Administrator, Engineering Assistant I, Senior Civil Engineer I, Director of Mechanical Engineering, Project Analyst II and III, and Civil Engineer II. The hourly charges for the 15 Wallace employees ranged from \$38.25 to 97.75 with the predominate rates in excess of \$80 per hour.

The bills for Administrative and Engineering work were “Approved by John L. Wallace.”

The billing statements for the Wallace Group for December 2009 (Exhibit 18) consisted of thirty-five pages and the total amounts for Administrative and Engineering services were \$68,098.69. There were now four categories of expenses being claimed as summarized on a “Memo” to Sabrina from Jill presumably from the Wallace Group. **It is noted that the Wallace Group is**

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explaining how the payments to the Wallace Group should be entered into the accounting/bookkeeping system at the District.

When comparing the summaries of expenses on the Wallace bills we observed substantial discrepancies between the "Summary" from the Wallace Group versus the actual billing statements from the Wallace Group:

<u>Summary</u>	<u>Actual Billing Statement</u>	<u>Description Per Jill</u>
\$12,438.54	\$6,497.77	District Admin
\$20,228.48	\$12,064.54	District Operations
\$ 1,440.04	\$1,135.69	Reimbursable Projects
<u>\$33,991.63</u>	<u>\$43,284.42</u>	MBI Projects
Total \$68,098.69	\$62,982.42	

Based upon the above summary, it is clear that there were discrepancies between what was claimed versus what the attached billing detailing documents supported. A copy of the actual check issued to the Wallace Group shows that the \$68,098.69 was paid. See billing detail below December 2012.

The billing detail for Administrative Services showed that 69.75 hours were charged and the billing rates ranged from \$47 to \$105 for the services of; Principal, Senior Engineer II, Senior Engineer Associate I and III, Senior Mechanical Engineer, GIS Specialist, Senior Financial Analyst, Admin Assistant II and III and District Administrative/Engineer for a total of ten individuals. The majority of services provide were in the \$90 per hour range.

The billing detail for Reimbursable Projects showed that 13.5 hours were charged and billing rates ranged from \$66 to \$98 for the services of; Senior Engineer I and Project Analyst I,

The billing detail for District Operations Projects showed that 124 hours were charged and the billing rates ranged from \$42 to \$108 per hour with the majority of billing over the \$90 per hour range. The services were provided by; Senior Mechanical Engineer I and II, Admin Assistant I and III, Director Administration/Engineer (John Wallace), Senior Engineer I, Senior Planner II, Engineering Associate III, Project Analyst I, Construction Administrator, and PW-Engineering Inspector (Field) for a total of eleven individuals.

The billing detail for Major Budget Items (MBI) projects showed that 456.5 hours were charged by; Principal, Engineering Associate I, Senior Mechanical Engineer II, Construction Administration, PW-Engineering Inspector (Field), Admin Assistant III, District Administration/Engineer, Senior Civil Engineer I,

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Engineering Associate I and II, Senior Mechanical Engineer II, Director of Planning, Senior Planner II, and Project Analyst III for a total of fourteen individuals. The predominate rate charged was over \$90 per hour. The total charges for both hours and fees charged were summarized by sub-category, but not totaled by the MBI project, which made the analysis complex and tedious and without the summary explanation from the Wallace Group, the bookkeeping/accounting process would have been impossible to decipher.

In total, there were 663.75 hours charged by the Wallace Group during December 2009 and a total of 28 Wallace Group employees charging fees to the District.

At the bottom of the bills there was a sentence, "For questions regarding this invoice, please contact the billing manager shown below."

The bills for Administrative, Engineering, District Operations Projects and Reimbursable Projects were all "Authorized by John Wallace" with what appears to be the Wallace initials.

The billing statements for the Wallace Group for November 2010 (Exhibit 19). The December 2010 bill was not complete so we used the November 2010 bill for our analysis. The previous trends as detailed in prior months persisted to this month's activity. We noted that there was \$59,434.55 billed for a total of 684.75 hours. We noted that there were many months in the 2010-year where billings exceeded \$70,000 and on a few occasions, the bills exceeded \$100,000.

The billing statements for December 2011 (Exhibit 20) consisted of thirty-two pages but the format changed from attaching a copy of the check paid to the Wallace group along with the Warrant Summary to attaching only a memo from Wallace explaining the category of charges and a schedule showing all payments made as of "12-31-11" compared to what was Budgeted for that particular category. The traditional copy of the check and Warrant Summary was no longer included in the billing data from Wallace.

The summary for District Administrative Services showed 95 hours charged at rates ranging from \$51 to \$108 per hour for a total of \$8,787.30. Category by individual; Principal, Director of Water Resources, Senior Civil Engineer I, Senior Engineer III, Civil Engineer I, Engineering Associate II, Admin Assistant III and District Administrator/Engineer (Wallace) for a total of 8 individuals.

The summary for District Operations Projects showed a total of 333.75 hours and a total of \$31,101.00 (page 4). Participants included; Senior Engineer III, Engineering Associate II and III, Senior Civil Engineer I and Senior Engineer I,

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Civil Engineer I, District Administrator/Engineer, and Project Analyst I (8 individuals).

The summary for District Reimbursable Projects showed 48.5 hours and a total of \$3,655.39 (page 2).

The summary for Major Budget Item Projects showed 41.25 hours charged and a total of \$3,577.15 (page 2) Participants included; Senior Engineer III, Engineering Associate III, Senior Civil Engineer I and Senior Engineer I.

Total hours billed was 518.1 for a total of \$47,120.84. We noted that this new format makes it extremely difficult to trace Warrants to the billings of the Wallace Group.

The District Budget for 2001 showed that the top rate for the Bookkeeper was \$4,363 per month or about \$27 per hour on an average work month of 160 hours. The salary for the Plant Superintendent was \$7,119 at the high-end, or an hourly rate of a little over \$44 per hour.

The bills for Administrative, Engineering, District Operations Projects and Reimbursable Projects were all “Authorized by John Wallace” with what appears to be the Wallace initials.

The billing statements for the Wallace Group for December 2012 (Exhibit 21) consisted of twenty-four pages. There was a copy of a warrant summary of “Admin & Engineering” Special Dept. Expenses for four categories, and a copy of the warrant issued to the Wallace Group in the amount of \$32,588.83. There was also a copy of EFS Authorization to Draw Warrant that summarized 4 subcategories of “Admin & Engineering – January” even though the attached bills were for December 2012.

The Invoice for “District Administration” showed a total of \$8,396.72 in charges and a total of 96 hours billed by; Senior Civil Engineer I, Senior Engineer III, Civil Engineer, Engineering Associate II, Senior Planer I, Admin Assistant II, District Administrator/Engineer, Sr Env Comp. I and II; a total of 9 employees of the Wallace Group. The hourly rates charge ranged from \$42 per hour to \$108 per hour with the majority of the hours exceeding \$90 per hour. The administrative charges related to; Staff reports, Budgets, SSMP Update, Minutes, Board Packets and Budget Changes.

We noted that according to past and present District Superintendents these were tasks (as stated above) normally performed by District employees “in-house,”

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which would have cost the District nothing more than the cost of the employee's salary. There would be no justification to bid out the work if it was being done "in-house."

The bills for Administrative, Engineering, District Operations Projects and Reimbursable Projects were all "Authorized by John Wallace" with what appears to be the Wallace initials.

However, when comparing the total amount billed as shown on the EFS Authorization to Draw Warrant per the Wallace invoices the following discrepancies were observed:

<u>Summary</u>	<u>Actual Billing Statement</u>	<u>Description Per Statement</u>
\$9,700.98	\$ 8,396.72	District Administration
\$17,111.63	\$14,573.88	District Operations Projects
\$3,395.97	\$ 1,943.30	District Reimbursable Projects
<u>\$2,380.25</u>	<u>\$12,035.75</u>	Major Budget Items
\$32,588.83	\$36,949.65	Totals

Based upon the above summary it is clear that there were substantial discrepancies between what was claimed versus what the attached billing detailing documents supported. A copy of the actual check issued to the Wallace Group shows that the \$32,588.83 was paid. Total hours billed for all categories was 300 hours.

We reviewed the Board Packets for January 24, 2013 and found the Warrant Register for December 2012 and payment made to the Wallace Group. We observed that the amounts totaling \$36,949.65 as shown in the above chart, were actually listed on the Warrant request (see attached page).

We reviewed the Board Packet for 2/20/2013 and copied a page from the Warrant Register submitted with the Board Packet and found that the "January" 2013 payments as listed on the EFS document were listed in the Warrant Register, which confirms that the bookkeeper or District personnel who assembled the billing records for the Wallace payments erred in putting the wrong summaries with the wrong billing statements from the Wallace Group.

We believe that whoever put the billing data together at the District erred by attaching the Wallace billing data to the wrong warrant summary data. These self-inflicted errors would make it very difficult for an auditor or investigator to track expenditures through the District financial data. Since this issue with matching warrants to billing statements was not addressed in the audited financial

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statements, or reports from anyone else who has reviewed the Wallace billings, it is our opinion that these Wallace billing statements have never been properly reviewed.

The billing statements for the Wallace Group for April 2013 (Exhibit 22) consisted of fifteen pages but the format changed from attaching a copy of the check paid to the Wallace group along with the Warrant Summary to attaching only the summary schedules for District Operations Projects (14.25 hours \$1,362.75, District Reimbursable Projects (25.25 hours \$1,793.29), and Major Budget Items Projects (36 hours, \$3,870.59). There was no summary schedule for Administrative Services, but there were itemized schedules showing 89.5 hours worked but no total as to what was charged. I used a “ballpark” hourly rate of \$90 per hour to arrive at a potential billed amount of \$8,055. Total hours billed for April were 165 and amount billed was approximately \$13,881.63.

There was no memo from Wallace explaining the category of charges as required by the 2011 Contract regarding billings to the District.

We noted that on the April billing statement for hours charged on “District Engineering” account 19-7076, there were a few entries that stood out:

“4/30/2013” “Billing, Heather ...directed by Mr. Karp to discontinue all reg compliance updates.”

Another series of entries related to Burkett, Christine on “4/15/2013, 4/16/2013 and 4/18/2013” “Purge and box files, folders and binders.” And on “4/19/2013” “Sort boxes from off-site storage.”

There was also an entry on “4/18/2013” for “Sever, Nicolas, Retrieved DISTRICT files, binders and boxes from off-site storage.”

There were also references to John Wallace on 4/3/2013 and other dates “coordinate with staff, organize files for transfer to District.”(Page 1-3 of billing summary).

Summary

There were several trends that we identified as follows:

In December 1999, total hours billed to the District by the Wallace Group was 81 hour per month for both Administrative and Engineering work, and by 2009, the Wallace Group had increased chargeable hours to over 663 hours per month.

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The monthly Wallace Group invoices for Administrative and Engineering Services in 1999 totaled \$3,600 and by 2010 the Wallace Group monthly invoices for all services had increased to a high of \$70,000. Taking into account the 1995-1999 Budget Reports, the yearly projected budget for "Dist. Administration" ranged from \$35,000 to \$45,000 or a monthly average of \$2,900 to \$3,750.

Wallace Group employees charging time to the District went from 7 in 1999 to over 28 by 2010. This would suggest that close to 50% of the 50 to 60 of the Wallace Group employees were working at the District during some months. Further, per the Wallace website, the Wallace Group was also providing Administrative & Engineering services to ten other county government organizations during the same period of time.

The number of MBI projects increased from 5 in 2000 to 60 projects by 2008.

The District Budget reports showed that the District Bookkeeper's salary ranged from \$20 per hour to \$27 per hour during the period 2001 to 2011; and the Plant Superintendent's salary ranged from \$33 per hour in 2001 to \$44 per hour in 2011. The lowest and highest billing person at the Wallace Group per the Wallace Group billing statements was \$45 to \$98 per hour with the average billing rate for all services closer to \$80 per hour.

We determined that as the billing statements were constructed, there was no way to confirm or audit the Wallace Group billings at the District, since all of the supporting records (reports, surveys, studies, analysis) related to the Wallace Group billings were not at the District but likely maintained at the Wallace Group. Further, for the period 2000 to 2008, the identity of the individual at the Wallace Group billing for services was not listed on the billing statements, which would make it impossible to audit the billing statements to verify that billed work was actually performed.

Although there was at times substantial detail on the Wallace billing statements, it was not particularly helpful in case an auditor wanted to verify work on a particular project (MBI). There was a date but not a time, so an auditor would not be able to verify whether there were billing problems, such as double billing. Moreover, there were numerous billing statements with charges related to "Principal" but there was no other detail other than a reference to "Airport Lease," "Chlorine Contact Chamber," or "Coord Facilities Plan." (November 2002 billing

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statement, 2009 billing statements). This lack of precise information was consistent for virtually all of the billings provided by the Wallace Group to the District.

There have been recent statements by former Board members who have stated that the District received a great deal from the Wallace Group since their billing rates were lower than other Water Treatment Plant facilities in the area. However, when reviewing the Wallace Group billing rates charged for just administrative services, we saw substantial charges for administrative services such as; Board Packets, Staff Reports that were in the \$90 per hour range but those services had previously been done by District employees whose rates were in the range of \$20 per hour to \$44 per hour.

Our review of the District's Annual Budget Reports (2001 to 2011) showed that salaries for the District bookkeeper ranged from \$20 per hour to \$27 per hour; and that the salary for the District Plant Superintendent ranged from \$33 per hour to \$44 per hour. When comparing the hourly rates charged by the Wallace Group for Administrative Services that ranged from \$45 per hour to over \$90 per hour to the hourly rates paid to the District's Bookkeeper and Plant Superintendent of \$27 per hour and \$44 per hour it is clear that there was no savings to the District by using the Wallace Group to take over the administrative duties of the District.

In our opinion there was a clear lack of controls related to the accounting of the District's payments to Wallace & Associates and the Wallace Group, and an apparent conflict of interest in Wallace as District Administrator approving billings to the District for administrative, engineering and other services provided by the Wallace Group. The fact that some former Board Members have stated that they reviewed the Wallace Group billings with Wallace is commendable, but puts the Board Member in an untenable position of vouching for each and every billing submitted to the District by the Wallace Group.

Further, we believe these meetings between Wallace and the Board Member(s) were not documented in a report to the Board of Directors to memorialize the fact that they (the Board Members) were acting in an official capacity as a Board Member, which would include details such as; date, time, place of review, bill(s) that were reviewed, and any issues addressed during the review.

As discussed in the "Operations" section of our report, District projects approved by the Board of Directors without a bidding process or a contract is in violation of the District's Policies and Procedures related to the expenditure of District funds.

Expenditures for Plant Chemicals

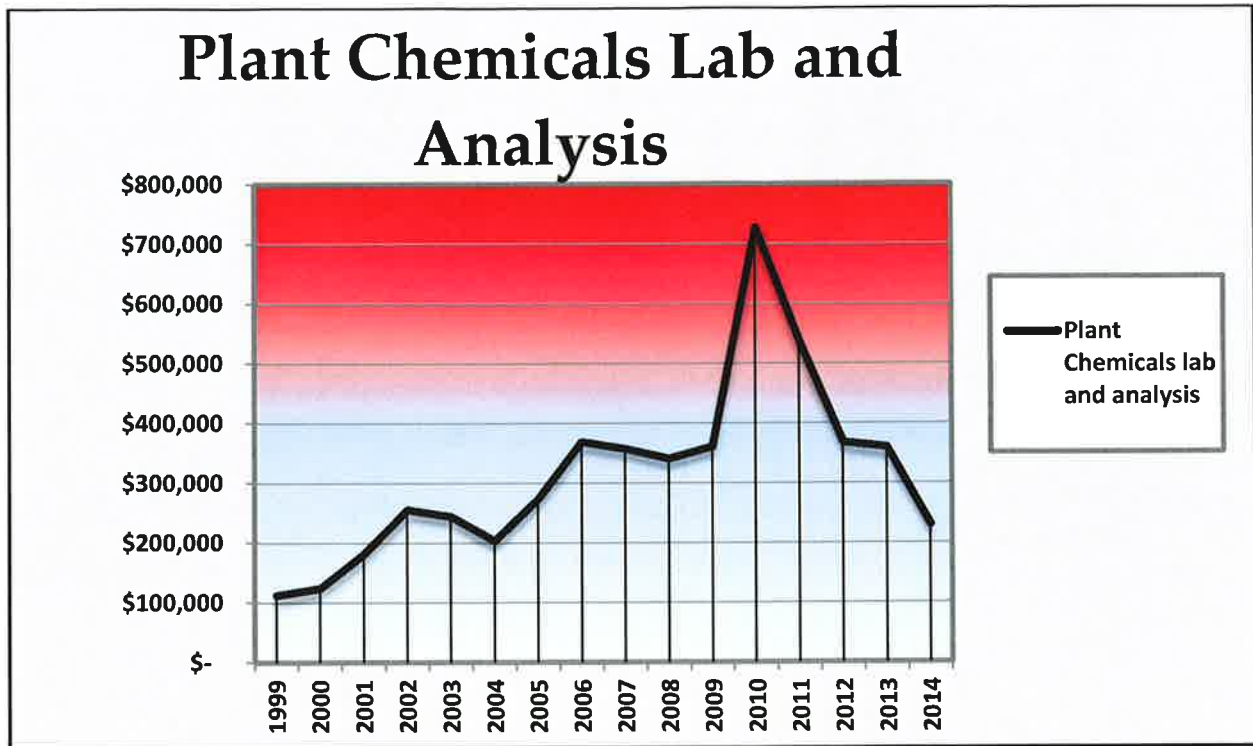
One of the issues raised during the RFP process and highlighted as a concern during the interview of current and former plant Superintendents was the high-usage of chemicals at the District. There were allegations that District employees were receiving kickbacks from one of the major chemical company suppliers and that this allegation could explain why the District was using an excessive amount of chemicals. However, the allegation about kickbacks did not include the Wallace Group or John Wallace and therefore would not be relevant for this report.

Further, we did follow up by asking some of the employees who were alleged to have received kickbacks from the chemical company and they disputed the allegation.

We reviewed the District's QuickBooks accounting related to "Plant Chemicals lab and analysis" for the period 2008 to 2014 and found the numbers to be substantially lower than those totals per the Audited Financial Statements. We have therefore used the "Audited Financial Statements" since we deem them to be more reliable since they were prepared in or near the time of the expenditures.

Based upon our review of the expense item "Plant Chemicals lab and analysis" as shown on the District's audited financial statements for the fiscal years 1999 through 2014, we prepared the chart below to show the "trend" in the costs of chemicals over a 14-year period. The chart shows that there was a 646% increase in costs during the fiscal years 1999 to 2010 with a substantial spike in the 2009 - 2011 period.

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Bob Barlogio, who took over as Plant Superintendent at the beginning of 2011 stated that he had noticed that the District was paying twice as much for chemicals from a chemical company. At the plant where he had previously been the Superintendent, they paid 50% of what the District was paying. Barlogio recalled that he contacted the chemical company and told them that they would have to reduce their price 50% if they were going to do business with the District, which they did.

The above referenced chart shows that there was a dramatic decrease in the costs of chemicals to the District starting in 2011. John Clemons, the current District Superintendent stated that his analysis of the chemical usage at the plant showed that over 1,000 pounds of chlorine a day were being used at the peak in 2010-2011 periods. Mr. Clemons stated that in contrast, the plant is now using just over 100 pounds of chlorine per day.

Major Budget Items Payments

We reviewed the Major Budget Item binders for 2010 to 2013 that were stored in the District office. We reviewed all of the binders in detail and found that there was not one contract, work plan, board approval memo, staff report, invoice or billing statement contained in the MBI folders that supported the Wallace Group

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billings on the MBI projects. We observed that invoices from other vendors were contained in the MBI folders, which were categorized by the particular MBI projects. Given this lack of documentation, it would have been virtually impossible for an auditor to audit the MBI payments with the documents stored at the District office.

We also reviewed the MBI folders for 2004-2005 that did contain a hand written Wallace billing summary by category, but no evidence of a contract, work plan, or detail describing what work had been performed by an identified Wallace employee.

During our interview of Bob Crosby, CPA, the outside auditor for the District 1986-2010, he recalled that Sabrina Spears maintained the MBI Binders in her office and that during his audits he had tested a few of the Wallace MBI charges and was satisfied that those expenditures were documented. It is possible that some of the MBI binders were changed after Mr. Crosby was no longer the auditor for the District (2010).

We reviewed excel spreadsheets retrieved from the District's computer system and found some excel files titled "Haber Files." We have reviewed all of the excel files that included spreadsheets that showed the detail of MBI charges by the Wallace Group for the fiscal years 2005 to 2008. We believe that the spreadsheets were prepared by the Wallace Group, and did confirm that the spreadsheet for fiscal year 2008-2009 was "authored" by "Lonnie Hughes," "Wallace Group" by viewing "properties" in the excel file and "detail" that identified the "author" of the file.

In our review of the Wallace Group MBI summary spreadsheets for the three fiscal years we observed that the number of MBI projects increased from 36 in the first year 2005-06 to 60 MBI projects in the years 2008-09. Each of the spreadsheets had monthly totals for the fiscal year, a section where it summarized the MBI payment by a specific accounting classification such as 7077 which is the accounting code for "Engineering Services," and a 3rd section that summarized MBI categories by the accounting fund were expended from i.e.; 19 (Operations), 20 (Expansion Fund), or 26 (Replacement Fund).

We have copied one such spreadsheet file for the Fiscal Year 2007-2008 and included it as Exhibit 23 to this report to demonstrate how the Wallace Group accounted for the 30 to 60 MBI projects where they billed for services. We made minor edits for presentation purposes, but the numbers and categories were not changed. Exhibit 23 shows that a substantial portion of the MBI payments were made from the account 19, the Operating Fund and charged as an expense to the

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District. There were also substantial MBI payments that were charged to a “Miscellaneous” accounting designation.

As we indicated previously in the “Wallace Billings” section of our report, we discovered a memo included in the Wallace Billings from Jill McPeck to Sabrina Spears explaining the categories of MBI charges made by the Wallace Group. Coupled with the Wallace Group MBI spreadsheets for 2004-2008, it would be fair to say that the Wallace Group accounted for the MBI project payments and provided summaries to the District.

The MBI projects are further discussed in the Operations section of our report.

Legal Expenses

During the period 2009 to 2013, the legal expenses in the District increased dramatically. We noticed sharp increases in the District’s legal counsel’s billings and other billings from “Outside Counsel” that were defending the District and John Wallace. Further, our review of the Wallace Group billings for the period 2009 to 2012 also showed substantial charges by the Wallace Group for working on legal matters. The legal work was intermingled with charges to “District Administration” and we have not undertaken the task of trying to separate out the various legal expenses.

Some of the legal proceedings in the District that we became aware of included; The Cogen Project, the Grievances filed by: Appleton, Mascolo and Douglas; The Grand Jury Investigation and the Water Board Litigation.

Our review of the District’s QuickBooks accounting showed that total legal expenses charged to the District in 2009 to 2013 were \$1.2 million, which were divided between expense category 19-7070 (District Counsel) and 19-7071 (Outside Counsel).

Review of District Budgets

The review of the District Budgets, for the period 1995 to 2000 that were prepared while Chuck Ellison was “Plant Superintendent,” showed that they had forecasted and contemplated the financial viability of the District by calculating the anticipated incoming revenues and expenses. The Budgets also followed the reserves with anticipated Major Budget Items (MBI’s) with the “pay as you go” concept as stated by Chuck Ellison. As indicated previously, the budgeted amounts for “Dist. Administration” for 1995 to 2005 ranged from \$35,000 to \$45,000 per year, and varying amounts ranging from \$30,000 to \$45,000 for Engineering.

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The early Budgets had a professional appearance and provided schedules, flow charts showing the source and use of District funds, and provided explanations on anticipated projects going forward. Each of the Budgets contained a Table of Organization that showed the District Hierarchy.

We noted that the Budget Reports for the years 2003, 2004, 2005, and 2006 stated, "prepared by Jeff Appleton, Plant Superintendent." This acknowledgment is disputed by Appleton who stated that the Wallace Group prepared the District Budget's after 2003. Sabrina Spears stated that the Budget Reports and Board Packets were put together by the Wallace Group, but that she had supplied some of the information contained in both reports. The Budget Reports for 2007 to 2012 did not have an acknowledgement of who prepared the Budget Report.

We reviewed the Budget Report to the District for the fiscal year 2009-2010, which contained several historical presentations of the cash balances of accounts 19, 20 and 26 (page 17, 37, 45) for the period 1985 to 2010. The chart for the Operating Account 19 showed that the cash balances of the District had been substantially declining starting in 2004 and running in the negative for three consecutive years 2007-2009. The footnote at the bottom indicated that the deficits were being covered by funds 20 and 26.

Review of Board Packets

In analyzing all of the DISTRICT "Warrant Requests" that were attached to the DISTRICT "Board Packets," we determined that the Wallace summary billing statements were not attached. We further noted that the Wallace billing summaries as required in the July 2011 contract between the District and the Wallace Group were not attached to the Board Packets. In our interviews of some of the Board of Directors they believed that Wallace was not complying with the terms of the July 2011 contracts. However, we did observe that some of the required billing summaries were attached to the Wallace billings to the District, but apparently were not attached to the Board Packets.

Jeff Appleton, CPO, stated that beginning in about 2003, he did not prepare the Board Packets since Wallace told him that his office would prepare them. Appleton stated that the plant office staff had prepared the Board Packets for years, but Wallace insisted that the Wallace Group prepare them, and as noted before, the Wallace Group billed the District for the preparing the Board Packets.

Our review of the Wallace billings showed that there were significant hours charged to preparing the Board Packets by the Wallace Group. A review of the December 2004 and December 2005 Wallace billing statements showed that a

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“Director of Mechanical Engineer” whose hourly rate was \$97.75 charged time for “Board Package.”

Our review of the Wallace billings actually showed that the Wallace Group was charging for Board Packets and Staff Reports as early as 2001.

The Board Packets are further discussed in the Operations section of our report

Review of Audited Financial Statements

As part of our Financial review of the District, we obtained copies of the Audited Financial Statements for the “fiscal” years 1999 to 2014 from the District, which were maintained at the District offices. We noted that Bob Crosby had prepared the Audited Financial Statements for the period 1999 to 2010, a span of eleven years, but we learned from Bob Crosby that he had prepared the Audited Financial Statements since the 1980’s. The accounting firm of Moss, Levy & Hartzheim, LLP have prepared the District’s Audited Financial Statements since the 2011 fiscal year. Current business practices in the accounting world suggest a change of auditors every five years. We believe the change in auditors came after the 2011 grand jury investigation.

We also received and reviewed the original “Audit File” for the years 2004 to 2011, which were stored at the District. We have reviewed all of the files and provided a discussion on a sampling of the files found below:

2004 Audit File – Prepared by Robert P. Crosby, CPA

- Printouts of Profit and Loss, Balance from client
- Journal Entries
- Depreciation schedules
- Fund reconciliations to County
- Audit Letter December 7, 2004

Page 2, para 10a. “Related party transactions, including revenues, expenditures/expenses, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.”

We noted that there was no “related party” disclosure in the audit work papers. We also reviewed the “Audited Financial Statement for the 2004 Year that was provided the Board of Directors and found that there was no discussion of “related party” transactions to the Board of Directors in the Summary of Significant

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Accounting Policies. There was no reconciliation to source of Revenue, the participating cities of; Arroyo Grande, Grover Beach or OCSD.

2006 Audit File – Prepared by Robert P. Crosby, CPA

- Printouts of Profit and Loss, Balance from client
- Journal Entries
- Depreciation schedules
- Fund reconciliations
- Audit Letter November 2, 2006
Page 2, para 10a. “Related party transactions, including revenues, expenditures/expenses, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.”

We noted that there was no “related party” disclosure in the audit work papers. We also reviewed the “Audited Financial Statement for the 2006 Year that was provided the Board of Directors and found that there was no discussion of “related party” transactions to the Board of Directors in the Summary of Significant Accounting Policies. There was no reconciliation to source of Revenue, the participating cities of; Arroyo Grande, Grover Beach or OCSD.

We also noted in “Audited Financial Statement under the “Reserves and Retained Earnings section on page 12 “A reserve has also been established for amounts set aside for solids handling, capital replacement and expansion.” The total amount listed in LAIF funds were \$5,735,829 and \$2,045,132 for a total of \$7,780,961.

2008 Audit File – Prepared by Robert P. Crosby, CPA

- Printouts of Profit and Loss, Balance from client (before QuickBooks)
- Journal Entries
- Depreciation schedules
- Fund reconciliations
- Major Budget Item Spread sheet, includes all payments to vendors including WG (Wallace Group) (Exhibit 80, Copy of schedule).

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There is no identification as to who prepared, but our opinion is that it was prepared by the Wallace Group.

- MBI spreadsheet 2008 appears to be QuickBooks generated, noted handwritten comments on right column on how to book the item i.e. Expense, CIP, or Book. Payments to the Wallace Group.
- No Audit Letter
- Proof of bids to other firms
- Draft of audit findings sent to Wallace for review.

We noted that there was no “related party” disclosure in the audit work papers. We also reviewed the “Audited Financial Statement for the 2008 Year that was provided the Board of Directors and found that there was no discussion of “related party” transactions to the Board of Directors in the Summary of Significant Accounting Policies. There was no reconciliation to source of Revenue, the participating cities of; Arroyo Grande, Grover Beach or OCSD.

2010 Audit File – Prepared by Robert P. Crosby, CPA

- Printouts of Profit and Loss, Balance from client QuickBooks (PBC)
- Journal Entries
- Depreciation schedules
- Fund reconciliations, Revenue to County
- Major Budget Item Spread sheet, includes all payments to vendors including WG (Wallace Group. There is no identification as to who prepared, but our opinion is that it was prepared by the Wallace Group.
- Work papers showed substantial changes to District accounting records and reclassification of Wallace payments.
- MBI spreadsheet 2010 appears to be QuickBooks generated.
- No Audit Letter
- Proof of bids to other firms.

We noted that there was no “related party” disclosure in the audit work papers. We also reviewed the “Audited Financial Statement for the 2010 Year that was provided the Board of Directors and found that there was no

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discussion of “related party” transactions to the Board of Directors in the Summary of Significant Accounting Policies. There was no reconciliation to source of Revenue, the participating cities of; Arroyo Grande, Grover Beach or OCSD.

2011 Audit File – Prepared by Ron A. Levy, CPA – Moss, Levy & Hartzheim

- Printouts of Profit and Loss, Balance from client QuickBooks (PBC)
- Journal Entries
- Depreciation schedules
- Fund reconciliations
- Trial Balance
- Wallace response to audit by Moss, Levy & Hartzheim (Exhibit 90)

Auditor finding 2011-4: Connection Fees: “it was noted that the connection fees received by the District were used for general operations. Connection fees are restricted for capital expansion project purposes only.” (Exhibit 24, Audit Report and response from District)

Summary

We noted that this use of “Connection Fees” for operations had been ongoing at the District for many years with no comment from the prior auditor especially when revenue to the operating account (account 19) was exceeded in every year by the operating expenses, and the fact that the “Reserves” were decreasing as well. Further, as previously stated in this report, the District Budgets, starting in 1995 and continuing up to 2012, had a chart indicating that “connection fees” were linked to the “expansion” fund 20 and no other account.

Our analysis showed that the operating fund (19) borrowed from the “connection fees” account (LAIF). And as previously stated, it was Wallace who made the transfers from the LAIF account to the Operating account up to 2011 when the Board of Directors assumed control of the LAIF transfers.

Further, the “related party” transactions had likewise never been commented upon by the previous auditor in their reports to the Board of Directors even though the

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payments to the Wallace Group began a dramatic increase beginning in 2003 to 2010.

There was no reconciliation to source of Revenue, the participating cities of; Arroyo Grande, Grover Beach or OCSD in any of the Audit files we reviewed. The Audited Financial Statements and the Original Audit Files were voluminous so we have not included them as exhibits. We have extracted certain documents as exhibits as detailed in our report.

Although the Original Audit files had evidence that bids were put out to other CPA Firms in compliance with the District policy on expenditures, the Board of Directors, upon the recommendation of Wallace, chose Bob Crosby. It wasn't until after the Grand Jury investigation that the string of having the same CPA firm over 25 years was broken. There is an irony in that bids were required for the CPA firm for auditing services, but bids weren't required by the Board for MBI projects for the Wallace Group.

OPERATIONS REVIEW

As we stated in our Introduction (page one), our goal was to "Evaluate past practices associated with plant operations, evaluate contracts for engineering, purchasing and capital projects to ascertain whether they are consistent with standard practices" or stated more precisely, whether the contracts conformed to the District's stated purchasing policy. As we did in our Financial Analysis of the District, we took a balanced approach that included the analysis of the complete Wallace Era that spanned twenty-seven years (1986 to February 2013). In doing so, we were able to put into perspective the last few years of the Wallace Era that ended in; a major spill episode, a Grand Jury Investigation, a Water Quality Board Investigation and fine, and several Personnel lawsuits filed against John Wallace and the District.

Background

As cited previously; *"Daily District management of the WWTP and collection system is carried out by the Plant Superintendent (**emphasis added**)*. The Plant Superintendent reports directly to the District Administrator **and** the District Board of Directors. The Plant Superintendent and District Administrator are **jointly** responsible for the implementation of the SSMP. The Plant

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Superintendent is also the designated staff member who is responsible for all wastewater collection operations and it is his operator's license that is legally required in order to operate the Oceano WWTP (DISTRICT Website)."

The District in their yearly Budget Reports provided a "Table of Organization" that listed the "Voters" or "Rate Payers" at the top of the Hierarchy or Chain of Command down to the "Technical Staff" or "Operators."

Our review of the District's historical operations showed that Chuck Ellison ("Ellison") was the plant superintendent (CPO) at the District WWTP during the 80's until 1999 when Jeff Appleton ("Appleton") took over as the plant superintendent. Appleton was plant superintendent from 2000 to 2011 with periods where he was on medical leave in 2009 and 2010. Bob Barlogio ("Barlogio") was the plant superintendent from 2011 to 2013, but he was interim plant superintendent for a few months in 2010 just before the December 2010 spill. John Clemons ("Clemons") has been the plant superintendent since 2013 and is also currently acting as the District Administrator.

The engineering firm of Kenney Jenks Consulting commended the District, John Wallace and Plant Superintendent Jeff Appleton in their 2005 report to the District:

"The District is in the position of currently and in the past, having an enviable record of meeting water pollution control objectives and waste discharge requirements. In the wisdom of your Board and Staff, it was seen to be important to define and to take steps to extend this enviable record into the future. Three factors serve to support this decision, 1) since design of existing plant, there has been a significant change in District wastewater characteristics. This change is seen by a decrease in per capita flow, resulting in an increase in wastewater strength, while contributing population has continually been increasing, 2} a change in water pollution control law resulting in mandatory monetary fines for violation of waste discharge requirements and, 3} recent change and anticipated additional change in State and Federally enforced waste discharge requirements of more stringency.

We take this means of expressing our appreciation for your interest and valuable assistance of your staff, **John Wallace and plant Superintendent Jeff Appleton** in particular during the course of our studies. We look forward to assisting the District in the

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implementation of a needed project, a project which is so *important to the continued meeting of District responsibilities in respect to the preservation and protection of the environment of the near-shore waters of the Pacific Ocean.*”

Reporting to the Board of Directors

Historically, the primary processes in how the Board of Directors received information on the Operations of the District were; Yearly Budget Projections, Board Packets (contained Staff Reports and Meeting Agenda's) and Public Meetings every two weeks. We also understand that the Board of Directors would visit the WWTP and would speak with members of the District staff and Operators. However, we have focused our attention on the two most prominent and reliable areas of communication, namely the Yearly Budget Projects and the Bi-Weekly Board Packets as detailed below:

Yearly Budget Project Reports

Our review revealed that The Yearly Budget Reports for the period 1995 to 2014 were prepared and provided to the District Board of Directors on an annual basis, usually before the end of the fiscal year ending on June 30th. We also learned from prior Board members that the Board would meet at the plant where they were given a Budget presentation by John Wallace where each budget item was explained, and questions were answered by Wallace related to the budget proposal.

We have included excerpts from some of the Yearly Budget Reports, but due to the sheer volume of paper, we have not included all of the Budget Reports as an exhibit in this report.

Our review showed that the Yearly Budget Reports were professionally done and projected the anticipated yearly revenues and expenses by category. In each of the Budgets, there was a resolution for the Board of Directors to adopt the budget as required by “State codes.”

Each of the Budgets provided a “Table of Organization” and a flow chart detailing the “Accounting of Funds” for accounts; Fund 19 – Operating, Fund 20 – Expansion (Major Expansion Projects), and Fund 26 – Replacement/Improvements. We copied a flow chart that was part of the 1995-96 Budget Report that showed the Table of Organization; and a chart “Accounting Funds that showed the relationship between source of revenue to funds 19, 20 and 26”; and how the revenue was to be spent (Exhibit 25). Of particular interest was

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the chart that showed Sewer Connections funds would go into account 20-Expansion and outgoing funds were to be spent only on Major Projects Expansion

The Budget Reports for the period 1997 to 2012 also provided a chart showing the same use of Sewer Connection funds to account 20-Expansion fund. Further, the Budget Reports contained a Flow Chart showing the “Combined Fund History” starting in 1986. This chart was especially useful in showing the financial viability of the District especially when forecasting plant expansion or the replacement of vital components at the plant.

Each Budget Report included a spreadsheet for each of the funds; 19, 20 or 26 with column's to identify expenses by category and accounting code. Each category or line-item expense on the Budget could then be compared to the projected totals for the current year and then compared to a column for the projected expenses for following year. The Budget Report allowed the reader to compare the budgeted amounts to the actual amounts and determine whether the anticipated budget goals had been achieved.

The Budget Reports also provided a Pie Chart by Fund 19, 20 or 26 that provided a visual representation of how the funds of the District were projected to be used.

The Budget Reports had a narrative section that provided explanations for the Major Budget Items and the associated cost and included photographs of the intended project. We did not see an explanation describing the role of “District Staff” or a role the Wallace Group in any of the Projects narrative.

In 1999 for the first time, the Budget Reports had a section for “Purchasing Policy” and had a resolution adopting the policies and procedures of the District for supplies, equipment, and construction services. We noted that there was specific language as to what was required by the District Administration or Plant Superintendent related to purchasing of “supplies and equipment and for the contracting for outside services and construction” (Article I, 1.2 D).

On July 7, 1999, The Board passed a Resolution adopting the policies and procedures for the expenditure of District funds for supplies, equipment, construction and services. The resolution was signed by the Board Chairman and John Wallace, Secretary to the Board.” (Exhibit 26, Copy of Resolution) This resolution was in effect until July 6, 2005 when the Board adopted a new resolution, but the 2005 resolution appears to contain the same language as the 1999 resolution. The 2005 resolution had a signature line for John Wallace, Secretary to the Board. It is not known whether the District's counsel drafted the

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resolution since there is no signature line on the resolution for the District's counsel.

On June 16, 2010, Resolution 2010-74 was included in the Budget Report and contained the same basic language as the 1999 and 2005 resolutions on Purchasing Policy:

Article I, 1.2 C. stated "To exercise positive financial control over purchases."

Article I. 1.2 D. stated "To clearly define authority for the purchase of supplies and equipment and for contracting for outside services and construction."

With respect to "The District Administrator" under section 2.4 "...as a purchasing agent for the District in connection with the obtaining of supplies, equipment, or services with a cost in excess of \$1,500 and not more than \$5,000." The same language was used in section "2.5" related to "services" between \$5,000 and \$35,000 and at para B 2. It states "The Board of Directors of the District shall approve of all purchases in excess of \$5,000 and less than \$35,000."

But in section "2.6" the amounts in excess of \$35,000 the reference to "services" was not included, but there was extensive language regarding the bidding process and awarding of contracts. The resolution was signed by John Wallace, Tony Ferrara, Chairman, and Michael W. Seitz, District's Legal Counsel. (Exhibit 27), Copy of 2010 Resolution)

Thus, a scenario was created whereby Wallace acting as the District Administrator would be obtaining services from the Wallace Group for engineering and MBI services.

Board Packets

The most consistent and direct form of reporting the Finances and Operations of the District were through the bi-weekly Board Packets, which were available at the District for the period 2004 to 2013. The Board Packets were available on the District Website for the period 2010 to present. We were provided PDF files by the District that contained the Board Packets for the period 2004 to 2009. We noted that the organization of the 2004 to 2009 Board Packets in some of the early years was inconsistent and hard to follow.

We subsequently sampled the board packets as detailed below with the following comments:

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June 2, 2004, 22 pages, included Warrant Request, Minutes, Staff Report and Draft Budget for 2004-2005 did not include copy of Wallace Group billing statements, statements that “staff” will do certain work related to Major Budget Items;

June 1, 2005, 86 pages included Warrant Request, Minutes, Staff Report; Copy of Budget for 2005-2006 did not include copy of Wallace Group billing statements.

January 3, 2007, Board Agenda, Warrant Register, Minutes, Staff Report, and Financial Statement cash on hand, revenue and expenses for accounts 19, 20 and 26, statements that “staff” will do certain work related to Major Budget Items

January 2, 2008; Agenda, Superintendent’s Report, Financial Summary for December 2007 for accounts 19, 20 and 26 including expenses and revenues for the month, Minutes, Warrant Register, no copy of Wallace Group billing summaries, Memoranda that “staff” will do certain work related to Major Budget Items. (Exhibit **28**, Copy of Agenda).

As part of the Board Packet, there was an attached Memorandum dated January 2, 2007 (should be 2008), from John Wallace, District Administrator, to Board of Directors. Under “Funding” the memorandum stated:

“The FY 07/08 Budget includes **Operating Account Number 8015 – Trunk Sewer Maintenance** -which is for the maintenance of various components in the trunk system. The current budget for FY 07/08 is **\$100,000** of which approximately \$5,000 has been committed to the cleaning and inspection of the Grover Beach Trunk Sewer.”

One of the recommendations for the Trunk line systems at paragraph 2, stated,

“Direct staff to process the award and proceed to administer the construction for this project.”

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The last paragraph on the page states, “Staff will be performing construction contract administration and periodic construction monitoring services verifying that work is performed in accordance with the Contract Documents.”

There is no information on the Memorandum from Wallace that explains the amount that the “staff” would charge for this work and the reference to “contract documents” creates the impression that staff (Wallace Group) had a contract for the work.

We reviewed the District’s accounting QuickBooks’s records and isolated all payments made to the Wallace Group for the period 2008 to 2013. We then sorted the data by “Account Classification,” which resulted in the data listed on the chart below. The chart shows that the Wallace Group began receiving payments in August 2008 and after the January 2, 2008 Memorandum to the Board, and in total, received \$45,052.10 during the 2008-2011 period.

Wallace Group Payments 19-8015			
Date	Accounting Classification		Amount
08/20/2008	19-8015	Trunk Sewer Maint	5,796.00
09/17/2008	19-8015	Trunk Sewer Maint	7,098.16
10/15/2008	19-8015	Trunk Sewer Maint	5,933.91
11/19/2008	19-8015	Trunk Sewer Maint	3,594.89
12/17/2008	19-8015	Trunk Sewer Maint	501.43
01/21/2009	19-8015	Trunk Sewer Maint	502.25
02/18/2009	19-8015	Trunk Sewer Maint	2,739.00
03/18/2009	19-8015	Trunk Sewer Maint	2,006.88
04/15/2009	19-8015	Trunk Sewer Maint	4,199.77
05/20/2009	19-8015	Trunk Sewer Maint	378.75
06/17/2009	19-8015	Trunk Sewer Maint	1,065.70
06/29/2009	19-8015	Trunk Sewer Maint	418.70
08/19/2009	19-8015	Trunk Sewer Maint	970.91
09/24/2009	19-8015	Trunk Sewer Maint	2,485.64
10/21/2009	19-8015	Trunk Sewer Maint	1,675.75
11/23/2009	19-8015	Trunk Sewer Maint	1,686.54
01/20/2010	19-8015	Trunk Sewer Maint	276.57
02/17/2010	19-8015	Trunk Sewer Maint	24.50

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03/17/2010	19-8015	Trunk Sewer Maint	214.25
05/19/2010	19-8015	Trunk Sewer Maint	597.00
11/17/2010	19-8015	Trunk Sewer Maint	678.50
08/15/2012	19-8015	Trunk Sewer Maint	49.00
09/19/2012	19-8015	Trunk Sewer Maint	231.00
11/20/2012	19-8015	Trunk Sewer Maint	<u>1,927.00</u>
Totals			<u><u>45,052.10</u></u>

December 17, 2008, Agenda (noted that Tom Zehnder is listed as “District Engineer, while Wallace is listed as District Administrator. Staff Report (Appleton was absent), no Wallace Group billing summaries.

January 21, 2009, Agenda, Minutes, Kennedy Jenks Consulting (KJC) report May 19, 2008 that stated:

“A long-range planning report was developed in 2005 that addressed plant capacity and redundancy concerns, and provided conceptual solutions for the South San Luis Obispo County Sanitation District's Wastewater Treatment Facility. The result of the report was to recommend that secondary treatment facility improvements, including aeration tanks and a redundant secondary clarifier, be constructed.”

“Based on the sizing of structures and support facilities, estimates of the probable cost of construction were prepared utilizing current industry costs. With a combined project, the estimated cost of the aeration tanks is \$5,400,000 and secondary clarifier is \$3,800,000 for a total estimated construction cost of \$9,200,000. "Soft costs" (design and construction support, administrative, etc.) would bring the total estimated project cost to \$11,400,000.” Tom Zehnder signing as “District Engineer” on related documents to KJC report.

November 17, 2010; Agenda, 47 pages, Agenda, Warrant Request, Staff Report on Violations and O&M Manual to be done by “District Staff”,

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Profit and Loss Statement for 2010-2011 Budget v Actual, Financial Summary October 2010, and a New Major Budget Item recommendation for **\$25,000** (Exhibit 29, Copy of Staff Report).

On the Staff Report to the Board of Directors from John Wallace, District Administrator, dated November 17, 2010 for the New Major Budget Item in the "Funding:" section there was a statement, "If approved, this project would become 10 MBI 11 - Operations and Maintenance Manual" and "Associated Standard Operating Procedures Training."

The Staff report also stated, "**District staff** had recently completed a significant update of the District Operations and Maintenance (O&M) Manual including new Operations SOP's..." And further stated, "Training would be conducted in-house with weekly 2-hour sessions...in an effort to minimize costs; staff will continue to develop new SOP's as part of their in-house duties..."

The Wallace statements' regarding "staff" is confusing and could lead the reader (such as a local resident) to believe that District employee's would be doing the work especially with the references to "in-house duties."

As listed below, we retrieved the data from the District's QuickBooks accounting which we had sorted by MBI Project, O&M Manual, which showed that the Wallace Group received \$54,132.95 for the prior MBI project "10 MBI 01":

Wallace Group Payments for "10 MBI 01 O&M Manual"		
Date	Amount	Description
		10 MBI 01 O&M
08/18/2010	4,612.45	Manual Update
		10 MBI 01 O&M
10/06/2010	13,921.00	Manual Update
		10 MBI 01 O&M
10/20/2010	15,938.90	Manual Update
		10 MBI 01 O&M
11/17/2010	18,251.50	Manual Update
		10 MBI 01 O&M
12/15/2010	443.10	Manual Update
		10 MBI 01 O&M
06/15/2011	118.50	Manual Update

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		10 MBI 01 O&M
06/30/2011	761.25	Manual Update
		10 MBI 01 O&M
08/03/2011	86.25	Manual Update
Total	<u>\$54,132.95</u>	

As previously stated in the Staff Report re the new Budget Item, "Training would be conducted **in-house** with weekly 2-hour sessions...In an effort to minimize costs; staff will continue to develop new SOP's as part of their **in-house** duties..."

As shown below, it was the Wallace Group that was once again paid, and the representation to the Board that "staff" would be doing this work "in-house" to minimize costs was deceptive since the accounting records of the District revealed that the Wallace Group received \$7,371.95 for the new O&M project.

Wallace Group Payments for "10 MBI 11 O&M Manual Training"		
Date	Description	Amount
	10MBI11 O&M	
01/19/2011	Manual&Training	539.00
	10MBI11 O&M	
02/16/2011	Manual&Training	1,117.10
	10MBI11 O&M	
03/16/2011	Manual&Training	955.50
	10MBI11 O&M	
04/20/2011	Manual&Training	1,351.00
	10MBI11 O&M	
05/18/2011	Manual&Training	1,388.10
	10MBI11 O&M	
06/15/2011	Manual&Training	734.25
	10MBI11 O&M	
06/30/2011	Manual&Training	<u>1,287.00</u>
Total		<u><u>7,371.95</u></u>

Finally, if the additional work were to be done "in house" why would there be a need for additional funding of \$25,000?

On November 17, 2010, in a Staff Report from John Wallace, District Administrator to the Board of Directors sought funding on "Budget Fund 19-7085" Biosolids Handling Contract in the amount of \$100,000. In the "Recommendation"

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at paragraph 2, it states “**Direct** Staff to process the bid documents and administer the contract to the project.”(Exhibit 30, Copy of Staff Report).

In the “Discussion” section of the Staff Report, the statements; “The Board directed Staff to solicit bids,” and “Staff conducted a thorough bid analysis,” again suggests that “Staff” would process and administer the contract, ultimately awarded to Liberty Composting. However, as in the other “Staff Reports” regarding MBI Projects, there was no amount approved or a “not to exceed” statement by the Board of Directors for the work that the “Staff” was to perform even if it was understood by the Board of Directors that “Staff” meant the Wallace Group.

Further, as previously discussed, the District Resolution (Exhibit 24) regarding purchasing policies as set forth by the Board of Directors; without a clear understanding of the limits of the MBI projects, the Board of Directors could not exercise positive financial control of purchases or establish the most efficient procedure for the purchasing of services.

Our analysis of the accounting records of the District for the account “19-7085 Bio-solids” showed that the Wallace Group was paid over the \$23,000 for the period 2008 to 2011 and over \$9,000 from October 2010 to 2011.

In our interview of Jeff Appleton, former District Superintendent, he stated that as the District Superintendent, he had always handled the “Bio-solids” work.

January 5, 2011, 40 pages, Agenda, Minutes of December 15, 2010, Staff Report (Update of December 19th Storm), Warrant Register.

The minutes for December 15, 2010 included a conversation between Board Member Hill, and John Wallace regarding the warrant requests related to the Wallace Group billings:

“Director Hill questioned the Wallace Group invoice with regards to the line item for Major Budget Items. Administrator Wallace replied that the charges incurred were for Major Budget Item expenses previously approved through the 2010/11-budget process and through subsequent Board authorizations for projects. He added that detailed invoices for all warrants are available for review at the meetings.

Director Hill stated that his specific question was whether the engineering services performed by Wallace Group for individual projects were included in the budget amount as a line item or just assigned.

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Administrator Wallace replied that the work performed by Wallace Group is approved through directions from the Board and the overall contract the District has with the Wallace Group. The majority of the work entails smaller projects with major engineering work contracted out to other engineering firms such as Kennedy/Jenks Consultants.

Director Hill also questioned the amount charged for operations projects by the Wallace Group.

Administrator Wallace replied that this line item is for a variety of miscellaneous services related to the daily operations of the plant. It was moved by Director Nicolls, seconded by Chairman Ferrara to approve the warrants as presented. Motion carried with Director Hill voting no.” (Exhibit 30, Copy of 12/15/2010 Minutes)

We believe the reference to the above statement: “The overall contract the District has with the Wallace Group,” necessarily pertained to the 1986 Contract between Wallace & Associates and the District. In 2004, Wallace & Associates was superseded by the Wallace Group, and there was no new contract between the Wallace Group and the District until July 7, 2011.

Even though the “Major” projects went to engineering firms such as Kennedy Jenks, the Wallace Group still billed substantial amounts to those projects as well. The discussion below on the Chlorine Contact Chamber Project was one such project.

August 3, 2011, Staff Report

Prepared by John Wallace, *District Administrator* proposed budget for fiscal year 2011/2012 was late and one month into the new fiscal year.

Major Budget Items

The proposed budget includes Major Budget Items that are discussed in detail in terms of scope and cost. Major Budget Items for FY 2011-12 are shown as well as future fiscal year budget items for a four-year look to indicate projects in the near term for planning purposes. It is important to note that each Major Budget Item will come before the Board for final approval prior to initiation of the item at which time the project could be approved or deferred depending

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upon on the District's financial position and the need to initiate the project.”

Also contained in the MBI analysis is a new section entitled "Project Detail" showing the breakdown of costs for a project into its components such as studies, design, construction, contract administration, etc. Each project is different and therefore the categories used to budget for the project also vary depending on the type and extent of services required outside of construction, or in the case of equipment, the purchase of that piece of equipment.”

August 3, 2011, Staff Report

Prepared by John Wallace, *District Administrator*

Funding:

The MBI Budget includes Major Budget Item 10 MBI 17 – Inflow and Infiltration Study – in the amount of \$30,500. To date the following expenditures have occurred:

- \$624.25 on Contract Administration;
- \$777.35 on Design and Survey;
- \$17,045.00 on Construction;
- \$1,365.00 on Flow Monitoring Administration;
- \$5,667.25 on Engineering Assessment;
- CONSIDERATION OF AMENDED CONTRACTS
FOR DISTRICT ADMINISTRATOR JOHN
WALLACE AND DISTRICT ENGINEER WALLACE
GROUP

“It was moved by Chairman Nicolls, seconded by Director Ferrara to accept the contract, with discussed changes, for the District Administrator Professional Services. Motion carried by roll call vote with Director Angello voting no.

It was moved by Chairman Nicolls, seconded by Director Ferrara to accept the contract, with discussed changes for the District Engineer Professional Services. Motion carried by roll call vote with Director Angello voting no.”

The report actually spelled out particular areas where funds were expended, but the

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narrative did not include the identity of the parties receiving the funds (Exhibits 31, Agenda and Minutes).

Selected Projects

The Chlorine Contact Chamber was engineered by Kennedy Jenks and the bid was awarded to Whittier Construction. The 2004-05 Budget Report indicated that the total projected cost would be \$2,000,000 but in the narrative there was no mention that the Wallace Group would be participating in any capacity. In the following year, the 2005-06 Budget Report stated that the cost would be \$1,750,000 and again there was no mention of the Wallace Group participating in any capacity. The 2006-07 Budget Report for the Chlorine Contact Chamber had a new figure of \$300,000 and again there was no mention that the Wallace Group would be involved in any capacity.

In reviewing the Wallace Group MBI accounting spreadsheets for the 2004 to 2007 period of time, we located a line item described as Chlorine Cont. Ch. Account 0026-0131-04 in the 2005-06 for a total amount paid to the Wallace Group during the fiscal year (July 2005 to June 2006) of \$141,164.76. We compared these individual numbers to the Wallace Billing Statements for the 2005 and 2006 and determined that these monthly charges were listed on the billing statements, thus corroborating the data listed on the Wallace Group spreadsheets.

We checked the Board Packets for the period 2005 and 2006, we saw numerous references in the Staff Reports to the Chlorine Contact Chamber and progress payments to the contractor Whittier Construction, but we did not see any reference to the Board directing "Staff" or "District Staff" to provide any services on this MBI project. Further, in our review of the MBI Binders at the District, we did not see a contract, bidding for the work by the Wallace Group, or an amount to be budgeted for the Wallace group work on the project.

Summary

Our review of the District's MBI Binder containing MBI Project data revealed that the MBI Binder did not include: a Contract, Bidding documents, Memorandum to the Board, Invoice from the Wallace Group or any other data that would allow accountants or auditors to verify or confirm payments to the Wallace Group. It is apparent that the Wallace Group maintained the accounting of the MBI project billings at their offices and supplied summaries of the data to the District bookkeeper.

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As was previously noted in the exchange between Chairman Hill and Mr. Wallace; “the charges incurred were for Major Budget Item expenses previously approved through the 2010/11 budget process and through subsequent Board authorizations for projects.”

This is a very similar statement that Mr. Wallace made during our recent interview; and our interviews of former Board Members Ferrara and Nicolls

REDUNDANCY

In 2000, effective in 2001, the state passed a new law providing enhanced penalties and fines for WWTP violations. According John Wykoff, Kennedy/Jenks Consultants, redundancy was not a critical issue with the Oceano WWTP before 2001, but after, it was a substantial issue that needed to be fixed. The engineering firm of Kennedy/Jenks Consultants (KJC) was the original engineering firm involved in the construction of the Oceano Waste Water Treatment Plant (WWTP) in 1965 and has provided engineering services to the District in the past and as recent as February 2015.

Kennedy/Jenks Consultants (KJC) Report(s)

Our review of the historical records of the District showed that KJC had provided engineering services during the early history of the Oceano WWTP leading up to 2005. In July 2005, the consulting firm of KJC was engaged to conduct a study and recommend a plan for needed improvements to the District’s wastewater treatment plant. The KJC long-range study estimated that it would cost \$6 million (in 2005 dollars) to meeting their uninterrupted discharge requirements (transmittal letter).

In their executive summary KJC stated:

“The District is in the position of currently and in the past, having an enviable record of meeting water pollution control objectives and waste discharge requirements (emphasis added). In the wisdom of your Board and Staff, it was seen to be important to define and to take steps to extend this enviable record into the future. Three factors serve to support this decision, 1) since design of existing plant, there has been a significant change in District wastewater characteristics. This change is seen by a decrease in per capita flow, resulting in an increase in wastewater

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strength, while contributing population has continually been increasing, 2} a change in water pollution control law resulting in mandatory monetary fines for violation of waste discharge requirements and, 3} recent change and anticipated additional change in State and Federally enforced waste discharge requirements of more stringency.”

The July 2005 report issued to the District cited at page 1-3 indicated a need to consider redundancy as a result of two State of California legislature initiated amendments to the State Water Code regulating treated wastewater discharge. The legislature was effective in 2001 and the Kennedy/Jencks report stated:

“Also, this change emphasizes the essential needs for treatment plant process redundancy and operation flexibility in order to insure uninterrupted meeting of requirements under foreseeable conditions of operation, including needs associate with normal maintenance and repair.” (Exhibit 32, Page 1-3 of report)

The 2005 Kennedy/Jencks report at page 4-14 identified specific areas of the plant that would require improvements:

- “The Fixed Film Reactor alone will be incapable of meeting design objectives, including ability to provide normally expected reliability by reason not having redundancy, or back-up.”
- “The Secondary Clarifier ...will not be capable of providing normally expected reliability by reason not having redundancy, or adequate back-up.”
- “The Sludge Thickener will be inadequate to meeting of design objectives, including reliability.”
- “The Sludge Centrifuge operating alone will be inadequate to meeting design objectives, including reliability.”
- “The Sludge Drying Beds operating alone will be inadequate to meeting design objectives, including reliability.”
- “The Standby Power facilities could become inadequate to meeting design objectives, depending upon future power loading conditions.”

The 2005 Kennedy/Jencks report at pages 5-7 to 5-9 sets forth an analysis of whether to construct a Fixed Film Reactor (FFR) or Aeration Tank Alternatives,

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which both separately (both judged equally) could meet the redundancy plans. The report at page 5-9 indicated that the FFR would cost \$6,063,000 (Present Worth) and the Aeration Tank Alternative would cost \$4,485,000 (Present Worth).

In the Executive Summary (page 6-1), The Long Range Plan, the report prioritizes the suggested improvements to the plant:

1. The new chlorine tank under construction.
2. A new aeration tank to operate in series with the existing fixed film reactor, each process unit being standby to the other.
3. A new secondary clarifier to operate in parallel or independently with the existing secondary clarifier, each being the standby of the other...
4. Supplemental standby power facilities.

We noted that in the 2005 (ending June 30, 2005) District's Audited Financial Statements (page 9), the Local Agency Investment Fund (LAIF) had a total of \$9,482,926 available, which would have funded the suggested "redundancy" projects for the FFR or the Aeration Tank.

On May 19, 2008 KJC issued a new report to the District that stated:

"A long-range planning report was developed in 2005 that addressed plant capacity and redundancy concerns, and provided ~~conceptual~~ solutions for the South San Luis Obispo County Sanitation District's Wastewater Treatment Facility. The result of the report was to recommend that secondary treatment facility improvements, including aeration tanks and a redundant secondary clarifier, be constructed."

"Based on the sizing of structures and support facilities, estimates of the probable cost of construction were prepared utilizing current industry costs. With a combined project, the estimated cost of the aeration tanks is \$5,400,000 and secondary clarifier is \$3,800,000 for a total estimated construction cost of \$9,200,000. "Soft costs" (design and construction support, administrative, etc.) would bring the total estimated project cost to \$11,400,000." (Board Packet January 21, 2009)

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In February 4, 2015 Kennedy/Jenks issued another “plant improvement” report (not attached as an exhibit) at the request of District. The 2015 Kennedy/Jenks report referenced the previous 2005 report, and provided a new cost analysis for the construction of the same processes as addressed in the 2005 report. Namely, the fact that “Redundancy” seemed to be an unresolved issue, and would seem to be an even more pressing issue ten years later.

The same improvements cited previously in the 2005 and 2008 KJC reports namely; the FFR, the Aeration Tank and the Secondary Clarifier and the New Biosolids Thickening facilities would now cost \$12,061,000, substantially more than the 2005 estimate. Total cost to the District, which includes; construction management and engineering has now been estimated to be \$19 million.

On December 18, 2012, the Central Coast Region Water Quality Control Board issued a “NOTICE OF VIOLATION FOR SOUTH SAN LUIS OBISPO COUNTY SANITATION DISTRICT WASTEWATER TREATMENT and stated:

“Safeguards and Vulnerability – The Central Coast Standard Provisions I.B.9 adopted as part of the existing permit states, “Safeguards shall be provided to assure maximal compliance with all terms and conditions of this permit.” The provision following states, “Physical Facilities shall be designed and constructed according to accepted engineering practice and shall be capable of full compliance with this order when properly operated and maintained. Proper operation and maintenance shall be described in an Operation and Maintenance Manual.” There are areas of vulnerability at the plant which have been noted during recent visits, including lack of redundancy in secondary treatment, lack of alarms on critical equipment, lack of operational documentation, and use of unqualified personnel.”

Further, the notice of violation made the following observations on **redundancy**:

“1. Lack of redundancy within the secondary treatment process units: The Water Board has been anticipating facility upgrades to address the lack of redundancy for several years. The facility’s permit adopted on October

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23, 2009, states (page F-6), “Addition of a second Secondary Clarifier (87’ diameter, 10’ below grade) and an Aeration Tank (124’ by 40’ dual basin, 18’ deep) is planned **during the timeframe of this permit**. These additions to the secondary treatment process will improve the facility’s ability to handle anticipated increased strength (BOD and TSS) of wastewater due to water conservation efforts of the Member Agencies. These changes will also provide redundancy in the secondary equivalent biological treatment process in the event of an emergency shutdown, mechanical failure, or routine maintenance.” [emphasis added.] We are now three years into the five-year permit and the anticipated upgrades appear no further along than they were in 2009.”

And further stated “In addition, the District appears to have recognized the importance of the upgrades as it has been an MBI since at least 2007, identified as “Long Range Plant Expansion 07 MBI 14.”

As described in the current budget’s project description, the project is “in the process of applying for SRF [State Revolving Fund] funding and is in the environmental review phase. Also as part of the SRF Process, Staff is also working on a rate study to determine if current rates are sufficient to qualify for the loan.” According to SRF Program records, an incomplete SRF application package was submitted in February 2009 by the Wallace Group.

SRF staff contacted Wallace Group in October 2011 and, according to SRF staff notes during the conversation, was told that the District was in the Proposition 218 process and expected to be finished in three to four months. Based on that time estimate, SRF staff contacted the Wallace Group again in March 2012 to check on the status of the project and whether Wallace Group intended to complete an application package. Wallace Group staff indicated that they were still working on a rate study and expected it to be another one to three years before it would be completed. Nearly four years and counting to complete a rate study is an unacceptable delay in the progress of this project.” (Exhibit 33, Copy of Report)

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Budget Reports

The District seemed to first address the redundancy issues in the 2002-2003 Budget Report, Item 11, "Design and Related Studies" \$350,000 in the long range plant improvements for "meeting treatment requirements and for redundancy when taking down major components for maintenance." The MBI project was carried over to the 2004 and 2005 Budget Reports.

However, it wasn't until 2005 before the District commissioned the Kennedy Jenks report. However, the Budget Report for the 2006-2007 fiscal years did not include the MBI project for Design and Related Studies. In the 2007-2008 Budget Report a new MBI #14 "Long Range Planning" appeared at a cost of \$200,000. The description stated "Improvements are outlined in the Long Range Plan ...to ensure treatment requirements and for redundancy when taking down major components."

The 2008-2009 Budget Report did not mention the \$200,000 MBI project, but included MBI 07-MBI 14 Long Range Plant Expansion \$700,000 {\$12,140,000} and referenced the Kennedy-Jenks report of 2005. "A pre-Design Report was written in 2008 in order to gain a better understanding of the estimated construction costs and the feasibility of a phased project." "This FY Budget Item includes the design portion of the project. Estimated construction costs are projected in future years."

The 2009-2010 Budget Report for 07 MBI 14 was now at \$760,000 [\$8,500,000]. A peer review by Corollo Engineers was done in 2008 and costs were revised downward to a more "palatable" \$7,500,000. "This project is in the process of applying for SRF funding and is in the environmental review phase." "Estimated construction Costs are projected in future years."

The 2012-2013 Budget Report (06-25-12) for 07 MBI 14 showed prior years costs \$139,366 for Studies and Design & Survey and projected costs of \$244,572 for Studies and Design & Survey, Project Mgt./Permitting in the coming fiscal year. No costs had been incurred at this point for Capital Equipment, Contract Administration or Construction. The narrative for the project was very similar to the 2009-2010 Budget Report.

On the redundancy issues; I asked Mr. Ferrara, former Board Member why this hadn't been addressed and resolved earlier since the issue had been documented as early as 2000 and highlighted in the 2005 report by Kennedy Jenks, the engineering firm that had been the consultant when the plant was built in 1965. Mr. Ferrara stated that it was a funding issue, the District didn't have enough

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revenue to do the larger projects and that was why they were looking for outside funds to get the Waste Water and Redundancy Projects completed. They couldn't continue to raise rates to the rate payers to accomplish the long range goals.

Looking at the funding issues from outside as a consultant wasn't really fair; you had to live in the moment on how things were happening at the time. It is easy to criticize, 100% hindsight, to say this should have been done, but it's not realistic. It wasn't for the lack of trying, but they just didn't have the funds.

Summary

As previously stated in the Central Coast Region Water Quality Control Board report:

“SRF staff contacted Wallace Group in October 2011 and, according to SRF staff notes during the conversation, was told that the District was in the Proposition 218 process and expected to be finished in three to four months. Based on that time estimate, SRF staff contacted the Wallace Group again in March 2012 to check on the status of the project and whether Wallace Group intended to complete an application package. Wallace Group staff indicated that they were still working on a rate study and expected it to be another one to three years before it would be completed. Nearly four years and counting to complete a rate study is an unacceptable delay in the progress of this project.”

However, the District records, as detailed above, established that this redundancy issue was planned, studied and strategized going back to 2002-2003 Budget Report and after charging the District \$139,000 for studies and reports as of the 2012-2013 Budget Report.

It is inexplicable, considering that if one of the main components such as the FFR or the 2nd Clarifier were to malfunction, the WWTP would have no alternative except to pump waste water directly into the Ocean thus causing an ecological disaster and exposing the District to severe and crippling fines that were experienced in the December 2010 spill and yet unresolved.

After being put on notice 15 years ago, neither the Board of Directors nor the Wallace Group were able to adequately address this critical issue. I have been informed by current management at the District that the “redundancy” issue has been made a top priority.

RECORDS AT DISTRICT

We were advised by Mr. Clemons and Ms. Simpson (current management) that, upon taking over the operations of the WWTP ("Plant"), the records of the plant were unorganized with virtually no inventory of what was stored and maintained at the plant. They subsequently had to spend considerable time organizing all of the District's business records, including; the Wallace Billing Statements, Vendor Files, Board Packets, and Yearly Budget Reports. All of the Wallace billings were organized by current management and are now stored in the District office in a file cabinet, organized by year. Other historical business and operational records were also organized by current management and stored in a "Sea Train" container located at the front of the WWTP property.

We initially learned from Ms. Simpson that soon after Wallace had retired in about March of 2013, Wallace returned 56 boxes of District records that had been stored at the Wallace Group offices in San Luis Obispo. Mr. Clemons, District Superintendent stated that he had picked up some of the 56 boxes from the Wallace Group headquarters in San Luis Obispo. The "Wallace" boxes were subsequently stored at the District in the "Sea Train."

We were advised by Paul Karp, the District Administrator who took over after Wallace, that he learned that Wallace had records of the District at the Wallace Group, and he therefore asked Wallace to return all of the District's records that were stored at the Wallace Group. Mr. Karp recalled that Wallace refused to return the District's records unless he was paid to organize the records even though the Wallace Group had charged millions of dollars in fees to the District over the years.

The Wallace Group billing records show that the District subsequently paid the Wallace Group \$14,000 (March-June 2013) to organize the District's records and, we learned through the Wallace billing statements that some of the District records had been "purged."

The fact that District records had been "purged" by the Wallace Group was not divulged by Wallace when he returned the District records back to the District. It wasn't until later during the review of the detailed billing statements that we learned that "Christine Burkett" from the Wallace Group had charged hours to organizing District records for their return to the District and also charged for "purging" of District records.

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Through the cooperation of Mr. Wallace, we subsequently made contact with Ms. Burkett, the former Wallace Group administrator, who explained that only duplicate records of the District were purged, but that there was no record of those documents that were purged. Ms. Burkett indicated that she regretted using the word “purged” since it had been seen by some that her office was doing something illegal, which it wasn’t.

During our interview of Mr. Wallace, he advised us that he did not seek permission to “purge” any of the District files and didn’t believe that he needed permission (October 2015, Interview)

We were advised by Mr. Clemons that Mr. Wallace has subsequently turned over PDF files of drawings and engineering work that had been done by the Wallace Group, but with no inventory as to what was being turned over. However, Mr. Clemons advised us that the CAD (Computer Animated Drawings) have not been turned over after repeated requests by the District.

We reviewed the Districts Operating & Maintenance Manual that was updated in November 2010 by the Wallace Group and in particular we reviewed Chapter VII – Records. There were several citations that provide guidance on District records as follows:

“The real goal of Records Management is making the desired information available at the required time with the least expense. This depends solely on the strength of the records foundation: the retrieval system.” (Page VII-3)

“All records need approval for destruction.” (Page VII-4)

“Any doubt as to whether a document is a record or not should be resolved by describing the document as a record or, if many similar documents are in question, the District’s Legal Counsel’s office should be asked for advice.” (Page VII-4)

Summary

From our review of the District’s records and in speaking to the District’s current management team, there did not appear to be a “retrieval system” in place at the District after Wallace retired. Further, it appears that those District records that were “purged” by the Wallace Group were not listed on a destruction list, nor is there any evidence at the District that shows Wallace sought approval from the District’s legal counsel.

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Further, in reading the O & M Manual, there is no provision for storing operating records at an off-plant location and a fair reading of the manual section on records would suggest that records were to be stored at the plant and not at the Wallace Group headquarters in San Luis Obispo.

In our interview of Jim Hill, the current Chairman of the Board of Directors and former Board member in 2008 to 2011, he stated that he was never made aware that Wallace was storing District records at the Wallace Group in San Luis Obispo, nor would he have approved such a situation, especially sensitive personnel matters regarding District employees

THE 56 BOXES FROM THE WALLACE GROUP

We have reviewed the Wallace Group Inventory Statements and also the 56 boxes of records that the inventory purportedly represented. We noted that the details as to the contents of each box were generic and did not contain specific detail as to when the documents were removed from the District, nor was there a "chain of custody". Further, our review of the Wallace Group Inventory Statements revealed that there was no detail of the PDF files turned over to the District or a listing of the CAD files that apparently Wallace still has in his possession as of this report. This is an important issue since these particular files contain drawings and studies that were paid for by the District and have a certain value assigned to them in the District's inventory of assets.

Of the 56 boxes, three boxes 52-54 were said to contain Personnel folders. However, boxes 52-54 were empty and we were by advised by management that those files had been transferred to a locked cabinet that was also located in the "Sea Train." We subsequently were allowed to review the contents of the file cabinet and found the personnel files of those individuals; [REDACTED] who were involved in a lawsuit against the District and Wallace. We also noted that the personnel files of [REDACTED] also in the file cabinet and presumably came from boxes 52-56. Again, there was no chain of custody for these "confidential and sensitive" files indicating when the files had been removed from the District's offices.

We were advised by Jeff Appleton, former District Superintendent that he knew that Wallace had taken some of the personnel files from the District and that at some point in 2011, he had requested that Wallace return the personnel folders [REDACTED] Appleton's recollection was supported by an email that he sent to Wallace on January 28, 2011 where he stated;

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"I understand that [REDACTED] personnel file has been retained at the District Administrator's Office for months. As discussed at a recent Board Meeting, it is inherent that District related files be maintained at the plant office."

Appleton was asking Wallace to return the files, but in the Wallace response he stated that he needed the files due to the current actions (pending litigation) [REDACTED] but Appleton could review the files at his (Wallace's) office. (Exhibit 34, copy of emails)

Summary

The review of the vital business and operating records of the District after Wallace retired has been challenging due to the fact that there was no "records retrieval" system or an inventory database in place at the District during the Wallace Era. There is no way at this point to know what historical records were stored at the District. In the infamous words of the current Director of the FBI; "We don't know what we don't know."

In our opinion, the failure to implement and maintain a "records retrieval" accounting system is a failure of past management to apply best business practices related to the District's extensive collection of the historical operating and business records.

Moreover, it is concerning that 56 boxes or more, of the District's business records, sensitive personnel files and operational records had been stored at the Wallace Group in San Luis Obispo for many years without an inventory as to what was taken from the District by Wallace or what was being stored at the Wallace Group.

It does not appear that this practice was authorized by the District's records retention protocols in the O & M Manual, or was sanctioned or known by the DISTRICT Board of Directors or the District's Legal Counsel. As previously documented in this report, Jim Hill former DISTRICT Board Member 2008-2011 and current Chairman of the Board stated that he was never made aware that Wallace was storing District records at the Wallace Group in San Luis Obispo, nor would he have approved such a situation.

We also learned that the Wallace Group had "purged" some of the District's records but kept no record or inventory of what records were "purged." We have been informed by District Management that Wallace has recently (November

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2015) indicated to the District that they still have records belonging to the District, which they will be returning in the near future. However, there are apparent CAD records or GIS records that have not been returned to the District after several requests.

OPERATING MANUAL FOR PLANT

As previously described in this report, the SLOWQB noted that the OEM manual had not been updated since 2000. We obtained a copy of the current OEM from the District, which was rewritten in 2010 by the Wallace Group, we asked for the previous version of the OEM, but there was no copy of the previous OEM manual at the District. (Exhibit 36, Copy of Operators Manual)

Bob Barlogio, CPO stated that the OEM was not completed when he was there in 2011 but in a process to be completed. He commented that Heather Billing, a Wallace Group employee, was providing training on the OEM, but in his view she didn't know what she was doing. Several of the Operators at the plant echoed Barlogio's observation on Billings, including Scott Mascolo who recalled that one of the directives regarding "flushing the FFR" would have in fact collapsed the entire structure upon flooding it to remove the undesirable snails and fly's growing within the media.

John Clemons, the current CPO and the Acting District Administrator stated that the O & M produced by the Wallace Group had errors that had to be fixed.

It is my understanding the Kennedy/Jenks wrote the first Operators Manual when the plant was constructed, and had the necessary expertise in the Waste Water Treatment Plants, but were not used by Wallace to update the manual.

As detailed previously at pages 54 and 55 of this report, the Wallace Group charged the District over \$61,000 to update the O&M manual.

Conflict of Interest

Jim Hill, DISTRICT Board Member raised this issue in a board meeting on 1/5/2011 (Minutes), and the Grand Jury Report dated 2011 also asserted that there was a conflict of interest between Wallace as the District Administrator and his role in assigning/awarding District Projects to the Wallace Group.

GRAND JURY REPORT

In the conclusions section of their report, the Grand Jury stated:

“Three issues emerged from the Grand Jury's investigation of District operations. The first issue is the District Administrator's conflict of interest and conflict of roles between his duties as District Administrator and

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his simultaneous role as majority owner of the Wallace Group.

The second issue is the Board's failure to acknowledge that this conflict of interest exists. As a result, it has not taken the steps necessary to eliminate, control or mitigate the conflict. The Board may have high regard for the personal integrity of the District Administrator, but that regard is not adequate to safeguard the interests of the District ratepayers.

The third issue is that the 25 year-old contract to manage the District may not provide the best organizational alternative for the District and there has been no independent evaluation of the situation.”

The Grand Jury report also concluded:

After examining the facts related to these issues, the Grand Jury has reached the following conclusions:

1. The District Administrator, John Wallace, and his company, the Wallace Group, have a pervasive presence in all facets of the District's operation, from executing Board policy and exercising oversight responsibility for daily operations and to providing numerous financial services, including budget preparation and financial reporting. There are few District activities that the District Administrator or the Wallace Group does not manage, provide or control.”

Based upon our review of District documents found in the “Haber” file, we found that the 2010/2011 San Luis Obispo County Grand Jury with Lee Stephens, as the Foreperson, conducted the inquiry into the operations of the DISTRICT. We also saw documents showing that the grand jury called many witnesses to interview and, requested and obtained evidence from the DISTRICT.

We did not obtain a list of those persons on the grand jury, but in our experience, the grand jurors would be a collection of local citizens varying in experience and

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education. We also know from our past experience that the grand jury is supervised by an attorney from the District Attorney's Office, who provides direction and legal advice to the grand jury.

We obtained the 28-page Grand Jury Report from the District that provided a historical narrative as follows:

"District Board of Directors: Structure and Composition

A Board of Directors oversees District operations. The current Board consists of three members, one from each city or community the District serves: Arroyo Grande, Grover Beach and Oceano.

Each Director is an elected official of his or her respective city or community. Directors are appointed under state law governing sanitation Districts; they are not selected because they have any special knowledge or qualifications regarding operation of a county sanitation District or wastewater plant. Over the past 10 years, there have been 15 different directors on the Board, 5 of whom served only 1-year or less.

District Board duties are not the primary activity for any of the current Board members. In addition to their City Council or Community Services District activities, Board members have other public and private organization memberships, duties, and/or employment."

Further on in their report, the Grand Jury report stated:

"The Bylaws of the District explain the responsibilities of the Board of Directors: "The primary responsibility of the Board of Directors is the formulation and evaluation of policy. Routine matters concerning the operational aspects of the District are to be delegated to professional staff members of the District." In addition, the Board is responsible for approval of the budget and expenditures in conformity with the budget.

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The Board meets twice a month. Until recently, the Board meeting duration was an hour or less. Board members are paid \$100 per meeting.

Board members are almost totally dependent on the District Administrator for the day-to-day management decisions, engineering, planning, budgeting, and administration of the District. As the Bylaws state, there are no expectations that the Board members have the time or expertise to become involved in daily management of District operations. The District Administrator provides management and is the conduit through which the Board receives most District information.”

We agree with the above findings, that there are inherent differences in the experience and education levels to Board Members, and that, as the Bylaws of the District were established; it is well understood that the bulk of the information related to the District’s finances and operations necessarily comes through the District Administrator.

Moreover, the District Budget Reports in every year (1995-2013) list the line of authority from the District Administrator to the Board of Directors. And in practice, the Bi-weekly Packets to the Board with accompanying Staff Reports are the most “documented” real-time forms of communications with the Board. The Board meetings also provided avenues of communication between the Board, District employees and the public with Board minutes documenting those events.

Further, in our interviews of the current and former members of the Board, we noted that some were engineers, local business people and attorneys who also devoted (donated) a substantial amount of their time in reviewing the operations at the WWTP. In particular there were Board Members such as; Tony Ferrara, Bill Nicolls, Jim Hill, Mathew Guerrero and Debbie Peterson, who stated that they had spent a considerable amount of time at the WWTP and had contact with the Superintendent and the Operators at the plant.

The Grand Jury cited a letter from Michael Seitz, District Counsel:

“In a letter dated July 22, 2010, responding to a public

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information request, the District's legal counsel stated:

"...the District Administrator has very limited ability to self-direct work to Wallace Group. Rather, any work that is going to be performed by Wallace Group as a part of any function at the District is approved by the Board of Directors and they are kept apprised of [sic] each meeting in regards to the costs associated with each project."

The Grand Jury stated that:

"The only safeguard in the contract that could mitigate the conflict of interest is the provision that services will only be provided by Mr. Wallace or his employees at the "direction and request" of the Board. However, the Board's budget and payment controls are effective mitigation of conflict of interest only if: 1) the Board fully understands what Wallace Group costs are in the budget; 2) the Board determines that these costs are reasonable for the work required; and 3) the Board determines that amounts paid to the Wallace Group conform to the budget. Such controls are ineffective or do not exist. The financial protection that was intended to be provided for the District by requiring the Board to "direct and request" Wallace Group services is illusory."

We believe that during some periods from 2000 to 2013, there was a collaborative effort with the District Administrator, the District Superintendent and the Board of Directors in putting together the Fiscal-year Budget Reports. Based upon our interviews of former Superintendents and Board Members, we learned that Wallace would discuss the anticipated Budget Report and the Major Budget Items at the WWTP and in the presence of the Board of Directors.

Whether the Board "requested or directed" Wallace to use his own people at the Wallace Group rather than the employees of the District on every project at the plant, MBI or otherwise, is the question. If that were the case, a prudent business practice would be to perform a "Cost Benefit" analysis in a staff report to the Board in order to provide transparency to the "rate payers" of the District.

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However, as detailed in the “Financial” section of our report, the hourly rates per the Wallace Group billings versus the hourly rates of District employees showed that the Wallace Group rates were substantially higher. The well documented situation, where Wallace Group employees took over the Administrative duties previously performed by District employees, was not beneficial to the District since the District employees, whose duties had been taken over by the Wallace Group, were still receiving their salary, ostensibly for doing less than what they had historically been paid to do.

In this scenario, we believe this is an apparent conflict of interest since it was not in the best interests of the District or the Best Management Practice. Indeed, the Best Management Practice would be to replace those people at the District who were unable to perform the tasks that they had been paid to do.

The comment of one Board Member stating that the Superintendent and the Part-time Secretary were unable to prepare Board Packets, Budget Reports or Staff reports is not a persuasive or reasonable excuse for having four or five Wallace Group employees charging the District \$45 to \$90 an hour to perform administrative services that would otherwise cost the District nothing since current and former District employees had performed those services.

COUNTY AUDITOR

In a report from Gere Sibbach, Auditor-Controller dated October 21, 2011, “FOCUSED INTERNAL CONTROL REVIEW” the County Auditor-Controller stated:

“Executive Summary”

The Grand Jury report identified a perceived conflict of interest between the contracted District Administrator who also serves as District Engineer. Therefore, we focused our review on procedures and controls that could mitigate the perceived conflict.

We assessed the District's internal financial controls, and in our opinion there are reasonable controls in place and operating adequately to mitigate the perceived conflict. We noted that the District had implemented some changes in contract controls, enhanced reporting, and

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controls of check signers *over* the course of the last fiscal year.

We identified some areas of improvement, which we list in our Findings and Recommendations below:

The County's role in the financial operation of the District is limited to maintaining the cash balances and processing vendor payments. County staff reviews the payment requests for two signatures. **Vendor invoices are not attached to the payment request. Therefore the County does not review the District's invoices or reconcile payments with the District's budget.** The District's payroll is handled by an outside firm and is not entered into the County's financial system,”

We verified that the District has complied with the Grand Jury's recommendation to rotate external auditors. The Board has selected a new outside auditor to audit the financial statements for up to three fiscal years starting with fiscal year 2010-11.”

Prior to issuing their report, the auditor-controller sent draft copies of their report to Wallace and the Board of Directors for their review, we have obtained copies of the emails from the auditor-controller's office but we have not included them as an exhibit.

Bill Nicolls, Chairman of the Board of Directors subsequently responded to the Auditor-Controller's report. We have included a copy of the Nicoll's response to the Auditor-Controller's report as (Exhibit 37). We have included the final paragraph of the response:

“All of the above discussion should not lose sight of the fact that your determination is that the contractual controls present in the District's contracts with its Administrator and with its Engineer adequately mitigate any perceived conflict of interest. We thank the County Auditor and its Staff for its time and efforts in preparing this report.”

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We contacted Kerry Bailey, the auditor who conducted the audit for the San Luis Obispo County Auditor and proposed several questions regarding the audits. Ms. Bailey provided a response to our questions in red:

Question: Am I to assume that this was the only audit of DISTRICT during the period 2004 to 2013? **Yes**

What period of time did your audit cover? **Our test work primarily encompassed FY 2010-11; however, we also used information and resources from fiscal years 2008-09 and 2011-12 as needed.**

During your audit at DISTRICT did you check the stated inventory to verify that all assets were located at the property (plant)? **No, we did not perform procedures around assets.**

Did you analyze any of the Wallace billings and test sample any of the billings to the Wallace Group's back up documents that would support the billings to DISTRICT? **Not for materials or supplies. We tested some labor expenses (see next question). We tested payments to the Wallace group to determine if the payments were authorized by Board members and agreed to invoiced amounts. Our findings are detailed in our audit report.**

Did you ask the Wallace Group to show proof of billings charged to the District, in other words to prove that the people listed on their billings actually did the work? Did you obtain the individual time sheets for the Wallace group employees who were working on projects at the District? **Yes, we randomly selected 20 time posting by employees and reviewed them determine if they related to District projects. Our findings are detailed in our audit report.**

Did you determine that there was no conflict with Wallace as the Administrator assigning District work to his engineering firm without any bidding protocols met? **We did not address the question in this way. Our findings are detailed in our audit report.**

On the new contracts in 2011 with Wallace did you determine whether he had issued the detailed reports to the Board that related to his billings for Administrative services and for Engineering services? **No, we did not sample FY 11-12 for expenditures.**

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the adversarial nature that existed [REDACTED]

[REDACTED] (Exhibit 38, Copies of [REDACTED])

Further, we learned from our interviews of the current and former Operators at the plant that there was a long-standing understanding that if the District employee had any issue regarding the plant; the chain of command was to the Superintendent and then the District Administrator. However, if the issue involved the District Administrator and if you tried to go over the head of the District Administrator you would be fired. Complicating the employee-employer relationship was the fact that Wallace was a contractor and not the employer.

In our experience, the HR Department can act as a buffer where there is an employee-employer disagreement, and can generally resolve disagreements or misunderstandings before they rise to the formal grievance process. Sound management practices would dictate that an HR person would be available, either through an in-house HR manager or an independent outside contractor. Independence is the key for the HR representative who can arbitrate disputes without influence or fear of retaliation from management.

Even though, John Wallace was a co-defendant in the three civil actions, he involved the HR Department of his company, the Wallace Group, to provide services in defense of the allegations asserted against him by the employees of the District. Further, Wallace or one of his Wallace Group employees removed the confidential personnel files from the District offices and stored them at the Wallace Group offices in San Luis Obispo.

Sharon Seitz, the wife of Michael Seitz, the District's attorney, was employed by the Wallace Group as their Director of Human Resources Department and our review of the Wallace Group billing statements showed that Sharon Seitz was billing the District regarding Mascolo and was researching "Anger Management" issues (Exhibit 40, Copy of Wallace Group billing statements April 2010 to June 2010).

From our interview with Mr. Seitz and our review of the billings (work charged to the District) of Mr. Seitz and the Wallace Group, it was clear that Mr. Seitz was intimately involved in the three personnel actions involving the District and John Wallace.

When we interviewed Mr. Seitz he indicated that his wife had in fact worked at the Wallace Group in the HR Department, but she had only worked there for 8 months. However, when we interviewed John Wallace, he indicated that Sharon Seitz had worked for the Wallace Group for two to three years.

Tony Ferrara, Board Member during this period of time, stated that there were personnel issues with other plant employees [REDACTED]

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Mr. Ferrara also stated that Wallace had used his own HR people to help with the plant personnel problems since the District didn't have an HR person because the size of the District really didn't warrant it.

These three highly toxic personnel situations demonstrated that an **"independent"** HR person could have been a vital "tool" for management to use in order to resolve the grievances. However, using the HR Department at the Wallace Group was a confusing concept since it was obvious that the HR people at the Wallace Group were not an advocate for the District employee.

In essence, the rate payer's funds were used to defend Wallace as an outside contractor against the interest of the District employees.



INTERVIEW OF PLANT EMPLOYEES (CURRENT AND FORMER)

Seeking and obtaining feedback from employees is a valuable tool that management can use in assessing plant performance, and by encouraging employees to offer their feedback is one way to foster a "buy-in" to the stated goals of the organization. We used the same interview template in order to make consistent inquiries of the employees into areas of management and plant operations. Each of the individuals interviewed were advised of the purpose of our interview and there was no promise made by our team that our conversation would be held in confidence.

Summary

As demonstrated above, there was a clear need for an Ombudsman or HR person who could have advocated for the employee and in our opinion, the issues could have been diffused without ending in expensive law suits bankrolled by the District rate payers. Further, the consensus of the District employees, the Operators, was that the Wallace Group was performing work at the WWTP that were not warranted or needed. This type of feedback through an HR person or person who was independent could have been valuable real-time feedback to the Board in the evaluation of the District including the District Superintendent, the District Administrator and the District Engineer.

MALFEASANCE IN OFFICE

During one of our visits to the District, in July 2015, we were interviewing John Clemons, District Superintendent when he mentioned that he had been thinking about a situation involving John Wallace and the Parks and Recreation, Oceano Dunes District (Parks & Recreation) that dated back to 2009. Mr. Clemons explained that the District had historically issued a discharge permit to the Parks & Recreation for the discharge station at the Lesage station. Mr. Clemons stated that shortly after he became the District Superintendent in 2013, he had a conversation

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with Dena Bellman, a specialist at Parks & Recreation regarding the issuance of a discharge permit for the LeSage station.

Dena Bellman had told him that the District refused to issue a discharge permit dating back to 2009 when she had submitted a request to the District. In her opinion, the reason why the District wouldn't issue the permit was that she refused to pay the Wallace Group to conduct a study of their station at LeSage and draw up new engineering plans. Mr. Clemons stated that this same problem had apparently happened at Yo Banana Boys with Dave Kraus, who had also been seeking a discharge permit from the District at about the same period of time.

Mr. Clemons stated that he met with Dena Bellman in 2014 and reviewed the new discharge application submitted to him by Ms. Bellman. He also visited the LeSage station, and subsequently issued a discharge permit. Mr. Clemons stated that he could not understand why the District had refused to issue the permit when everything seemed to be in order. Furthermore, he found out that even though Parks & Recreation had no permit from 2009 on, they continued to dump at the LeSage station with no apparent protest from the District.

At about the same time in 2013-2014, he met with Dave Kraus of Yo Banana Boys and issued him a discharge permit as well, and could find no reason why the discharge permit was not approved for Kraus by the District in 2009.

Parks & Recreation

Based upon this information, I contacted Dena Bellman at the Parks & Recreation Facility located on Pacific Boulevard in Oceano (less than a mile from the Oceano WWTP) and interviewed her regarding the incident with the District and John Wallace. Ms. Bellman stated that she had been contacted by John Wallace, acting as the District Administrator and a group of District people during the month of July 2009. Wallace advised her that they were getting high BOD readings at the Oceano WWTP and they had determined that the discharge station at LeSage was the source of the problem and that they were going to be shut down and fined for violations related to chemicals or high readings of chemicals at their dump station.

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Ms. Bellman recalled that during the July 2009 meeting, she asked Wallace for proof of the violations or reports showing that the apparent violation came from her dump sight. Wallace or one of the other people, she believed it was Bill Lindahl, showed her a report that allegedly documented the violation. When she looked at the report it had a date of 2006 which was three years earlier, she told Wallace that this report was three years old and wanted to see something that was current that showed that it was their dump station that caused the problem.

A District person introduced as Heather Billing who was also with Wallace explained that there was Formaldehyde detected at the plant and they were certain that it came from the LeSage dumpsite. At that time there was no report shown to Ms. Bellman to support that claim either. Ms. Bellman stated that she requested a copy of the 2006 report, but it was not provided.

Wallace, at that meeting, said that the problem could be easily fixed by his firm, The Wallace Group, and with that he handed her one of his calling cards for the Wallace Group. Wallace told her that his firm could draw up new engineering plans for their discharge site for a cost of \$300,000. Ms. Bellman recalled telling Wallace that she didn't believe she would need his firm to do the plans since they had their own group of engineers who could do the plans without any cost to Parks & Recreation. Ms. Bellman recalled at that meeting she felt that Wallace was threatening to close down the dumpsite if she didn't use his firm to fix the apparent dumpsite issues that had something to do with apparent violations. This was very upsetting to her.

She also noticed on Heather Billing's calling card that it had the District logo on the card, which made her believe that Billing was an employee of the District, but she also noticed that the email address for Billing was for the Wallace Group. Ms. Bellman had kept a folder of her contacts with the District and the other people who had accompanied Wallace to the meeting. It was her belief that all of the people with Wallace worked for the District. Ms. Bellman provided us a copy of the Billing calling card, which confirmed that the District logo was on the calling card but with the Wallace email address (Exhibit 41)

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As an aside, when we interviewed Jeff Appleton, the former plant CPO, we asked him about Wallace employee's using a District calling card and he recalled that Wallace had the calling cards made up for his employees with the District logo and the cost of the cards was paid by the District.

Ms. Bellman recalled that there were other meetings with whom she thought were District employees but as she later learned they all worked for the Wallace Group. Ms. Bellman provided us copies of her files that related to the LeSage dumpsite and her dealings with the District. I have attached certain portions of those files as exhibits to this report.

However, after all of the meetings and providing additional information, she was getting the run around about getting the permit. She finally got tired of all the delays and called Bill Nichols in 2010, who she knew and she also knew that he was on the Board of Directors for the District. She arranged to meet with Mr. Nichols at the offices of her boss, Superintendent Andy Zilke where they planned to tell Mr. Nichols of their concerns about the improper business proposal made by John Wallace. On the day of the meeting, she walked into the meeting room and immediately saw that Bill Nichols had brought John Wallace with him. She was surprised and shocked that Nichols had brought Wallace to the meeting because they wanted to discuss this sensitive issue without Wallace. Ms. Bellman recalled that Wallace had a smirk on his face when she noticed that he was in the room. At that time, she and her boss decided not to bring up the issue with Nichols about Wallace's attempt to shake them down for \$300,000, but kept the conversation on and about getting the discharge permit. At the end of the meeting, Wallace made a gesture to Ms. Bellman and said "we're going to get you that permit" and he did it with a smirk on his face. After the meeting her and her boss, Andy Zilke decided not to press any further on getting the permit because they were "weirded out" by Nichols and Wallace and they definitely were not going to pay \$300,000 to Wallace.

Bellman had subsequent conversations with Heather Billing about the status of the application, and was told that it was still being considered. Bellman recalled that

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Billing told her that they found out that the source of the Formaldehyde was not from their dump station, but from a Taxidermist in Arroyo Grande.

Bellman recalled a conversation with Wallace in 2012, where she asked him about the status of the Discharge Permit Application and he stated to her that they were still working on it.

As an aside, during my recent interview of Bill Nichols, I asked him about the 2010 meeting with Ms. Bellman and Andy Zilke and he replied that he didn't recall such a meeting, but recently had a nice chat with Dena Bellman.

Review of Bellman's Files:

During our meetings with Ms. Bellman, she provided copies of her files related to their discharge station and the documents that were contained therein. Ms. Bellman made copies for us that are contained in our investigative file and we have referenced some of those documents in our report as Exhibits 41 through 44).

As indicated above, the calling card for Heather Billing had the District logo and indicates that she was a "compliance inspector" with the address of the Oceano WWTP. The email address showed a "wallacegroup" address (Exhibit 41)

The next document from Ms. Bellman was a string of emails dated July 08 to July 13, 2009 that were exchanged between John Wallace and Dena Bellman. In the email dated July 8, 2009, bottom of page 1, Wallace states that "now is a good time for improving the station ..." In the email dated July 13, 2009, Wallace confirmed the meeting for the next day at the Parks & Recreation office. (Exhibit 42)

Exhibit 43 is a copy of a permit issued to the Parks & Recreation dated "9/27/04" and signed by "Tom Zehnder, P.E. District Engineer." I am aware that Tom Zehnder is an employee of the Wallace Group. There is no indication on the permit that states that Zehnder was acting on behalf of District and it is unclear as to whether Zehnder had the legal authority to issue such a permit.

Exhibit 44 is a copy of a Discharge Permit Application that was filled out by Curt Linse, District Maintenance Chief III on "8/19/2009. There was a sticky-note that

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had the names of Bill Lindahl, Mike Borger, and Jill McPeck. I have become aware that these three individuals were employees of the Wallace Group.

Review of District Files:

Mr. Clemons indicated that he had retrieved a few folders from "Box 38" a box (of the 56 boxes) that had been returned to the District by Wallace in or about June 2013. There were two folders labeled; Yo Banana Boys and State Parks, which I subsequently took custody of and informed District management. I have reviewed the files and selected several documents from the reports as follows:

State Parks & Recreation Folder

My review of this folder showed miscellaneous records dating back to 1994. In my review of this folder I was looking for Discharge Permit Applications to the District for the period 2004 to 2013. The documents within the file were unorganized and not in date order and it appeared that some of the documents had been in another three-ring binder. I did not find the 2004 Discharge Permit in this file as previously provided by Dena Bellman (Exhibit 43). I did find the 8-19-2009 Discharge Permit Application in the District file which has been previously included as Exhibit (44) in my report. This application was attached to an 8/19/2009 email from Dena Bellman to "heatherb"@wallacegroup.us.

I also noted that there were handwritten notes in file by Heather Billing and written on Wallace Group stationary. I have attached a July 22, 2010 Memorandum written by Heather Billing regarding a meeting she had with Dena Bellman and Andy Zilke regarding the 2009 Application for a Discharge Permit. In the first page at Topics Discussed Section, para "e" there is a notation that the application was "*revised and re-issued to State Parks on this date.*" (Exhibit 45, Copy of 2010 Memorandum)

After reviewing the entire file for Parks & Recreation, I could find no such Application that was granted by the District. Further, Dena Bellman stated that their discharge application in 2009 was never granted, but they continued to discharge into the District sewer system.

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I further noted several emails dated in 2006 between Chuck Ellison, former CPO at District who had retired in 1999, and Tom Zehnder and Lonnie (Wallace Group) regarding testing results from the "LeSage dump station." Jeff Appleton, the current CPO was not on the distribution lists for the emails.

I have reviewed the billing statements for the Wallace Group for the period July 2009 and have found that Wallace, Heather Billing and Bill Lindahl charged the District for a meeting at the "LeSage" on July 14, 2009. Wallace charged 3 hours, Heather Billing charged 3.75 hours and Bill Lindahl charged 2.25 hours for the same meeting (Exhibit 46, Copy of Wallace Billing, July 2009)

Yo Banana Boys

Based upon the information provided by John Clemons, CPO at the WWTP, I contacted Mr. Kraus by telephone, since he no longer resides in the Pismo Beach area where his company is located. Mr. Kraus provided the following information:

He searched his files and could not find anything regarding the whole affair, but did have his most recent permit from John Clemons.

He first spoke with Wallace in the fall of 2008. They received initial approval from Wallace in December to go forward. At one of the meetings with John Wallace, Wallace originally wanted his firm (Wallace Group) to draw-up the building & site plans for the project. Mr. Kraus did not recall whether pricing was ever discussed for using the Wallace firm for this service, maybe it was, and that is why He drew up the plans by his self.

Kraus subsequently got a Land-Use approval from SLO County and obtained building permits (approved by both Wallace & OCSD) from the County Building Dept. They received the finalized signed Use-Permit from the District dated January 19, 2009. They did not start the actual construction of their dump-station until they had the Use-Permit in hand. They started building their dump station and completed it in February 2009. It was first used it the weekend of President's Day 2009. Then shortly after, less than one month, John Wallace closed their dump station down...without giving any "real" reason. He just said more sample-tests needed to be done.

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On their end, Kraus stated that he complied with every request given to him by Wallace or the OCSD. They gave numerous samples, without receiving any completed results or explanation why the continued closure of his dump station.

Over the next two years, Kraus tried through many phone conversations & emails with John Wallace & other Wallace Group employees (they kept giving him a new contact person), to get their dump station re-opened, stating their case and the importance of the dump station to their business success. Unfortunately, they never heard anything else further from Wallace, and their dump station remained closed.

Kraus first met with John Clemons (CPO) in October 2013 about opening the dump station. After their meeting, Mr. Clemons authorized the re-opening of their dump station in November 2013. They have been doing the required self-sampling, and have not had any problems with OCSD or the District.

Review of Yo Banana Boys Folder

This folder was found in Box 38, a box that was received by the District from John Wallace after Wallace had resigned from the District in 2013. The box had no inventory or listing of the folders or documents contained in the box. My review of this folder showed miscellaneous records dating back to 2008. In my review of this folder I was looking for Discharge Permit Applications to the District for the period 2004 to 2013. The documents within the file were unorganized and not in date order and it appeared that some of the documents had been in another three-ring binder.

I did discover what appears to be a hand-drawn schematic titled "Dump Station Detail" that had a notation in red stating "Plans drawn by "Yo Banana Boy" Approved for Permit Process. And signed by Loch ... I have attached a copy of this drawing as Exhibit 47. I noted at the bottom of the page it stated "Page 1 of 3" but I did not find pages 2 or 3 in the folder. There were several emails in the folder with the name of Loch Dreizler, a Wallace Group employee.

I also reviewed a "marked up" Permit dated January 19, 2009 which was the approval for Yo Banana Boy to operate a Significant Industrial User (SIU) that allowed the discharge of waste water from the Yo Banana Boy station located at 4th

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street in the city of Oceano. The permit was signed by Tom Zehnder and Dave Kraus (Exhibit 48).

I attempted to interview Heather Billing, but she indicated through John Wallace that she would not talk to me without John Wallace being present, under those circumstances, due to the confidential nature of the questions that I wanted to ask, I decided that I would not interview Ms. Billing.

Summary

The interviews of Ms. Belman, Andy Zilke, and Dave Kraus suggests that John Wallace attempted to use his position as District Administrator to obtain work for his company, the Wallace Group, from government agencies and local businesses that were attempting to obtain operating permits from the District. The interviews also established that Wallace used several of his employees at the Wallace Group that blurred the lines of whether they were acting on behalf of the Wallace Group or on behalf of the District. Employees of the Wallace Group obtained District calling cards, which caused the public to believe they were District employees, but were in fact employees of the Wallace Group.

Our recommendation would be that this report be forwarded to law enforcement officials for a review of potential violations of the law regarding Malfeasance. We did not interview Heather Billing or Tom Zehnder or other employees of the Wallace Group since Mr. Wallace insisted on being present during the interviews of his employees. Due to the obvious sensitivity of the allegations, we did not ask Mr. Wallace questions regarding the allegations during our interview of Mr. Wallace.

CONCLUSIONS

The results of our review of Past Management Practices of the SSLOCSD (District) regarding the Financial and Operational affairs of the District are summarized as follows:

- John Wallace, as the District Administrator/Manger, during the period 1986 to 2004, performed admirably and was given high marks by the consulting

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firm of Kennedy Jenks, the engineering firm that designed and assisted in the construction of the Oceano WWTP. During this same period, Mr. Wallace's interaction with the Board of Directors was excellent and his management of the District was beyond reproach; his relationship with the District employees was cordial and professional.

- Historically the District Administrator/Manager was a part time job; the monthly contract payments started at \$500; the Chief Plant Operator/District Superintendent controlled the District finances, and was the legal authority for the operations of the WWTP.
- However, as time went on, Mr. Wallace gained more and more control of virtually all aspects of the District's finances with full knowledge of the Board of Directors. This finding is consistent with the results of the Grand Jury investigation of 2011.
- The original contract between the District and John Wallace & Associates was not renewed by the Board for 25 years (1986 to 2011). Even though the standing of Wallace & Associates was legally changed to the Wallace Group, the District did not adopt a new contract with the Wallace Group until July 2011. There is no indication in the District records that Wallace received a performance evaluation for the years 1986 to 2011.
- There was no contract with the participating cities, Arroyo Grande, Grover Beach or Oceano (OCSD) that spelled out the relationship of the revenue collection, or provided the ability of the District to audit the revenue collection activity of the participating cities.
- There were no checks and balances in place at the District in order to verify the Wallace billings for services. The bookkeeper and the CPO's stated that they did not review or have the authority to challenge the Wallace billings. Wallace approved his own billings for Administrative and Engineering services to the District.
- There were no reliable inventory system at the District in order confirm that work being done by The Wallace Group, namely studies, drawings and CAD files were actually in the possession of the District and not at the offices of the Wallace Group.
- There was no HR function at the District that allowed for employees at the District to file complaints or grievances without the threat of retaliation. Wallace maintained some of the personnel files at his office at the Wallace Group. Those files were related to [REDACTED] [REDACTED] employees who had filed grievances against Wallace and the District.

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- The critical functions at the District, namely the issue of “Redundancy” of the Fixed Film Reactor and the 2nd Clarifier as acknowledge in the Kennedy/Jenks reports of 2005 and 2014 were not addressed and will now cost the District twice the amount as suggested in 2005 (\$6M to \$12M).
- The same Auditor for the District audited the District accounting records for over 25 years and never addressed “related party” transactions regarding Wallace and the Wallace Group.
- The Board Minutes were recorded by John Wallace and typed up by Sabrina Spears, the recordings were not maintained so citizens or other Board Members could review the recordings to determine the accuracy of the board minutes.
- There was a sharp decline in cash and cash equivalents of about \$7 million during the ten-year period ending in 2012, the last full year of the Wallace Years. Expenses grew steadily every year and exceeded revenue by a substantial margin in each and every year from 2003 to 2012.
- As shown by our “trend analysis,” the yearly billings by the Wallace Group starting in 2000 showed modest increases, but after 2001 there was a dramatic increase in their billings that peaked in the 2009-2010 period. Our analysis showed that after the Grand Jury investigation began in 2011 and after the rewriting of the Wallace contracts in July 2011, the monthly billings decreased substantially until the retirement of Wallace in 2013.
- In December 1999, total hours billed to the District by the Wallace Group was 81 hour per month for both Administrative and Engineering work, and by 2009, the Wallace Group had increased chargeable hours to over 663 hours per month.
- The monthly Wallace Group invoices for Administrative and Engineering Services in 1999 totaled \$3,600 and by 2010 the Wallace Group monthly invoices for all services had increased to a high of \$70,000. Taking into account the 1995-1999 Budget Reports, the yearly projected budget for “Dist. Administration” ranged from \$35,000 to \$45,000 or a monthly average of \$2,900 to \$3,750.
- Wallace Group employees charging time to the District went from 7 in 1999 to over 28 by 2010. This would suggest that close to 50% of the 50 to 60 of the Wallace Group employees were working at the District during some months. Further, per the Wallace website, the Wallace Group was also providing Administrative & Engineering services to ten other county government organizations during the same period of time.

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- The number of MBI projects increased from 5 in 2000 to 60 projects by 2008.
- In our opinion there was a clear lack of controls related to the accounting of the District's payments to Wallace & Associates and the Wallace Group, and an apparent conflict of interest in Wallace as District Administrator approving billings to the District for administrative, engineering and other services provided by the Wallace Group. The fact that some former Board Members have stated that they reviewed the Wallace Group billings with Wallace is commendable, but puts the Board Member in an untenable position of vouching for each and every billing submitted to the District by the Wallace Group. Further, we believe these meetings between Wallace and the Board Member(s) were not documented in a report to the Board of Directors to memorialize the fact that they (the Board Members) were acting in an official capacity as a Board Member, which would include details such as; date, time, place of review, bill(s) that were reviewed, and any issues addressed during the review.
- District projects approved by the Board of Directors without a bidding process or a contract is likely a violation of the District's Policies and Procedures related to the expenditure of District funds.
- Our review of the District's QuickBooks accounting showed that total legal expenses charged to the District in 2009 to 2013 were \$1.2 million, which were divided between District Counsel and Outside Counsel.
- We noted that this use of "Connection Fees" for operations had been ongoing at the District for many years with no comment from the prior auditor especially when revenue to the operating account (account 19) was exceeded in every year by the operating expenses, and the fact that the "Reserves" were decreasing as well.

The Wallace Group for the period 2000 to June of 2013 was paid \$6.2 million with the highest earning year of 2010 at \$826,594.

RECOMMENDATIONS

Based upon our Past Management Practices Review of the District, we have provided our observations, and have offered the following suggestions for remediation:

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Recording of Board Meetings

Regardless of the size of the Board of Directors, there will always be differences in opinion which can turn into dissension between Board Members. This is a weakness in all Boards, which has no easy solution. However, there are a few things that a Board can do to ensure that their actions and issues at Board meetings can be reported correctly with no editing or filtering of essential information, or the misinterpretation of occurrences at Board meetings.

Suggestion

Recorded Board Minutes must be retained at the District for three years. This will allow a digital back up to the written minutes and provide an audit trail for those issues arising out of the business conducted at the board meetings.

Contracts for Collection of Revenue by Participating Agencies

This was an issue that was not resolved during the Wallace years (1986 to 2013) and was just recently brought to the Boards attention. We are reasonably sure that the previous auditors never “audited” the revenue side of the Profit and Loss Statement of the District. In my experience, this is routine in the audit of a going business concern.

One of the first steps would be to verify that some written arrangement was contained in the files of the District, which would then allow the auditor to verify that the terms of the agreement were being met, complied with.

As I understand the process, the District secretary/bookkeeper received a monthly check from each of the participating agencies related to collections made at the agencies. There was no reconciliation attached to the monthly check and therefore the District would not know how much had been collected from the ratepayers and/or have an appreciation of how many ratepayers were in arears. Further, there didn't seem to be a yearly summary provided to the District by the participating agencies and as previously indicated, there does not appear to be an audit of the participating agencies by the District Auditors. This is an important concept since the yearly budget is based upon “revenue” being collected by the participating agencies and passed through to the District.

Suggestion

Prepare a contract with the participating agencies, which will require monthly and yearly summaries of collections, and include a provision where the District in

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cooperation with the participating agencies can audit the collections of District revenue. In the alternative, have the County collect the fees on a semi-annual basis thus bypassing the Agencies altogether.

Audits

The Board needs to review the audit engagement letters and determine the scope of the audit and perhaps consider adding a requirement to check variances of expense items that exceed an increase of 10% on a yearly basis.

Human Resources

Given the recent history of the District's legal expense related to personnel problems, it seems prudent to adopt a District Policy to include a "professional" and "Independent" human resources person to be a safety net for employees who have a grievance with District leadership without the fear of retaliation. I would suggest that the HR person be assigned from the Water Quality Board, who has legal authority on issuing the Operator's licenses and the NPDES Permit for the plant.

Record Keeping

The record keeping of the District has suffered for years of having portions of their records stored at the offices of the Wallace Group. We also believe that District records are in the possession of the former District Attorney's law offices.

Suggestion:

The current District Counsel should send a demand letter to the Wallace Group and the former District Counsel asking for all of the District's files and assets be returned, forthwith.

The District needs to update their recording keeping and filing system to comply with current sections of the Operator's Manual. Electronic-type record keeping programs have been in existence for many years and would make the records and files retrievable without going through boxes and boxes of unorganized records.

Legal Expenses

I would suggest a "Policy" that prohibits District Managers or District Legal Counsel to be involved in defending lawsuits that directly or indirectly implicate their actions as a cause for the lawsuit. Given the incredible amount of legal expenses paid by the District to The Wallace Group and Michael Seitz to

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essentially defend their actions, and at the same time pay The Wallace Group and Michael Seitz in excess of 100s of thousands of dollars to “consult” or aid in the defense seems to reward them for their incompetence, and in our opinion is a potential conflict of interest as previously cited in the 1999 “Sarbanes-Oxley” law passed by Congress.

In my experience, outside of the government, outside counsel with outside consultants would look at the conflict with a clearer vision of the issues and in all likelihood could fashion a resolution without squandering rate payer’s funds

Malfeasance

Vendors who have contracts/dealings with the District should be advised of the regulations/laws that prevent a conflict of interest whereby a District employee cannot receive any form of payment from the vendor, either directly or indirectly through businesses where they have an interest.

APPENDIX A
DOCUMENTS REVIEWED

Wallace resume received from John Wallace.

Contract between District - District Administrator/Engineer March 19, 1986 (4 pages)

District Contract - John L. Wallace (Engineer) 7/26/2011 (7 pages) Bill Nichols, Chairman and Michael W. Seitz, District Legal Counsel

District Contract – John L. Wallace as “District Administrator” 7/26/2011, Bill Nichols, Chairman, and Michael W. Seitz, District Legal Counsel.

Banker Boxes located in the “Sea Train” on District Property which was received from Wallace (1-56) (three months after resignation). Wallace provided inventory of boxes, but could not produce inventory when asked (9-2015)

District Vendor Files A-Z (50 boxes of records) located in “Sea Train” on District property

Copies of District Plant Logs for operating equipment located at Administrative Offices at Plant

Copies of Audited Financial Statements for District for the period 2004 to 2013 received from Amy Simpson, District Bookkeeper/Secretary

District Staff Reports 2004 to 2013 from District

Minutes of the Board Meetings (2010 to 2013) from District

District Violations Logs for Plant Operations

Auditors reports of District (2004-2013) from District

Copy of District QuickBooks records on Thumb Drive for:

Account 19, Account 20 and Account 26

APPENDIX A

DOCUMENTS REVIEWED (cont.)

Copy of Matthew G Haber - Computer File from District computer system (6.2 gigs of data, 3,227 files).

State of California, Forms 700 for John Wallace from District

Website WaterBoards.CA.Gov re Complaint and legal proceedings SSLOCSD

Complaint and responses

Testimony of Appleton

Copies of MBI reports 2004 to 2013 from District

Original Audit Files for 2004 to 2011 from District

2009 NPDES Permit Application from District

Box 36-37 of Wallace retained District documents from District

APPENDIX B
INDIVIDUALS INTERVIEWED

Debbie Peterson, Former Mayor of Grover Beach, Board Member 2013

John Shoales, current Board Member

Tony Ferrara, former Board Member (2005-2014)

Jim Hill, Current Board Chairman

Michael W. Seitz, Former District Legal Counsel (1986 to 2015)

Bill Nichols, Former Board Member of and Chairman of the Board

Paul Karp, Former District Manager of 1984-86 and 2013

Scott Mascolo, Former Operator III employee of District

Amy Simpson, Current Bookkeeper/Secretary at District (2014-present)

John Clemons, Current Plant Superintendent (2013- to present) and Acting District Administrator.

Rick G. Sweet, Former District Manager (2013-2015)

Chuck Ellison, Former Superintendent (CPO) (1980-1999)

Sabrina Spears, Former District Bookkeeper

Trinidad ("Trini") Rodriquez, Former "Operator III" at District

Fanny Mui, Current "Operator/Lab Tech/ECI District

William (Rick) Jackman, Current "Lead Operator" at District

William (Billy) Romhild, Current Operator II at District

Davina Douglas, Former employee (Lab Tech) at District

APPENDIX B

INDIVIDUALS INTERVIEWED (cont.)

Dena Bellman, Park and Recreation Specialist, Oceano Dunes District

Andy Zilke, Former Superintendent of Oceano Dunes District

Aaron Allen, Former Operator II at District

Katie DiSimone, Water Quality Board

Jeff Appleton, Former Plant Superintendent (CPO) 2000-2011

Shannon Sweeny, Engineer Consultant (2013)

Dave Kraus, Owner Yo Banana Boys.

John Wallace, Former DISTRICT Manager, Engineer

John Wykoff, Vice President, Kennedy/Jenks Consulting Firm

Mathew Guerrero, Board Member OCSD

Laurie Angelo, Former Board Member OCSD

Bob Barlogio, Former SSLCOSD Plant Superintendent

Alex Hom, CPA,

Bob Crosby, CPA

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Did you analyze any of the Wallace billings and test sample any of the billings to the Wallace Group's back up documents that would support the billings to DISTRICT? **Not for materials or supplies. We tested some labor expenses (see next question). We tested payments to the Wallace group to determine if the payments were authorized by Board members and agreed to invoiced amounts. Our findings are detailed in our audit report.**

We agree with the County Auditor to the extent that the Conflict was mitigated with the new 2011 contracts, but the Conflict of Interest clearly couldn't be mitigated prior to the July 2011 contract where there was no contract in force for the Wallace Group or other formal documents spelling out "contractual controls" on the work to be performed by the Wallace Group. In fact, as detailed in this report, there is a clear demonstration that if the Board of Directors were exercising "contractual control" on the Wallace Group, it wasn't effective in keeping the payments to the Wallace Group under control.

Further, during our investigative review, we documented two cases where there is a clear Conflict of Interest related to; 1) the Personnel issues at the plant, and 2) the abuse by Wallace in the role as the District Administrator attempting to obtain work for the Wallace Group as a condition of approving "permits" under the control of the District Administrator. The 2nd case is more fully detailed in the "Malfeasance" section of our report at page 107.

PERSONNEL ISSUES

Through our investigative review we determined that the District has never had an HR (Human Resources) Department or "Ombudsman" where an employee could seek advice, counsel or representation related to issues or grievances with the District management. In our experience, the human resource manager is the "face of HR" and therefore can be relied upon to be both a human resources expert and also an *employee advocate*.

When the issues between [redacted] and [redacted] began, Sabrina Spears, the District secretary/bookkeeper acted as a **"HR representative"** in a March 29, 2010 meeting between [redacted] and [redacted]. There was no pretense of an "advocate" available to [redacted]. Likewise, when the issues between [redacted] and [redacted] began, it was [redacted] who was again acting as a witness and [redacted] relationship with [redacted] was adversarial. We have attached as exhibits a string of documents that we recovered from the "Haber Files" that were stored on the District computer system that demonstrate