Municipal Secondary Market Disclosure Information Cover Sheet

This cover sheet should be sent with all submissions made to the Municipal Securities Rulemaking Board, Nationally Recognized Municipal Securities Information Repositories, and any applicable State Information Depository, whether the filing is voluntary or made pursuant to Securities and Exchange Commission rule 15c2-12 or any analogous state statute.

See www.sec.gov/info/municipal/nrmsir.htm for list of current NRMSIRs and SIDs

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IF THIS FILING RELATES TO A SINGLE BOND ISSUE:

Provide name of bond issue exactly as it appears on the cover of the Official Statement (please include name of state where issuer is located):

See Below

Provide nine-digit CUSIP* numbers if available, to which the information relates:

See Below

IF THIS FILING RELATES TO ALL SECURITIES ISSUED BY THE ISSUER OR ALL SECURITIES OF A SPECIFIC CREDIT OR ISSUED UNDER A SINGLE INDENTURE:

Issuer's Name (please include name of state where Issuer is located): **CITY OF SAN DIEGO, CALIFORNIA, AND OTHERS**

Other Obligated Person's Name (if any): ____________

(Exactly as it appears on the Official Statement Cover)

Provide six-digit CUSIP* number(s), if available, of Issuer: **797299, 797448, 797260, 79727L, 797290, 797236, 797263, 79730C, 79730A, 79729P, 797316, 802808, 797283, 797300, AND 797304**

*(Contact CUSIP's Municipal Disclosure Assistance Line at 212.438.6518 for assistance with obtaining the proper CUSIP numbers.)

TYPE OF FILING:

Electronic and Facsimile (Number of pages attached): **5 PAGES (INCLUDING THIS COVER SHEET), PLUS PENSION REFORM COMMITTEE FINAL REPORT (74 PAGES), R.H. VORTMANN MINORITY REPORT (46 PAGES), AND ITALIANO AND ELMORE MINORITY REPORT (4 PAGES)**

If information is also available on the Internet, give URL: **N/A**

WHAT TYPE OF INFORMATION ARE YOU PROVIDING? (Check all that apply)

A. Annual Financial Information and Operating Data pursuant to Rule 15c2-12
(Financial information and operating data should not be filed with the MSRB.)

Fiscal Period Covered:

B. Audited Financial Statements or CAFR pursuant to Rule 15c2-12Fiscal Period Covered:

C. Notice of a Material Event pursuant to Rule 15c2-12 (Check as appropriate)

1. Principal and interest payment delinquencies _____
2. Non-payment related defaults _____
3. Unscheduled draws on debt service reserves reflecting financial difficulties _____
4. Unscheduled draws on credit enhancements reflecting financial difficulties _____
5. Substitution of credit or liquidity providers, or their failure to perform _____
6. Adverse tax opinions or events affecting the tax-exempt status of the security _____
7. Modifications to the rights of security holders _____
8. Bond calls _____
9. Defeasances _____
10. Release, substitution, or sale of property securing repayment of the securities _____
11. Rating changes___

D. Notice of Failure to Provide Annual Financial Information as Required ____

E. Other Secondary Market Information (Specify): **VOLUNTARY REPORT OF INFORMATION** ____________________

I hereby represent that I am authorized by the issuer or obligor or its agent to distribute this information publicly:
Issuer Contact:

Name_____**P. LAMONT EWELL** _________________________Title_____**CITY MANAGER**_________________________
Employer_____**CITY OF SAN DIEGO** ____
Address_____**202 C STREET, MAIL STATION 9A**__________City ___**SAN DIEGO**__State__**CA**__Zip Code__**92101** ____

Dissemination Agent Contact:

Name: _____ **P. LAMONT EWELL** ________________________Title: _____ **CITY MANAGER** ________________________
Employer: _____ **CITY OF SAN DIEGO** ____
Address: ______**202 C STREET, MAIL STATION 9A** ______ City: ___ **SAN DIEGO** ___State: __**CA**__Zip Code:_**92101**_

Obligor Contact, if any:
Name ____Title____
Employer ____
Address ____City ______________State______ Zip Code ______________

Investor and Credit Relations Contact:
Name_______________________ ___________________________Title____
Telephone____Fax: _____ ____

Press Contact:
Name: ___**GINA LEW** __________________________________Title:__ **DIRECTOR OF PUBLIC AND MEDIA AFFAIRS**
Telephone:__**(619) 236-6851**________________________________Fax: **(619) 236-6067** __________________________________

VOLUNTARY REPORT OF INFORMATION
DATED SEPTEMBER 24, 2004

The City of San Diego, California (the "City") is submitting this Voluntary Report of Information (this "Report") to the Municipal Securities Rulemaking Board ("MSRB"), the Nationally Recognized Municipal Securities Information Repositories ("NRMSIRs") via DisclosureUSA, and others as stated on the Distribution List. The City may or may not from time to time voluntarily submit additional information. This submission does not constitute a commitment to provide information beyond the disclosure requirements of any Continuing Disclosure Agreements.

This Report is dated as of September 24, 2004 (the "Dated Date") and speaks only as of the Dated Date. Readers are cautioned not to assume that any information has been updated beyond the Dated Date unless this Report expressly states that it constitutes an update of a specific matter in a document. The City expressly disclaims any duty to provide an update of this Report or a further update of any document, or matter therein, specifically referenced.

The filing of this Report does not constitute or imply any representation (1) that any or all of the information provided is material to investors, (2) regarding any other financial, operating or other information about the City, or related issuances, (3) that no changes, circumstances or events have occurred which may have a bearing on the security for the issuances or an investor's decision to buy, sell or hold the issuances.

Any statements regarding the issuances, other than a statement made by the City in an official release or subsequent notice or annual report, published in a financial newspaper of general circulation and/or filed with the MSRB or the NRMSIRs, are not authorized by the City. The City shall not be responsible for the accuracy, completeness or fairness of any such unauthorized statement.

Dated: September 24, 2004

CITY OF SAN DIEGO

By: P. Lamont Ewell
P. LAMONT EWELL
City Manager

VOLUNTARY REPORT OF INFORMATION
DATED SEPTEMBER 24, 2004

On September 9, 2003, the City Council established the Pension Reform Committee to address the concerns about the unfunded liability of San Diego City Employees Retirement System (SDCERS). Attached are the (i) the Council Resolution, dated September 9, 2003, establishing the Pension Reform Committee, and (ii) the Pension Reform Committee Final Report, dated September 15, 2004, with two minority reports, addendums to the Pension Reform Committee's Final Report, one authored by R.H. Vortmann, dated September 21, 2004, and one authored by Judith Italiano and Stanley Elmore, dated September 21, 2004. These reports were presented to the City Council on September 21, 2004.

Distribution List:

VOLUNTARY REPORT OF INFORMATION
DATED SEPTEMBER 24, 2004

Municipal Securities Rulemaking Board

Via DisclosureUSA:

Bloomberg Municipal Repository

DPC Data Inc.

FT Interactive Data

Standard & Poor's J. J. Kenny Repository

BNY Western Trust Company (Trustee)

U.S. Bank, N.A. (Trustee)

Union Bank of California, N.A. (Trustee)

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Ambac Assurance Corporation (Insurer)

FGIC (Insurer)

MBIA Insurance Corporation (Insurer)

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Financial Security Assurance (Insurer)

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Citigroup Global Markets Inc. (Underwriter)

(R-2004-213 REV.)

RESOLUTION NUMBER R-298359

ADOPTED ON SEPTEMBER 9, 2003

WHEREAS, during the past several months concern has been expressed about the current unfunded liability of the San Diego City Employees Retirement System [CERS]; and

WHEREAS, the San Diego Taxpayers Association and several City Councilmembers have called for an independent audit of CERS; and

WHEREAS, the Mayor has proposed establishing a Pension Reform Committee pursuant to City Charter section 43 (b); and

WHEREAS, pursuant to Council Policy 000-16, the Pension Reform Committee will adhere to the requirements of the California Brown Act; and

WHEREAS, the Mayor and City Council desire to assure the public that prospective members do not have conflicting business relationships with CERS or the City; NOW, THEREFORE,

BE IT RESOLVED, by the Council of the City of San Diego, that there is hereby established pursuant to City Charter section 43 (b) a Pension Reform Committee consisting of nine members including a chairperson who shall be appointed by the Mayor and confirmed by the City Council. The composition of the Pension Reform Committee shall be as follows:

a. Five individuals who are not City employees and not City retirees and who have experience or expertise in defined benefit pension plans; and

b. One taxpayer advocate, who is not a City employee or City retiree; and

c. One member of the City Retirement Board who is not a City employee or City retiree; and

d. One City retiree who is not a member of the City Retirement Board; and

e. One City employee.

BE IT FURTHER RESOLVED, by the Council of the City of San Diego, to assure that members of the Pension Reform Committee do not have potentially conflicting business relationships with CERS or the City, subsequent to appointment and prior to confirmation, prospective members shall be required to execute an affidavit under penalty of perjury declaring that they do not have any business relationships related to providing financial services to CERS or the City (other than as a member of the Board or member of CERS for those members appointed pursuant to paragraphs c, d, and e) and further, that such prospective member shall refrain from establishing any such business relationship with CERS or the City for a one year period following the dissolution of the Pension Reform Committee.

BE IT FURTHER RESOLVED, by the Council of the City of San Diego, that there is hereby established pursuant to City Charter section 43 (b) the Pension Reform Committee with the following defined objectives:

a. Report back to the City Council no later than 120 days from the date appointments are confirmed.

b. After reviewing and considering the scope and depth of audit activity currently being conducted by CERS, conduct any additional or supplemental independent audits, studies, or investigations deemed necessary and appropriate.

c. Provide recommendations to address any unfunded liability problems of the system.

d. Examine how the existing pension system has performed compared to other similar systems, including examination of actions other systems have taken to address funding shortfall problems, such as issuance of pension obligation bonds.

e. Examine whether changes should be made to the existing pension system.

f. Examine whether the make-up and representative constitution of the Retirement Board should be restructured.

g. Examine whether the system should be changed from a defined benefit plan to a defined contribution plan for new employees.

h. Examine whether the City should join the California Public Employees Retirement System or any other retirement system.

i. Make any other recommendations as appropriate.

BE IT FURTHER RESOLVED, by the Council of the City of San Diego, that the expectation of the Council is for CERS and the Pension Reform Committee to cooperate in the sharing of documents, information, and resources in order for both CERS and the Pension Reform Committee to efficiently and expeditiously fulfill their respective duties and responsibilities.

APPROVED: CASEY GWINN, City Attorney

By ___________________________________
Richard A. Duvernay
Deputy City Attorney

RAD:jab
08/29/03
09/12/03 REV.
Or.Dept:Rules
R-2004-213

FINAL REPORT

CITY OF SAN DIEGO PENSION REFORM COMMITTEE

SEPTEMBER 15, 2004

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EXECUTIVE SUMMARY

CITY OF SAN DIEGO PENSION REFORM COMMITTEE

SEPTEMBER 15, 2004

Ms. April Boling, CPA (Chairperson)
President
San Diego County Taxpayers Association

Mr. Stephen Austin, CPA
Managing Partner
Swenson Advisors, LLP

Mr. Robert Butterfield
Attorney
Butterfield Schechter LLP

Mr. Timothy Considine, CPA
Of Counsel
Considine & Considine

Mr. Stanley Elmore
Past President Retired Fire & Police Association
City Retiree

Ms. Judith Italiano
President and General Manager
San Diego Municipal Employees Association

Mr. William Sheffler
Consulting Actuary
Sheffler Consulting Actuaries, Inc.

Mr. Richard Vortmann
President
National Steel and Shipbuilding Company

Ms. Kathleen Walsh-Rotto
Senior Relationship Manager
Principal Financial Group

THIS DOCUMENT MAY CONTAIN PROJECTIONS, FORECASTS, ASSUMPTIONS, EXPRESSIONS OF OPINION, ESTIMATES AND OTHER BACKWARD-LOOKING RECONSTRUCTIONS OR FORWARD LOOKING STATEMENTS, ARE NOT TO BE CONSTRUED AS REPRESENTATIONS OF FACT, AND ARE QUALIFIED IN THEIR ENTIRETY BY THIS CAUTIONARY STATEMENT. ONLY STATEMENTS MADE BY THE CITY IN AN OFFICIAL RELEASE OR SUBSEQUENT NOTICE OR ANNUAL REPORT, PUBLISHED IN A FINANCIAL NEWSPAPER OR GENERAL CIRCULATION AND/OR FILED WITH THE MSRB OR THE NSMSIRs ARE AUTHORIZED BY THE CITY. THE CITY SHALL NOT BE RESPONSIBLE FOR THE ACCURACY, COMPLETENESS OR FAIRNESS OF UNAUTHORIZED STATEMENTS.

OBJECTIVES OF THE COMMITTEE

- Report back to the City Council no later than 120 days from the date appointments are confirmed.
- After reviewing and considering the scope and depth of audit activity currently being conducted by SDCERS, conduct any additional or supplemental independent audits, studies, or investigations deemed necessary and appropriate.
- Provide recommendations to address any unfunded liability problems of the system.
- Examine how the existing pension system has performed compared to other similar systems, including examination of actions other systems have taken to address funding shortfall problems, such as issuance of pension obligation bonds.
- Examine whether changes should be made to the existing pension system. Examine whether the make-up and representative constitution of the Retirement Board should be restructured.
- Examine whether the system should be changed from a defined benefit plan to a defined contribution plan for new employees.
- Examine whether the City should join the California Public Employees Retirement System or any other retirement system.
- Make any other recommendations as appropriate.

BACKGROUND – PENSION ISSUES

- Current employees and the pension plan sponsor (the City of San Diego) make annual contributions to the pension plan which is a trust. The annual contribution to the City of San Diego's pension plan (Plan) is computed by an actuary. (This annual contribution is typically expressed as a percentage of payroll.)

- When actual experience does not match the assumptions used, the shortfall is spread (amortized) over a period of time and payments are made to ultimately make up the difference.

- When there is a deficit, it means that those assets are not in the Plan's investment pool where they would be generating investment earnings (foregone earnings).

- The City Manager recommends and the City Council approves the Plan benefits. Employees bargain for those benefits through the "Meet and Confer" process.

- The San Diego City Employees' Retirement System (SDCERS) Trustees (the Retirement Board) administer the plan.

THE CURRENT FUNDED STATUS OF THE SYSTEM

- The most recent formal Actuarial Valuation of the Plan is as of June 30, 2003. In that valuation, the Unfunded Accrued Actuarial Liability (UAAL) was calculated at $1.157 Billion and the Plan was determined to be 67.2% funded.

- At June 30, 2003, the Fair Market Value (FMV) of Plan assets was $2.329 Billion, while the Actuarial Value was $2.375 Billion. The difference of $46 Million will be recognized over future periods. ***Note: Adjusted to exclude Port and Airport Assets.***

- The annual valuation does not consider the present value of the Plan's contingent benefits. Contingent benefits are primarily Corbett settlement, 13th check, COLA etc.

- The UAAL was updated to January 31, 2004. Rather than $1.157 Billion as was identified at June 30, 2003, the UAAL had increased to $1.167 Billion. The funded ratio, however, had increased slightly to 68.7%.

The Committee calculated the amount of contribution that would need to be transferred into the Plan during FY05 to keep the UAAL from growing as follows:

Contribution Components	(in millions) **Contribution Amounts**
Normal Cost	$76.01
Contingent Benefits	20. 30
Retiree Medical Benefits (current year premium only)	13.00
Interest (foregone earnings) on the UAAL	93.36
Total	$202.67*

(*Excludes the unfunded liability for medical costs)

In FY04, the City's contribution to the Plan was $85 Million. The agreed-upon payment for the lawsuit in FY05 is $130 Million, ramping up to approximately $180 Million in FY08.

RETIREE HEALTH CARE

THE SECOND DEFICIT IN SDCERS RELATES TO RETIREE HEALTH CARE.

Current retirees' health care is being paid from a special reserve within the Pension Plan.

Currently, this is a "pay as you go" system. Based upon a 5% annual "Medflation" rate, the liability is estimated at $545 million.

	(in millions)
Normal Cost	$26.08
Amortization of Liability	$58.96
TOTAL	**$85.04**

HOW DID ALL THIS HAPPEN?

MAJOR REASONS FOR THE UNDER-FUNDED PROBLEM
(From July 1, 1996 to June 30, 2003)

1. Investment performance	**6%**
2. Under-funding by City	**10%**
3. Use of Plan earnings for contingent benefits	**12%**
4. Net Actuarial losses	**31%**
5. Benefit improvements	**41%**
	100%

Note: This analysis of under-funding does not include future impact of contingent Corbett Settlement and 13th Check.

DESCRIPTION OF CAUSES FOR UNDER-FUNDED STATUS

1. Investment Performance

The actual investment performance experience in fact has been 8% on average over the long-term.

2. Under-Funding by the City

The City purposely under-funded the Plan through MP I and II. Even if the City had not entered into MP I and II, the deficit would have grown due to the amortization system selected. This was exacerbated by the drain on Plan assets from the payment of contingent benefits and retiree medical benefits.

It appears that this and previous Mayors and City Councils did not understand all the implications of the foregoing and it is possible that many, if not most, of the Retirement Board trustees did not understand.

3 Use of Plan earnings for contingent benefits

The Plan is, in fact, experiencing 8% earnings on its assets. It does not, however, retain those earnings in order to pay future retirement benefits. Instead, a significant portion is siphoned off to pay contingent benefits such as:

13th Check
Corbett Settlement

NET ACTUARIAL GAINS AND LOSSES

Major Drivers:

– Extremely low employee turnover

– Significant service purchase subsidies

– Pay increases above those assumed

Retirement/DROP elements

5. Benefits Improvements

A variety of retirement benefits have been granted since 1996. The past service element of these benefits has caused a significant portion of the increase to the Plan's UAAL. The long-term impact of these benefit improvements was not fully understood.

HOW DO WE REDUCE/ELIMINATE THE UAAL?

The UAAL has been treated as off balance sheet debt when in fact it is a full obligation of the City.

When assessing solutions to the Plan's under-funded status, there are two discreet components of the issue:

Recommendations with respect to reduction or elimination of the Unfunded Actuarial Accrued Liability (UAAL) and Recommendations regarding the ongoing annual costs of the basic plan and the contingent benefit.

PENSION OBLIGATION BONDS (POBS)

Recommendation #1

$600 Million in assets should be infused into the plan over the next three fiscal years. Of that amount, no less than $200 Million should be placed in the Plan during FY05 (preferably by December 31, 2004) and that amount should be attained through the issuance of Pension Obligation Bonds. Subsequent infusions, bringing the total to $600 Million can be through POBs, or some form of real estate secured transactions.

The Pension Reform Committee does not support the idea of negative interest amortization and believes that the payment against the UAAL should always be set at a level that actually decreases the debt rather than adding to it.

Recommendation #2

The City Charter should be amended to require that when amortizing net actuarial gains or losses, a period of no longer than 15 years be used for the amortization of losses and that a period of no shorter than 5 years be used for the amortization of a surplus. <u>This change should be effective for FY08</u> contributions.

Recommendation #3

The City Charter should be amended to require that for all new pension benefit improvements to the currently existing plan, SDCERS will, when setting actuarial assumptions and methodologies, for funding purposes, use an amortization period no greater than straight-line 5 years fixed for any past service liability for each new benefit improvements. <u>This change should be effective immediately.</u>

Because they are not considered in the calculation of a Normal Cost, the net result is that the UAAL grows each year by the amount of the contingent benefits paid and the amount of the addition to the Plan's retiree "health care reserve". <u>The Pension Reform Committee believes that an amount equal to the value of the contingent benefits siphoned from the Plan earnings should be replaced by the City annually based on an estimate calculated at the beginning of the fiscal year for that fiscal year.</u>

Recommendation #4

The City's annual required contribution to the Plan for a given year should be defined as the total of Normal Cost, UAAL amortization (including interest), and an amount equivalent to the estimated contingent liabilities related to that year.

TREATMENT OF RETIREE HEALTH CARE BENEFITS

Recommendation #5

Payments for retiree health care benefits should no longer be funded via the retirement plan. SDMC 24. 1502(a)(5) should be eliminated thereby removing health care benefits from the Plan's distribution waterfall.

REDUCTION OF NORMAL COST

The City's pension benefits are generous by almost any standard applied (24% of payroll.)

Recommended changes 6-10 will impact new hires only. The savings illustrated will only be fully realized only when all employees under the existing benefit structure have retired.

Recommendation #6

The normal retirement age should be raised by seven years for all employees and the early retirement age should be set at a number of years that are five years less than the normal retirement age. Any retirement earlier than normal age will be cost-neutral, actuarially reduced.

This will result in a savings of 3.69% of pay, or based on current payroll, $22,342,000.

The above recommendation will result in the following normal and early retirement ages:

	Normal	Early
General members	62	57
Fire and Police	57	52
Legislative	62	57

REDUCTION OF NORMAL COST

Recommendation #7

The annual accrual rate for the percentage of the final base payroll to be used in calculating the pension benefit is reduced by 20%.

This will result in a savings of 2.61% of pay, or based on current payroll, $15,774,000.

The above recommendation will result in the following accrual rate percentages:

General Members	2.0%
Fire and Police	2.4%
Legislative	2.8%

Recommendation #8

The final base payroll should be based on an average of the employee's highest three years of salary rather than on the highest one year of salary.

This will result in a savings of 1.06% of pay, or based on current payroll, $6,413,000 annually.

Recommendation #9

The final base payroll should exclude salary differentials such as second shift differential, bilingual differentials, etc.

This will result, conservatively, in a savings of 3.5% of pay, or based on current payroll, $21,175,000 annually.

Note: The cumulative effect of Recommendations 6-9 is substantial, but not additive.

RETIREE MEDICAL BENEFITS

Recommendation #10

Eliminate specific programs that permit DROP and purchase of years of service credits, except those that are federally protected.

Recommendation #11

The City should establish either a separate trust or a separate accounting within the pension trust to account for the assets and liabilities of the retiree medical benefit plan. Retiree Medical Plan assets may be commingled with Retirement Plan assets for investment purposes, but be accounted for separately for all other purposes. Annual contributions to the Retiree Medical Plan should be separately identified in the City budget and in no way be confused or commingled with Retirement Plan contributions.

The Governmental Accounting Standards Board (GASB) has acknowledged this problem.

The newly-issued Statement 43 provides a framework for transparent financial reporting by governmental entities that have fiduciary responsibility for OPEB plan assets regarding their stewardship of plan assets, the funded status and funding progress of the plan, and employer contributions to the plan.

RETIREE MEDICAL BENEFITS

Recommendation #12

Adopt GASB Statement #43 (Financial Reporting for Participant Benefit Plans other than Pension Plans), effective July 1, 2005

The above recommendations deal with the accounting for the benefits, they do not address the ability or inability of the City to fund this already-existing liability.

Recommendation #13

When amortizing the unfunded liability for retiree medical benefits, a method should be used that does not create negative amortization of the liability.

The City Charter currently dictates the composition of the 13 member Board of Trustees as follows:

- 3 representatives from City management
- 2 representatives elected by police and fire members
- 3 representatives elected by General Members
- 1 representative elected by retired members
- 4 independent citizens nominated by the Mayor and appointed by Council

At the heart of the concern is that, of the 13 members of the Retirement Board, 8 members (62%) can clearly benefit by enabling the City to fund its current operating budget at the expense of the retirement plans.

The second significant problem is the technical skill required to understand the complex issues may not be sufficient.

GOVERNANCE

Recommendation #14

Change the composition of the Retirement Board to seven members appointed by the City Council. These members will serve with staggered terms of four years each, with a two consecutive term maximum. Such appointees will have the professional qualifications of a college degree and/or relevant professional certifications, fifteen years experience in pension administration, pension actuarial practices, investment management (including real estate), banking, or certified public accounting. Such appointees will be US Citizens and resident of the City of San Diego, but cannot be City employees, participants (directly or indirectly through a direct family member) of the SDCERS, nor a union representative of employees or participants, nor can such appointees have any other personal interests which would be, or create the appearance of, a conflict of interest with the duties of a Trustee.

Recommendation #15

An additional provision should be made to the City Charter that would codify the current disability retirement determination process as it is now except that the hearing officer's decision would be final rather than a recommendation for the Board for approval.

Study disability retirement application process and systems.

OTHER RECOMMENDATIONS

Recommendation #16

The City should establish a committee to review the entire disability retirement system. Representatives on this committee should include knowledgeable employees of both the City and SDCERS as well as outside professionals with experience in this area (Employee/Employer Sharing of Pension costs.)

Recommendation #17

The City Council Rules Committee should require a report (with recommendations) From SDCERS on the issue of the 50/50 employer/employee cost split by the end of the calendar year (Actuarial Assumptions).

Committee Members

In September 2003, the Mayor nominated and the City Council approved appointment of a nine person Pension Reform Committee (the Committee) to address the growing public concern over the financial status of the City's pension system (the System). The Committee was to include a City retiree with pension experience, a City employee with union pension experience, a member of the Retirement Board, a taxpayer advocate and five citizens with experience in defined benefit pension plans.

Task Force Member	***Professional Background***
Ms. April Boling (Chairperson)	San Diego County Taxpayers Association (Taxpayer Advocate)
Mr. Stephen Austin	Swenson Advisors, LLP (Pension Plan Experience)
Mr. Robert Butterfield	Butterfield Schechter LLP (Pension Plan Experience)
Mr. Timothy Considine	Considine & Considine (Pension Plan Experience)
Mr. Stanley Elmore	City of San Diego Retiree with pension experience
Ms. Judith Italiano	San Diego Municipal Employees Association (City Employee/Union member with pension experience)
Mr. William Sheffler	Sheffler Consulting Actuaries, Inc. (Pension Plan Experience)
Mr. Richard Vortmann	San Diego City Employee Retirement System Board member/National Steel and Shipbuilding Company, NASSCO (Retirement Board Member)
Ms. Kathleen Walsh-Rotto	Principal Financial Group (Pension Plan Experience)

* Biographical information available in **Appendix A**

Objectives of the Committee

1. Report back to the City Council no later than 120 days from the date appointments are confirmed.
2. After reviewing and considering the scope and depth of audit activity currently being conducted by CERS, conduct any additional or supplemental independent audits, studies, or investigations deemed necessary and appropriate.
3. Provide recommendations to address any unfunded liability problems of the system.
4. Examine how the existing pension system has performed compared to other similar systems, including examination of actions other systems have taken to address funding shortfall problems, such as issuance of pension obligation bonds.
5. Examine whether changes should be made to the existing pension system. Examine whether the make-up and representative constitution of the Retirement Board should be restructured.
6. Examine whether the system should be changed from a defined benefit plan to a defined contribution plan for new employees.
7. Examine whether the City should join the California Public Employees Retirement System or any other retirement system.
8. Make any other recommendations as appropriate.

Introduction

The Committee has met weekly since early October. The City Council received a report **(Appendix B)** from the Committee on January 22, 2004. Additional information was provided to the Council on April 19, 2004 **(Attachment 1.)**

Certain recommendations made by the Committee required changes to the City Charter. While the Committee would have preferred to make these recommendations in the context of the total report, time constraints surrounding the placing of changes to the Charter on the ballot required that these proposals be brought forward ahead of the body of the report. The Committee presented proposed Charter changes to the Council's Rules Committee and the City Council and actions have been taken by the Council on those proposals.

Since early October, the Committee has gathered data, interviewed staff and other knowledgeable individuals related to the plan, and analyzed the information presented. Specific individuals with interest or expertise in the System were invited to present their issues to the Committee (See Section XIII Bibliography – Item 97.) The extent of the problem was identified and various corrective actions were evaluated. This report summarizes the analysis the Committee performed and presents the Committee's corrective recommendations and the rationale therefore. The recommendations contained herein relate only to the City of San

Diego's portion of the System.

I. BACKGROUND

Under a defined benefit pension plan, current employees and the pension plan sponsor (in this case, the City of San Diego) make annual contributions to the pension plan which is a trust. The theory is that these annual contributions, combined with the investment earnings of the pension plan, will ultimately provide sufficient funds to pay retirement benefits to all of the pension plan's participants who retire.

The annual contribution to the City of San Diego's pension plan (Plan) is computed by an actuary based upon the characteristics of the retirement commitment (e.g. age of retirement, percentage of replacement of base pay, etc.) and a variety of assumptions (e.g. rate of investment return, rate of inflation, mortality, etc.) This annual contribution is typically expressed as a percentage of payroll.

When actual experience does not exactly match the assumptions used by the Plan's actuary, it is possible to have either more or less assets in the Plan than needed to meet the projected liabilities. The shortfall is spread (amortized) over a period of time and annual payments are made to ultimately make-up the difference.

It should be noted that when there is a deficit, it means that those assets are not in the Plan's investment pool where they would be generating investment earnings. As a result, the payoff of the deficit must also account for the forgone earnings. This is analogous to principal and interest on a mortgage.

Because actual experience never perfectly matches the actuarial assumptions, the total annual contribution to any defined benefit plan will have two components: one is the cost of benefits earned during the year, and the other is the payment to close the deficit or surplus.

The City Manager recommends and the City Council approves the Plan benefits. Employees bargain for those benefits through the "Meet and Confer" process. In the opinion of the City Attorney's office, an employee becomes vested in the characteristics of the Plan as of the date he or she is hired. It is not possible, therefore, to change Plan benefits for either retirees or any current employee.

The San Diego City Employees' Retirement System (SDCERS) Trustees (the Retirement Board) administer the Plan. That includes managing the Plan's investment portfolio as well as ensuring the timely delivery of retirement benefits to the Plan's beneficiaries. The Trustee's primary fiduciary duty is to the beneficiaries of the Plan. Administration of the Plan includes approval of actuarial assumptions to be used in determining the annual contribution by the employees and the City. The composition of the Retirement Board is set by the City Charter.

II. THE CURRENT FUNDED STATUS OF THE SYSTEM

Note: Section XII of this report is a glossary of terms. We encourage the reader to review the glossary before continuing with this report. Two important terms are defined here as well to assist the reader in understanding the following section of the report.

Normal Cost is defined as that portion of the actuarial present value of pension plan benefits and expenses which is allocated to a valuation year by the actuarial cost method, excluding any payment in respect of an unfunded actuarial accrued liability.

The Unfunded Accrued Actuarial Liability or UAAL is defined as the excess of the Actuarial Accrued Liability over the Actuarial Value of Assets.

A critical task of the Committee was to determine the amount of the deficits present in the SDCERS system.

The Pension Plan

The most recent formal Actuarial Valuation of the Plan was as of June 30, 2003. In that valuation, the Unfunded Accrued Actuarial Liability (UAAL) was calculated at $1.157 Billion and the Plan was determined to be 67.2% funded.

It is important to understand that the Plan assets are not valued at Fair Market Value (FMV) for purposes of the Actuarial Valuation. As with other pension plans, unrealized gains and losses are smoothed over a period of time to mitigate the effects of dramatic swings in the stock market. In the SDCERS Valuation, a smoothing period of five years is used. At June 30, 2003 the FMV of Plan assets was $2.329 Billion, while the Actuarial Value was $2.375 Billion (adjusted to exclude Port and Airport assets.) The difference of $46 Million will be recognized over future periods.

The annual valuation does not consider the present value of the Plan's contingent benefits. Contingent benefits (Corbett settlement, 13th check, COLA etc.) paid to the beneficiaries out of Plan earnings, thereby reducing the amount of earnings that stay with the Plan to fund its future commitments to retirees. Because these costs are considered contingent, they are not part of Normal Costs and, therefore, are not included in the calculation of the City's annual payment to the Plan. The net result is that even if the investment earnings exactly match the actuarial assumption, the UAAL increases each year by the amount of the contingent benefits.

Further, the current method and period being used for amortization of the UAAL does not generate a required payment that is high enough to cover even the forgone investment earnings, much less pay down any of the underlying UAAL.

Put another way, when one considers the drain on Plan earnings caused by payment of the retiree health costs and contingent benefits coupled with the fact that the UAAL amortization is applying nothing to the actual principal portion of the liability, it becomes clear that "full actuarial funding" is a misleading term at best.

In the spring of this year, the Committee requested and received an updated calculation of the UAAL from the Plan's actuary. The Committee was aware that there had been positive movement in the market but was also aware that there would be additional losses recognized from earlier periods due to asset smoothing. The UAAL was updated to January 31, 2004. Rather than $1.157 Billion as was identified at June 30, 2003, the UAAL had increased to $1.167 Billion. The funded ratio, however, had increased slightly to 68.7%.

Based on an assumption that the UAAL would still be at $1.167 Billion as of June 30, 2004 (meaning no further variances from the actuarial assumptions) and that there would also be no variances from the actuarial assumptions for FY05 (the year ended June, 2005), the Committee calculated the amount of contribution that would need to be transferred into the Plan during FY05 to keep the UAAL from growing as follows:

	(in millions)
Normal Cost	$76.01
Contingent Benefits	20.30
Retiree Medical Benefits (current year premium only)	13.00
Interest (foregone earnings) on the UAAL	93.36
Total	$202.67*

* Excludes the unfunded liability for medical costs discussed in paragraph B below

In FY04, the City's contribution to the Plan was $85 Million. Under the settlement, the lawsuit brought by the System's retirees, the agreed-upon payment for FY05 is $130 Million, ramping up to approximately $180 Million in FY08.

Retiree Health Care

The second deficit in SDCERS relates to retiree health care. Currently, the City itself is not making any payments on the liability. Current retirees' health care is being paid from a special reserve within the Plan. The reserve is funded by "siphoning off" earnings from the Plan as discussed above, thereby increasing the UAAL.

The larger problem, however, is that this is a “pay as you go” system, meaning that there is no recognition of the long-term liability for the medical premiums of retirees in future years nor is there recognition that the City is also incurring a liability every year for the existing employees’ right to a health benefit when they eventually retire.

In the opinion of the City Attorney, various groups of employees and retirees have different levels of vesting related to health care. Based on the assumption that current and future retirees will continue to receive this benefit at the same level as enjoyed currently, the Pension Reform Committee requested and received an analysis of the current liability associated with this commitment. Based upon a 5% annual “medflation” rate, the liability is estimated at $545 million. This is <u>in addition to</u> the $1.167 Billion UAAL identified above. The payment required to cover the Normal Cost associated with retiree health care and to eliminate the unfunded liability of $545 over 15 years is calculated as:

	(in millions)
Normal Cost	$26.08
Amortization of Liability	<u>$58.96</u>
Total:	$85.04

This payment is required in addition to any payment needed to fund the Plan itself.

III. HOW DID THIS HAPPEN?

In attempting to describe how we believe the current pension and retiree health problems came to be, the Pension Reform Committee’s purpose is not to find fault or allocate blame. Rather it is to ensure a full understanding of the interrelated causes of the problem as a means to ensure they are not repeated in the future. In this section we will address causes. In subsequent sections we will address corrective recommendations.

Quantification of Causes

The Pension Reform Committee requested and received an analysis of the components of the increase in the Unfunded Actuarial Accrued Liability (UAAL) from July 1, 1996 to June 30, 2003. This analysis, prepared by the Plan’s actuary, provided the following allocation:

Investment performance	6%
Under-funding by City	10%

Use of Plan earnings for contingent benefits	12%
Net Actuarial losses	31%
Benefit improvements	41%
	100%

Note: This analysis of under-funding does not include future impact of contingent Corbett Settlement and 13th Check.

It should be noted that the Retirement Board commissioned a similar study that resulted in a significantly different allocation resulting from the interdependence of the various factors. The variance is currently being analyzed by the Retirement Board. The most insignificant variance, however, was in investment performance where the Retirement Board's study indicates an allocation factor of 7% rather than 6%.

Description of Causes

Investment performance

While this is the least significant factor mathematically, it warrants discussion because the market "bubble" of the late 1990s masked the other factors, providing an unwarranted sense of well-being by the Retirement Board and the City.

As discussed in the initial section, the City's annual contribution is calculated using a variety of actuarial assumptions. One of those assumptions is an 8% average rate of return on investment. Looking back over ten years, the experience has, in fact, been 8% on average over the long-term.

During the late 1990s, the City felt comfortable not only increasing benefits but also making lower contributions than it should have. When the market adjusted back to the investment rate of return originally anticipated in the actuarial assumptions, the fiscal impact of decisions made during the bubble became evident. As a result, there was an inclination to blame the declining funded status of the Plan on the decreasing market rather than acknowledging that the stabilization of the market was simply baring the results of ill-advised decisions.

Under-funding by the City

As previously discussed, the term "full actuarial funding" is misleading given the City's method of implementation. It implies that a Plan sponsor is paying an amount sufficient to cover not only current costs but also to pay an amortized portion of any unfunded liability. In the case of the City's Plan, the unfunded liability increases due to the drain on Plan earnings resulting from payments into the reserve for retiree medical benefits or any of the contingent liabilities. Additionally, because of the amortization method and schedule used to retire the deficit, the deficit actually grows.

Full actuarial funding as currently defined did not and does not result in a required payment large enough to keep the Plan's deficit from growing.

It appears that this and previous Mayors and Councils did not understand all the implications of the foregoing and it is possible that many, if not most, of the Retirement Board trustees did not understand it either. As a result, when the City Manager approached the Retirement Board in 1996 asking that it agree to contributions of less than "full actuarial funding", it did so. This action was perpetuated by a similar agreement entered into in 2002. Even at "full actuarial funding", the City would have been increasing its liability. By paying less than that, the problem was exacerbated.

Use of Plan earnings for contingent benefits

When determining the annual contribution, the actuary uses an 8% earnings assumption. The Plan is, in fact, experiencing 8% earnings on its assets. It does not, however, retain those earnings in order to pay future retirement benefits. Instead, a portion is siphoned off to pay contingent benefits. The most widely discussed of these contingent benefits are (described in layman's terms):

a. 13th Check - In 1980, when the Plan's investments were doing well, the Council created the 13th check to share the Plan's unexpectedly high rate of earnings with the retirees. In 1983, that policy generated potential 13th checks that were higher than the recipient's usual total annual benefit. As a result, the Retirement Board attempted to pass a Rule that would limit the amount of the 13th check to $30 per year of service. A lawsuit was filed against the City. The City lost and appealed. Before the appeal was completed, the City and the plaintiff reached a settlement which was approved by the court. Because of this settlement, the Retirement Board must make an additional payment to the employees in years where the Plan has earnings (the definition is complex and not particularly relevant), however those payments are capped at (with some variation) $30 per year of service. Thus, a retiree with thirty years of service will typically receive $900. In years where there are no earnings, the check is not payable and, in fact, cannot be paid. Each year stands on its own, and there is no forward accumulation if there are not earnings in a particular year. As this payment is made to all retirees, it is an expanding population. Currently, these payments are about $4 Million per year.

b. Corbett Settlement - In another California jurisdiction, a question arose as to whether or not retirement benefits had been calculated using all pertinent elements of salary A lawsuit was brought and it was determined that they had not. Similar suits were brought in other jurisdictions including San Diego. A decision was made to settle the lawsuit. As a result, the City changed its methodology. In addition, it is now bound to make additional payments to a specific group of retirees. Those payments are made out of the Plan's earnings (again the complex definition). Unlike the 13th check, these payments accumulate. If a payment is not made in one year due to the Plan's earnings level, that payment is payable in the next year when there are earnings. The payment does not, however, accrue interest. Because these payments are made to a specific group of retirees, this is a decreasing population. These payments are currently about $5.5 Million per year. There was also a one-time retroactive payment of approximately $20 Million.

c. Other - There are other smaller contingent benefits including a reserve for the supplemental COLA.

Actuarial Gains and Losses

These represent deviations from the actuarial assumptions. Based upon the Plan actuary's analysis, these are:

- Extremely low employee turnover
- Significant service purchase subsidies
- Pay increases above those assumed
- Retirement/DROP incidence

Benefit Improvements

When a new or improved benefit is granted to existing employees with retroactive applicability for all prior years of service, not only does the "Normal Cost" of the Plan increase, but a "past service liability" is also created. This is most easily understood through the following example:

> Joe has worked for the City for 25 years. During those 25 years, the Plan called for retirement based on 2.5% benefit for every year of service. Joe was expecting to retire at 75% of base pay if he stayed for 30 years (30 years X 2.5% per year = 75% of base pay). The actuary also expected the same thing and the contribution into the plan was based upon that 75% assumption. But during Joe's 26th year of service, there was a plan improvement. Instead of receiving 2.5% for each year of service, he will now receive

> 3.0% for each year. An option would have been to have Joe receive 2.5% for his first 25 years of service and 3.0% for the future 5 years, but that was not the way the benefit was granted. Because of the "retroactive element," Joe now will retire at a 90% of base pay (30 years X 3%). The actuary will adjust Normal Cost for the upcoming years to reflect the increase, but the shortfall related to Joe's first 25 years of service becomes a "past service liability".

A variety of such benefits have been granted since 1996. The past service element of these benefits has caused a significant portion of the increase to the Plan's UAAL.

IV. REDUCING/ELIMINATING THE UAAL

When assessing solutions to the Plan's under-funded status, there are two discreet components of the issue: 1) recommendations with respect to reduction or elimination of the Unfunded Actuarial Accrued Liability (UAAL), and 2) recommendations regarding the ongoing annual costs of the basic plan and the contingent benefits. This section deals with the first of these two items.

An ongoing theme among Pension Reform Committee members was concern that the UAAL is not treated as a real obligation of the City. It is referred to publicly as "soft debt" because it is not required to be disclosed as debt on the financial statements of the City. Since it is not included in the City's debt, it is (and this is subject to considerable debate) not considered by lenders when decisions are made as to other City bonded indebtedness including bonding capacity. One of the underlying goals of the Committee is to bring this debt onto the books of the City so that the full obligation is acknowledged and dealt with.

One strategy for reduction of the UAAL is to do nothing and hope that the market simply takes care of the problem. This is a naive and unrealistic strategy given that the actuarial expectation is an 8% investment return. For the UAAL to be permanently relieved through the market, the Plan would need to achieve (over many years) a consistent return of more than 8%. Further, since the $1.157 Billion in assets (the amount of the UAAL) is not in the Plan currently, the Plan now loses the benefit of <u>any</u> earnings those funds might realize.

The only real option is an infusion of assets into the Plan coupled with a ramp-up of annual contributions.

Pension Obligation Bonds (POBs) as an Option

Assuming that the City has adequate bonding capacity and can borrow at interest rates below the Plan's investment rate of return (currently an 8% assumption), there is the potential benefit of interest arbitrage (i.e. borrow at 6.5% and invest at 8%) . The cash provided by the POB is contributed to the Plan to reduce the deficit thereby increasing the funded status of the plan. Such bonds are taxable and are generally looked upon more favorably by investors if they are part of an overall plan to reduce the deficit and control costs.

Using City Real Estate as a Funding Mechanism

It was recognized that there may be limits to the City's debt capacity or other pressing City needs for that capacity that would make the extensive use of POBs either not possible or not attractive. The City owns a considerable amount of real estate that could be used, in a variety of forms, to provide the needed cash infusion. The most straight-forward option would be for the City to sell City-owned real estate and transfer the cash into the plan. Another possibility would be to borrow against the real estate, using it as collateral.

The third possibility would be to transfer specific real estate into the Plan. The concern about this option was that this would put the Plan in the position of becoming an unintentional landlord and might also expose the Plan to any liabilities associated with the property. Assuming the Plan was willing to hold the real estate, the Council-adopted Investment Guidelines related to percentages of Plan assets invested in certain types of investments (in this case, real property) may need to be changed.

A fourth possibility would be to allow the Plan to hold a fully amortizing note carrying the actuarially assumed interest rate of 8% secured by specific City real estate. This would have the benefit of assuring the actuarial rate of return without the City losing the use of the real estate or its potential gain in value. As with the third possibility discussed above, this may require a change to the Council-approved Investment Guidelines. While it was determined that this is a viable possibility, it is clear that the Plan's investment advisors would prefer to have the City borrow against the real estate and place the cash into to the Plan.

Recommendation #1

$600 Million in assets should be infused into the plan over the next three fiscal years. Of that amount, no less than $200 Million should be placed in the plan during FY 05 (preferably by December 31, 2004) and that amount should be attained through the issuance of Pension Obligation Bonds. Subsequent infusions, bringing the total to $600 Million can be through POBs, or some form of real estate secured transaction.

Implementation of this proposal should bring the Plan back to an 85% funded status by FY07.

To illustrate the impact of this recommendation on the funded ratio through fiscal year 2010, the following is a projection of the UAAL on 6/30/05 followed by a projected payment schedule.

PROJECTION OF UAAL @ 6/30/05

Projected 6/30/04 UAAL @ market	**$1,167.0**
Interest on UAAL $1,167 X 8%	**93.4**
Normal Cost '05 $605 active salary X 11.95%	**72.3**
Corbett (2 years past)	**5.5**
Corbett (1 year past)	**5.4**
Corbett (based on FY '04 earnings)	**5.3**
13th check (based on FY '04 earnings)	**4.1**
Supplemental COLA	**2.9**
FY '05 settlement payment	**(130.0)**
Projected UAAL @ 6/30/05	**$1,225.9**

$ expressed in millions

PROJECTED PAYMENT SCHEDULE (in millions)

Assumptions:
$200 POB 12/31/04
$200 TD or other secured loan 12/31/05
$200 TD or other secured loan 12/31/06
UAAL 30-yr for '06 & '07, reset to 15-yr in '08 (06/30/06 valuation)

Expressed in millions	**FY '05**	**FY '06**	**FY '07**	**FY '08**	**FY '09**	**FY '10**
Normal Cost ($605 active salary X 1.0425% inflation X 11.95%)		75.4	78.6	81.9	85.4	89.0
Corbett		5.3	5.2	5.1	5.1	5.0

13th Check		4.1	4.2	4.3	4.3	4.4
Supplemental COLA		2.9	2.9	2.9	2.9	2.9
Annual contribution excluding medical and UAAL amortization		87.7	90.9	94.2	97.7	101.3
$200 POBs @ 6.36%/29 years/Issued 12/31/04		15.5	15.5	15.5	15.5	15.5
$200 Trust Deed @ 8%/30 years/Issued 12/31/05			17.9	17.9	17.9	17.9
$200 Trust Deed @ 8%/30 years/Issued 12/31/06				17.9	17.9	17.9
UAAL Amort / .965% per 100 / 30 years		(22.3)	(17.4)			
UAAL Amort / 1.59% per 100 / 15 years				10.8	14.4	18.5
Interest on remaining UAAL		82.4	68.2	53.6	52.7	51.5
		75.6	84.2	115.7	118.5	121.3
Total payment (excluding medical)		**163.3**	**175.0**	**209.9**	**216.2**	**222.6**
Estimated Plan Liabilities	4000	4400	4800	5400	6014	6600
UAAL		1029.9	852.2	669.6	658.7	644.3
$200 Each TD issued 12/31/05 & 12/31/06		-200.0	-200.0			
Principal amortization		22.3	17.4	-10.8	-14.4	-18.5
	1029.9	852.2	669.6	658.7	644.3	625.8
Funded Ratio	**74.25 %**	**80.63%**	**86.05%**	**87.80%**	**89.29%**	**90.52%**

Increased Annual Contributions

As discussed previously, the UAAL has been growing, in part, as a result of the use of a payment calculation mechanism that results in the unfunded balance increasing in the early years of the amortization schedule.

Under the current methodology (widely used in public pension plans), the payment is calculated as a fixed percentage of inflation adjusted payroll based upon a 30-year amortization schedule. Thus, rather than the payment remaining constant as with a home mortgage, the payment amount increases each year as payroll increases due to inflation. **(Appendix C)** Since the interest rate on the unpaid balance remains constant at 8%, the net result is a payment in the early years of the schedule that does not cover the interest. The unpaid interest is then added to the principal. In other words, a $1 Billion debt would increase to approximately $1.16 Billion before it would start decreasing.

While it is true that such a method will result in full payment of the UAAL by the end of year 30, the common practice among public plans is to start over on the amortization plan as soon as the ever-increasing payment level becomes uncomfortable.

The Pension Reform Committee does not support the idea of negative interest amortization and believes that the payment against the UAAL should always be set at a level that actually decreases the debt rather than adding to it. While there is certainly more than one way to eliminate negative amortization, the Pension Reform Committee sees no reason to believe that the Retirement Board will choose an amortization method other than the fixed percentage of inflation adjusted payroll. Assuming use of that method, the longest amortization period that will not result in negative amortization is fifteen years.

Conversely, the Committee was concerned that if there is a surplus, that surplus could be amortized over a one-year period, resulting in a contribution "holiday". Because actuarial methods consistently strive for the smoothest possible (within reason) payment schedule, the Committee believes that a period no shorter than five years should be used for the amortization of a surplus.

Recommendation #2

The City Charter should be amended to require that, when amortizing net actuarial gains or losses, a period of no longer than 15 years be used for the amortization of losses and that a period of no shorter than 5 years be used for the amortization of a surplus. This change should be effective for FY08 contributions.

As previously discussed, the retroactive granting of new or improved benefits to existing employees creates a past service element/cost. While this form of benefit enhancement is certainly the prerogative of the Mayor and Council, the Pension Reform Committee believes that the past service cost should be dealt with over a reasonably short period of time so that a more accurate comparison can be made between the impact of a current compensation enhancement (e.g. pay raise) and the current impact of a retroactive pension benefit increase.

Recommendation #3

The City Charter should be amended to require that for all new pension benefit improvements

to the currently existing plan, SDCERS will, when setting actuarial assumptions and methodologies for funding purposes, use an amortization period no greater than straight -line 5 years fixed for any past service liability for each new benefit improvement. This change should be effective immediately.

V. TREATMENT OF CONTINGENT BENEFITS

As previously discussed, contingent benefits and retiree health care premiums are paid from Plan earnings. Because they are not considered in the calculation of "Normal Cost", the net result is that the UAAL grows each year by the amount of the contingent benefits paid and the amount of the addition to the Plan's health care reserve**.**

To make matters worse, the payment for any given fiscal year is paid in the subsequent year (usually November). For example, there are sufficient earnings in FY04 to trigger payment of the 13^{th} check. Currently, that liability is not reflected in the June 30, 2004 actuarial valuation nor is there a reserve established for it at June 30, 2004 even though the fact of the liability is known. The payment is made in FY05 and because it was not considered in Normal Cost, adds to the UAAL at 6/30/05. The UAAL for 6/30/05 is quantified during FY06 and amortization of that liability begins in FY07.

The Pension Reform Committee believes that an amount equal to the value of the contingent benefits siphoned from the Plan earnings should be replaced by the City annually based on an estimate calculated at the beginning of the fiscal year for that fiscal year. For example, the amount of the 13^{th} check related to FY06 should be calculated on the assumption that it will be paid. That amount should be added to the FY06 contribution for Normal Cost and the contribution for amortization of the UAAL. If, at the end of FY06, it is determined that there are not sufficient Plan earnings to trigger the 13^{th} check, then additional City contribution to the Plan would become an actuarial gain.

In the case of the Corbett settlement, a reserve should be established for any amounts not paid due to lack of Plan earnings. The treatment is different because Corbett accumulates and the 13^{th} check does not. Other contingent benefits should be replaced by the City in a similar manner to that discussed above.
It should be noted that the above funding mechanism affects only the calculation of the City's annual contribution to The Plan and does not affect the way in which the contingent benefits themselves are calculated or paid.

Recommendation #4

The City's annual required contribution to the Plan for a given year should be defined as the total of Normal Cost, UAAL amortization (including interest), and an amount equivalent to the estimated contingent liabilities related to that year.

VI. TREATMENT OF RETIREE HEALTH CARE BENEFITS

While the liability related to retiree health care benefits is discussed in a later section, elimination of the current method of payment is more appropriately addressed at this juncture as it is akin to the treatment of contingent benefits.

Recommendation #5

Payments for retiree health care benefits should no longer be funded via the retirement plan. SDMC 24.1502(a)(5) should be eliminated thereby removing health care benefits from the Plan's distribution "waterfall".

VII. REDUCTION OF NORMAL COST

The City's pension benefits are generous by almost any standard applied. According to the latest actuarial valuation, the "Normal Cost" of the plan is approximately 24% of payroll. This amount is split nearly equally (to be discussed further in a later section) between the employer (the City) and the employee.

One rationale presented to us was that the employees are entitled to generous pension benefits because they are paid at a lower rate than the private sector during their working career. Evidence to support his assertion was primarily anecdotal. Other evidence indicated that the non-safety employees have been well represented through the collective bargaining process and that areas of significant under-compensation have been surfaced and corrected. After two meetings on this topic, we concluded that there was insufficient evidence to conclude that City employees are paid either better or worse than their counterparts.

Another rationale presented to us was that the pension benefits are generous because City employees do not participate in Social Security. This means that neither the employer nor the employee pay 6.2% FICA. The fact, however, is that as an offset to the absence of a Social Security benefit, the City was required to provide General Member employees a Supplemental Pension Savings Plan (SPSP). Safety members are not entitled to SPSP but are entitled to a higher pension factor than General Members. SPSP is a defined contribution plan that is in addition to the defined benefit plan. The City pays 3.05% of the employee's salary into this SPSP plan. The employee is required to contribute 3.05% also and can voluntarily contribute up to another 3% which the City will match. Thus, if the employee takes advantage of the full employer match, the City has to contribute up to 6.05% of the employee's salary.

The Committee determined that there is nothing inherently wrong with a defined benefit plan and that eliminating the defined benefit plan in favor of a defined contribution plan would not necessarily result in an improved situation. This is particularly true in light of the City Attorney's opinion that any Plan changes can only affect newly hired employees.

Furthermore, a conversion to a defined contribution plan for new hires could result in increased cost for all employees as a group. Applying the normal cost of the Plan of approximately 24% as a contribution percentage for the demographically younger group and new hires will have the actuarial effect of increasing the normal cost as a percentage of payroll for the group of employees remaining in the Plan. This is because the actual normal cost for younger employees is lower than the 24% average normal cost, and the actual normal cost for older than average employees is significantly more than the 24%. The newly hired, younger than average employees, under the current Plan in effect subsidize the older than average employees.

The Committee believes City employees overwhelmingly are seeking the long-term benefits of a defined benefit plan. The Committee believes, based on credible evidence, that the City would experience recruitment and retention difficulties in offering only a defined contribution plan in lieu of a defined benefit plan to its newly hired employees.

The Committee received credible evidence that the long-term investment performance of the existing Plan will significantly exceed the performance of individually directed contribution accounts, resulting in greater benefit for employees as a group per dollar of City/employee contribution. The Committee also recognized the difficulty of replicating current disability benefits without a defined benefit plan.

The Committee also concluded, based upon data obtained from the California Public Employees Retirement System (CalPERS), that it would not be fiscally prudent for the Plan to join CalPERS. There is no evidence to suggest that CalPERS is better managed than the City's system, nor that its investments are performing at a superior rate of return.

The conclusion of the Pension Reform Committee was that the City should stay with a defined benefit plan but that benefits should be scaled back for new hires. We understand that these changes cannot be unilaterally dictated by the Mayor and Council, but will be negotiated through the "meet and confer" process. If, in the end, agreement cannot be reached, we believe the City will ultimately have no financial choice but to either require that the employees pay a larger share of the pension costs or else convert to a defined contribution plan. To this end, we are recommending a series of potential plan changes affecting new employees.

Recommendations 6-10 will impact new hires only. The savings illustrated will be fully realized only when all employees under the existing benefit structure have retired.

Recommendation #6

The normal retirement age should be raised by seven years for all employees and the early retirement age should be set at a number of years that are five years less than the normal retirement age. (See Appendix D) Any retirement earlier than normal age will be cost-neutral, actuarially reduced.

This will result in a savings of 3.69% of pay, or based on current payroll, $22,342,000.
The above recommendation will result in the following normal retirement ages:

General members	62
Fire and Police	57
Legislative	62

Early retirement ages would be:

General members	57
Fire and Police	52
Legislative	57

Recommendation #7

The annual accrual rate for the percentage of final base payroll to be used in calculating the pension benefit is reduced 20%. . (See Appendix D)

This will result in a savings of 2.61% of pay, or based on current payroll, $15,774,000.

The above recommendation will result in the following accrual rate percentages:

General members	2.0%
Fire and Police	2.4%
Legislative	2.8%

Recommendation #8

The final base payroll should be based on an average of the employee's highest three years of salary rather than on the highest one year of salary.

This will result in a savings of 1.06% of pay, or based on current payroll, $6,413,000 annually.

Recommendation #9

The final base payroll should exclude salary differentials such as second shift differential, bilingual differential, etc.

This will result, conservatively, in a savings of 3.5% of pay, or based on current payroll, $21,175,000, annually.

Recommendation #10

Eliminate specific programs that permit DROP and purchase of years of service credit, except those that are federally protected.

The cost of DROP has not been projected due to technical issues. However, it is instructive to note that this benefit was created to alleviate a problem that was produced by poor judgment in plan design. Namely, that the current benefit structure encourages early retirement. In fact, some employees suffer a loss of benefits if they do not take early retirement. While focusing on the costs of various benefit improvement options, inadequate consideration has been devoted to the incentives of the current plan design and their effect on employment.

Simply stated, expensive early retirement benefits led to the additional costs of DROP. A more carefully crafted set of early retirement benefits would have reduced plan costs initially, and made DROP unnecessary.

Based on current employment levels, total losses of $22,000,000 to $25,000,000 would be avoided due to elimination of service purchase. That amount translates into savings on annual amortization payments of $2,380,000 to $2,705,000.

The SDCERS actuary, Gabriel, Roeder, Smith & Company, calculated the values and costs presented in Recommendations 6 through 10. Their complete analysis, including methods and assumptions are contained in **Appendix E.**

The pricing of each of these benefit changes was made independently of any other change. Due to the effect of overlapping changes, such as retirement ages, and benefit factors, the cost savings for the proposals will be less than the sum of the individual estimates. A more precise determination can be made once the components have been finally agreed upon.

VIII. RETIREE MEDICAL BENEFITS

The unfunded liability related to the City's retiree medical benefit commitment is arguably an even worse problem than the pension liability. This is not necessarily related to its size ($545 Million vs. $1.157 Billion for the pension) but is related to the fact that it is hidden and is being deferred out to future year's' taxpayers.

As was discussed under the funded status of the system, these benefits are currently being covered by a pay-as-you go basis out of earnings of the Plan. In a previous recommendation we have indicated that such a practice should stop.

<u>Recommendation #11</u>

The City should establish either a separate trust or a separate accounting within the pension trust to account for the assets and liabilities of the retiree medical benefit plan. Retiree Medical Plan assets may be commingled with Retirement Plan assets for investment purposes, but be accounted for separately for all other purposes. Annual contributions to the Retiree Medical Plan should be separately identified in the City budget and in no way be confused or commingled with Retirement Plan contributions.

The liability for the Retiree Medical Plan should be clearly stated on the books of the City. The Governmental Accounting Standards Board (GASB) has acknowledged the problem that is being created nationally by lack of accounting for the liabilities associated with these plans. This year it issued Statement 43 Financial Reporting for Post employment Benefit Plans Other Than

Pension Plans. Other post employment benefits (OPEB) include healthcare and other non-pension benefits provided to employees as part of their compensation for services. In its news release of
May 11, 2004, Karl Johnson, the GASB project manager states:

> "Statement 43 provides a framework for transparent financial reporting by governmental entities that have fiduciary responsibility for OPEB plan assets regarding their stewardship of plan assets, the funded status and funding progress of the plan, and employer contributions to the plan."

While GASB #43 is not yet effective and the City is therefore not yet required to comply, the Pension Reform Committee urges its early adoption.

<u>Recommendation #12</u>

Adopt GASB #43 effective July 1, 2005

The above recommendations deal with the accounting for the benefits, they do not address the ability or inability of the City to fund this already-existing liability**.**

While an in-depth review of the retiree medical benefits is outside the "charter" of the Pension Reform Committee, we suggest that the City should conclude, as soon as possible, whether the current employees have a vested right to retiree health care. If the answer is no, the employees should be given that information. If the answer is yes, a plan for payment of the liability should be immediately developed.

<u>Recommendation #13</u>

When amortizing the unfunded liability for retiree medical benefits, a method should be used that does not create negative amortization of the liability.

IX. GOVERNANCE

The Pension Reform Committee discussed the basic component of governance of the pension system. The city ostensibly has created an independent Board, separate from the City, to manage the pension. However, the City Charter dictates the composition of the 13 member Board of

Trustees as follows:

3 representatives from City management
2 representatives elected by police and fire members
3 representatives elected by General Members
1 representative elected by retired members
4 independent citizens nominated by the Mayor and appointed by the City Council

While contributions to the Plan are made by both the employees and the City, only the City acts as the final guarantor of all benefits paid by the Plan. This ultimate guarantee of the Plan's ability to pay the agreed-upon benefits means that the primary, if not the sole, stakeholder in the operation of the Plan itself are the citizens of the City of the San Diego.

At the heart of the concern is that, of the thirteen members of the Retirement Board, eight members can clearly benefit by enabling the City to fund its current operating budget at the expense of the retirement plan as long as the ramifications to the Plan are not severe over the short term. The notion that the Board is simply administrative, as some would argue, is countered by the fact that the intentional under-funding of the plan requested by the City Manager in both 1996 and 2002 had to be approved by the Board before it could even be heard by the City Council.

The second significant problem is the technical skills required to understand the complex issues that are present in the administration of the Plan. The combination of the highly technical rules for pension administration and the need to understand the use of arcane actuarial science in the measurement of present and future Plan liabilities requires an experienced and trained Board member to effectively govern the Plan. While some may argue that the purpose of the Board member is to set policy and that technical aspects are handled by trained professionals, lack of understanding of the finer points of administration means that a Board member may be unable to ask meaningful questions.

Finally, there is an issue in communication between the City Council and the Retirement Board. The City Council seems to view the Board as its eyes and ears in the retirement system. Councilmembers have repeatedly commented that if there are any problems in the retirement system, they depend on the Board to let them know. This includes any actions the Council might consider taking that could be potentially harmful, even in a minor way, to the Plan. The Board, on the other hand, views itself as strictly administrative and does not seem to feel that advisory input to the Council is appropriate.

For all of these reasons, the Pension Reform Committee believes that the Plan, the beneficiaries, and the City would be better served by a Board composed of qualified professionals who have no vested interest in the Plan.

Recommendation #14

Change the composition of the Retirement Board to seven members appointed by the City Council. These members will serve with staggered terms of four years each, with a two consecutive term maximum. Such appointees will have the professional qualifications of a college degree and/or relevant professional certifications, fifteen years experience in pension administration, pension actuarial practices, investment management (including real estate), banking, or certified public accounting. Such appointees will be U.S. Citizens and residents of the City of San Diego but cannot be City employees, participants (direct or indirectly through a direct family member) of the SDCERS, nor a union representative of employees or participants, nor can such appointees have any other personal interests which would be, or create the appearance of, a conflict of interest with the duties of a Trustee.

Another governance issue that was addressed related to applications for disability retirement. Currently, when an application is submitted for disability retirement, it is first reviewed by SDCERS staff. If the application is recommended for approval, it moves directly to the Board for action. If the application is not recommended for approval, it is forwarded to an outside adjudicator who hears from both parties, reviews documents, and renders a finding. That finding then returns to the Board where, more often than not, the whole application is heard again, though not under oath.

Again due to the possible conflicts of interest present when a Board member is asked to make these types of findings related to another employee who either was or is in the same bargaining unit, this process places Board members in an extraordinarily awkward position. The Pension Reform Committee felt it would be in the best interest of everyone concerned to create a process whereby applications forwarded to an adjudicator would not be returned to the Board. Instead, the finding of the adjudicator would be final.

Recommendation #15

An additional provision should be made to the City Charter that would codify the current disability retirement determination process as it is now except that the hearing officer's decision would be final rather than a recommendation to the Board for approval.

X. OTHER RECOMMENDATIONS

A. Study disability retirement application process and system

In grappling with the issues surrounding the cost of the City's Plan, the Pension Reform Committee found that the complexities and nuances of the portion of the system related to disability retirement appear to have resulted not only in inconsistent treatment among employee groups but have created a system that appears ripe for abuse.

At one point the Committee attempted to recommend application of the Social Security definition to the City system, but determined that it could create unintended consequences. This area clearly needs additional study and should be reviewed by a team of individuals who have appropriate human resources and/or legal experience.

Recommendation #16

The City should establish a committee to review the entire disability retirement system. Representatives on this committee should include knowledgeable employees of both the City and SDCERS as well as outside professionals with experience in this area.

Employee/Employer Sharing of Pension Costs

Section 143 of the City Charter states:

> "The City shall contribute annually an amount substantially equal to that required of the employees for normal retirement allowances, as certified by the actuary, but shall not be required to contribute in excess of that amount, except in the case of financial liabilities accruing under any new retirement plan or revised retirement plan because of past service of the employees."

This section of the Charter has apparently been loosely interpreted to mean that the employees bear 50% of Normal Cost and that all other costs are borne by the City. Another reading would be that past service costs (discussed earlier) are the sole responsibility of the City, but that any other costs should be split 50/50. Even if one agrees that the 50/50 split applies to Normal Cost only, then it appears that the Charter may not be being followed.

The Pension Reform Committee attempted to get a full explanation of these issues, but was not able to do so. This issue was identified fairly late in the process and it appears that it will take a significant amount of investigation and possible legal interpretation.

Even if it is determined that the employees have not been paying an amount consistent with the intent of the Charter, a question remains as to what can be done about that either retroactively or prospectively. It is our understanding that the Retirement Board is now investigating this matter.

Recommendation #17

The City Council Rules Committee should require a report (with recommendations) from SDCERS on the issue of the 50/50 employer/employee cost split by the end of the calendar year.

Actuarial Assumptions

The Plan's actuary has recommended several changes to the actuarial assumptions used to determine the employer and employee contribution rates. Recently the Retirement Board engaged a second firm to audit the June 30, 2003 actuarial valuation and to evaluate the assumptions being used and/or recommended.

The Committee supports the recommended changes to assumptions with the exception of the recommendation regarding investment return.

As discussed extensively in earlier sections, the Plan's assets generate investment earnings and increase in value due to both inflation and market forces. The problem is that a portion of those earnings are siphoned off to pay for other commitments such as retiree medical benefits and contingent benefits. The Committee has addressed this by recommending a change to the computation of the City's annual contribution that would require replacement of those "lost" earnings.

Both the Plan's actuary and the auditor chosen by the Retirement Board have recognized this same phenomenon and attempted to compensate for it by reducing the assumed investment return to acknowledge the fact that the entire investment return is not applied to Plan growth.

The Plan's assumed investment rate of return is 8%. The Plan has been experiencing 8%. Therefore the Committee believes that it is simply more straightforward to deal with the dilution of Plan assets annually rather than artificially adjusting the investment rate of return to compensate.

XI. Appendices

A. Biographical information on Pension Reform Committee

B. Interim Report of Pension Reform Committee to Mayor and City Council
January 22, 2004

C. Example: 30-year Amortization Schedule – Fixed % of Inflation-Adjusted Salary

D. Retirement Age Factors for Benefits

E. Study from Gabriel, Roeder, Smith & Company on Proposed New Benefit Structure

Appendix A

BIOGRAPHICAL INFORMATION
PENSION REFORM COMMITTEE

Mr. Stephen Austin, a certified public accountant, is the managing partner at Swenson Advisors, LLP in San Diego, where he specializes in auditing a wide variety of companies and their pension plans. Mr. Austin received a bachelor's degree in accounting from Bob Jones University and a master's of business administration from the University of Georgia.

Ms. April Boling, president of the San Diego County Taxpayers Association, was nominated by that organization and serves on the Committee as the taxpayer advocate. She served on the Mayor's Blue Ribbon Committee on City Finances and the City of San Diego's Citizens' Budget Committee. Ms. Boling, a certified public account and owner of a private accounting practice, holds a bachelor's degree in accounting from the University of San Diego and also serves as the chair of this Committee.

Mr. Robert Butterfield is an attorney at Butterfield Schechter LLP, where he specializes in employee benefits, ERISA, executive compensation, retirement planning and taxation. Mr. Butterfield served on the San Diego City Employees Retirement System Board and on its Investment Committee from 1986 to 1991. He received his bachelor's degree in business from Boston University and his law degree from the University of San Diego.

Mr. Timothy Considine operates his own accounting business, Considine & Considine, which manages the affairs of various types of pension plans. Mr. Considine provides regular financial advice on the investment of retirement assets and understands the importance of proper fund allocation to maximize results for plan beneficiaries. He received a bachelor's degree in accounting from San Diego State University.

Mr. Stanley Elmore was nominated by the City of San Diego Retired Employees' Association and the San Diego Police Officers Association Inc. to serve on the Committee as the City retiree. He is a member and past president of the Retired Fire & Police Association and the San Diego City Employee Retirement System Health Advisory Committee. Mr. Elmore holds a degree in police science from San Diego City College.

Ms. Judith Italiano is the president and general manager of the San Diego Municipal Employees Association, (MEA), the City's largest labor union representing over 5,000 employees. As the lead negotiator for MEA, Ms. Italiano has developed extensive knowledge of the City of San Diego Employee Retirement System. She holds a degree in early childhood education from Fresno State University and serves on the Committee as the City employee representative.

Mr. William Sheffler, a consulting actuary for his own firm, provides actuarial services for defined benefit plan administrators and trustees. Mr. Sheffler provides actuarial testimony on valuation of employee benefits. He holds a bachelor's degree in economics and mathematics from Claremont Men's College and a master's degree in mathematics from the University of Arizona.

Mr. Richard Vortmann serves on the Committee as the San Diego City Employee Retirement System Board member and Vice Chair. Mr. Vortmann is president of National Steel and Shipbuilding Company, NASSCO. He has also served on the Mayor's Blue Ribbon Committee on City Finances. Mr. Vortmann holds a bachelor's degree in finance and a master's degree in business administration from the University of California, Berkeley.

Ms. Kathleen Walsh-Rotto has over fourteen years of experience in working with defined benefit plans. Ms. Walsh-Rotto is currently employed by the Principal Financial Group as a Senior Relationship Manager and has expertise in defined benefit plan design, IRS required testing, legislative issues, fiduciary due diligence and compliance. She holds a bachelor's degree in political science from Iowa State University.

Appendix B

Pension Reform Committee

Date: January 22, 2004

Attention: Honorable Mayor and Members of the City Council

Subject: Interim Report from the Pension Reform Committee

On September 9, 2003, the Mayor and City Council established the Pension Reform Committee

(Committee) to address concerns about the current unfunded liability of San Diego City Employees Retirement System (SDCERS) and review the scope and depth of audits to be performed on SDCERS. On September 24, the nine Committee members were officially appointed by the Mayor and City Council.

The Committee held its first meeting on October 1, 2003 and established a weekly meeting schedule. A special web site was set-up on the City of San Diego's web site to provide the public with the minutes, agendas and background information on the Committee. Since inception, the Committee has had two primary areas of focus: a) education, b) scope of SDCERS' audits.

Education

The Committee has requested and received a number of formal presentations from City staff and consultants to educate them on various aspects of SDCERS. The educational presentations they have received to date were on the following topics:

1. **Retirement System Overview –** The Retirement System Administrator provided an overview of the System's Benefits, Actuarial Valuation and Investments.
2. **Laws and Regulations Relating to City Employee Benefits and Collective Bargaining –** A presentation on the meet and confer process was provided by an attorney from the City Attorney's Office, and a presentation on laws pertaining to SDCERS was provided by the general counsel to SDCERS.
3. **Actuarial Valuation** - The actuary for SDCERS provided an overview of actuarial analysis and how it applies to SDCERS.

4. **Distribution of Surplus Earnings –** The Retirement System Administrator provided an overview of the history of SDCERS' surplus earnings, how they are distributed and applicable municipal code provisions.
5. **401K, SPSP and Deferred Compensation –** The City's Risk Management Department provided a presentation on the City's three defined contribution plans including Supplement Pension Savings Plans SPSP, SPSP-M, SPSP-H, 401(k) and Deferred Compensation (457) Plan.

6. **Pension Obligation Bonds (POBs) –** The City Manager's Office provided a presentation on what POBs are, why they are issued, the legal basis for POBs and their risks and benefits.
7. **Compensation Comparisons –** The City's Human Resources Manager provided a presentation comparing public sector compensation. The data compared the salary and compensation of the City's safety classifications with that of the County, the cities within the County, and the ten largest cities in California.
8. **City Employee Labor Organizations –** The following labor organizations provided input to the Committee on pension reform issues: Police Officers' Association (POA) and Municipal Employees Association (MEA). American Federation of State, County and Municipal Employees, Local 127 and International Association of Firefighters Local 145 are scheduled to provide a presentation at the January 27 meeting of the Committee.

<u>Retirement System's Audits</u>

The SDCERS Retirement Board has commissioned three audits on the Retirement System: a) actuarial, b) investment operations, and c) best practices. The Committee is hopeful that the findings from the audits will be available for review by April, 2004. The Committee has asked the Audit Committee of the SDCERS Retirement Board to utilize the audit process to confirm that the Committee can rely upon work of the SDCERS actuary. In addition, the Committee has asked to have the audit process confirm that the investment results for SDCERS are correctly placed in the top decile when compared to other organizations. Once these confirmations are complete, the Committee plans to contract the actuary for further studies the Committee needs to complete its work for the City. The Committee estimates the cost of these and other studies to be undertaken by the Committee will be approximately $100,000. This funding has been identified by the City.

Sincerely,

April Boling

Chair, Pension Reform Committee

Appendix C

EXAMPLE - 30 YEAR AMORTIZATION SCHEDULE - FIXED % OF INFLATION-ADJUSTED SALARY

	Salary (4.25% incr.)	UAAL Balance	Interest @ 8.0%	@9.667%	Apply to Prin.

YEAR	1	605,000,000	1,000,000,000	80,000,000	58,485,350	(21,514,650)
YEAR	2	630,712,500	1,021,514,650	81,721,172	60,970,977	(20,750,195)
YEAR	3	657,517,781	1,042,264,845	83,381,188	63,562,244	(19,818,944)
YEAR	4	685,462,287	1,062,083,788	84,966,703	66,263,639	(18,703,064)
YEAR	5	714,594,434	1,080,786,852	86,462,948	69,079,844	(17,383,104)
YEAR	6	744,964,698	1,098,169,956	87,853,597	72,015,737	(15,837,859)
YEAR	7	776,625,697	1,114,007,815	89,120,625	75,076,406	(14,044,219)
YEAR	8	809,632,289	1,128,052,035	90,244,163	78,267,153	(11,977,009)
YEAR	9	844,041,662	1,140,029,044	91,202,324	81,593,507	(9,608,816)
YEAR	10	879,913,432	1,149,637,860	91,971,029	85,061,232	(6,909,797)
YEAR	11	917,309,753	1,156,547,657	92,523,813	88,676,334	(3,847,479)
YEAR	12	956,295,418	1,160,395,136	92,831,611	92,445,078	(386,533)
YEAR	13	996,937,973	1,160,781,669	92,862,534	96,373,994	3,511,460
YEAR	14	1,039,307,837	1,157,270,209	92,581,617	100,469,889	7,888,272
YEAR	15	1,083,478,420	1,149,381,937	91,950,555	104,739,859	12,789,304
YEAR	16	1,129,526,253	1,136,592,633	90,927,411	109,191,303	18,263,892
YEAR	17	1,177,531,118	1,118,328,740	89,466,299	113,831,933	24,365,634
YEAR	18	1,227,576,191	1,093,963,107	87,517,049	118,669,790	31,152,742
YEAR	19	1,279,748,179	1,062,810,365	85,024,829	123,713,256	38,688,427
YEAR	20	1,334,137,477	1,024,121,937	81,929,755	128,971,070	47,041,315
YEAR	21	1,390,838,319	977,080,622	78,166,450	134,452,340	56,285,891
YEAR	22	1,449,948,948	920,794,732	73,663,579	140,166,565	66,502,986
YEAR	23	1,511,571,778	854,291,746	68,343,340	146,123,644	77,780,304
YEAR	24	1,575,813,579	776,511,442	62,120,915	152,333,899	90,212,983
YEAR	25	1,642,785,656	686,298,458	54,903,877	158,808,089	103,904,213
YEAR	26	1,712,604,046	582,394,245	46,591,540	165,557,433	118,965,894
YEAR	27	1,785,389,718	463,428,352	37,074,268	172,593,624	135,519,356
YEAR	28	1,861,268,781	327,908,996	26,232,720	179,928,853	153,696,133
YEAR	29	1,940,372,705	174,212,863	13,937,029	187,575,829	173,638,800
YEAR	30	2,022,838,545	574,062	45,925	195,547,802	195,501,877

Appendix D

RETIREMENT AGE FACTORS FOR BENEFITS

	General			Safety		
	Current	Recommendations		Current	Recommendations	
Age	Plan	#6	#7	Plan	#6	#7
50				3.00%		
51				3.00%		
52				3.00%	2.06%	2.40%
53				3.08%	2.30%	2.46%
54				3.19%	2.55%	2.55%
55	2.50%	1.35%	2.00%	3.29%	2.80%	2.63%
56	2.50%	1.54%	2.00%	3.29%	3.04%	2.63%
57	2.50%	1.72%	2.00%	3.29%	3.29%	2.63%
58	2.50%	1.91%	2.00%	3.29%	3.29%	2.63%
59	2.50%	2.09%	2.00%	3.29%	3.29%	2.63%
60	2.55%	2.28%	2.04%	3.29%	3.29%	2.63%
61	2.60%	2.46%	2.08%			
62	2.65%	2.65%	2.12%			
63	2.70%	2.70%	2.16%			
64	2.75%	2.75%	2.20%			
65	2.80%	2.80%	2.24%			

Recommendation #6: Early Retirement Factor Changes
Recommendation #7: Normal Retirement Factor 20% Reduction

Appendix E.

August 31, 2004

To: Pension Reform Commission

RE: Study to Isolate Impact of Elements of Pension Reform Commission's Proposed New Benefit Structure

Dear Members of the Commission,

We are summarizing results of our actuarial analysis in regard to isolating elements of a revamped benefit structure you are proposing:

Since we have previously isolated the impact of various elements and have already isolated the impact of extending the final average compensation period from 1 to 3 years in May, all calculations in this report are based on the existing 1 year final average period for compensation determination.

All demographics and assumptions are the same as those used in the June 30, 2003 actuarial valuation except for lower service retirement incidence in Scenarios #1 and #2 at earlier retirement ages.

We assumed that 90% benefit caps would apply.

As was the case for our August 13 report, the Elected Officer group is so small that we have not done any analysis of any change so as to keep our fees to a minimum.

The summary of what we were asked to value follows:

Scenario #1: Isolate the impact of Early Retirement Reduction Factors

Future General hires will receive the same benefit of 2.65% per year of service at the deemed Normal Retirement Age of 62. Actuarially reduced early retirement factors will be available at age 55 for those with at least 20 years of service. The early retirement reduction factors are the same as we used in our August 13 study report and are reflected in the appendix.

Future Safety hires will receive a benefit of 3.29% (this is equal to the 2.99% benefit formula multiplied by 1.1 to reflect the 10% augmentation to final average compensation) per year of service at the deemed Normal Retirement Age of 57. Actuarially reduced early retirement factors will be available at age 52 for those with at least 20 years of service.

There is an element in this Scenario in which we asked for clarity: what level of employee contributions are to be used. As we were not given a definitive answer, we are using **unchanged** employee contributions for this Scenario. The rationale for using unchanged employee contribution rates is as follows: at the age which the PRC deems to be the Normal Retirement Age, there is no change in the benefit multiplier. In practice, **some adjustment** to the General employee rate could be considered to have a more equal sharing of normal costs between the City and the employee (unless pick ups are viewed in a different light than currently).

The following results do not have an amortization component of cost as it is presumed that new members enter the system with no accrued liability.

These are our results, expressed as percents of active member pay, under the Projected Unit Credit (PUC) funding method SDCERS uses:

SCENARIO #1: Isolating Impact of Early Retirement Factors

Future General Hires (Excluding Elected Officials)

	2003 Valuation	PUC
	(Mid-year contributions assumed)	
Gross Normal Cost	20.32%	17.38%
Less		
Employee Contributions (weighted)	10.54%	10.53%
Equals		
City Normal Cost	9.78%	6.85%
Valuation Pay	$356,055,141	

Future Safety Hires

	2003 Valuation	PUC
	(Mid-year contributions assumed)	
Gross Normal Cost	30.56%	25.33%

Less

Employee Contributions (weighted)	12.86%	12.86%
Equals		
City Normal Cost	17.70%	12.47%

SCENARIO #2: Impact of 20% Reduction in Multipliers

Future General Hires (Excluding Elected Officials)

	2003 Valuation	PUC
	(Mid-year contributions assumed)	
Gross Normal Cost	20.32%	16.15%
Less		
Employee Contributions (weighted)	10.54%	8.42%
Equals		
City Normal Cost	9.78%	7.73%

Valuation Pay $356,055,141

Future Safety Hires

	2003 Valuation	PUC
	(Mid-year contributions assumed)	
Gross Normal Cost	30.56%	24.26%

Less

Employee Contributions (weighted)	12.86%	10.29%
Equals		
City Normal Cost	17.70%	13.97%
Valuation Pay	$176,697,345	

In this instance, we believe it is clear to reduce the employee contribution rates by 20% to reflect the intent of the Municipal Code language on the "50/50" split on Normal Cost between the employee and the City. Thus, the net numbers will not be comparable between Scenarios #1 and #2 due to this differing treatment.

Scenario #3: Eliminating Performance Pay from Includable Pension Compensation

On August 19, Pat Frazier gave us base salaries of $583.6 million that correlate to the $605 million dollar figure they have been using for annual pension payroll. As there was no breakdown between Safety and General, we will assume a uniform 3.5% reduction in evaluating the impact.

The normal cost rates would be the same but they would apply to smaller amounts of payroll. We applied the weighted City normal cost rate of 12.42% in the 2003 valuation to projection valuation payroll (based on June 30, 2003 valuation payroll and the long-term inflation assumption of 4.25% per annum) and derived a reduction in the normal cost by roughly $2,370,000. Our sense is that this somewhat understates the true costs since most performance pay bonuses would likely be available to those in management and other more senior positions.

If this had always been excluded from payroll and active member accrued liabilities declined by 3.5% as a result, the impact on the accrued liabilities as of June 30, 2003 would have been roughly $60 million dollars.

As always, we look forward to answering your questions.

Sincerely,

Rick Roeder

Rick Roeder, EA, FSA, MAAA

Cc: Larry Grissom
Paul Barnett
Lamont Ewell

GLOSSARY

TERM	DEFINITION
Accrued Benefit	The amount of an individual's benefit (whether or not invested) accrued as of a specified date, determined in accordance with the terms of a pension plan and based on compensation and service or participation to that date.

Accrued Liability	see ACTUARIAL ACCRUED LIABILITY
Accumulated Benefit Obligation (ABO)	The ACTUARIAL PRESENT VALUE of pension benefits attributed by a pension benefit formula to employee service rendered before a specified date and based on service and compensation (if applicable) prior to that date; see also PROJECTED BENEFIT OBLIGATION
Accumulated Plan Benefit	see ACCRUED BENEFIT
Actuarial Accrued Liability	That portion, as determined by a particular ACTUARIAL COST METHOD, of the ACTUARIAL PRESENT VALUE of pension plan benefits and expenses which is not provided for by future NORMAL COSTS.
Actuarial Assumption	The value of a parameter, or other choice, having an impact on an estimate of a future cost, or other actuarial item, under evaluation.
Actuarial Calculations	Calculations that make use of ACTUARIAL ASSUMPTIONS and ACTUARIAL METHODS.
Actuarial Cost Method	A procedure for determining the ACTUARIAL PRESENT VALUE of pension plan benefits and expenses and for developing an ACTUARIALLY EQUIVALENT allocation of such value to time periods, usually in the form of a NORMAL COST and an ACTUARIAL LIABILITY; see also ACTUARIAL METHOD.
Actuarial Equivalent	see ACTUARIALLY EQUIVALENT
Actuarial Gain or Loss	A measure of the difference between actual experience and that expected based upon a set of ACTUARIAL ASSUMPTIONS, during the period between two ACTUARIAL VALUATION dates, as determined in accordance with a particular ACTUARIAL COST METHOD.
Actuarial Liability	see ACTUARIAL ACCRUED LIABILITY
Actuarial Method	A procedure by which DATA are analyzed and ACTUARIAL ASSUMPTIONS used to estimate a future cost or other actuarial item; see also ACTUARIAL COST METHOD.

Actuarial Present Value	The value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of ACTUARIAL ASSUMPTIONS; see also ACTUARIALLY EQUIVALENT, PRESNT VALUE.
Actuarial Report	A document, or other presentation, prepared as a formal means of conveying the actuary's professional conclusions and recommendations, of recording and communicating the methods and procedures, and of ensuring that the parties addressed are aware of the significance of the actuary's opinion or findings.
Actuarial Valuation	The determination, as of a VALUATION DATE, of the NORMAL COST, ACTUARIAL ACCRUED LIABILITY, ACTUARIAL VALUE OF ASSETS, and related ACTUARIAL PRESENT VALUES for a pension plan.
Actuarial Value of Assets	The value of cash, investments and other property belonging to a pension plan, as used by the actuary for the purpose of an ACTUARIAL VALUATION.
Actuarially Equivalent	Of equal ACTUARIAL PRESENT VALUE, determined as of a given date with on the basis of the same set of ACTUARIAL ASSUMPTIONS.
actuary	A person professionally trained in the technical and mathematical aspects of insurance, pensions and related fields. The actuary estimates how much money must be contributed to a pension fund each year in order to support the benefits that will become payable in the future.
Amortization Payment	That portion of the pension plan contribution which is designed to pay interest on and to amortize the UNFUNDED ACTUARIAL ACCRUED LIABILITY, or other liability.
Ancillary Benefit	A benefit or coverage which is incidental to a larger program and the cost of which is not material to the total program cost.

Asset Risk	The risk that the amount or timing of items of cash flow connected with assets will differ from expectations or assumptions as of the VALUATION DATE for reasons other than a change in investment rates of return. Asset risk includes the risk of default or other financial nonperformance; distinguished from CREDIT RISK, INVESTMENT-RATE-OF-RETURN RISK, MARKET RISK, and REINVESTMENT RISK.
Asset Valuation Basis	The method used to determine the stated value of a particular asset.
COLA	see COST OF LIVING ADJUSTMENT
Contingent Benefits	Indeterminate benefits as to either their amount or their occurrence, in the context of this report, these are benefits that are not part of the pension plan as originally conceived.
Contingent Liability	Indeterminate liabilities as to either their amount or their occurrence
Cost of Living Adjustment (COLA)	An increase or decrease in a benefit in the course of payment, that is intended to reflect a change in living costs since the last prior adjustment.
Credibility	Statistical reliability (of experience data) as a basis for making projections.
Credit Risk	Risk associated with the possibility of a loss on an investment security, either in whole or in part; distinguished from ASSET RISK, INVESTMENT-RATE-OF-RETURN RISK, MARKET RISK, REINVESTMENT RISK.
Data	Statistical or other information that is generally numerical in nature or susceptible to quantification.
Death Benefit	A benefit payable as a direct result of the death of an insured individual or a covered participant.
Defined Benefit Plan	A retirement plan with contributions dependent on benefits defined in the plan.
Defined Contribution Plan	A retirement plan with benefits dependent on contributions defined in the plan.

EA	see ENROLLED ACTUARY
EANC	see ENTRY AGE NORMAL COST METHOD
Employee Retirement Security Act (ERISA)	A statute enacted in 1974, and amended subsequently, that established the Pension Benefit Guaranty Corporation and established limits and minimum standards for eligibility, vesting, benefit levels, and funding for qualified pension plans in the U.S.
Enrolled Actuary	A designation granted by the U.S. Joint Board for Enrollment of Actuaries to persons satisfying requirements established by ERISA for performing actuarial services for qualified defined-benefit pension plans.
Entry Age Normal Cost Method	A cost method under which the normal cost to fund the benefits under the plan is set as a level percentage of compensation from the date a participant becomes eligible to enter the plan until retirement.
ERISA	see EMPLOYEE RETIREMENT INCOME SECURITY ACT
Experience Factors	Those elements which reflect actual experience.
Experience Gain or Loss	see ACTUARIAL GAIN OR LOSS
Exposure	Extent of RISK and/or possibility of LOSS
Fair Market Value (FMV)	The value of property established between a willing buyer and a willing seller in an arm's length transaction.
FASB	Financial Accounting Standards Board
full actuarial funding	annual payment of NORMAL COST plus AMORTIZATION of UNFUNDED ACCRUED ACTUARIAL LIABILITY
Funding Method	see ACTUARIAL COST METHOD
GAAP	Generally Accepted Accounting Principles
GASB	Government Accounting Standards Board
Investment Risk	Uncertainty surrounding the realization of a specified investment income stream.

Investment-Rate-Of-Return Risk	The risk that investment rates of return will depart from expectations or assumptions as of the VALUATION DATE, causing a change in the amount or timing of asset or obligation cash flows; distinguished from ASSET RISK, CREDIT RISK, MARKET RISK, and REINVESTMENT RISK.
Market Interest Rates	Yields that are available on new money invested at a particular time.
Market Risk	Uncertainty regarding the future market value of an asset; distinguished from ASSET RISK, CREDIT RISK, INVESTMENT-RATE-OF-RETURN RISK, and REINVESTMENT RISK.
Mortality Table	A statistical table showing the death rate of each age.
Normal Actuarial Cost	see NORMAL COST
Normal Cost	That portion of the actuarial present value of pension plan benefits and expenses which is allocated to a valuation year by the ACTUARIAL COST METHOD, excluding any payment in respect of an unfounded actuarial accrued liability.
Obligation	Any tangible or intangible commitment by, requirement of, or liability of a plan or an insurer that can reduce receipts or generate disbursements.
Open Group Cost Method	An Actuarial cost method under which ACTUARIAL PRESENT VALUES associated with expected future entrants are considered.
Participant	An individual covered by a benefit plan.
Pay-As-You-Go	A method of financing a benefit plan under which the contributions to the plan are generally made at about the same time and in about the same amount as benefit payments and expenses becoming due.
PBO	see PROJECTED BENEFIT OBLIGATION
Pension Obligation Bonds	Public indebtness issued by the City that is used explicitly to fund pension plan obligations
POB	Pension Obligation Bond

Present Value	The value today of an amount receivable or payable in the future, reflecting the TIME VALUE OF MONEY; see also ACTUARIAL PRESENT VALUE.
Projected Benefit Obligation	The ACTUARIAL PRESENT VALUE as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date, including recognition of changes in future compensation levels if appropriate; see also ACCUMULATED BENEFIT OBLIGATION.
Projected Benefits	Pension benefit amounts which are expected to be paid at various future times under a particular set of ACTUARIAL ASSUMPTIONS, taking into account such items as the effect of advancement in age and past and anticipated future compensation and service credits.
Projected Unit Credit Cost Method	A cost method under which the normal cost to fund the benefits under the plan is set as the present value of the benefit earned during the year, including an allowance for future salary increases. Under this method the cost of each member’s benefit increases annually.
PUC	see PROJECTED UNIT CREDIT COST METHOD
Reserve	An amount determined as of a VALUATION DATE to provide for future payments.
service purchase	the practice of a member paying a fixed amount for additional pension benefits or credits, which were not earned during their term of service in the system.
Terminal Funding	A method of funding a pension plan under which the entire ACTUARIAL PRESENT VALUE of benefits for each individual is contributed to the plan's fund at the time of withdrawal, retirement, or benefit commencement.

Time Value of Money	The principle that an amount of money available at an earlier point in time has different usefulness and value than the same amount of money at a later point in time.
UAAL	see UNFUNDED ACTUARIAL ACCRUED LIABILITY
Unfunded Accrued Liability	see UNFUNDED ACTUARIAL ACCRUED LIABILITY
Unfunded Actuarial Accrued Liability	The excess of the ACTUARIAL ACCRUED LIABILITY over the ACTUARIAL VALUE OF ASSETS. (UAAL)
Unfunded Actuarial Liability	see UNFUNDED ACTUARIAL ACCRUED LIABILITY
Valuation Assets	see ACTUARIAL VALUE OF ASSETS
VBO	Vested Benefit Obligation
Vested Benefit Obligation	vested portion of the ACCUMULATED BENEFIT OBLIGATION

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ATTACHMENT 1

ADDITIONAL INFORMATION TO CITY COUNCIL

APRIL 19, 2004

City of San Diego

Pension Reform Committee

R.H. Vortmann's Minority Report

September 15, 2004

THE CITY OF SAN DIEGO

--Minority Report--

City of San Diego

Pension Reform Commission

R.H. Vortmann's Minority Report

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I. Introduction

This report is a "minority report" addendum the Pension Reform Committee's (PRC) final report dated September 14, 2004. It is not the intent of this "minority report of one" to detract from nor supplant the PRC's report. Since I concur with much of the PRC's report and recommendations, my intent is to augment and expand upon the PRC's report, placing greater emphasis on certain issues and introducing other issues not addressed by the PRC.

The opinions and recommendations included herein are mine alone and not the PRC's. This report is derived from my experience as Vice Chairman of the PRC, as a two year Trustee of the San Diego City Employee Retirement System, as a member of Mayor Murphy's Blue Ribbon Committee on the City's Fiscal Health, as the author of that Committee's Report section on pensions, and from my many years experience with private sector defined benefit and defined contribution plans.

The nine member Pensions Reform Committee devoted significant personal time and effort over the last ten months to understand, analyze and debate the current status of the City Retirement Plan, the cause of such, and to recommend courses of action to remedy such. Given the diverse backgrounds of the PRC members, including accounting, private sector business management, legal, labor union, city retiree, and prior SDCERS experience, many different perspectives and personal philosophies were brought to the PRC's deliberation. This was precisely Mayor Murphy's intent in forming the PRC.

I believe the resultant PRC composition was very constructive and the discussion and debate brought forth by the different perspectives was enlightening and productive. While the PRC was able to reach unanimous agreement on several issues, there were other issues where unanimity was not achieved and committee positions were established by simple majority rule. Other decisions were reached by compromise as the debated issue evolved. Finally, other issues were not resolved. As with most committee efforts, the ultimate committee report and conclusions were tempered by the inherent compromise of achieving consensus across the disparate perspectives of the members.

I did not agree with the emphasis and direction of some of the conclusions in the PRC's report. Further, several points, about which I feel very strongly, did not make it into the final report. Thus, I have written the following report stating my opinion regarding the City's employee retirement program, its current condition, how the current condition evolved, and what I believe the City should do to correct the problem.

Some of the recommendations in my report are similar if not identical with ones made by the PRC. Most are not. Where my recommendations are the same as the PRC's it is so annotated in the text for clarity. As can be seen from my report, I truly believe the problem is more severe and of a more fundamental nature than is implied in the PRC's report.

I offer this report in the hope it will add to an enlightened and comprehensive understanding and debate by the Mayor and the City Council over what needs be done to address the City's current problems with its retirement programs. Most importantly, I hope this report will help ensure that aggressive, comprehensive corrective action is taken in a timely fashion. The City's employees and taxpayers deserve that.

Respectfully submitted,

R.H. Vortmann

II. EXECUTIVE SUMMARY

A. FINDINGS AND CONCLUSION

The intent of this report is to establish a true, factual picture of the current situation of the City's retirement plan liabilities and to make recommendations how to correct the problem. The issues are complex and a thorough understanding of such is complicated by the inherent need to deal with numbers and trends projected out 30 to 40 years through obtuse actuarial statistics and methodologies.

However, once understood, the basic issues are relatively straight forward and clear. The City has a major problem with its post retirement benefits program. The problem comprises two separate pieces: i) pension plan liabilities and ii) retiree health benefits. These two problems, while somewhat different in their origins, both represent sizeable dollar challenges for the City.

It should be pointed out as comfort to existing retirees that the Pension Trust is not in any immediate risk of insolvency. There are sufficient existing assets in the trust ($2.3 Billion as of 6/30/03, the latest available formal actuarial evaluation) to pay benefits for many years to come. (The present value of **existing** retirees' pension benefits is $1.7 Billion compared to the assets of $2.3 Billion).

Unfortunately, the same short term assurance cannot be given regarding retiree health benefits. There was only $21 million available is a SDCERS reserve account as of 6/30/03 for retiree health benefits and that will most likely deplete shortly requiring the City to fund current retiree health care costs out of the General Fund – something the City has not yet been willing to do!.

A City, not a SDCERS Problem

It must also be pointed out at the outset, the overall problem is not with San Diego City Employee Retire Systems (SDCERS). The problem is with the City and its fiscal management practices. At worst, SDCERS can be viewed as an "enabler" which allowed the City to create the problem for itself over several years. And I would submit the issue of the current composition of the SDCERS Board is the most likely explanation of how SDCERS became an "enabler".

Further, this problem was not created by the current City leadership. Rather, it is the product of actions or inactions taken by prior City leaderships going back at least eight years. It should further be recognized that the City is not unique in facing this problem. Many other local and state governments are currently living with very similar problems. San Diego County appears to be one of them.

Investment Performance

SDCERS has performed exemplarily well in one of its most important functions – the investments of the funds entrusted to it. SDCERS investment performance over the last 10 years has repeatedly been in the top 25% of all municipalities.

The poor investment returns from the recent post bubble, stock market crash are not a principal cause of the City's current problems. Quite the contrary; in hindsight, it was most likely the excellent investment performance during the bubble market of the 90's which masked the underlying problems of the City's practices. When those unprecedented market gains were reversed with the market plunge in 2002, the problems became painfully visible.

"Bottom Line"

The bottom line issue is that the City has progressively created over time extremely "rich" and therefore very expensive post retirement benefits for its employees. The City is quick to point out that some of these benefit improvements have resulted from "lost" litigation, i.e. Corbett. However, this seems a disingenuous defense given that the City subsequently raised the benefits even further than the court settlement, all on its own accord.

Critically, the City has chosen not to pay for these benefits currently as they are earned. It appears this choice was due to economic necessity; in other words the City has promised benefits to its employees which it has not been able to afford.

As a result of several different processes, the City has effectively been deferring the cost of these promised benefits out to future year's City budgets and to future year's taxpayers. This deferral, much analogies to an individual citizen hooked on credit card debt, has created a ballooning liability due to the compounding nature of the deferral and the interest cost accumulating on that liability.

As of the most recent full actuarial evaluation (6/30/03) the Pension Plan has an unfunded liability – a deficit – of $1.16 Billion. The Pension Trust is only funded to 67% of what is should be. The Pension Trust had been funded in the low 90 percents in the 1990's, with one year (often proudly referred to) hitting 105% as a result of the stock market bubble.

The Retiree Health Benefit liability is essentially not funded at all (save for a $21 million reserve in the Pension Trust as of 6/30/03). While projecting medical costs out 30-40 years is quite problematic, SDCERS' actuary has estimated, that if the current benefits promised to retirees and existing employees are to be paid, then this liability as of today is approximately $545 to $672 million depending on whether a 5% or 6% annual medical inflation factor is used. In fact, this liability could be much larger recognizing that for the last five years medical costs have been increasing in double digit percentages.

Pension Costs

The actuarial computed annual cost to the City to properly fund the pension plan has been steadily and dramatically rising. As measured as a percentage of payroll cost which should be paid each year, the City's required annual contribution to the pension fund has risen from 6% in 1994 to the current year's 28%, and a projection of 34% by 2009. In FY '04 the City contributed $85 million to the Pension fund (which was less than the actuarially computed required annual amount). By 2009, the required annual contribution amount is projected to be $240 million – a staggering increased requirement on the City's budget!

Retiree Health Benefits

Worse, none of the foregoing dollar amounts include anything for the Retiree Health liability. The City currently has been making **no** payments from its annual budget for Retiree Health. Rather they have been paying only existing retiree medical expenses as they come due (i.e. "pay as you go" with no recognition and accrual of the liability they are incurring every year for their existing employees' eventual medical bills when they retire).

Worse this modest payment of the current portion of the Retiree Health expense is being made not from the City's annual budget but from a deliberate, if maybe not well understood, siphoning off of pension trust assets. Thus the entire cost of retiree health benefit is being pushed out to future year's taxpayers.

Combined Pension and Retiree Health Burden on the City

What is most disturbing is the projected annual cost to the City to pay for the on-going costs of these promised retiree benefits and at the same time to pay off the accumulated "debt" from not having paid the full cost of these benefits in the past.

At the City's current rate of **partial** payment of retiree costs, in FY '05 pension costs alone will represent 13.6% of the City's total general fund as seen below.

FY '05 Budget [1]
($ in millions)

	Total Fund	Pension Contribution	Retiree Health	City "Pick-up"	Total Retiree Benefit Cost	% of Budget
General Fund	$817	$87	0	$24	$111	**13.6%**
All Other Funds (Principally Enterprise Funds)	1,196	43	0	11	54	8.2%
Total	$2,013	$130 [2]	$0	$35	$165	12.2%

[1] Data per Pat Frazier, City Manager's Office
[2] Amount dictated by the Gleason settlement

What is staggering to contemplate is that the projection for **full** funding of both the pension and the retiree health benefit (discussed in detail later) would necessitate a dramatic increase in annual payments as follows:

Pension	$240 million [1]
Retiree Health	$ 85 million [2]
Total annual Contribution	$325 million

[1] Using FY '09 full actuarial funding rate based on 15 year amortization discussed later in this report (SDCERS actuary projection).

[2] Full actuarial funding rate based on 15 year amortization (Source: PRC computation which includes SDCERS actuary calculation of normal cost)

To illustrate the severity of the fiscal challenge to the City, and to focus on the key question of whether the City can truly afford these retiree benefit promises it has made, this full funding annual payment of $325 million (with approximately 67% or $217 million of this total allocated to the City's General Fund) would be a staggering **27%** of the total General Fund (as measured against the FY '05 budget). This would represent over one quarter of the total General Fund just for retiree benefits! And this is before any city "pickup" of the employee's share of pension cost, which is the current practice.

Very simply and critically, the City must address the basic question of whether it can afford these benefits. Can it find funding for the absolute annual dollar increase, from $130 million to $325 million? Can it afford to have one quarter of its entire General Fund spent just on retiree benefits? Is the City willing to make the hard choices to defer other spending priorities in order to be able to pay its employees the benefits they have been promised?

If the City's answer is to be "yes", then the City, for its credibility to its employees, its taxpayers and its bond holders, must demonstrate through a comprehensive long range financial forecast exactly how it intends to pay for these benefits.

If, however, as I strongly suspect, the City concludes it cannot afford these benefits, the City needs to take immediate action to prevent the problem from growing, by reducing benefits for all new employees and reducing the cost of benefits for existing employees where allowable by law. Several recommendations to address this are made below.

Summary Conclusion

To summarize, the City's problem with its post retirement benefit plans is very significant and is growing at an expanding rate. These problems need be addressed immediately and aggressively.

It is recognized the solutions will be fiscally painful, to the City, to the employees, and to the taxpayers, but less painful the sooner the solutions are enacted. Time will only exacerbate, rather than solve, these problems.

B. RECOMMENDATIONS

I have made a series of 31 recommended actions for the City and/or SDCERS to implement to address the overall situation summarized above. The individual recommendations are stated in the body of the report, set in context of the discussion of the problem the recommendation is intended to address.

The 31 recommendations have been categorized and are discussed in the following subgroups:

1. Solution to the current Pension Deficit
2. Creation of a new, less costly retirement Benefit Plan for all new City employees
3. Solution to the Retiree Health Liabilities
4. Recommendations on various other issues:
    a. 50-50 City – Employee sharing of pension cost
    b. Disability/Pension
    c. “Excess Earnings” and the “Waterfall Distribution”
    d. Role of Retirement Benefits in City’s Total Compensation Pkg.
    e. Desired Pension Trust Funded Ratio
    f. DROP
5. Improvements in Governance in SDCERS
6. Recommendation to prevent reoccurrence of the current problems

The 31 recommendations do not all carry equal weight in that some address major issues while others address minor, underlying issues. Some of the 31 recommendations presumably will be relatively easy to implement while others will be difficult and fiscally painful.

III. CURRENT STATUS OF SDCERS: THE PROBLEM!"

The City faces two separate, but related overall problems:

i) The cost of pensions
ii) The cost of retiree health care.

The first problem has been more discussed in the media recently but both problems are very real and very significant. The overall issue is very simple and straight forward. The City has promised its employees retirement benefits (pension and post retirement health care) at levels the City has been unwilling or, presumably, unable to pay for currently, as those benefits are earned by the employees. The City has chosen through various means to defer payments for these benefits to future years' budgets and future years' taxpayers. This deferral is compounding at an increasing rate and is placing a very inappropriate and unfair burden on the next generation of taxpayers.

The City's rationale was that while financial hardship precluded paying the full cost of these benefits currently, in the future, when times "were better," the City could not only pay the then full annual cost but also pay the catch up on all prior years' shortfalls.

The problem is analogous to an individual with a credit card. The individual buys his goods/services today and defers payment until tomorrow. Tomorrow he does the same thing. Soon the payments the individual does make are insufficient to cover even the interest on the debt. As a consequence the problem continues to balloon. What was difficult to pay back at the outset has become order of magnitude more difficult, if not impossible, to pay in the future.

The overall problem, simply stated is how will the City be able to pay for the post retirement benefits it has promised its employees. The City has not been paying the full cost of such currently for several years now, and the resulting growing "debt" clearly makes the problem far more onerous in the future.

A. UNDER FUNDED PENSION PLAN

A critical question which has been subject to much public debate is what exactly is the financial condition of the San Diego Pension System?

The quantification of the Pension System's financial status can lead to a variety of numbers, and therefore some confusion, since the estimation of liabilities that will have to be paid out over 40-50 years necessitate several assumptions for long periods out into the future (e.g. mortality averages, wage increases, inflation, investment earnings etc.). Change an assumption and you get a different answer. While the answers will differ, all scenarios indicate that he City has a significant financial shortfall in its Pension System.

The most recent formal actuarial valuation report as of June 30, 2003, showed the following financial condition of the Pension Plan.

As of June 30, 2003	Assets at Market Value	Assets at "Smoothed" Value
Total Actuarial liabilities	$3.53 Billion	$3.53 Billion
Assets Allocated to funding	2.34 Billion	2.37 Billion
Unfunded Actuarial Accrued Liability	($1.19 Billion)	($1.16 Billion)

> **(Note:** This unfunded liability, i.e. the deficit, would be even **larger** if all the "contingent" liabilities of the system were properly included. This is discussed further below.)

Recognizing that asset values fluctuate, sometimes widely, over short periods of time due to investment performance, actuaries often use "smoothing" valuation techniques to smooth out such valuating for annual measurement purposes. Thus, whether measured at market value of assets or at an actuarially "smoothed" value of assets, there is a deficit of between $1.16 Billion to $1.19 Billion. This deficit means the Pension Trust is only some 67% funded.

Funding to cover the Pension Plan liabilities comes from two sources: i) annual cash contributions from the City and ii) investment earnings on the assets held by the Pension Trust.

The City currently makes annual cash payments to SDCERS. The most recent amount, as agreed to in Manager's Proposal II, was $74.4 million in FY '04. The City actually paid $85 million (the additional $11 million coming from the Enterprise funds). This equaled 15% of payroll. Manager's Proposal II (enacted in FY '02) like its predecessor Manager's Proposal I (enacted in 1997) allows the City to contribute a formula driven annual dollar amount which is less than the actuarial determined contribution amount required for "full funding." If the City had paid the full amount due in FY '04 it would have been $117.1 million or 21.1% of payroll. Thus, the actual funding was $32 million **short** in FY '04.

With the recently agreed to tentative settlement of the Gleason litigation, by 2008, the City will have to make an annual payment of $177.5 million or 25.9% of payroll, almost two and half times more than current amount. While this $177.5 million amount is being characterized in the Gleason Settlement as "Full actuarial funding," I would submit this is somewhat disingenuous. It is only "true" given that a critical assumption was explicitly changed. The amortization period for the unfunded liability was extended from the existing 18 years to 30 years. This is analogous to extending the length of your home mortgage. When you do such, your required monthly payments go down – i.e., it costs less to be "fully funding". But obviously you must pay at that lower annual rate for a much longer time, and with the required interest added in, the total payments are much higher. In pension fund amortization schemes, the amortization computation is made not to yield a level principal and interest payment each year (like a conventional home mortgage), but rather to create a level percent of payroll payment each year. Since payrolls are projected to increase annually (due to inflation and typical head count growth), a level percent of payroll cost actually yields a “negative amortization” in the early years of a 30-year amortization schedule. This reduces the amount of payments that have to be made in earlier years and pushes those dollars out to future years.

Thus the Gleason mandated funding amounts in FY ’06, ’07 and ’08 are a “creative” full funding. The unfunded liability will continue to grow (all other variables held constant) in those years.

By 2009 when the Gleason mandates expire, full funding on a 15-year amortization schedule would require a payment of $240 million (per SDCERS actuary’s projection).

Given the fact the City has no formal five or ten year financial planning process, it is extremely difficult to see how the City, when it can’t afford to pay the full $117.1 million in FY ’04, will be able to pay $240 million in FY ’09. This uncertainty represents a major fiscal challenge for the City. It also represents a major creditability problem for the City. Can the City honestly tell its employees how it is to pay for the promises it has made to them? Can the City explain this to the taxpayers?

In the meantime it is very clear that future years’ taxpayers will continue, for many years in the future, to have to pay for services of City employees of **prior** years. This is a highly inappropriate fiscal policy.

B. RETIREE HEALTH CARE

The second problem the City faces relates to retiree health care. Currently the City is not making any payments on its liability for retiree health at all! Current retirees’ health bills are being paid from a special reserve within SDCERS. The funding of this reserve is a “siphoning off” of funds contributed for pension costs. This siphoning off increases the aforementioned unfunded pension liability.

This is a “pay as you go system” for current retirees, year by year, as actual medical bills are incurred. There is no recognition of the long term liability for the medical costs of these retirees in future years. Worse, the City has never recognized it is also incurring a liability every year for the existing employees’ right to a health benefit when they eventually retire. This liability is totally ignored by the City, or is rationalized away with the argument that this benefit is not really vested until an employee retires and that the City can do away with this benefit if it so chooses. This argument appears disingenuous in that the existing employees are currently being told they will have health benefits in retirement.

If these retiree health benefits are in fact going to be paid (as it certainly appears the current work force believes they are entitled to), then the City has a very real liability which it must recognize. While this liability is difficult to precisely quantify due to the vagaries of predicting medical costs out 40-50 years, SDCERS' actuary has quantified, as a rough estimate, the liability to range from approximately $545 million to $672 million given medical cost inflation of 5-6% per year. I submit, it could in fact be much larger, given that medical costs over the last five years have been increasing in double digit percentages, not 5-6%.

This $545-672 million for retiree health care is **in addition** to the $1.16 Billion of unfunded pension liabilities. The burden to fund this retiree medical cost of prior years' employee service out of future years' City budget will be extremely challenging. If this $545-672 million medical liability is to be funded over the next 15 years, it alone would cost approximately $85 m/year (PRC calculation).

C. RICH PENSION BENEFITS

A description of the City's problem would be incomplete without pointing out that the pension and retiree health benefits promised to employees are quite rich by any measurement. Every variable in the City's deferred benefit pension plan has been tweaked through the union "meet and confer" negotiations to the high end of the scale. The most glaring examples are that employees can qualify for a full pension at age 55 (General Members) or age 50 (Safety Members). The notion that you earn a reasonable, "livable" retirement from your employer as you work through your career is seriously compromised with the notion of a career completing at age 50 to 55. This is particularly true with the increasing longevity and the recognition that people in general need/want to work longer. The normal retirement age in private industry today is 62 if not 65. Social Security retirement age has been raised to 66-67. The U.S. Pension Benefit Guarantee Corp. assumes people work until age 65 and they reduce benefits to anyone retiring earlier. Medicare also assumes people pursue their career until age 65, earning medical benefits while working until that age.

The problem with this early retirement age is significantly compounded by a very lucrative pension payout itself, 2.5% of salary times years of service (General Members) to 3.0% of salary (Safety members). This is close to twice, if not more, the norm for the private sector. As an example, an individual (General Member) starting work at age 22 can retire at age 55 with a pension equal to 83% of his/her highest salary for the rest of his/her life – statistically almost as many years as he/she worked. A Safety Member starting at age 22 can retire at age 50 with a pension equal to 84% of his/her highest salary for the remainder of his/her life – and as measured from age 50, the individual will on average receive pension payments for **more** years than he/she actually worked. And these pensions also escalate over time with a COLA such that the exampled retiree will be making **more** money in retirement than they earned when working.

Other examples of the "richness" of the plan are:

- i) Salary is defined to be employee's **single** highest year salary versus the **average** of either the three or five highest year's salary found in most private sector plans,
- ii) A very liberal criteria for disability pension

iii) A “13th check” (contingent on certain events)
iv) A supplemental COLA (contingent on certain events)
v) A DROP program wherein the individual can continue working at full salary on benefits for up to 5 years, while **at the same time** receiving his/her pension (a problem exacerbated by the very early retirement age).
vi) Ability to purchase service year credits to add to their pension.

Simply stated, a very rich pension is being earned over a relatively short working career. Consequently, the cost of such pension to the City on a per year worked basis is quite high.

D. CITY’S “PICK-UP” OF EMPLOYEE’S SHARE

The basic pension plan was originally designed by City Charter to be paid for 50% by the City and 50% by the employee. However, any “past service liability” is by City Charter to be paid 100% by the City. Worse, as the City has continued to richen up the pension plan and the cost of such has risen for the employee, the City has agreed to “pick-up” an increasing portion of the employee’s 50%. Currently because of this “pick-up” the City is obligated to pay approximately 88% (General Members) and 91% (Safety Members) of the total pension “normal cost” plus 100% of all costs deemed to be “past service liability,” rather than just the City’s 50% in the basic 50-50 City-Employee sharing concept.

E. EMPLOYEES DO NOT GET SOCIAL SECURITY

It is often said that the reason City pensions are so “rich” is that City employees do not participate in Social Security. That is true. As such the employee saves the 6.2% FICA tax payroll deduction and the City saves the corresponding employer’s 6.2% payroll tax. However, as an offset to the absence of a Social Security benefit, the City has granted General Member employees a SPSP plan (but not Safety Members, who enjoy a bigger pension factor than General Members, 3.0% v. 2.5%). The SPSP is a defined contribution pension plan which is in **addition** to the basic pension (the defined benefit plan). The City pays 3.05% of the employee’s salary into this SPSP plan. The employee must contribute 3.05% as well and can voluntarily contribute up to another 3% which the City will match. Thus the City has to contribute up to 6.05% of the employee’s salary – an amount essentially equal to the Social Security tax the City does not have to pay. So in essence, the City employee gets the same employer paid benefits through SPSP that he otherwise would get in Social Security, although it is a defined contribution rather than Social Security’s defined benefit. A further note on Social Security, a City employee retiring at 50 and 55 would not receive much from Social Security participation when they reach age 65 since Social Security assumes you work and pay Social Security tax until age 62 or 65. The City’s SPSP plan, being a defined contribution plan, has no such age based reduction.

F. CONCLUDING OBSERVATION

This overall retirement cost problem facing the City, both pension and retiree health, was well articulated in the Mayor's Blue Ribbon Finance Committee report of February '02 (albeit significantly under stated based on the incomplete understanding by the Blue Ribbon Committee at that time). The Blue Ribbon Committee recommended that the City grant no further retirement benefits until the City fully comprehended the problem they already faced and devised a corrective plan of action. Unfortunately the City did not heed this advice and instead granted further pension benefit improvements and orchestrated, via Manager's Proposal II, a further deferral of costs out to future year's taxpayers.

The City of San Diego is not alone in regards to employee retirement program problems. Many other municipalities and state governments currently face similar problems, with many of the same basic causes for such. Close to home, San Diego County has faced a similar pension under funding problem caused by an extremely rich benefit plan. That problem has recently been "solved," or rather "masked," by the issuance of successive, sizeable pension obligation bonds. Thus, while the San Diego County's pension trust does not show as large a percentage deficit as does San Diego City, the County has incurred significant bond indebtedness to cover past years' pension expenses; those bonds will have to be paid off by future year's taxpayers for many years to come. Thus, the County, much like the City, has pushed prior year's employee retirement costs out on to future year's taxpayers.

As further evidence of the broad ranging scope of these retirement benefit problems, Federal Reserve Bank Chairman Allen Greenspan recently admonished Congress to cut Social Security and Medicare benefits, saying "the government has promised more than it can deliver".

The private sector is also encountering significant problems with defined benefit pension plans, particularly in the old legacy smokestack industries and the airlines; witness Bethlehem Steel which defaulted on its pension plan leaving a deficit of $3.6 Billion and United Airlines' pending default with a deficit of $8.3 Billion. The Pension Benefit Guarantee Corp. is reportedly already $10 Billion short of what it needs to pay the benefits it has assumed from private company plans which have gone broke.

However, notwithstanding, the fact the other plan sponsors, both public and private sector, are suffering similar or greater problems as is San Diego, the City **must** aggressively address and solve this problem in as short a period of time as possible to minimize the burden pushed out on to future years taxpayers for past years' inappropriate fiscal practices.

IV. HOW DID THIS HAPPEN? THE "ROOT CAUSE!"

A. THE PENSION PROBLEM

First and foremost it is useful to state what did **not** cause the problem. The problem is not one of SDCERS' creation; rather it is the **City's** problem. SDCERS is the Plan Administrator and fiduciary manager of its assets; the City is the Plan Sponsor and the financially responsible party. At worse, SDCERS can be seen as an "enabler," whose actions or inactions allowed the City to create this problem by not paying its bills currently.

Secondly, the problem is **not** the result of investment losses. Much has been said publicly on this issue recently, and again each of those answers must be taken in context of their respective questions. Recent actuarial reports have stated that the majority of the increase in unfunded liability was the result of poor investment returns. This is true when looking only at the last few year's of serious "bear" market results. However, more importantly, what is also true is that SDCERS, to its credit, over the long term has done very well with its investment performance – much better than the average municipal pension fund. SDCERS investments results have been essentially equal to its required actuarial investment earnings assumption of 8% per year.

SDCERS' investments did very, very well during the unprecedented stock market boom of the '90's and then performed less well (i.e. did not make their actuarially necessary 8% per year) after the stock market bust in 2000. However, when measured overall for the past 10 years, on average, investment performance has **not** been a principal culprit in creating the current $1.17 Billion unfunded liability. SDCERS' Actuary recently (5/18/04) stated unequivocally that his analysis shows "the existing level of unfunded liability is principally due to elements **other than investment activity**" (emphasis added).

If not investment performance, what then was the cause? The basic cause was that the City did not fund SDCERS adequately. This became acute in 1997 with the passage of "Manager's Proposal I." This is where SDCERS's culpability enters, in that they allowed this to happen instead of demanding the City pay its full fare currently. The City pleaded financial hardship and sought and received permission to defer payment until a later date. Greatly exacerbating this fatal first step, were four critical additional issues.

Pension Improvements

First, the City continued to grant further pension improvements while pleading financial hardship and inability to pay its current obligations. With annual funding fixed per Manager's Proposal I these new benefits created a further funding shortfall.

Litigation Increased Benefits

Second, the "Corbet" litigation was settled and, in the process, benefits were improved even further (again without any increase in funding).

Actuarial Losses

Third, over time the plan incurred actuarial experience losses. These were created when actual results such as employee turnover, pay increases, service purchase subsidies, DROP computation, turned out to be more costly in actuality than they were actuarially projected to be. This also added to the funding shortfall.

Contingent Benefits

Fourth, the City granted the employees certain "contingent" benefits which were to be paid out of CERS' "excess earnings." "Excess earnings" is a complete fiction in actuarial terms. The concept assumes in years when actual investment earnings exceed the 8% actuarial earnings assumption, there is "free" money to be used for other things, rather than the obvious reality that actual earnings tend to cycle around the **average** of 8% over multiple years. If the excesses are siphoned off in good years, there is nothing available to cover the shortfall in the "bad" years (when earnings fall short of the 8% target). Corbet benefits, the 13th check, the supplemental COLA, the medical bills of current retirees, and a portion of the City's "pick-up" of the employee's 50% of pension costs were funded through this creative fiction of "excess earnings."

There is no "free" money. The siphoning off of assets leads to actuarial losses which must be made up with additional funding in future years from the City. It is another clever device for pushing current year's cost out to future year's taxpayers. SDCERS' actuary has been counseling against this concept, or at best to properly account for it, for some time now, to deaf ears (again, culpability of SDCERS). It is of interest to note that when these contingent benefits to employees are "funded" in this manner, the costs of those benefits in essence become "past service liabilities" which by law are paid 100% by the City instead of a 50-50 sharing between the City and the employee.

Past Service Liability

Another factor that causes significant increases in pension funding in general is the concept of "past service liability."

When a new, improved benefit is granted to existing employees with retroactive applicability for all prior years of service (as essentially all recent years' benefit improvements have been structured by the City), a "past service liability" is created along with an increase in the annual pension "normal cost." The normal cost is the cost of this new benefit to be earned by the employees in each of the years they work from the date of the new benefit until retirement.

Thus that normal cost is properly paid out of the annual budget (and therefore by that year's taxpayers) in the year the City (and the taxpayer) derives the benefit of that employee's service. In contrast, the past service liability must be paid by future years' taxpayers over a specified number of years in the future (i.e. the past service liability "amortization period"). Thus those future years' city budgets (and future years' taxpayers) bear the costs of employee service which was rendered many years in the past.

Exacerbating this problem is the fact that the City Charter dictates 100% of this past service liability is to be paid by the City whereas normally the cost of the pension benefits are shared by the City and the employee 50-50. Clearly the retroactive nature of a benefit improvement for existing employees is an extremely expensive proposition for the City. Essentially all of the benefit improvements over the last 10 years have been retroactive for existing employees rather than prospective only. (There is a recommendation below to better deal with this problem in the future.)

Stock Market Performance

Coincidentally, while all this was happening in the late '90's, the stock market was booming and CERS investments were earning greater than actuarially assumed. This gave "cover" for the aforementioned shortfalls. For everyone who wanted to believe stock market booms last forever rather than cycle up and down, the City had "no problem." Then when the stock market turned down in 2000, the problems become very visible. This is when some chose to (disingenuously) say it was now all the fault of poor investment performance.

Quantification of Causes of Deficit

SDCERS' actuary recently made an analysis to quantify the component causes of the increase in the pension funding shortfall from $57 million level in 1996 to the current (FY '03) $1.16 Billion (i.e. a $1.1 Billion increase in the deficit). The study showed that investment performance was only a very minor (i.e. 7%) contributing factor over the last 7-8 years. The City's improvement in pension benefits, use of "excess earnings" for additional benefits, purposeful under funding by the City and actuarial losses were the principal causes or can be seen in the following table.

Causes of Deficit
($ in millions)

Benefit Improvements-Past Service:		
General	$225	21%
Corbett	242	22%
Sub-total Benefit Improvements Past Service	**$467**	**43%**
Use of Reserves for Additional Benefits		
General [1]	$187	17%
Corbett	35	3%
Sub-total Use of Reserves for additional Benefits	**$222**	**20%**
City's Under Funding (MP I 7 MP II)	$186	17%
Assumption changes & non asset experience	104	9%
Asset Investment Performance	78	7%
Service Purchase Liability Loss	40	4%
Total	**$1096**	**100%**

[1] Includes excludable reserves of $81 million or 7%

(**Note**: The above table reflects a revised analysis from what was included in the PRC report. This analysis, which was confirmed with only minor differences by an independent audit performed by Mercer Human Resources Consulting for SDCERS, became available after the PRC report went to press. It does not alter any of the PRC report's conclusion. A precise allocation of dollars by cause is complicated by the interdependency of these issues.)

B. RETIREE HEALTH BENEFITS

Retiree Health is a separate and distinct problem from the Pension Trust deficit. The cause of the retiree health problem is simple and straight forward. The City has very simply just chosen not to recognize that they are incurring an expense every year they promise existing employees a health benefit upon retirement. Sadly, there are no government accounting rules which require the disclosure of this liability (although this is about to change), and the City chooses not to recognize it.

Private sector accounting rules changed back in 1990 and began requiring disclosure of retiree health cost liabilities. As a result of no longer being able to "hide" from this latent liability, many private sector companies in recognizing this liability at that point, realized they could not afford what they had offered. Many cancelled their program for existing retirees and/or existing employees. Many of these companies lost in the ensuing litigation and had to reinstate and pay for the benefits. Most companies did successfully eliminate or sharply curtailed the benefits prospectively for existing employees and for new employees.

The complete absence of any recognition of this growing liability for the future retirement health care of existing employees has now created a $545-672 million problem (assuming those benefits are not cancelable by the City to avoid this liability). This bill must be paid. Future years' taxpayers are already on the hook for the City's negligence of past years. The longer it takes the City to address this very formidable fiscal challenge, the longer **future** years' taxpayers will be paying for **prior** years' City services.

C. CONCLUSION

To summarize, the cause of the City's problem is quite simple. Once you blow away all the smoke, best case, the City **chose** not to pay its retiree liabilities currently in favor of other funding priorities; worst case, the City was **not able** to pay for its retiree liabilities. If the latter is true, as I suspect, the problem is severe indeed, as the liabilities not paid to date have grown significantly, with interest thereon (and continue to grow at an escalating rate), such that payment tomorrow will be much more challenging than what proved impossible to do the last few years.

Future years' taxpayers are already "in debt" for past years' City expenses. The longer it takes the City to stop perpetuating this highly inappropriate fiscal behavior, and the longer it takes to correct this very serious problem of the past, the longer the future generation of taxpayers will be burdened with the fiscal mistakes of the past.

V. RECOMMENDED SOLUTION TO PENSION DEFICIT

A. ALTERNATIVES INVESTIGATED

The PRC investigated a variety of approaches to increase the amount of money in the Pension Trust. Consideration was given to what other public agencies who faced similar problems have done. San Diego County's repeated use of Pension Obligation Bonds is but one example.

The principal alternatives which the PRC investigated and considered are the following:

- Optimistically "hope" for an investment market boom to make up the shortfall.
- Reduce the level of benefits for current employees and then reduce there by future cost to the City.
- Change the actuarial assumption to make the deficit appear smaller.
- Encourage early retirements.
- Call for a general tax increase to specifically fund the deficit.
- Seek additional cash contributions from the City.
- Seek additional cash contribution from the employees.
- Pension obligation bonds.
- City contributes real estate to the Pension trust.

B. OPTIMISTIC "HOPE" FOR INVESTMENT MARKET BOOM

The stock market losses or poor investment performance was not a principal cause of the current problem. Therefore "hope" for above average investment performance in the future is not a viable or acceptable corrective strategy.

C. REDUCE THE LEVEL OF BENEFITS FOR CURRENT RETIREES AND/OR EMPLOYEES

It was concluded from legal advice received this was not legally possible. Existing retirees have a clear vested right to their current benefits. For current employees, unlike in the private sector where pension benefits can be curtailed or modified prospectively (but not retroactively), by State law a public employee is essentially guaranteed to receive at his/her eventual retirement date the level of benefits he/she was promised on his/her **date of hire**.

Thus this potential solution is not legally available. It is possible to "close" the existing pension plan to new, yet to be hired employees and offer the new employees a less expensive plan. This alternative will not reduce the current pension deficit but would, by lowering the City's future cost for pensions, make funding the current deficit easier. This alternative is discussed more fully in Section VI below.

D. CHANGE THE ACTUARIAL ASSUMPTIONS

It is well understood that an actuarial computation of pension liability out 40 years is dependent upon many actuarial assumptions. Change any of those assumptions and you change the present value of the pension liability, and thus the deficit.

However, the current actuarial assumptions are reasonable and therefore it would be disingenuous to alter those to create the illusion of a smaller pension deficit. But while the current actuarial assumptions are reasonable, SDCERS should convert its actuarial **method** back to the Entry Age Normal (EAN) method from the current Planning Unit Credit (PUC) method. EAN method is clearly the more widely used method by municipalities. It tends to call for higher funding in earlier years of an employee's tenure. The City and SDCERS' switched from using the EAN to the PUC in the mid '90's.

E. ENCOURAGE EARLY RETIREMENT

This is not left to be an effective nor appropriate solution.

F. CALL FOR A GENERAL TAX INCREASE

The PRC concluded it was not in their purview to call for general tax increases to fund the pension plan. This was believed to be the purview of the City Council or, in most cases, the purview of the City voters who would have to vote on such a tax increase.

G. SEEK ADDITIONAL CASH CONTRIBUTION FROM THE CITY

Obtaining additional monies from the City is critical and is central to any solution. The City has to get its annual cash contribution up to the full actuarial computed funding rate as soon as possible. The recent pending settlement of the Gleason litigation requires the City to contribute at the "full rate" starting in FY '05, however that resulting dollar amount was effectively reduced by the pending settlement allowing a change in actuarial assumption – the past service liability amortization period being extended from 18 years to 30 years.

It was a surprise to learn that the use of amortization periods of greater than 18 years that are designed to create annual payments as a constant percentage of City payroll, actually creates a "negative amortization" in the first several years of that formula. This means that a "negative" principal payment is made. Instead of paying both interest and some principal each year as a homeowner does with a conventional level payment mortgage, the City would pay full interest **minus** the negative principal "payments."

As a consequence, it is recommended below that in the future (after the Gleason legal settlement time table) that no amortization period longer than 15 years should be used.

H. SEEK ADDITIONAL CASH CONTRIBUTIONS FROM EMPLOYEES

This is not felt to be a viable alternative. However a closely related issue is addressed below under the section 50-50 City – Employee sharing of Pension cost.

I. PENSION OBLIGATION BOARDS (PBO's)

The PRC discussed these alternatives at great length. It was recognized that, assuming the City has adequate bonding capacity and can borrow at interest rates below The Pension Trust earnings assumption (currently 8%), then there is the potential benefit of interest arbitrage – i.e. borrow at 6% and invest at 8%. There is also the benefit of "maturity arbitrage" in that PBO's can be written for some 30 years. The cash provided by the PBO will be contributed to the Pension Trust to eliminate (or reduce) the deficit. The City will pay off the PBO's, principal and interest, over 30 years, whereas otherwise the Pension unfunded liability would have had to be paid off in the current 18 year amortization period (or the below recommended 15 years).

Further it is felt there is great benefit of converting the current pension deficit which could be viewed as a "soft liability" or "off balance sheet debt" (the payment of which could be delayed or manipulated through devices such as Managers Proposal I and II) into a "hard debt" (a specific third party lender liability on the City's books). This "hard liability" is clearly and unambiguously disclosed, and it **must** be paid annually – there is no potential for "deals" to delay payments to some later date.

It was also recognized that the use of PBO would inject the largest amount of money in the quickest time frame into the Pension Trust. It was felt that, importantly, this would allay the growing and disturbing fears of retirees and employees that they might not get their pension.

J. CITY CONTRIBUTES REAL ESTATE

It was recognized that there might be limits on the City's debt capacity or other pressing City needs for that capacity thus making the PBO means of injecting cash into the Pension fund problematic. An alternative is for the City to sell City owned real estate and to contribute the cash proceeds or to contribute the actual real estate in kind to the Pension Trust. This could be a means of significantly reducing the Pension deficit without a "cash cost" to the City.

K. CONCLUSION

A sizeable infusion of assets into the Trust phased in over three years as a partial "catch-up" is imperative. Additionally the City has to fund to the full actuarial funding rate each year starting in FY '06 (using the liberal 30 years amortization period specified in the Gleason Settlement) and by FY '09 to switch to the more prudent 15 year amortization period (which will require larger annual dollar funding contributions than the "temporary" 30 year amortization period).

Recommendation # 1: *(Identical to PRC's Recommendation)*

The City is to inject a special $600 million infusion of assets into the trust over three years as follows:

The City to issue $200 million POB by 12/31/04.

The City to inject a second $200 million into the Fund by 12/31/05 from either a POB or real estate (the sale of City owned real estate with the cash contributed to the Trust, or the real estate itself contributed to the Trust).

The City to inject a third $200 million into the Fund by 12/31/06 from either a POB or real estate.

The City to contribute annually at the full actuarial funding rate starting in FY '05, FY '06, '07, and '08 based on 30 year amortization (the "Gleason Settlement"), and in FY '09 and thereafter based on a 15 year amortization (whether "fixed" or "rolling" is left to SDCERS to decide). These required full funding annual contributions are to be computed with full recognition of the increase in Plan assets resulting from this aggregate $600 million injection of funds.

This should reduce the current funding deficit by well more than half by FY '09. It will however significantly increase the annual cost of the City as follows:

Approximate annual City cash cost (to fund the Pension Trust and to pay off the PBO's) would be as follows:

FY '05	*$130 million **
FY '06	*$163 million **
FY '07	*$175 million **
FY '08	*$210 million **
FY '09	*$216 million **

**set by litigation settlement*

This will be a significant fiscal challenge for the City but it is a critical first step. The result of these recommendations is that the current 67% funded ratio of the Pension will improve to approximately 89%. Obviously despite this very significant increase in annual City expense, the pension fund will still be well below 100% funded.

<u>Recommendation # 2:</u>

Create a City Charter requirement for SDCERS to utilize an amortization period no greater than 15 years for actuarial losses and no shorter than five years for actuarial gains, starting in FY '09 after the Gleason Settlement provision terminates.

SDCERS should switch from the current PUC (Planned Unit Credit) actuarial method to the EAN (Entry Age Normal) in FY '09.

L. <u>CONTINGENT LIABILITIES</u>

In addition to the current $1.16 Billion deficit, there are also a series of "contingent" benefits which are not included in the actuarially computed deficit. These include the 13th check, the Corbet settlement, the supplemental COLA.

Since their payment is contingent upon the availability of "excess earnings," SDCERS has decided not to include them in the computed liability. When they are actually paid out in any given year, that payment creates an actuarial loss and as such adds, a year at a time, to the unfunded liability.

This is not a prudent manner to account for these benefits. Since the City has granted these benefits they should be fully recognized (given due deference to their contingent nature where appropriate) and included in the actuarial computation. By doing such would increase the Pension deficit but it would make this very real, albeit contingent, liability fully visible and well understood.

<u>Recommendation # 3:</u>

Instruct SDCERS to include all contingent liabilities in the actuarial computation of total pension liabilities and in the actuarially computed annual funding rate.

If this recommendation is not accepted, then it is imperative to reduce the actuarial earnings assumption to otherwise account for the actuarial drain caused by these contingent benefits. However, care must be taken in doing this so as not to unintentionally enhance the value of these contingent benefits through the mechanics of the "excess earnings waterfall" discussed later below.

M. ADMINISTRATIVE EXPENSES INCLUDED IN ACTUARIAL CALCULATION

Currently SDCERS administrative budget is not considered as a cost in the actuarial assumptions to determine the City's funding requirements. Thus the City is not paying this cost currently. This annual budget is approximately $20 million, the largest component of which is investment managers' fees.

The payment of this budget annually by SDCERS creates actuarial losses which adds to the Pension deficit. Thus the City, instead of paying this cost currently, on an annual basis is spreading this cost out of many years in the future.

Recommendation #4:

SDCERS's annual operating budget be included in the actuarial computation of annual funding requirements such that the City pays this cost currently and no longer pushes it out to future year's taxpayers.

N. CITY "PICK-UP" OF A PORTION OF EMPLOYEE'S SHARE OF PENSION COST

Costly to City

One aspect that makes the existing pension plan even more expensive for the City is the "Pick-up" concept. The original premise of the pension plan was that the cost of the normal pension was to be shared 50-50 between the City and the employees. Over the years as the City has improved the level of pension benefits and the cost of the pension has risen accordingly, the City, through Meet and Confer union negotiations, has agreed to "pick-up" or pay on behalf of the employee, a portion of the employee's 50%. This has become so pronounced that now the City is paying 76% of the General Member's 50% and 78% of the Safety Member's 50%. Thus given the City's 50% plus the City's pick-up of this large part of the employee's share, the City is now paying approximately 88% (General Members) and 91% (Safety Members) of the "normal cost" of the pension rather than 50%.

City is pushing this cost out on to future year's taxpayers.

Worse, part of the City's pick-up for current year employee's expense is being paid, not out of the current year city budget, but rather through the accounting fiction of "excess earnings" in the SDCERS Trust. By so doing, the City spreads the actual cash cost to the City for the current year's expense out some 18 years through SDCERS' amortization of actuarial losses. It is unclear to me on whose authority this was done, the City's or SDCERS.

Opportunity for immediate City cost reductions

While the extremely rich levels of benefits in the pension plan cannot by law be reduced for current employees, this "pick-up" is one area where the City can make reductions in an effort to get the total cost of this pension plan back down to affordable levels. Such a step will be in essence an income reduction to the City employees. However, it must be recognized the "hurt" in reforming this unaffordable pension plan must be shared by all, including those who benefit from the rich plan.

> ***Recommendation #5:***
>
> *The City should (through Meet and Confer if necessary) phase out the "pick-up" of employee contributions over the next three years. The three year phase out is to cushion the economic pain (in essence a "wage" cut of some 2.7% - 3.3% per year for each of the three years) to the employees. The City must commit to utilize this budget "savings" to help fund the necessary increases in annual contributions for both pension and retiree health recommended elsewhere in this report to ensure the employees will, in fact, receive their promised benefits in the future..*
>
> ***Recommendation #6:***
>
> *As an alternative to reducing the City's pick-up of a sizeable portion of the Employee's 50-50 share of the pension cost, if this is felt too severe a reduction in the employee's effective take home pay, the City should then investigate the legality of negotiating a reduction in the current "unaffordable" pension plan and retiree health benefits in lieu of reductions in the City's pick-up.*

VI. NEW BENEFIT PLAN FOR NEW EMPLOYEES

The City has to come to grips with whether or not it truly can afford the current levels of retirement benefits it has promised its employees.

As mentioned above, it is recognized that by California Law, the benefits for existing retirees and existing employees cannot be reduced or eliminated. Thus the City must find the fiscal wherewithal to, at a minimum, continue to pay those benefits to the entire existing workforce. However costs in the future could be reduced down to more affordable levels by "closing" the current pension plan to any new participants and creating a new plan for all yet to be hired new employees.

It is recognized that by doing such the City would be creating two "class of citizens" in the workforce with different benefits despite the employees working side by side in the same job. However, the fact that the existing plan has proven (de facto) to be unaffordable by the City necessitates this action.

Recommendation #7: *(Identical to PRC's Recommendation)*

Considering the richness of the annual plan and the City's unwillingness or inability to currently pay for that plan, the existing plan should be closed immediately to all new employees.

Recommendation #8:

A new, much less expensive plan must be created for all new employees. The value of the new benefits should be reconciled with prevailing practice in private industry and not compared to municipal or state plans, as the latter have tended, over time, to match one another to the highest common denominator.

The City must chose between a new defined contribution plan (DC), which leaves no residual liability to the City, or a new defined benefit (DB) plan of the same character as the current plan but with much less rich terms.

Given the fact that the initial annual cost to the City for both a DC and a DB plan can be set essentially equal through the establishment of the specific benefit terms of each plan, the criteria for choosing which type plan will be more philosophical rather than cost driven. Issues such as classic employer paternalism wherein the employer retains responsibility for retirement fund investment (and investment market liability or benefit from such responsibility), versus giving that responsibility directly to the employee. The DC plan tends to offer more portability which has value to many employees who tend to *change jobs whereas the DB plan, at least in theory, tends to encourage longevity of employment with a single employer.*

The choice between a DC and a DB involves many issues and the City's Human Resources Dept. need assess such carefully.

However, in the event the new plan is determined to be a defined benefit plan like the existing one, then the recommended key changes from the existing plan, to place the value of the pension plan in closure conformity to the norms of the private sector, are as follows:

1. *Increase the age for normal retirement to:*

General Members	*62*	*(from 55)*
Fire & Safety	*57*	*(from 50)*
Legislative	*62*	*(from 55)*

2. *Reduce the full retirement percentage payout factors for Retirement Benefits to no greater than (**<u>and</u> <u>ideally</u> <u>less</u> <u>than</u>**):*

General Members	*2.0%*	*(from 2.5%)*
Fire & Safety	*2.4%*	*(from 3.0%)*
Legislative	*2.8%*	*(from 3.0%)*

3. *Increase in the minimum age to elect a reduced, early retirement to:*

General Members	*55*
Fire & Safety	*52*
Legislative	*55*

   Benefits for an early retirement will be actuarially reduced on a cost neutral basis.

4. *Change from the highest year's salary to the average of highest three year's salary.*

5. *Eliminate the DROP and purchase of years of service credit provision for all New Employees of the City, except where required by California or Federal Law.*

6. *Strengthen the criteria for disability (see discussion of disability pensions below).*

7. *Eliminate the COLA in the pension plan.*

8. *Eliminate participation in the 13^{th} check and the supplemental COLA.*

VII. <u>RECOMMENDED SOLUTIONS TO RETIREE HEALTH LIABILITIES</u>

The City has a very serious problem with its promised retiree health care benefit. It is well recognized that medical costs have been and continue to skyrocket. Also, we have an aging population with longevity continuing to increase. Thus any retiree health care benefits are a very expensive proposition to begin with. The City's current "pay as you go" system ignores the accumulating liability being incurred each year as current employees earn their right to retiree health care. While this right to health care will not manifest itself in cash expenditures until the employee retires, the expense is being incurred now, each year the employee works. This is completely analogous to the pension benefit – i.e. paid at retirement but earned and expensed each year the employee works. While the City sets aside monies each year for these ultimate pension benefits, it does not set aside **<u>any</u>** money for the retiree health. This has led to a totally unfunded liability estimated by SDCERS actuary to be between $545 and 672 million depending on medical cost inflation assumption (5-6% per year). I believe the liability is much greater than that given the history of medical cost increases being far in excess of 5-6% per year.

It is recognized that most other municipalities follow this same practice as the City of not funding this liability. Additionally many private sector companies also do not fund their future retiree medical liability. However, private sector accounting rules (FASB) require this medical liability to be clearly shown on the Company's balance sheet.

<u>CONCLUSION</u>

The City's policy of not recognizing its retiree health care liabilities must be changed. For the City to render an accurate, clear picture of its financial condition, this liability must be disclosed. Additionally, the current practice of funding only on a pay as you go basis must be changed, particularly when it is recognized that even this very limited pay as you go funding is not being paid out of the City budget each year but rather is being paid by an inappropriate siphoning off of pension assets (via "excess earnings"). The City must stop pushing this liability out on to future year's taxpayers.

Further the City cannot have it both ways – i.e. telling employees they are earning a retiree health benefit and at the same time saying they do not have to fund the cost of such a benefit since it is "not vested" and therefore the City does not necessarily have to pay it if it chooses not to. Cleary, this is not fair to the City's employees. The City acknowledges the existing retirees do have a vested benefit to medical care but that existing employees do not.

These necessary corrections to current City practices will require significant monies out of the annual City budget. However that is a fiscal reality. It exists today but it is well hidden and simply being deferred out to future year's taxpayers. If the City concludes it cannot afford this cost, it must decide whether it wants to continue this employee benefit.

***Recommendation #9*:**

The City must definitely conclude whether the current employees have a vested right to retiree health care. If the answer is no, the employees should be honestly told so. If the answer is yes, the liability for such needs be recognized and funded.

***Recommendation #10*:**

Immediately stop funding retiree health care through the current method of siphoning off pension assets though the fiction of "excess earnings." Eliminates Muni Code Section 24.1502(a)(5) which specifies this current treatment. Commence funding annually from City budget on an actuarial basis with an amortization period no greater than 15 years. (This will be necessary for the existing retirees at a minimum since their benefit is clearly vested, and for existing employees as well ***if*** *the City confirms its commitment to retiree health benefits.)*

***Recommendation #11*:** *(Identical to PRC's Recommendation)*

Establish a separate trust for Retiree health care, separate and distinct from the Pension Trust.

For administrative efficiency have SDCERS manage both the Pension and the Retiree Health trust and allow SDCERS to commingle the two trust funds for investment purposes only, if they so decide.

Recommendation #12: *(Identical to PRC's Recommendation)*

To assure adequate disclosure and visibility on the cost and funding status of Retiree Health benefits, City should adopt GASB 43 accounting reporting requirements at the beginning of FY '05.

***Recommendation #13*:**

Consistent with Recommendation #8 regarding a new, less expensive Pension plan for new employees, the City should develop a new retiree health care plan for new employees which puts a clear cap on future medical cost per employee and which is deemed affordable by the City given that it must be funded annually on an actuarial basis.

VIII. OTHER ISSUES

During the PRC's investigation several other issues came to light and were discussed to varying degrees but were not driven to a conclusion.

A. 50-50 CITY-EMPLOYEE SHARING OF PENSION COST

The basic premise of the pension plan established in the Muni Code back in the 1930's is that the cost of a "normal pension" is to be paid 50% by the City and 50% by the employee. Any past service liability is to be paid 100% by the City. It is unclear what was meant 70 years ago by the term "normal pension". However, it is clear that this should not be confused with the current actuarial term of art, "normal cost" of a pension.

Cost of benefit improvements

When benefits are improved the actuarially computed cost of such increases are to be shared 50-50. When actuarial assumptions are changed, then the resulting change in actuarial computed costs are to be shared 50-50. This latter point was contested by San Diego employees and litigated decades ago and the City's position was confirmed up through the California Supreme Court.

Appears SDCERS not properly calculating employee rates

It is questionable whether CERS has been administering the plan according to the above stated rules. It is unclear whether the cost of every benefit increase was in fact shared 50-50, and, if it was, whether the employee rates were adjusted timely. There were some benefit increases that were granted in the time period when Manager's Proposal I had "frozen" the City's contribution rate with the City's deficiency to be made up later. But it is unclear whether future make up of the employee's required increased rates was comprehended. Benefits were also increased as a result of litigation. It is unclear whether the employee rates were appropriately increased for such.

It is apparent that when some (or all) of the recent actuarial assumptions changes were made (or were frozen by MP-I, to be "paid for" by the City later), the employee rates were not increased.

The consequence of the foregoing is that it appears the City is paying more than its 50% share in conflict with the basic premise of the pension plan being shared 50-50 between the City and the employee.

Not all elements of pension cost properly included in employee share

It also appears that not all the elements of the current pension plan are even included in the computation of the 50-50 sharing. As an example, the disability benefit, the DROP benefit, the 13th check, and the supplemental COLA do not appear to be included in the 50-50 sharing.

Actuarial assumption changes not made timely – thereby delaying employee rate increases.

Another concern is the lack of timeliness in addressing actuarial assumption changes. The cost of such a change going forward is supposed to be shared 50-50, but the cost of the past service liability created by that assumption change is paid 100% by the City. Thus any delay in recognizing assumption changes moves cost from a 50-50 share to 100% - 0%, City pays all.

Employee Rate Computation

It appears when changes are made to employee rates they are made on an average basis for ease of administration rather than on a specifically calculated adjustment for each age related group. It appears that this approach leads to a higher cost to people hired in at a young age and a subsidized cost for employees hired in at an older age.

Recommendation #14:

The PRC was not able in the time available to get a full explanation of the 50-50 City-employee sharing and the Pension costs. Therefore, the City, as Plan Sponsor, should request a full accounting from SDCERS by 12/31/04 as to:

A. Why are not all cost elements of the Pension Plan included in the 50-50 City-employee cost sharing computation?

B. Were the costs of all benefit increases properly and timely reflected in the employee's rates?

C. Were the costs of all actuarial assumption changes properly and timely reflected in the employee's rates?

D. What action, if any, regarding City and employer contribution rates would be appropriate given the results of the above full accounting?

(A response to the above is apparently in development by SDCERS staff in response to a Trustee's request.)

Recommendation #15:

City should request SDCERS to establish by 12/31/04 a formal policy for establishing employer and employee contribution rates, including regularly scheduled reviews and assessments of actuarial experience trends and actuarial assumptions. (This is in development by SDCERS Staff.)

B. DISABILITY PENSION

High cost driver

One of the high cost drivers of the total cost of San Diego's Pension Plan is the disability provision. Disability accounts for close to 15% of the Total Normal Cost of the Pension. Worse, at present (as described above) the City is paying 100% of this cost with the employee **not** sharing 50-50.

At present, an incredible 23% of all City retirees are drawing a disability pension. When just focusing on Safety Members, 36% of all Safety retirees are on disability. Over 1/3 are disabled!

Lenient criteria for disabilities

It would appear this shocking large percentage of retirees on disability is due to the relatively lenient definition of "disability" used in the Pension Plan. An employee only has to demonstrate he/she is unable to perform their job. This is true even if the individual incurred this disabling injury on their personal time away from work.

A more demanding criteria for obtaining a disability pension is used by the Social Security System. Here a person must be unable to do any work in order to qualify. If an employee is injured on the job, the workers compensation system is designed to pay not only his medical bills, but if he/she is permanently disabled or permanently partially disabled, there is a payment made to cover the individual's diminution of earning power. Additionally, payments are made for retraining in other types of employment. The Social Security disability, becomes operative only if the individual is unable to be employed any where.

Financial incentive to claim disability

Currently when a City employee is injured on the job and is deemed unable to perform his job any longer, that individual will receive worker's compensation **and** a disability pension **and** be able, physical condition permitting, to go secure employment elsewhere. Thus as a result of their work related injury/disability they can easily wind up making far more money than what they made as a City employee. The basic rationale for a disability plan is to project the employee with an economic safety net in the event he can't work any longer – not to create the potential for a wind fall.

In years past, the City Muni Code provided protection against “double dipping” from both workers compensation and disability simultaneously. Also there were protections which reduced disability payments for other income earned. Apparently these provisions were negotiated away to the Unions in meet and confer.

A further incentive to claim disability comes from SDCERS’ chosen way of implementing the Muni Code. The issue here is the fact that a disability pension is, by IRS Code, 50% tax free income whereas a normal service pension is fully taxable.

Thus when an individual is eligible for a service pension (which is usually of greater dollars than a disability pension), if that individual can perfect a disability claim, SDCERS pays the person first the disability pension (50% of which is tax free) and then “tops it off” to get up to the full value of the service pension (that “top off” being fully taxable). Thus there is a tax savings incentive to claim disability. While this does not directly cost the City any more for that individual’s pension (just the IRS “loses”), the City does incur significant administrative expenses to investigate and adjudicate the disability claim. Worse, these financial incentives can create an unwarranted culture in the workforce to seek disability retirements. The very large percentage of City retirees on disability already might suggest this is a problem.

Potential conflict of interest in the administration of disability pension

One of the many appearances (if not realities) of a conflict of interest on the Board is when Board members who are elected union officials have to sit in judgment on a union member’s application for disability approval.

On questionable disability applications the Board sends them to an independent Hearing Officer who, after a formal legal style proceeding, returns a “recommendation” to the Board. The Board then must approve or override that recommendation.

The Board has no legal or medical expertise and, worse, the Board attempts to sit as an “appeals court” hearing pleas from applicants and their lawyers without any semblance of legal due process, including such basics as testimony under oath, the impermissibility of new evidence, etc.

SDCERS not currently complying with Muni Code regarding monitoring of disability pension.

Muni Code Section 24.0407 **requires** SDCERS to seek an annual affidavit from disability pensioners affirming they are still disabled. Section 24.0408, requires SDCERS to have disability pensioners submit to periodic physical exams to independently confirm their disability. SDCERS is not currently doing either of these requirements.

***Recommendation #16:* (identical to PRC's recommendation)**

To eliminate the appearances of a conflict of interest in the administration of disability pensions and to institutionalize a rigorous, independent, judicial based process with proper medical expertise and legal due process, SDCERS should change their current practices when sending questionable disability applications out to an independent administrative law hearing officer. Instead of the Hearing Officer's conclusion being a "recommendation", it should be a "final decision" on behalf of the Board; such a decision, as with the current process, would still be appealable to Superior Court by either the applicant or the Board. This recommendation will remove the Board from making disability decisions when it does not have the expertise nor a reasonably equitable process to do such.

The PRC had submitted a proposed City Charter amendment to effect this recommendation. However City Council, on a 4 yes, 2 nay vote to approve, failed to carry this motion for a ballot proposition. Consequently I now strongly urge the City to recommend that the SDCERS Board to adopt this practice.

Recommendation #17:

Establish an economic ceiling on a disability pensioner's aggregate receipt from worker's compensation, disability pension and income from other employment. That ceiling should not exceed the ***current*** *rate of pay for the position the individual had held at the time of his disability. SDCERS to establish a process to administer this ceiling and reduce disability payments where the ceiling is breached.*

Eliminate the practice of paying a disability pension topped off to equal the service pension solely to afford tax free income to the retiree.

Recommendation #18:

SDCERS to perform their obligation under Muni Code 24.0407 and 08 regarding monitoring of disability pensioners, including periodic physicals to confirm continued disability. If a person drawing a disability pension is no longer deemed disabled their disability pension will cease assuming the City is willing to reinstate them as an employee. The City is to be encouraged to return the rehabilitated individual to City employment as a moral if not legal commitment to their employees and as a means of controlling total employment costs.

Recommendation #19:

If a new Pension Plan is to be created for new hires, replace the current criteria for disability with the Social Security system criteria.

C. “EXCESS EARNINGS” AND THE “WATERFALL DISTRIBUTION”

The City has directed SDCERS to make certain payments out of trust assets based on the concept of “excess earnings”. When the Trust’s annual “realized” investment earnings (cash earnings from dividends, interest, or gains on actual sale of a security) reach a certain threshold then earnings in excess of that amount are deemed available for payment of certain prescribed benefits. The priority of those payments is referred to as the “waterfall”.

Excess earnings are distributed according to the following “waterfall” dollar priority:

1st 8% (Actuarial earnings assumption) multiplied by the employer contribution reserve is credited to that reserve.

2nd 8% multiplied by the employee contribution reserve is credited to that reserve

3rd Annual SDCERS administrative budget is deducted

4th Retiree Health reserve (for amount of actual retiree health expense that year)

5th 13th check to retirees

6th Corbet payments to retirees

7th Supplemental COLA reserve

8th Employee Contribution Rate reserve

(There is also a deduction made and contributed to the Port and Airport employer reserves to compensate for the fact their members do not participate in the City’s contingent benefits, to the 5th, 6th, 7th and 8th priorities.)

If there are insufficient excess earnings to satisfy all priorities, the lower priorities get nothing that year. Corbet is the only item which, not being paid in any given year, rolls forward on a cumulative basis to the next year, but without interest.

If there is more than enough “excess earnings,” the remaining amount gets credited to the Employer Contribution Reserve, unless SDCERS, in the Board’s sole judgment, creates some other “reserve.”

In the last two years, for the first time ever, there were no investment “excess earnings” and therefore retirees did not receive any 13th check or Corbet payments.

As stated earlier, this "excess earnings" concept is conceptually flawed. There is no such thing as excess earnings. The pension trust fund needs to earn 8% per year on average. Some years will be better, some years will be less. To dissipate the "excess earnings" from the good years obviously leaves nothing to cover the shortfall in the bad years.

The City has purposefully chosen to use this accounting slight of hand to pay for employee benefits, not from the City's annual operating budget as they should be, but rather by siphoning off assets from the trust fund in "good" years. However, there is no free money. This siphoning off creates actuarial losses which contribute to the unfunded liability. As stated earlier, this was one of the major contributors to the current $1.16 Billion deficit in the Pension Fund.

It is important to note that not only is the concept of earnings "excess" flawed, but also the measurement is inappropriate. First, the excess earnings computation works with "realized" (i.e. cash) earnings, not total earnings despite the fact the entire actuarial model works on "total earnings" (both realized and unrealized – i.e. "paper" gains not yet liquidated). Secondly, the excess earnings computation only accounts for an 8% earnings increment on the employer and employee reserves before deeming all else "excess" and available for other uses. This is a serious conceptual flaw. It neglects incrementing the present value of the retiree liability by the actuarially necessary 8%. For example, a preliminary estimate of "excess earnings" for FY '04 is as follows:

Estimate realized earnings for FY '04	$247.7 million
8% of Employer and Employee contribution reserves	- 77.1 million
"Available" excess earnings	$170.6 million

In reality, even if you want to measure excess earnings on a year by year stand alone basis, one should first deduct 8% times the **total** actuarial liability to reflect the proper actuarially computed growth in plan liabilities. Using FY '03 actuarial report values for illustrative purposes, the correct computation would be:

Estimate realized earnings for FY '04	$247.7 million
8% of total actuarial liabilities of $3.5 Billion	-280.0 million
"Available" excess earnings (loss)	(-$ 32.3 million)

In this example which is a close approximation to what the numbers will actually be for FY '04, if you are going to use "realized" earnings rather than "total earnings, then instead of having $170 million to "spend", there is actually a deficit of $32.3 million.

This "excess earnings" and "waterfall" aspect of SDCERS is one of the more glaring examples of the complexity and confusion of the Pension Plan. Not only is the overall concept flawed, but its use can lead to unintended consequences. For example, if SDCERS was to decide, for prudence sake, to lower the actuarial earnings assumption and therefore to increase the City's contribution rate, this move would, unintendedly, make the payment of the contingency benefits easier (i.e. less "excess earnings" now required to trigger payment of the contingent benefits), and thus more valuable to the retiree and more costly to the City.

<u>Recommendation #20:</u>

The conceptually flawed concept of "Excess Earnings" and the "Waterfall Distribution" must be corrected. Nothing should be paid from excess earnings. All contingent payments should be included in the actuarial calculation. The earlier recommendation (#3) calling for full inclusion of this contingent benefits will get them properly accounted for costing purposes for the City.

However, it must be remembered that there are several retiree benefits whose payments are contingent in nature and the contingency is determined by this accounting concept, flawed or not. The City has two choices, One, the current computational test, as conceptually flawed as it is, can, if desired, continue to function as the contingency test. To change the test would change the degree of contingency and therefore would be an improvement in value to the retiree.

Alternatively, the City could choose to greatly simplify the current plan's complexities involving this "excess earnings" concept and the "waterfall" by choosing to eliminate the contingency associated with these benefits and make them fixed. This would amount to a benefit increase, in that the annual payment of the 13^{th} check would now be guaranteed and the payment of Corbet would likewise be guaranteed rather then deferred in some years.

Given the current significant cost problems the City already faces with its pension plan, the notion of increasing benefits (i.e. removal of the contingency) and thereby incurring cost is highly questionable. Nonetheless it is recommended that this alternative be analyzed to determine its cost impact (e.g. with the cost of these benefits more properly reflected in the 50-50 City – Employee split given they would then be accounted for as "normal pension," versus currently being accounted for as an actuarial loss which is 100% for the account of the City.) Further such a benefit "increase" might serve as part of a negotiation to secure agreement on the recommended elimination of the employee "pick-up" (see recommendation #5.

Removing the Retiree Health benefit funding from this excess earnings concept has already been recommended. However, since retiree health is a higher priority than the other contingent benefit, if the contingency nature of benefit is to be maintained, the removal of health care benefits from the "Waterfall" inappropriately enhances the probability of and therefore the value of the Contingent benefits. Therefore an appropriate proforma adjustment will need be made to the Waterfall each year.

EMPLOYEE CONTRIBUTION RATE RESERVE

The last item on the Waterfall is the Employee Contribution Rate Reserve. This is another clever accounting maneuver designed by the City to not pay current year's cost out of the current year's budget, but rather to push those costs out to future years.

A few years back, the City in decided to "pick up" even more of the employee's 50% share of the pension cost. However instead of paying this bill currently, they use "excess earnings" to pay for such. The problem with this use of excess earnings has been well addressed above. The overall issue of the City's pick up is also addressed above.

> ***Recommendation #21:***
>
> *The City should immediately stop using excess earnings to pay for the "pick-up" of employee's contribution. If the City desires, or is obligated by Meet and Confer, to "pick-up" this amount of employee contribution, the City should make such payments out of the annual City budget.*

D. ROLE OF RETIREMENT BENEFITS IN CITY'S TOTAL COMPENSATION PACKAGE

During the PRC's deliberations, it was often heard that the reason the City's pension benefits were so "rich" was that such was necessary to offset less than competitive salary structure in a total employee compensation package.

The PRC was not able to obtain data nor pass judgment on whether the City's salary structure was in fact "below market" Or not.

However there are obvious pitfalls of using pension benefits to offset salary inadequacies. City pension benefits, once offered, are fixed and cannot, by law, be adjusted downward or eliminated if future economic conditions would so necessitate. Conversely, salary structures are not prevented by law to be adjusted to prevailing economic conditions.

The salary component of the compensation package must be paid currently, while the cost of pension benefit increases, particularly the past service liability portion, can be deceptively spread well out into the future. Thus it is an often used tactic by government officials to trade higher pension benefits for lower salary increases as a way of deferring the economic pain to the budget. This tactic is one of several which created the City's current pension and retiree health care deficits.

This tactic can often back fire, as follows: Once the pension benefits (which are formula driven based on salary) are increased in lieu of salary increase, then there is a "catch up" wage increase and the employee gets a compounding of both increases.

Recommendation #22:

The City should not use extra pension or retiree health benefits to compensate for less than competitive salary structures. If employee turnover rates or hiring difficulties substantiate the allegation of a less than competitive wage packages, the City should adjust the wage package and pay for it currently out of the annual City budget. Do not purposely trade off salary increases for pension improvements, the cost of which is pushed out onto future year's taxpayers.

E. DESIRED PENSION TRUST FUNDED RATIO

The PRC discussed at some length what should be the goal for the funded ratio of the Pension Trust (and for the new Retiree Health trust once created as is recommended above). The issue reduces to one of i) fiscal prudence – i.e. 100% or greater funding, versus ii) pragmatic realities of employer – union negotiations wherein historically when funding approaches 100%, and certainly if it exceeds 100%, there is significant union pressure to increase benefits for the employees.

The PRC did not reach a consensus recommendation on this important issue. However, I believe the City should be well cognizant of this debate and recognize that any "goal" of less than 100% funding, while maybe "helpful" in union negotiations, clearly pushes current year City costs out into future year's City budgets and future years' taxpayers. This, I submit, is highly inappropriate fiscal management.

Recommendation #23:

The City, as plan sponsor, instructs SDCERS to set actuarial funding requirements to achieve a target of 100% funding.

F. DROP

The DROP benefit is a very controversial program. It is often referred to as the "double dip." This is what appears to generate the adverse publicity in that an employee can draw his/her salary **and** a pension payment **simultaneously**.

Union officials put forth an analysis (which they did to the PRC) which shows the DROP program, notwithstanding this "double dip," actually saves the City money. (The best defense is a good offense!) The argument is that since the "DROP'ed" employee is already receiving his/her pension there is no further pension expense computed for this pension (save for the City's extra payment to the employee's DROP account) and thus by keeping this DROP'ed employee on the payroll the City avoids having to pay a full pension expense accrual for a new employee if the DROP'ed employee had truly retired.

The analysis appears mathematically correct but it is totally predicated on the extremely generous early retirement age. Since the employee doesn't have to work until 62 to get a full pension, they can DROP at 55, get their pension immediately and continue to work and earn their salary for another five years.

Change the retirement age to a more appropriate age – i.e. 62, and you eliminate most, if not all of the motivation for this double dip program.

Recommendation #8 calls for DROP to be completely eliminated for all new employees. For existing employees (for whom it would appear DROP can not be eliminated) there is an administrative change that needs be made

Currently SDCERS is choosing to credit DROP accounts with interest at the actuarial assumed earnings assumption of 8%. This is a controversial practice within SDCERS itself. The actuarial earnings assumption is, of necessity, a "long term" investment assumption. DROP money is far more short term in nature. The DROP program itself is up to a maximum of 5 years. Participants have the <u>choice</u> to leave their funds invested after they cease working. For the last few years it has been a "no brainer" to choose to leave your money in SDCERS at an 8% risk free rate of return, "guaranteed" by the City.

When SDCERS' actual earnings fall short of this assured 8% then SDCERS loses money on these DROP accounts. Conversely, when SDCERS makes greater than 8%, it "makes money" on their DROP accounts (although if the investment markets were to routinely pay more than 8% one would assume the retired DROP participants would withdraw their money from the SDCERS "8% bank" and invest elsewhere). Thus SDCERS is stuck with an unbalanced proposition.

> ***<u>Recommendation #24:</u>***
>
> *DROP accounts: CERS should credit short to medium term (max 5 year) money market/short term note rates of interest to the DROP accounts and hedge these DROP funds with 5 year investments such that SDCERS is essentially taking no risk nor seeking any gain in their investment of DROP monies.*
>
> ***<u>Recommendation #25:</u>***
>
> *The administrative rules of DROP should be changed such that upon retirement, a DROP participant must withdraw his/her DROP fund from SDCERS. Such withdrawal can be rolled into an individual IRA, but SDCERS would no longer be involved. There is no reason for SDCERS to be involved in managing this money.*

IX. <u>GOVERNANCE</u>

The City ostensibly has created an independent Board, separate from the City, to administer the pension plan and to manage the assets held in trust.. However the City Charter dictates the composition of the 13 member Board of Trustees, as follows:

- 3 Representatives from City management
- 2 Representatives elected by police and fire members
- 3 Representatives elected by General Members
- 1 Representative elected by retired members
- 4 Independent citizens nominated by the Mayor and appointed by City Council

Thus the question of an "independent" board is raised. Do you have true independence when:

1. The majority of the trustees are direct beneficiaries of the decisions made by the Board?
2. When some trustees are members of senior management of the City, particularly when the City management has purposely advocated under funding of the plan?
3. When some trustees are elected union officials, arguably beholding to their members who voted for them, who are direct beneficiaries of the decisions made by the Board?

This certainly raises a question of appearance if not the reality of a conflict of interest. Some have argued that there is no potential conflict of interest since benefit levels are set by the City and not by SDCERS's Board. While the latter is true, it must be recognized that there are many decisions which the Board makes which do have a direct impact on the value or cost of the benefit to employees, of which the majority of the trustees are direct beneficiaries. The fact that SDCERS acquiesced to the City's demands for under funding as a means to increase pension benefits inherent in Managers Proposals I and II are examples of the appearance if not the reality of conflict.

The Board's complete authority in setting of DROP interest rates, of establishing pricing for Purchase Service Credits, of establishing actuarial assumptions which affect City and employee contribution rates are compelling examples of potential conflicts. The entire issue of the 50-50 cost split between the City and the Employees (discussed above) raises questions of how well the Board administered this.

To cure this appearance if not reality of conflict of interest which could undermine the "independence" the SDCERS Board, the Board should be comprised of all independent and professionally qualified individuals with substantial education and experience in the relevant disciplines in pension management. The Board should be reduced in size from its current unwielding 13 members to seven to facilitate informed discussion and debate on the many issues brought before it.

There should be more disclosure and visibility on the financial condition of SDCERS and more direct accountability of the responsible officers of the System. For example while SDCERS is purportedly an independent agency, at present the Chief Financial Officer of SDCERS is the City Auditor.

Recommendation #26: *(Identical to PRC's Recommendation)*

Change the City Charter (through a vote of the citizens) to have a SDCERS Board comprised of seven members, all to be "independent," with no City employee, no member of City management, no Union leaders or City retirees on the Board. The seven members would each have a college degree or relevant professional certification and 15 years experience in pension administration, pension actuarial practice, accounting or investment management. The positions would be appointed by the Mayor and approved by the City Council for a maximum of two consecutive four year terms. A proposed City Charter amendment was submitted by the PRC to the City prior to the writing of this report in order to meet the time requirement for inclusion in the year's ballot.

Recommendation #27:

Assign the responsibility of Chief Financial Officer of SDCERS to a member of the SDCERS management team. Currently the position is held by a member of the City Manager's management team.

Recommendation #28:

SDCERS, in conjunction with an outside financial audit firm, should develop a process of personal management accountability as to the accuracy of the financial statements, operating information and internal controls of SDCERS consistent with the new Sarbanes Oxley reporting requirements in the private sector.

X. POLICY AND PROCESS CHANGES TO PREVENT REOCCURRENCE OF CURRENT PROBLEMS

A completely independent SDCERS Board is a key step to preclude a reoccurrence of this problem. Being independent of City Management and Union/Employee interest in having higher benefits but deferring the payment of such, an independent Board will force the City to pay its bills when due and thereby preclude the City from committing to benefit improvements it cannot afford.

A. PAST SERVICE ELIGIBILITY FOR NEW PENSION BENEFITS

Benefit improvements have been "retroactive"

The City has over time granted improvements in retiree benefits to its employees. Essentially all of these improvements were "retroactive" for existing employees (i.e. granted for years of employee's service prior to the benefit improvement) as well as prospective, to be earned over the employee's future years' of service. Thus, the day a new benefit is granted not only will future years' expenses be higher but there is also a "past service" liability created which must be paid off over some decided upon number of future years (the "past service liability amortization period").

Very costly to City

This past service liability, by City Charter, is paid 100% by the City and not shared 50-50 with the employee. Thus this "retroactivity" makes the new pension benefit very costly for the City. Worse this past service liability is not paid from the City budget currently. The cost for this pension benefit from employee service going back 20-30 years will be paid out of City budgets over the SDCERS unfunded liability amortization period – currently 18 years out into the future.

A ballooning expense for future years taxpayers

When successive pension improvements with past service applicability are made over the years, this creates a sizeable and growing, ballooning cost being pushed out onto future years' taxpayers. There is a concern that when new benefits are proposed for City Council approval there is not a full awareness of the overall cost of this proposal and how long it will take to "pay off" this new debt – i.e. the past service liability that is created.

Recommendation #29:

Any new pension benefits should ideally be prospective only (i.e. no past service applicability). ***If*** *a new benefit is going to be "retroactive" for current employees (i.e. for past service), then the resulting past service liability must be amortized over a time* *period no greater than 5 years. The PRC proposed a City Charter amendment to effect this.*

B. <u>FULL DISCLOSURE AND DISCUSSION OF PROPOSED NEW BENEFITS</u>

I believe that the Meet and Confer process, with its frequent 11th hour negotiations, does not assure adequate understanding by the City Council of all the fiscal impacts of new proposed benefit improvements. An independent, comprehensive presentation of the long term costs of all proposed benefit improvements must be made to the City Council before it approves such.

<u>Recommendation #30</u>:

*A complete actuarial cost projection for at least a 15 year period is to be prepared for each proposed new benefit improvement. The President of SDCERS is to make a comprehensive explanation of the cost of this new benefit (and any administrative nuances with such) to the City Council to assure a full understanding by the Council of all the ramifications of this new proposal **<u>before</u>** they vote to approve the benefit.*

C. <u>CITY'S LACK OF LONG RANGE FINANCIAL PLANNING</u>

The City apparently does not have a practice of routinely developing long range financial plans. If such a practice had existed, the growing inability to pay for promised retiree benefits would have become quite apparent long ago.

<u>Recommendation #31</u>:

The City should institute a formal long range finance planning process (5-10 years) to assure visibility of long term cost commitments such as post retirement benefits. This recommendation was also made by the Mayor's Blue Ribbon Committee on City Finances back in February 2002.

CITY OF SAN DIEGO
PENSION REFORM COMMITTEE'S
MINORITY REPORT OF MEMBERS
JUDITH ITALIANO AND STANLEY ELMORE

September 21, 2004

This brief report is offered by the undersigned two Committee members as an addendum to the Pension Reform Committee's final report dated September 15, 2004.

Our purpose in issuing this Minority Report is to highlight key differences of opinion between us two and the "majority" view which the final report reflects.

We agree – as we believe was obvious from the first day of the Committee's existence – that **under funding of the pension system** as a means to fund the City's other spending objectives in any given year (without having to raise fees or impose on San Diegans to pay their fair share for services), or as a means to balance the City's budget – is fiscally unsound and should not reoccur.

But **we disagree** that the under funding trap was the product of incompetence. Many experts on which reasonable people relied over the course of several years agreed that the under funding was *prudent* at the time the decisions to under fund were made. No one saw the gathering storm clouds as clearly as they can now be seen in hindsight.

We, as Committee Members, were at times embarrassed by the discourtesy – even disdain – some of our fellow Committee Members demonstrated toward City staff that appeared before the Committee. We were equally ashamed of the disrespect some of our fellow Committee Members displayed when referring to the City's elected officials and their actions regarding Pension issues. This behavior created unnecessary rancor on the Committee and diminished the credibility of those who spoke this way.

We **disagree** with those Committee Members who insisted that an "apples-to-apples" comparison between the City's pension plan and private sector pension plans could or should be fairly made. The more valid comparison – as to benefit levels, performance, and governance – is to other public sector pension plans. But the results of this legitimate comparison were dismissed and the warnings from actuary Rick Roeder about private/public sector comparisons were ignored – in favor of the convictions of certain Committee Members based on their individual, personal experience.

Benefit Levels. To an outside observer, the City's pension benefits may appear "generous." But these benefits are the product of more than two decades of collective bargaining during which improvements in pension benefits were made a priority by Union-represented employees – and concessions in other forms of compensation were made in exchange. The Committee did not attempt to put those improvements in perspective or to evaluate how the City's budget had been balanced in past years by those economic concessions.

And the documentation the Committee did receive showed that the level of pension benefits enjoyed by City of San Diego employees – when compared to other public agency employers in California – falls at the high end of the *middle* of the range.

While the amount of the "pick up" – i.e., that portion of the employee's contribution to the pension system which the City agrees to pay in addition to its own – should and undoubtedly will be under discussion during the next "meet and confer" between the City and its labor unions, the creation of an inferior pension plan for new hires is not a sure-fire fix. The City already has the evidence of that based on the morale and recruitment problems which led to the elimination in 1988 of the former, inferior (and short-lived) "Tier II" pension plan implemented in 1982.

In sum, we **disagree** with the notion that the Committee had sufficient information to purport to guide the City in making changes to its pension benefits – any more than this Committee is qualified to recommend whether the City should make future deals with owners of sports teams, sponsor a super bowl or political convention, or build more libraries or other capital improvements for its residents. The collective bargaining process will ultimately determine those benefits as it has in the past. The Committee spent no more than an hour at the end of a very long meeting without all members present in discussing the reported changes for new hires. Numbers were thrown out and accepted without any foundation or documentation and Council should not go forward with these numbers without the required due diligence. At a minimum, it would seem that an accurate and complete comparison between the benefit compensation package, including pension, offered by the City of San Diego and that offered by other public sector employers is needed. After all, it is these other employers who are the City's real competitors when attracting quality employees in mission-critical areas of the City's operations. *This Committee did not have that information.* Nor did this Committee have the data to determine if the City's DROP program is cost neutral, cost effective, or costly. Only the City is in a position to evaluate the risks posed by its competition and by the difficulties in recruiting and maintaining quality employees, and then to bargain an outcome in light of all relevant factors, including the undisputed high cost of living in San Diego County. All this Committee *can say* is that the City should pay into the pension system the amount needed to fund the benefits it promises and the City's overall budget should be balanced each fiscal year with this obligation in mind.

Performance. We believe that the staff of the Retirement office are highly skilled and have conducted the business of the pension plan and invested the money entrusted to them in an exemplary manner, making CERS one of the best run pension systems in the country. There are many *public* pension plans and *private* ones in far worse shape than the City's.

Governance. * We **disagree** that the governance of the pension system – in place for decades – is broken, and "if it ain't broke, don't fix it." We believe that the call to change the make-up of the Retirement Board is wrong. The facts speak for themselves on this: "public member" trustees on the Retirement Board voted in favor of the City's past under funding proposals just as the "City employee" trustees on the Board did!

And we **disagree** with the unprecedented notion that minimum qualifications – "a college degree and/or relevant professional certifications, 15 years experience in pension administration, pension actuarial practices, investment management, banking, or certified public accounting" – should be required of a Trustee in order to be eligible to serve. *Unprecedented* because we impose no such minimum eligibility requirements and demand no similar educational degrees or experience when other elected or appointed officials seek to serve the public or lead their nation or community – not even when the highest elected office in the nation or state is at stake! Nor do we make a similar demand on candidates who seek election to local office or who seek appointment to Boards or Commissions. And despite the Committee's misplaced insistence on borrowing from the *private* sector when comparisons served their opinions, the Committee ignored the fact that Congress does not impose such requirements on the trustees of ERISA-covered private pension plans.

Again, the make-up of San Diego's pension fund governance – its 13-member Board of Trustees – is nearly identical to every other public pension system in California – with the employer and employees sitting as voting members.

**** On this item four of the nine committee members disagreed with the majority on the changes that were recommended to you.***

Finally, we feel the Committee did not have the time to offer any useful guidance on the issue of health insurance. While the City's practice of paying for this benefit on a "pay-as-you-go" basis is common among employers, it is a matter that needs immediate attention and we feel immediate attention should be paid to meeting with Unions ASAP on developing a plan to change that funding.

We remain concerned that the long-term consequences of the Committee's recommendations that the City issue pension obligation bonds and use its real estate as funding mechanisms have been thoroughly identified. While either or both of these mechanisms *may be appropriate solutions*, we strongly encourage the City to take adequate time to explore the full cost and liability consequences of such actions before succumbing to the political pressure – created at least in part by the Committee's report – to adopt these seductive quick fixes.

By: Judith Italiano
Judith Italiano

By: Stan Elmore /cs
Stanley Elmore

Retirement Calculations
for Job Classifications in MEA's Bargaining Units

Classification	Monthly Salary *	Annual Salary *	Annual Retirement Salary **	Monthly Retirement Salary **
Auto Messenger I	2,387.82	28,653.84	**14,326.92**	**1,193.91**
Account Clerk	2,874.36	34,492.32	**17,246.16**	**1,437.18**
Administrative Aide II	3,890.28	46,683.36	**23,341.68**	**1,945.14**
Librarian II	4,554.30	54,651.60	**27,325.80**	**2,277.15**
Combo Inspector II	4,924.56	59,094.72	**29,547.35**	**2,462.28**
Sr. Power Plant Tech Supervisor	5,490.66	65,887.92	**32,943.96**	**2,745.33**
Supervising Criminalist	7,890.72	94,688.64	**47,344.32**	**3,945.36**

* These figures are based on E step wages from the most current City of San Diego Salary Table

** This formula is based on 20 years of service, using the employees highest one-year, retiring at age 55 with the 2.5 factor

Please note that City employees *DO NOT* participate/contribute to Social Security.