UPDATED

INTERIM REPORT NO. 24

REPORT TO THE PEOPLE OF SAN DIEGO

REGARDING THE SAN DIEGO CITY

EMPLOYEES' RETIREMENT SYSTEM

REPORT OF THE

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I.
INTRODUCTION

The San Diego City Attorney is releasing this updated version of Interim Report 24 on 29 January 2009. The Report is incomplete because the actuary for the City pension plan did not include critical information in the 2007 actuarial report. The City Attorney has repeatedly requested the information left out of the 2007 actuarial report. Amongst the information not provided is the following: (1) present value of future benefit of amount in excess permitted under IRS Code 415; and (2) total deductions. This report is being forwarded to the Securities & Exchange Commission to ensure that the City is complying with its duty of disclosure. It should also be noted that the City Council and Mayor have failed to renew the contract for the City's outside actuary for 8 months.

San Diego taxpayers have a right to know about the financial crisis they face. The liability for future pension benefits at the San Diego City Employees' Retirement System (SDCERS) is nearly $6.5 billion. Several hundred million dollars of the underlying pension benefits were not paid for or earned. This report is written to make certain that San Diegans understand the harsh financial reality they face, with the hope that they will support effective action to reduce their looming debt burden.

The current financial problems at SDCERS began in 1996, when City and pension officials agreed to increase benefits in exchange for decreasing the contributions below the level set by the SDCERS' actuary.

City officials have not only committed taxpayers to pay $6.4 billion for employee pension benefits, they have diverted hundreds of millions of dollars into the pension system that could have been spent on essential services vital to the operation of a city. These mounting contributions, however, have not kept pace with the pension obligations made in the name of taxpayers by City officials.

The City Attorney has repeatedly requested the City Council and Mayor take action to conform the administration of the pension plan to the plan documents. In addition, the case to set aside pension benefits based upon breaches of the state and local liability and conflict of interest laws is before the appellate court.

The specific action requested of the City Council and Mayor by the City Attorney to correct existing violations of law are as follows:

<u>10 VIOLATIONS OF LAW THAT NEED TO BE CORRECTED TO SAVE CITY EMPLOYEES PENSIONS</u>

1. <u>Employees are permitted to receive both their salary and pension benefits for five years after retirement age, even though it is not cost neutral as required by law.</u>[1]
   Solution: Require program to be operated at cost neutrality.

[1] This benefit is known as DROP and under Municipal Code § 24.1401(b): "DROP is intended to be cost neutral." Enforcing the law would save taxpayers between $200-$400 million.

2. Employees were allowed to buy pension years below cost rather than work for pension years. The law requires employees to pay the full cost for pension years they bought.[2]
   Solution: Reduce pension years purchased to actual value.

3. Elected officials are permitted to buy more pension credits than permitted under term limit law.[3]
   Solution: Immediately rescind the pension years bought by elected officials.

4. Employees are allowed to use pension years they bought below cost to satisfy the rule that requires 10 years of work to get a pension.[4]
   Solution: Require employees to work 10 years as mandated by City Charter.

5. Employees can use pension years they purchased to retire at age 55 rather than 62.[5]
   Solution: Require employees to work 20 years in order to retire at age 55 as mandated by City Charter.

6. Employees who act as their union's presidents are able to combine their union salary with their City salary to increase their retirement benefits in violation of the Internal Revenue Code.
   Solution: Pay retirements benefits only based on an employee's City salary.[6]

7. Firefighters are allowed to convert their unused vacation time to pension service credits to increase their pension benefits in violation of the Internal Revenue Code.[7]
   Solution: Use only an employee's actual service time and cost neutral purchased service credits to determine their pension benefits.

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[2] 23 July 1996 City Manager's Retirement Proposal memo: "Employees would pay into the retirement fund an amount, including interest, equivalent to the employee and employer full cost of such service." Cost savings is $146 million savings.

[3] Charter § 12(f): "no person shall serve more than two consecutive four-year terms as a Council member from any particular district."

[4] The City Council's minutes provide the: "action will remove the prohibition and allow the purchase of creditable service to apply towards the ten year vesting requirement."18 November 2002 Minutes San Diego City Council pp 9-10.

[5] Charter § 141 "No employee shall be retired before reaching the age of 62 years and before competing 10 years of service for which payment has been made, except such employees may be given the option to retire at the age of 55 years after 20 years of service for which payment has been made with a proportionally reduced allowance."

[6] 20 December 2007 Internal Revenue Service Voluntary Correction Program Compliance Statement provided that: the terms of the City pension plan that provided special retirement benefits to past and current union presidents of the three of the City's unions "were not permitted by the (Internal Revenue) Code."

[7] 20 December 2007 Internal Revenue Service Voluntary Correction Program Compliance Statement provided that "the ability to convert annual leave accrued after July 1, 2002, to service credit in SDCERS or extend their participation in the System's Deferred Retirement Option Plan (DROP)" was an "impressible cash or deferred arrangement in violation of Code section 401(a)."

8. The City is using a 20-year or longer period to amortize the pension debt.[8]
Solution: Enforce Charter section requiring pension debt be paid off in 15 years.

9. Retirement System is paying benefits above IRS limits.
Solution: Require Vote of the People before paying benefits above IRS limits.

10. Retirement System using outside attorney as General Counsel.
Solution: Elected City Attorney to act as pension attorney as mandated by City Charter.

II.
BACKGROUND

The City of San Diego created a pension system in 1946. The San Diego City Charter established the program and stated, "The Council of the City is hereby authorized and empowered by ordinance to establish a retirement system and to provide for death benefits for compensated public officers and employees…"

The City created the San Diego City Employees' Retirement System to administer the retirement plan per the rules approved and established by the San Diego City Council. The plan is currently structured as a defined benefit plan, which means that employee benefits are calculated based on a formula, using factors such as salary history and duration of employment.

The City and the employee pay into the system. Earnings are collected on those funds before the employee retires. The employee's and the employer's monies over time accrue with the hope that it will be enough to pay the employee's retirement for life.

In order to calculate an individual's pension payment, the system uses a formula in which the employee's number of years worked is multiplied by the employee's one year highest salary. The product of these two is then multiplied using the City's "multiplier," a percentage negotiated by the City and its municipal unions. A visual representation of the formula is:

(Years Worked X High Salary) X Multiplier = Pension Payment

For example, to determine the monthly pension payment for a City employee who worked for 20 years, whose one-year high salary is $100,000, and whose multiplier is 2.5 percent. The calculation appears:

20 years X $100,000 X 2.5 percent = $50,000 per year pension payment.

Using the formula, a City employee who has worked for 20 years with a one-year high salary of $100,000 will earn $50,000 per year in retirement. It is worth noting that the multiplier is different for public safety, general service, and elected officials.

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8 Charter § 143 :"Effective July 1, 2008, the Board shall place the cost associated with net accumulated actuarial losses on no greater than a fifteen year amortization schedule."

The City has created a series of retroactive benefits for City employees:

1. The first of these increases was approved as part of a deal between the San Diego City Council and the board of the San Diego City Employees' Retirement System. The deal, approved in 1996 and commonly referred to as Manager's Proposal I increased the multiplier for City employees; created a plan to allow employees to buy years of service; and implemented the Deferred Retirement Option Plan, which allowed City employees to receive their paychecks and their retirement payments from the retirement system at the same time.

2. The second retroactive increase was approved by the City Council as part of a settlement commonly referred to as the Corbett settlement. By agreeing to the settlement, the City Council and SDCERS substantially increased pension benefits.

3. The third retroactive pension enhancement for employees came as a result of a deal between the City Council and SDCERS called Manager's Proposal II (MPII) in 2002. This deal gave employees another increase in the multiplier.

A retroactive benefit increase means that the benefit increase is made back to the employee's start on the job. This causes an instant debt for a retirement system. This is because the employee makes his weekly contributions to the pension based on his salary, years worked, and multiplier, as discussed above. A retroactive increase in the multiplier, for example, would create a benefit that is not funded, since neither the City nor the employee had been contributing funds for this benefit in the past.

III.
DISCUSSION

A. The Amount of Pension Benefits

The amount to be paid to retirees is staggering when looked at in the context of comparison to the finances of the City. The City of San Diego's retirement system, like all other retirement systems, measures the total amounts due to each City employee and retiree by measuring the "present value of future benefits." This is a term used by actuaries – the financial experts paid to monitor and make financial projections – to detail the fiscal health of pensions. The present value of future benefits represents the total dollar amount in today's dollars of all benefits the pension plan will pay to current retirees through their expected life spans; plus all benefits the plan will have to pay to people who are eligible for retirement benefits but not yet retired. The present value of future benefits at June 30, 2007, is more than $6.8 billion.

A look at the present value of future benefits owed to highly-paid City officials is illustrative of the imbalance of executive level pensions at the City. For instance, the present value of benefits for just one current retiree is $2.3 million. The actual total payout that the City will pay this one individual is much more than $2.3 million over the course of that individual's retirement. It must be emphasized that more than 417 current and retired employees have pension benefits with a present value greater than $1 million. If these 417 individuals received their benefits in a lump sum today, the payout to each of them would exceed $1 million. Table 1 illustrates the size of the present value of benefits for 20 of these 417 retirees:

Table 1 - Examples of Lump Sum Benefits

Retiree No.	PV Benefit Lump Sum
City Retiree 1	$2,354,565
City Retiree 2	$2,150,878
City Retiree 3	$1,982,747
City Retiree 4	$1,922,354
City Retiree 5	$1,907,539
City Retiree 6	$1,900,539
City Retiree 7	$1,894,243
City Retiree 8	$1,892,588
City Retiree 9	$1,842,264
City Retiree 10	$1,821,462
City Retiree 11	$1,821,316
City Retiree 12	$1,815,019
City Retiree 13	$1,813,178
City Retiree 14	$1,811,114
City Retiree 15	$1,792,430
City Retiree 16	$1,785,099
City Retiree 17	$1,766,511
City Retiree 18	$1,754,014
City Retiree 19	$1,750,614
City Retiree 20	$1,748,823

To put Table 1 in perspective, Table 2, below, details the annual amounts the City and SDCERS will pay 20 current retirees annually for the remainder of their lives.

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Table 2 - Examples of Annual Pension Benefits

Retiree No.	Total Annual Benefit
City Retiree 1	$ 148,335
City Retiree 2	$ 147,942
City Retiree 3	$ 147,749
City Retiree 4	$ 141,282
City Retiree 5	$ 134,637
City Retiree 6	$ 134,421
City Retiree 7	$ 133,833
City Retiree 8	$ 133,460
City Retiree 9	$ 129,918
City Retiree 10	$ 126,190
City Retiree 11	$ 125,942
City Retiree 12	$ 124,866
City Retiree 13	$ 124,205
City Retiree 14	$ 123,323
City Retiree 15	$ 121,281
City Retiree 16	$ 118,064
City Retiree 17	$ 117,575
City Retiree 18	$ 114,969
City Retiree 19	$ 114,114
City Retiree 20	$ 113,736

Standing behind the 417 retirees holding benefits with present values above $1 million, are 11,246 current and former employees who will get pensions when they retire over the next several years. Taxpayers are facing a $1.183 billion debt for past unpaid pension bills and $1.019 billion of future unpaid benefits. Table 3 lists the different categories of those who have retired and are receiving benefits and those who will be retiring and receiving benefits.

Table 3 - Breakdown of Plan Participants

City Employee Status	Number	Present Value of Future Benefits by Category
Current Employees *	8,494	$3,503,065,097
Terminated Vested Employees *	2,606	$239,571,040
Disabled **	1,245	$383,228,325
Retirees **	4,354***	$2,589,431,710
Beneficiaries **	1,080	$128,934,025
Total	**17,779**	**$6,844,230,197**

* Not yet receiving benefits. ** Receive benefits *** 1,045 in DROP

Last year, the number of employees that entered retirement grew by 236, an increase from 4,118 retirees in 2006 to 4,354 retirees in 2007. This growing stock of new retirees is causing rapid growth in pension liabilities to SDCERS and the City. Specifically, pension liabilities increased from $$6,474,469,077 in 2006 to $6,844,230,197 in 2007 – an increase of more than $369 million.

Unless certain benefits that were improperly given in the name of San Diego taxpayers are rescinded, the people of San Diego will be burdened with billions of dollars of debt that will hinder the City's ability to provide the basic safety and services needed to keep it in sound condition.

B. Present Value of Future Benefits

The "present value of future benefits" (PVFB) has increased by $900 million in the last two years. The PVFB measures the total amount of money owed to all active employees and retirees who have worked long enough to receive a pension. Since 2000 the PVFB has increased by more than 85 percent since, from $3.6 billion in 2000 to $6.8 billion in 2007.

Five specific benefits given to employees without funding have driven PVFB growth. The five unpaid-for benefits are (1) retroactive benefits, (2) purchased service years, (3) the DROP benefit, (4) the supplemental benefit (13th check) and (5) the supplemental cost of living benefit. The Mayor and City Council's current plan is to transfer the burden of paying these benefits to the next generation.

Table 4 and Charts 1 and 2, below, document the rapid growth in the PVFB. They also show that while payroll went up 14 percent and active and retired employees increased by 4 percent between 2000 and 2007, pension benefits increased by more than 85 percent.

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Table 4 - Growth in Present Value of Future Benefits 2000-2007

Year	SDCERS Active, Retired, Participants	Present Value of Future Benefits*	City Payroll	% Increase In Present Value of Future Benefit	% Increase In Payroll
2000	15,718	$3,681,800,000	$448,501,827		
2001	16,342	$3,890,000,000	$481,863,318	6%	7%
2002	17,051	$4,382,900,000	$535,156,545	13%	11%
2003	17,290	$4,941,000,000	$533,595,405	13%	0
2004	17,356	$5,467,447,943	$540,180,941	11%	1%
2005	17,429	$5,957,900,719	$557,630,735	9%	3%
2006	17,647	$6,475,469,077	$534,102,801	9%	-4%
2007	17,779	$6,844,230,197	$512,440,197	5.69%	-4.06%

*2000-2004 do not include the present value of Corbett, the 13th check, DROP, Supplemental COLA or adjustment for benefit in excess of Internal Revenue Code 415 limits.

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Chart 1 - Increase in Present Value of Future Benefits 2000-2007

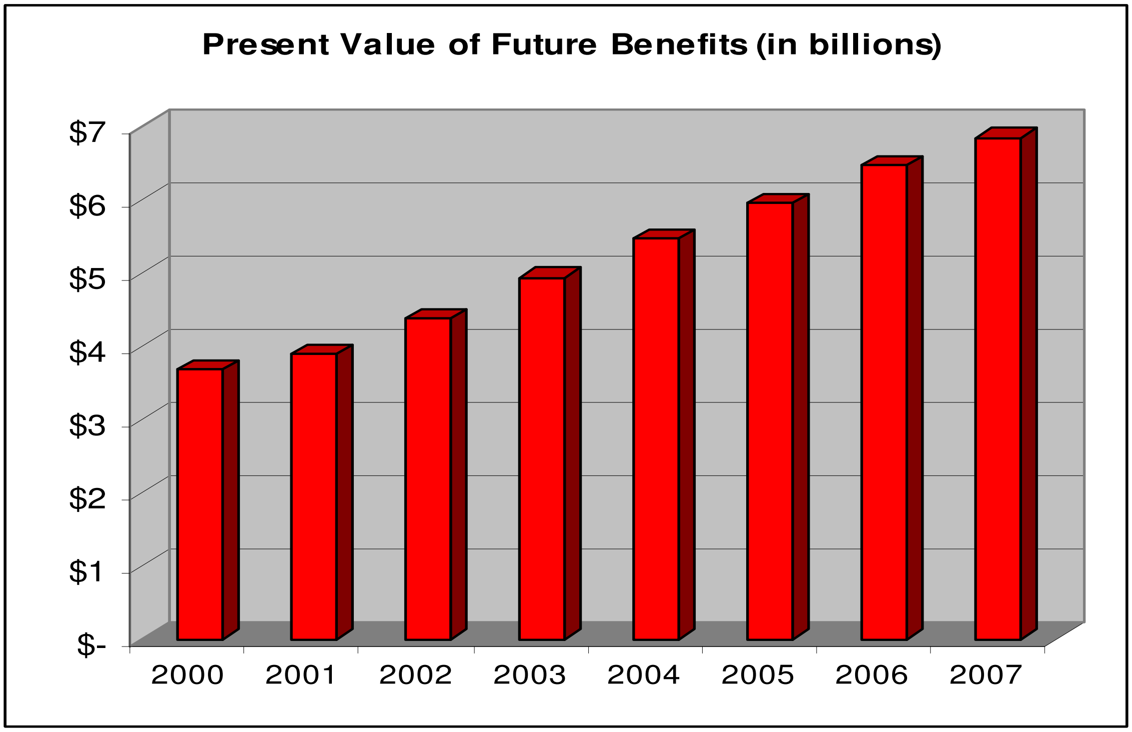
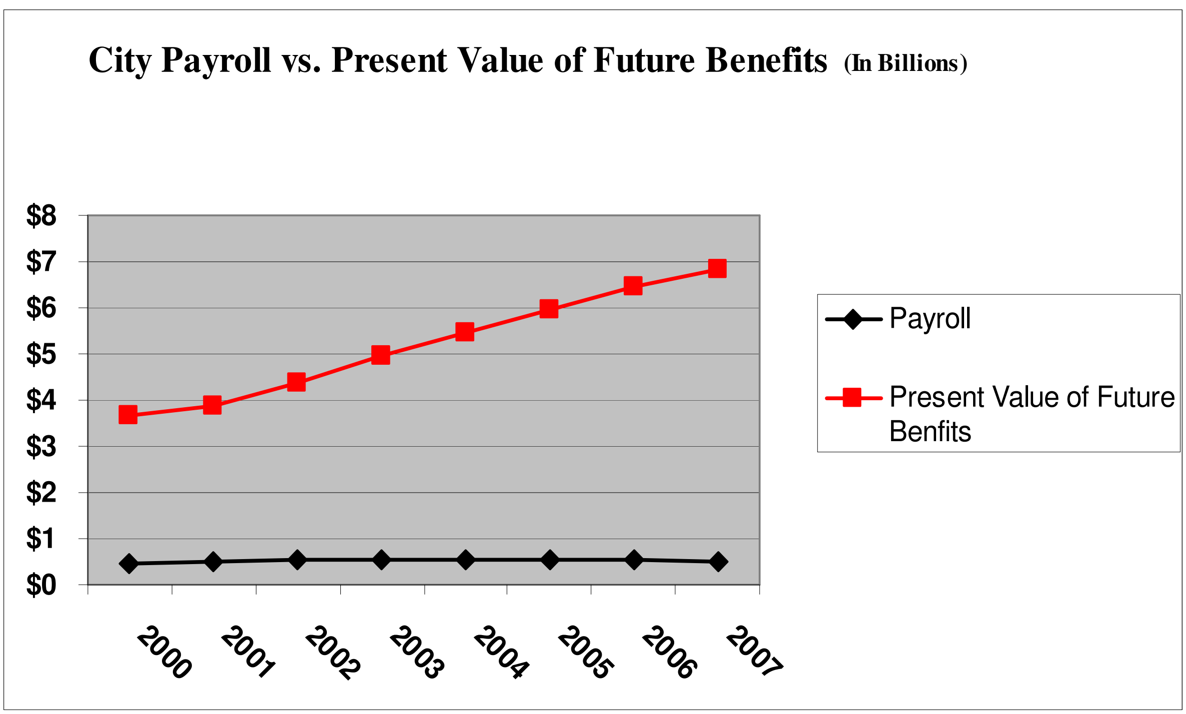


Chart 2 - Comparison of Payroll to Present Value of Future Benefits 2000-2007



As a result of the increase in the future value of benefits, the City will be faced with increasing annual payments to the pension system from its General Fund. This will result in less money available for City services.

C. Unpaid Service Years

Over $146 million of the pension deficit is for unpaid and unearned service years sold to City employees below actual cost.

As part of Manager's Proposal I in 1996, City employees were given the opportunity to buy service years to boost their retirement calculation. As an example, an employee who works for the City for 20 years was permitted to increase his or her years worked by buying five years of service. The pension would then be based upon 25 years. The service years were not priced at actual cost, as was required under the law. Employees were supposed to pay full costs. SDCERS officials knowingly priced the service years below actual cost and the current board has refused to charge the actual price required.

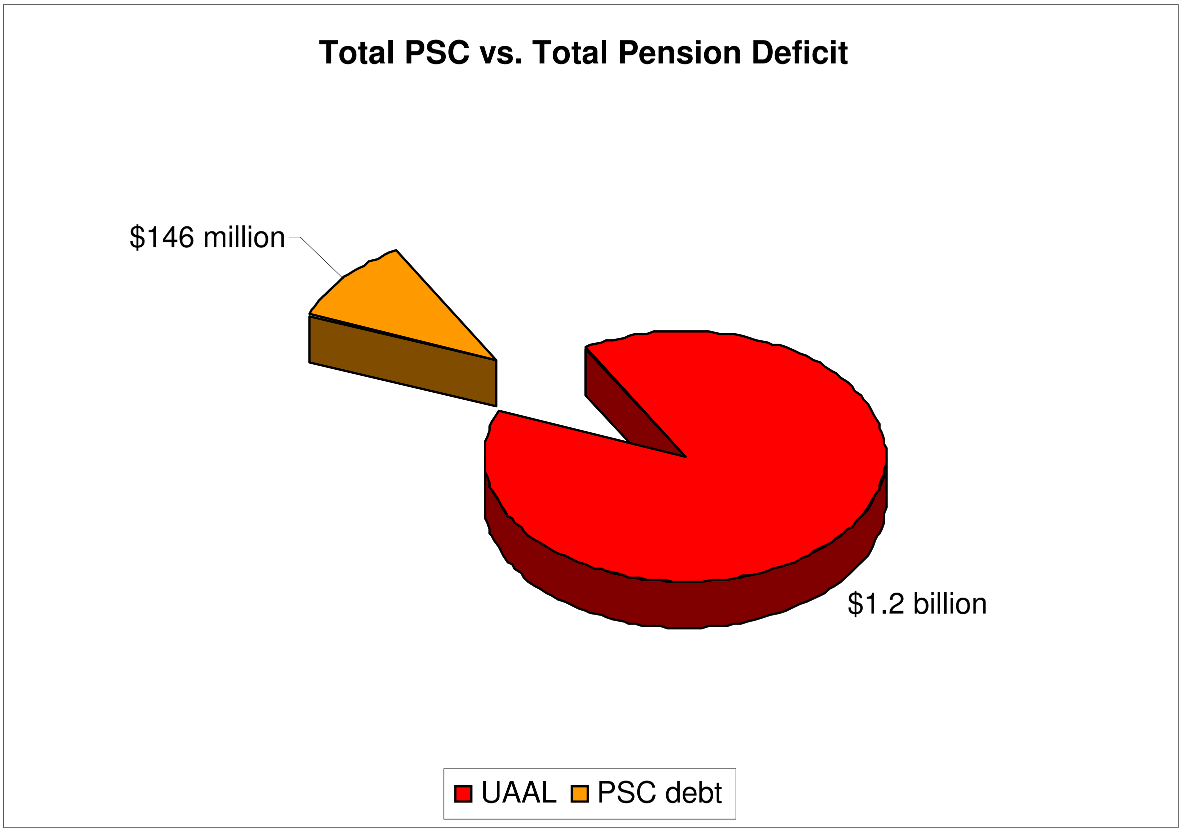
Unless a way is found to enforce the law requiring actual cost pricing, taxpayers will now have to pay at least $146 million for the 8,268 service years given away. Table 5 and Chart 3 show when the 8,268 unpaid years were given away. Table 5 shows the average unpaid service credit benefit received by those who did not earn or pay for the 8,268 service credits:

Table 5 - Itemization of Unpaid Service Years

Date Range	Total Service Credits Sold	Service Credits Not Paid For	Years Not Paid For	Number of Contracts	Unpaid Per Year Average
Pre-2000	$32,817,001	$20,000,000	1,031	447	$19,399
7/1/2000 through 6/30/2002	$120,254,728	$63,000,000	3,157	1578	$19,956
7/1/2002 through 8/15/2003	$72,091,615	$29,000,000	1,674	1186	$17,324
8/16/2003 through 10/31/2003	$112,129,360	$34,000,000	2,374	2392	$14,322
11/1/2003 through 6/30/2006	$12,524,368	$425,000	32	372	$13,281
TOTAL	$340,817,073	$146,000,000	8,268	5975	$17,658

In order to understand the magnitude of how much money has been given away at the expense of taxpayers, the chart below illustrates the debt caused by the under-pricing of the purchase service credits as a portion of the total unfunded actuarially accrued liability ("UAAL") of the pension system, currently $1.2 billion.

Chart 3 - Unpaid Service Credits compared to Unfunded Liability



As Chart 3 makes clear the size of the pension debt could be materially reduced if the City were to require that the years of service be re-calculated using the true cost of the service years purchased.

On 16 November 2007 the SDCERS declined to charge the correct amount for the services years given away. Instead, the SDCERS board voted to transfer the $146 million cost to San Diego City taxpayers and the Mayor and City Council have acquiesced despite repeated demands for corrective action from the City Attorney.

Finally, purchased service credits are also being used to satisfy the requirement that employees must work 10 years to vest in the City pension. Purchased service credits are also being used to satisfy the condition that employees can retire early at 55 years of age if they worked 20 years for the City. The Charter does not permit purchased service credits to be used as a substitute for actually working the prescribed periods. The City Attorney's office has advised SDCERS that employees may not satisfy the 10 year vesting rule or the 20 year early retirement by purchasing service years.

Furthermore, SDCERS failed to revise the Rates of Retirement assumption when the Purchase of Service Credit Program was adopted. The 30 June 2007 Actuarial Valuation used an assumption that 20 percent of general members will retire at age 55. The Distribution of

Active Members reveals that 47 percent of general members reaching age 55 actually retired. In other words, the assumption tables underestimate retirees and therefore underestimate the total liability impact on the system.

Several key pension and city executives have retired with pensions based upon purchased service credits. These include the following set forth in Table 6.

Table 6 - Partial List of Pension and City Executives Purchasing Service Credits

Position	Member Name	Member Status	Effective Date	Years Purchased	Estimated Under Payment	% of Unpaid Benefit
City Auditor	RYAN, ED	Retired DROP	12/27/1997	5.00000	$61,439	
Pension Administrator	GRISSOM, LAWRENCE	Retired	12/8/1999	1.00000	$12,288	
Former Pension Board member	WILKINSON, SHARON	Active DROP	12/13/1999	5.00000	$61,439	
Deputy City Manager	LOVELAND, GEORGE	Retired	2/2/2000	5.00000	$61,439	62.16%
City Council member	MC CARTY, JUDY	Retired DROP	2/16/2000	5.00000	$61,439	
City Attorney	GWINN, CASEY	Retired	3/15/2000	5.00000	$61,439	
Pension Lawyer	CHAPIN, LORAINE	Deferred Vested	4/27/2000	5.00000	$61,439	
Deputy City Attorney	CHAPIN, JAMES	Retired	4/28/2000	5.00000	$61,439	
Mayor	GOLDING, SUSAN	Retired	11/17/2000	5.00000	$51,592	
City Council member	VARGAS, JUAN	Retired	11/28/2000	5.00000	$51,592	
City Council member	KEHOE, CHRISTINE	Retired	11/29/2000	5.00000	$51,592	
Pension Administrator	GRISSOM, LAWRENCE	Retired	3/18/2001	0.23000	$2,373	
City Auditor	WEBSTER, TERESA	Deferred Vested	4/23/2001	5.00000	$51,592	
Pension Administrator	GRISSOM, LAWRENCE	Retired	6/20/2001	0.44000	$4,540	
Pension Administrator	GRISSOM, LAWRENCE	Retired	6/20/2001	0.15000	$1,548	
Pension Administrator	GRISSOM, LAWRENCE	Retired	6/20/2001	0.18000	$1,857	
Deputy City Attorney	DEVANEY, FRANCIS	Deferred Vested	11/6/2001	2.00000	$20,637	
City Council member	MADAFFER, JAMES	Active	12/6/2001	5.00000	$51,592	
Mayor Staff	KERN, JOHN	Retired DROP	1/16/2002	0.64307	$6,635	
Mayor Staff	KERN, JOHN	Retired DROP	1/16/2002	0.12571	$1,297	
Pension Administrator	GRISSOM, LAWRENCE	Retired	2/24/2002	0.33300	$3,436	
Pension Administrator	GRISSOM, LAWRENCE	Retired	2/24/2002	0.66700	$6,882	
Deputy City Attorney	CASTLEMAN, PENNY	Retired	4/19/2002	5.00000	$51,592	52.05%
Mayor Staff	KERN, JOHN	Retired DROP	5/17/2002	0.62810	$6,481	
Mayor Staff	KERN, JOHN	Retired DROP	5/17/2002	0.54251	$5,598	
City Council member	INZUNZA, RALPH	Retired	5/24/2002	1.49334	$15,409	
City Council member	INZUNZA, RALPH	Retired	5/30/2002	3.50666	$36,183	
Former Pension Board member	TORRES, JOHN	Active DROP	6/10/2002	5.00000	$51,592	
Mayor	MURPHY, RICHARD	Retired	6/12/2002	1.87090	$19,305	
Mayor	MURPHY, RICHARD	Retired	6/12/2002	0.38685	$3,992	
Mayor	MURPHY, RICHARD	Retired	6/12/2002	0.38685	$3,992	
Mayor	MURPHY, RICHARD	Retired	6/12/2002	1.28976	$13,308	
Mayor	MURPHY, RICHARD	Retired	6/12/2002	0.38685	$3,992	
Mayor	MURPHY, RICHARD	Retired	6/12/2002	0.67879	$7,004	
City Council member	MAIENSCHEIN, BRIAN	Active	6/20/2002	0.91768	$9,469	
City Council member	MAIENSCHEIN, BRIAN	Active	6/20/2002	4.08232	$42,123	
Former Pension Board member	SAATHOFF, RONALD	Active DROP	7/26/2002	3.57902	$25,339	40.55%
Deputy City Attorney	HOLLINGSWORTH, DEBORAH	Retired	8/1/2002	5.00000	$35,400	

Mayor	MURPHY, RICHARD	Retired	9/6/2002	5.00000	$35,400	
Pension Administrator	GRISSOM, LAWRENCE	Retired	1/6/2003	0.33300	$2,358	
Pension Administrator	GRISSOM, LAWRENCE	Retired	1/6/2003	0.66700	$4,722	
Ethics Commission	FULHORST, STACEY	Active	2/3/2003	5.00000	$35,400	
Labor Relations Head	LEXIN, CATHY	Deferred Vested	2/18/2003	5.00000	$35,400	
Deputy City Attorney	DUVERNAY, RICHARD	Deferred Vested	2/27/2003	5.00000	$35,400	
City Council member	ZUCCHET, MICHAEL	Retired	4/23/2003	2.12395	$15,037	
City Council member	ZUCCHET, MICHAEL	Retired	9/16/2003	0.81238	$3,518	
City Council member	ATKINS, TONI	Active	9/23/2003	5.00000	$21,653	30.28%
City Council member	ZUCCHET, MICHAEL	Retired	10/14/2003	2.06367	$8,937	

D. Drop Not Cost Neutral as Required

The use of purchased service credits to retire early at age 55 conflicts with the use of DROP to retire later. Employees can add purchased service credits to those they received for years actually worked to meet the 20 year requirement that allows for retirement at age 55. Thus, purchased service credits can help employees retire early. Under DROP employees can enter a program that gives them their retirement benefit and their salary for 5 years.

Under the Deferred Retirement Option Program ("DROP") employees accumulate an adjusted retirement allowance in sum greater than their normal retirement for up to 5 years. In other words, the DROP participants get their City salary while their retirement allowance is credited to a separate account. This allows employees to receive a lump sum payment at retirement and their annuity payments after retirement.

While purchased service credits were pushed as a way to allow City employees to retire early, DROP was advocated as a means to keep to keep employees at the City past their retirement age for up to five additional years. DROP was supposed to be cost neutral but several actuarial reports have found it operates at a significant cost to taxpayers by as much as $400 million.

Moreover, as the SDCERS solvency test in the 2007 actuarial report shows, only 41% of pension liabilities for active members are covered by SDCERS reported assets. When an employee enters DROP they are given credit for 100% of their retirement, when in fact only 41% is covered by existing assets. The DROP participant is credited with 8% on 100% of their retirement allotment, again even though SDCERS has only 41% of needed assets on hand. Taxpayers are saddled with having to pay for the past due bill but also to pay 8% on 100% of the DROP participants allotment which further adds to the pension deficit.

SDCERS maintains a DROP reserve account to pay for the retirement benefits of DROP members. The amount in this DROP reserve has increased 491 percent and the average amount attributable to each participant has increased 155 percent since 2000. There are currently 1,575 participants in DROP, 995 active service employees and 580 retirees. The total DROP liability is $282,259,890. There are also 8,500-plus active employees still eligible to participate in DROP. The cost of DROP will continue to rise.

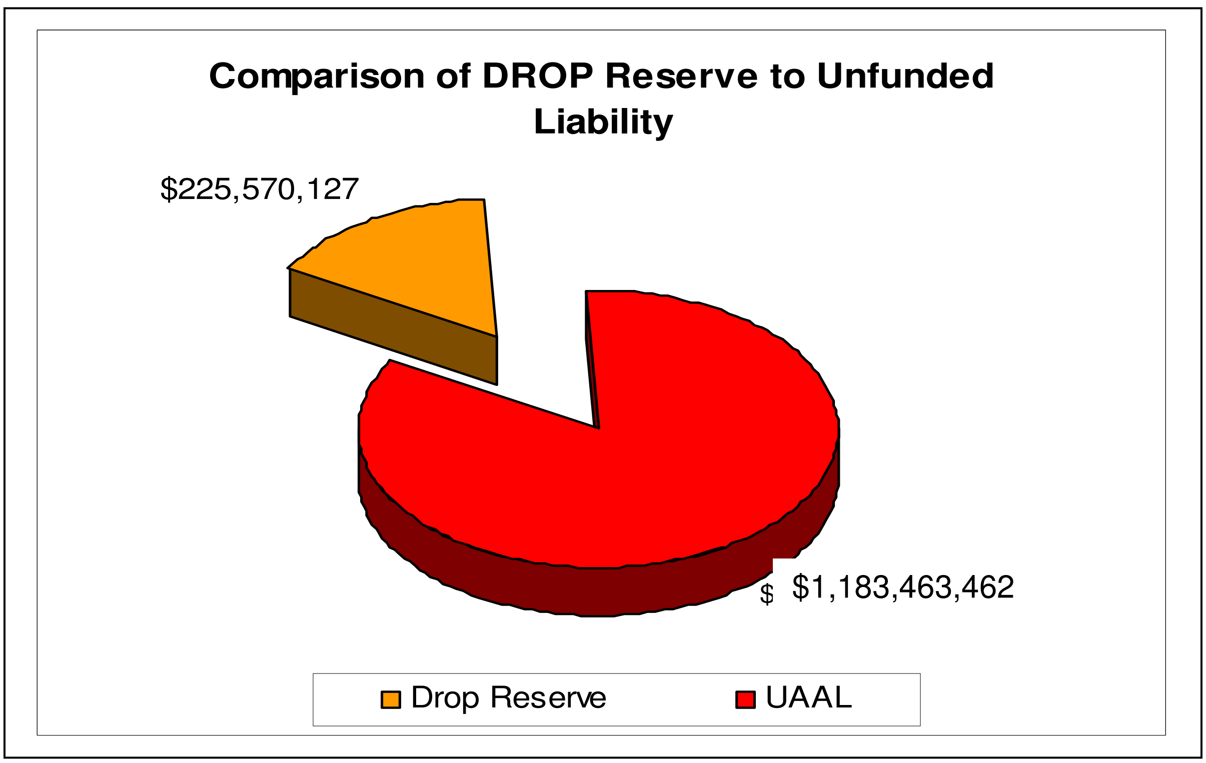
Table 7 and Chart 4 show the growth in the funds transferred to the DROP reserve account, which is used to pay the DROP benefit.

Table 7 - Growth in DROP Reserve Account

Year	DROP Reserve Account	DROP Participants	Average Per DROP Participant
2000	$38,154,055	414	$92,160
2001	$66,304,643	547	$121,215
2002	$97,293,204	522	$186,385
2003	$136,435,116	732	$186,387
2004	$184,487,525	781	$220,152
2005	$225,223,783	838	$268,763
2006	$225,570,127	959	$235,214
2007	$228,000,000 est.	1,045	$218,182

The following table illustrates the growth of the reserve for DROP participants. Despite clear evidence suggesting DROP has not been administered as a cost-neutral benefit the City has so far taken no corrective action.

Chart 4 - Growth in DROP Reserve



It is easy to see the substantial growth in the amount of money that must be set aside each year for DROP. On top of the basic DROP payments to its participants, the City is also responsible for paying into each DROP account 8 percent interest, compounded quarterly. Thus, during their participation in DROP, each DROP member receives:

1. normal salary;
2. a monthly retirement benefit with a guaranteed 8 percent interest compounded quarterly;
3. a 3.025 percent matching City contribution; and
4. The 13th check.

DROP accounts for over $200 million of the pension's $1.2 billion deficit. DROP employees are estimated to be up to $200 million more expensive than replacement employees, according to the City's actuary. Thus, DROP is estimated to cost City taxpayers up to $400 million (a $200 million increase in the pension deficit and $200 million in higher payroll costs).

E. Retroactive Benefits

City officials awarded employees retroactive pension benefit increases in 1996, 2000 and 2002. These new benefits increased the pension multiplier, the yearly percentage used to determine pension benefits, from less than 2 percent to 2.5 percent for general employees and to 3 percent for public safety employees. For example, for every year of service a safety employee works or purchases, he or she will receive a pension benefit equal to 3 percent of his or her highest one-year salary times the total number of years of service.

The pension increases granted in 1996, 2000 and 2002 were made retroactive to each employee's start date. In other words, as the pension multiplier was increased from 1996 to 2002, each employee's total pension benefit was increased using the higher multiplier for all years worked. This occurred even though these employees had already been paid for the work performed and had only contributed to the pension based on a lower pension multiplier. So, even though prior to 1996, employees contributed to the pension fund based on the assumption that their pension multiplier was less than 2 percent, by 2002, their multiplier was 2.5%, thus creating an instantaneous windfall for the employee and a shortfall for the pension system.

The employees were not made to contribute any additional funds to pay for this increased benefit. Nor has the City provided funding to pay for these substantial increases in pension benefits, other than increasing its annual amortization contribution. <u>Therefore, current and future taxpayers are now liable for these costs</u>. Table 8 and Chart 5 show the amount of the current under-funding attributable to the granting of these retroactive benefit increases.

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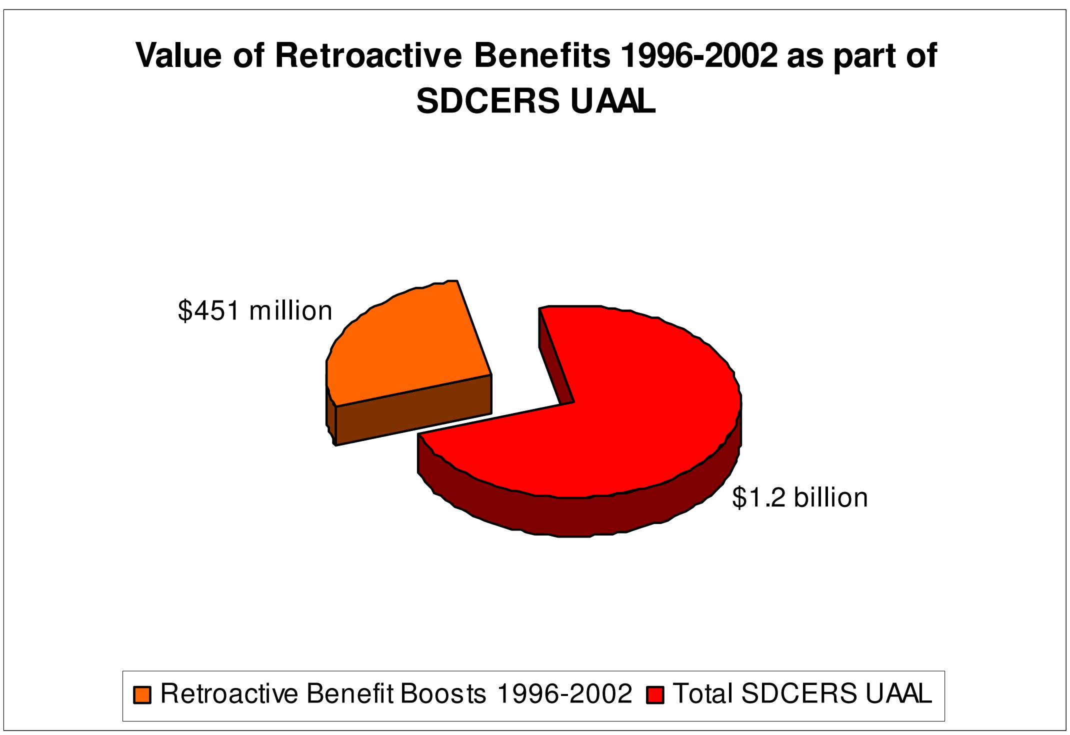
Table 8 - Retroactive Benefits

Year – Benefit Increase Source	Retroactive Benefits
1996 - MP-1	$159,000,000
2000 - Corbett	$115,000,000
2002 - MP-2	$177,000,000
Total	$451,000,000

The retroactive benefit enhancements approved and granted by the Mayor and City Councils between 1996 and 2002 have resulted in a $451 million debt to the City and its taxpayers. This amount represents nearly 40 percent of the current pension deficit. These benefits were not funded when these benefit increases were granted and no future funding source has ever been identified to pay these benefits.

Chart 5 - Retroactive Benefit Debt as part of Pension Deficit



F. Excess Benefits

Since 2000 SDCERS officials have made $2.8 million in payments above the limits of Internal Revenue Code ("IRC") Section 415. This code section is enforced by the Internal Revenue Service ("IRS"). IRC Section 415 places an upper limit on the amount a retiree may receive annually. This rule is prevents preferential tax benefits for monies received in retirement. The number of retirees to whom excess payments were made has increased from 12 in 2000 to 58 in 2007. Table 9 and Chart 6 provide details about these excessive payments. [9]

Table 9 - Excess Benefit Payments

415 Limit Year	Persons in Year	415 Testing Benefit	Adjusted 415 Limit	Amount Overpaid	Overpayments Rolled Forward to 6/30/07
2000	12	$ 1,020,156	$ 1,043,222	$ 84,853	$ 145,424
2001	15	$ 1,316,911	$ 1,233,572	$ 150,301	$ 238,510
2002	18	$ 1,544,697	$ 1,617,640	$ 168,962	$ 248,261
2003	23	$ 2,068,641	$ 2,173,698	$ 223,764	$ 304,431
2004	29	$ 2,485,186	$ 2,761,943	$ 252,334	$ 316,626
2005	40	$ 3,378,272	$ 3,617,051	$ 397,661	$ 463,399
2006	56	$ 4,752,430	$ 4,962,075	$ 665,880	$ 719,126
2007	58	$ 5,856,269	$ 5,401,703	$ 862,581	$ 862,583
Total		**$ 22,422,562**	**$ 22,810,904**	**$ 2,806,336**	**$ 3,298,360**

The alarming trend in Table 8 is the increase of new retirees receiving benefits in excess of IRC 415 limits. Twelve retirees received excess benefits in 2000. This number grew to 58 in 2007. The corresponding cost climbed dramatically from $84,853 in 2000 to $862,581 in 2007. Chart 6 shows the increase.

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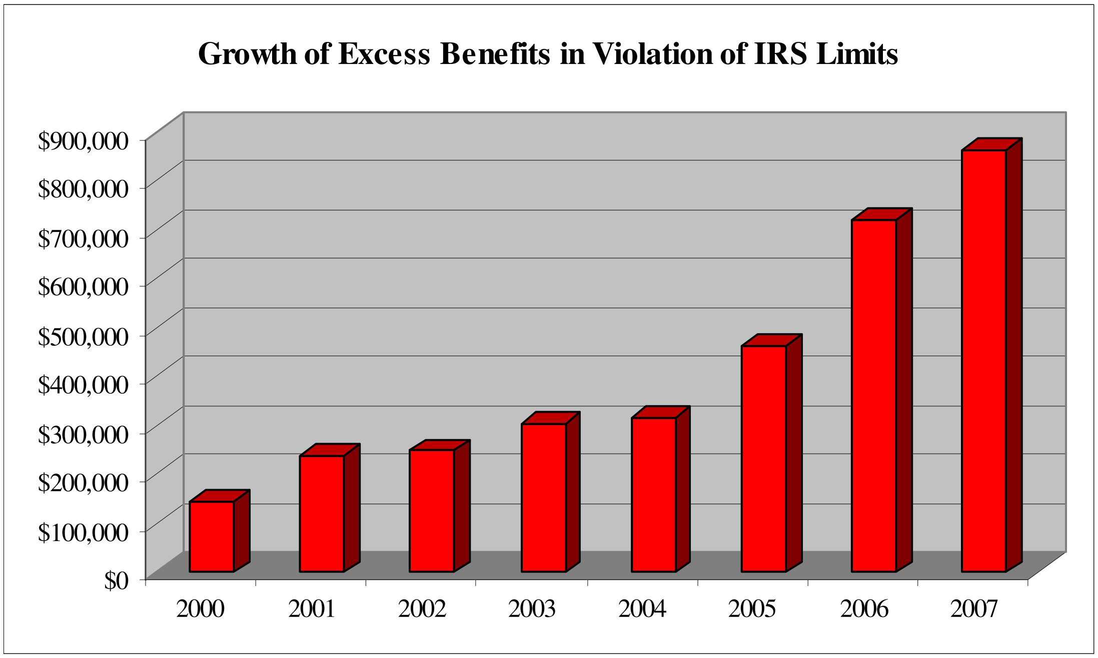
9 On 13 December 2007 SDCERS submitted this Excess Benefit IRC 415 Report to the Internal Revenue Service, reducing the number of excess benefit recipients from 102 to 58 and reducing the total amount of excess from over $8 million in payments to $3,779, 221.

Chart 6 - Growth in Excessive Benefits



SDCERS has not disclosed the potential City liability for future excess benefits.

G. Unfunded Liability

The 8,268 years of unpaid service credits, the deficit at which DROP operates, certain retroactive benefits given without funding, actuarial mistakes, and intentional under-funding have led to a 1,600 percent increase in the deficit between pension assets and pension liabilities in just seven short years.

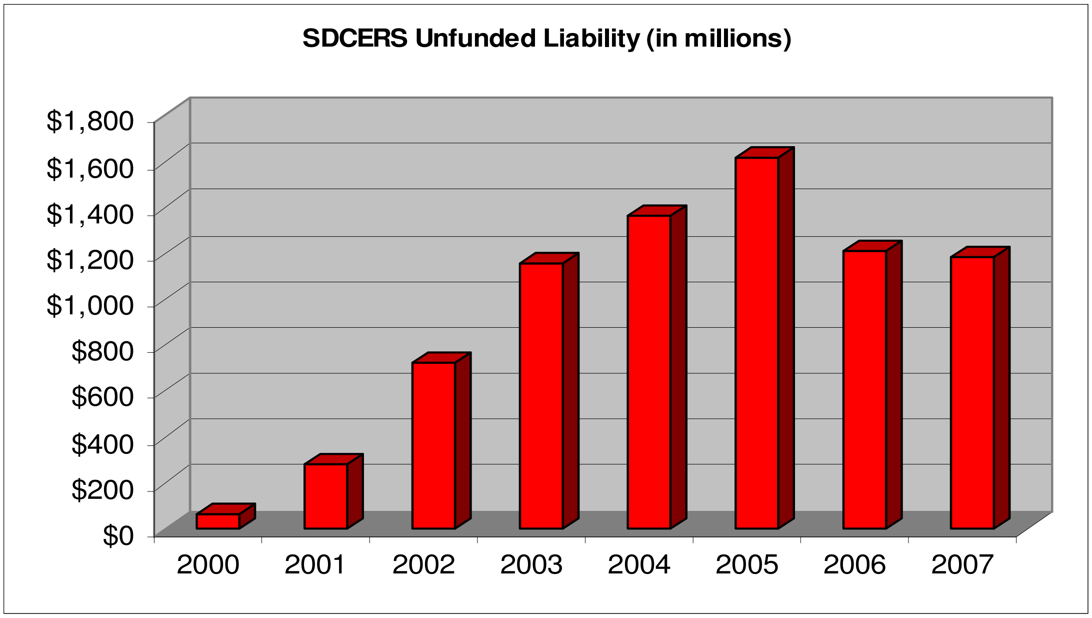
The total unfunded actuarially accrued liability in 2000 was $68.9 million and it has grown to $1.2 billion in 2007. Table 10 and Chart 7 show the dramatic growth in the unfunded liability:

Table 10 - Growth in Unfunded Liability

YEAR	Unfunded Liability *
2000	$68,959,000
2001	$283,893,000
2002	$720,713,000
2003	$1,157,194,000
2004	$1,368,648,000
2005	$1,618,961,916
2006	$1,210,029,642
2007	$1,183,463,462

*** 2000-2004 based on PUC funding, 2005-2007 based on EAN funding**

Chart 7 - Growth in Unfunded Liability



The unfunded liability decreased $27 million from $1.210 billion to $1.183 billion between 2006 and 2007, based on EAN funding. In his 2006 valuation, the SDCERS actuary has conceded that the unfunded liability is likely to go up in the near term: "it is anticipated that the UAL will increase in the early years then decrease in the later years." The dip in unfunded liability between 2005 and 2006 is primarily attributable to a one time infusion of $108 million by the City and a change in the method used by SDCERS to measure its investment returns. The unfunded liability is unlikely to go down unless the City continues to significantly increase its yearly contributions.

H. "Contingent" Benefits: The 13th Check and Supplemental COLA

With a $1.2 billion deficit, the SDCERS board had to decide what bills to pay and what bills not to pay. SDCERS has used creative accounting practices to solve its problem. At the heart of those creative accounting practices are the "waterfall" and "surplus undistributed earnings."

SDCERS used fictional surplus earnings to create a fictional "waterfall" of funds. The waterfall was used to pay a 13th check benefit and a supplemental cost of living benefit (supplemental COLA). In doing so, SDCERS increased its deficit by the amount paid for these two contingent benefits. Surplus earnings were also used to pay other SDCERS bills. The use of surplus earnings are meant to offset SDCERS' funding deficit.

SDCERS and City officials have found surplus earnings in all but one year since 2000. During this same period, SDCERS' funding deficit increased 1,600 percent, from $68.9 million to $1.2 billion. Any cash returned on investments was needed to reduce the SDCERS' deficit.

The City retained outside investigation counsel, Vinson & Elkins, to review the City's disclosure practices. The firm determined that the use of surplus earnings was fundamentally flawed:

The surplus earnings concept ignores this long-term dynamic of actuarial projections. It evaluates returns on a year-by-year basis and treats all cash generated by system assets (beyond assumed rates of return) as free money. This, of course, flies in the face of the basic premise of actuarially assumed returns: they are rarely met for any individual year, but are expected to average out over time to approximate the projections. Therefore, the concept of "surplus earnings" is a misnomer. Unless and until it can be demonstrated that the actuary's projections are unrealistically conservative, *all* earnings are necessary to support the long-term viability of the system – none are truly "surplus" or "excess."

Table 11, Table 12 and Chart 8 show amounts expended for the 13th check and supplemental COLA. They also show earnings declared to be surplus, while the pension deficit grew. Taxpayers under the existing terms of the pension plan are required to pay the deficit shortfall caused by improper surplus funding practices.

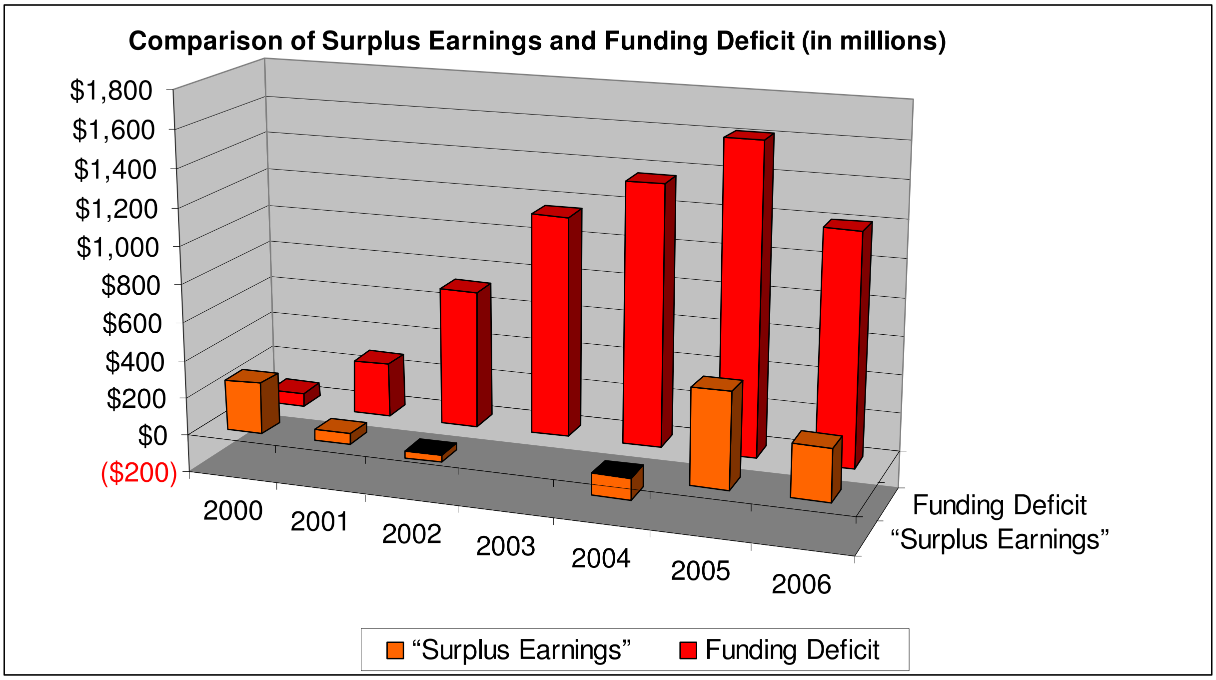
Table 11 - 13th Check and Supplemental Cola

Year	13th Check	Supp. COLA
2000	$3,427,519	$3,678,210
2001	$3,540,643	$4,161,525
2002	$3,627,495	$4,434,946
2003	Not Available	Not Available
2004	$14,374	$3,986,604
2005	$4,139,464	$3,899,449
2006	$4,206,260	$3,685,076
2007	Not Available	Not Available

Table 12 - Comparison of Surplus Earnings to Funding Deficit

Year	"Surplus Earnings"	Funding Deficit
2000	$270,930,906	$68,959,000
2001	$58,565,610	$283,893,000
2002	($38,305,977)	$720,713,000
2003	Not Available	$1,157,194,000
2004	($113,021,789)	$1,368,648,000
2005	$495,592,461	$1,618,961,000
2006	$270,819,587	$1,210,029,642
2007		$1,183,463,462

Chart 8 - Comparison of Surplus Earnings to Funding Deficit



I. Contributions

The pension system is funded by contributions from both the employee and the City. Between 2000 and 2006 the City increased its pension contributions to the pension plan by 807 percent. In 2007 the City lowered its contribution from $271 million to $165 million. The increase in the City's contribution in 2006 was a one-time event connected to the settlement of litigation. The City's contribution increased from $29 million in 2000 to $271 million in 2006. However, the City also paid a part of the employee's contributions between 2000 and 2007.

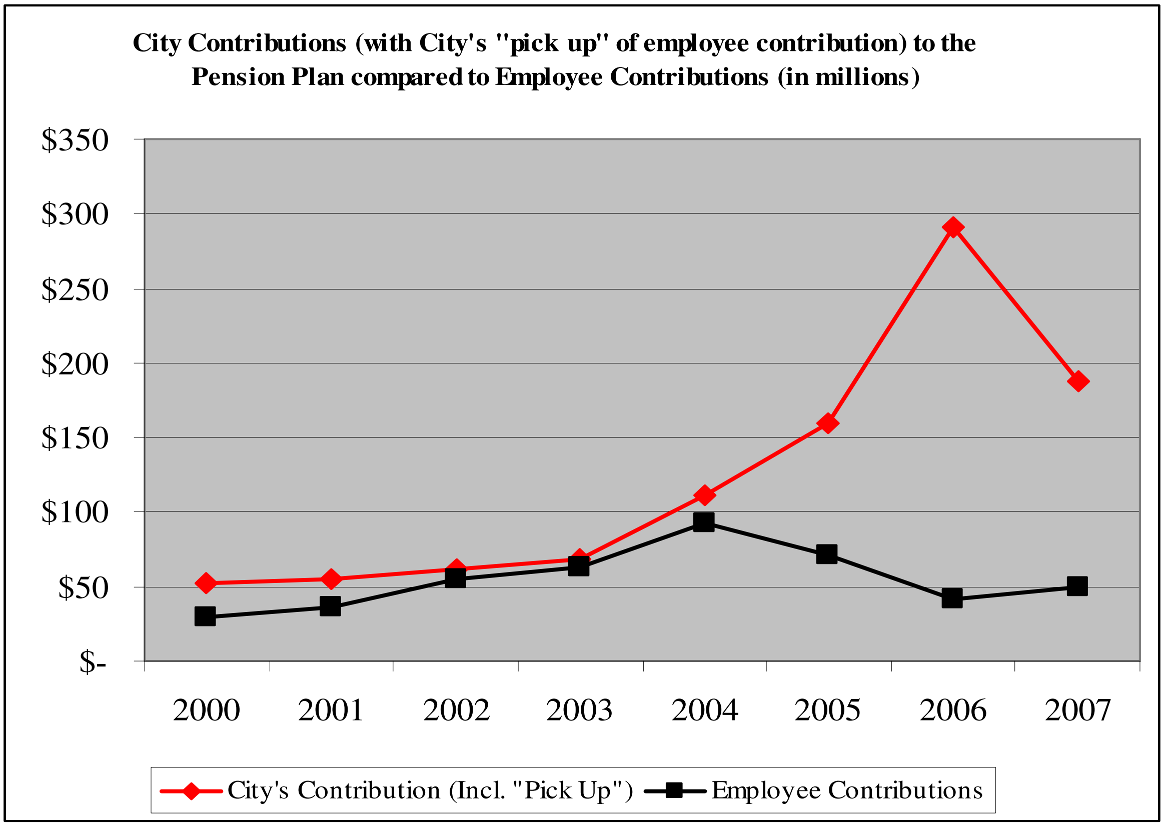
The opportunity cost of the funds diverted to pension contributions for unearned or unpaid benefits are essentially a trade-off for city services such as street repairs and park maintenance. Table 13 and Chart 9 show the growth in the City's contributions to the pension system and provide a comparison to the employees' contributions.

Table 13 - Growth of the City's Contributions to the Pension Plan

Year	City Contribution Amount	City "pick up" of Employee Contribution	Total City Contribution	Employee Contributions	Total Contributions
2000	$29,908,000	$21,986,996	$51,894,996	$29,533,246	$81,428,242
2001	$31,426,737	$23,896,431	$55,323,168	$36,360,970	$91,684,138
2002	$35,254,746	$25,896,431	$61,151,177	$54,640,917	$115,792,094
2003*	$39,988,927	$28,573,503	$68,562,430	$62,712,108	$131,274,538
2004	$80,937,000	$30,204,840	$111,141,840	$92,886,011	$204,027,851
2005	$130,000,000	$29,893,945	$159,893,945	$71,661,307	$231,555,252
2006	$271,298,430	$19,261,595	$290,560,025	$41,662,341	$332,222,366
2007	$169,126,073	$18,270,490	$187,396,563	$49,074,662	$236,471,225

*Employee DROP contribution estimated

Chart 9 - City Contributions (with City's "pick up" of employee contribution) to the Pension Plan Compared to Employee Contributions



The City's contributions to the pension plan, as discussed above, are taking a toll on the City's budget priorities. For example, the City has failed to maintain its roads, so that 70 percent are now in a condition below national standards.

Citizen concerns are legitimized when one looks at contributions in relation to the City's general fund. Chart 10 illustrates the point:

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Chart 10 - City Contribution (with City employee pick up) to Pension vs. General Fund

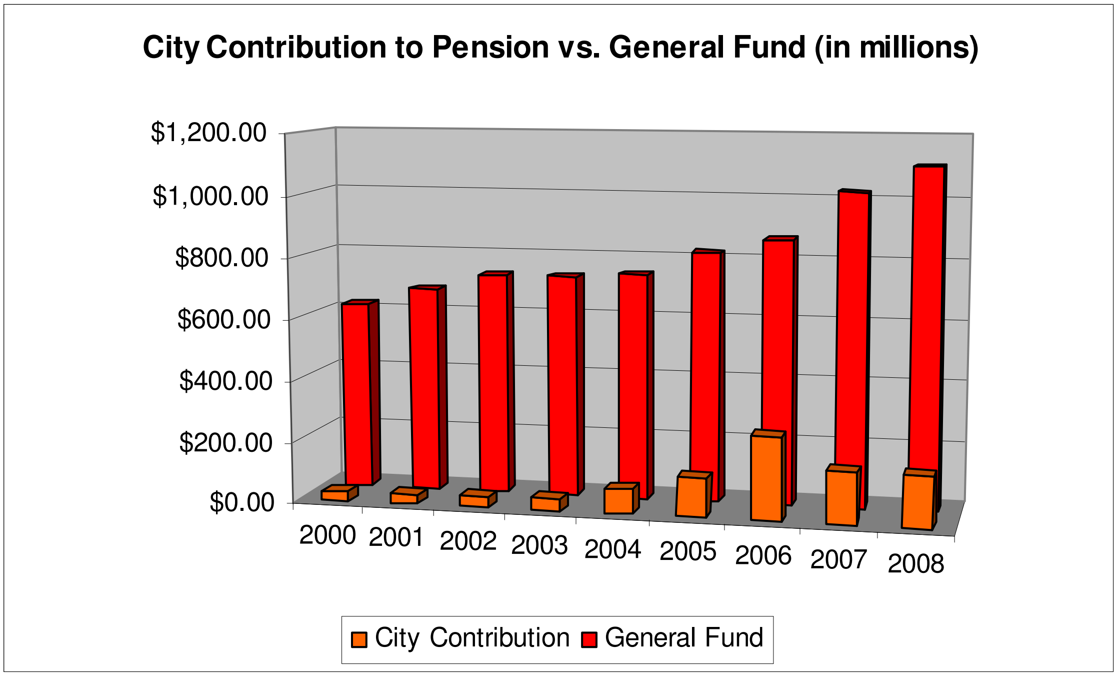


Chart 10 illustrates the alarming growth of the City's contribution to the pension system, as represented by the light bars. One can see the upward growth of the General Fund, as represented by the dark bars, as it is not increasing at the same pace. The practical effect of this disparity of growth will be the continued cuts to funding of City services and the erosion of the quality of these services. In other words, there will be a significant reduction of the quality of life for San Diego residents.

J. Deductions Compared to Contributions

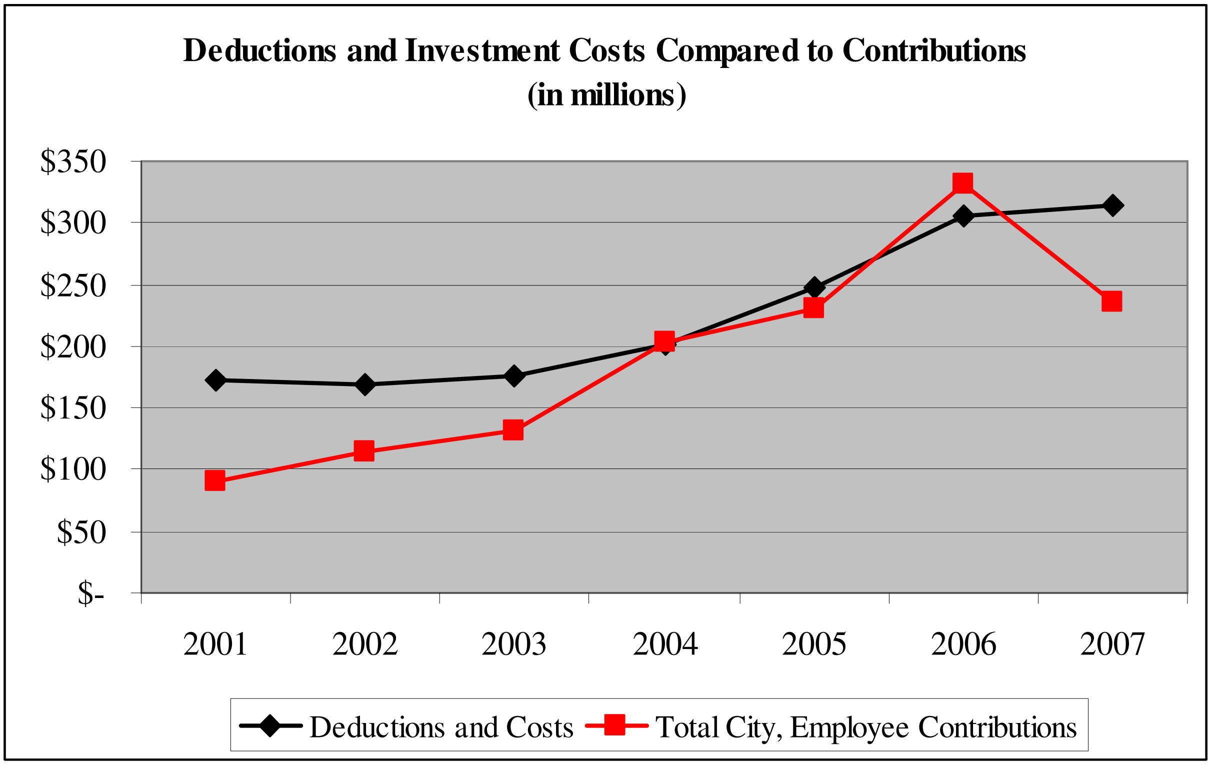
The money spent by SDCERS on benefits and costs reduces pension fund principal and results in smaller earnings. Contributions in several years have been below SDCERS' deductions and costs of operations. Therefore, the pension fund is growing only by investment earnings, with no new principal in most years. The City reduced its base contribution from $271 million to $161 million in 2007 that resulted in deductions and costs being substantially higher than contributions. Table 14 and Chart 11 illustrate these points:

Table 14 - Deductions and Investment Costs Growth Compared to Contributions

Year	Deductions	Investment Costs	Total Deductions Invest Costs	Total City & Employee Contributions
2000	$117,678,839	$9,561,581	$127,240,420	$81,428,242
2001	$162,336,721	$11,212,248	$173,542,969	$90,058,836
2002	$158,541,303	$11,273,944	$169,815,247	$115,792,094
2003	$164,948,329	$11,956,062	$176,904,391	$131,274,538
2004	$187,885,446	$14,781,389	$202,666,835	$204,027,851
2005	$232,302,504	$16,330,752	$248,633,256	$231,555,252
2006	$290,261,712	$15,000,000*	$305,261,712	$332,222,366
2007	$300,000,000*	$15,000,000*	$315,000,000*	$236,471,225

*estimate

Chart 11 - Deductions and Investment Costs Compared to Contributions



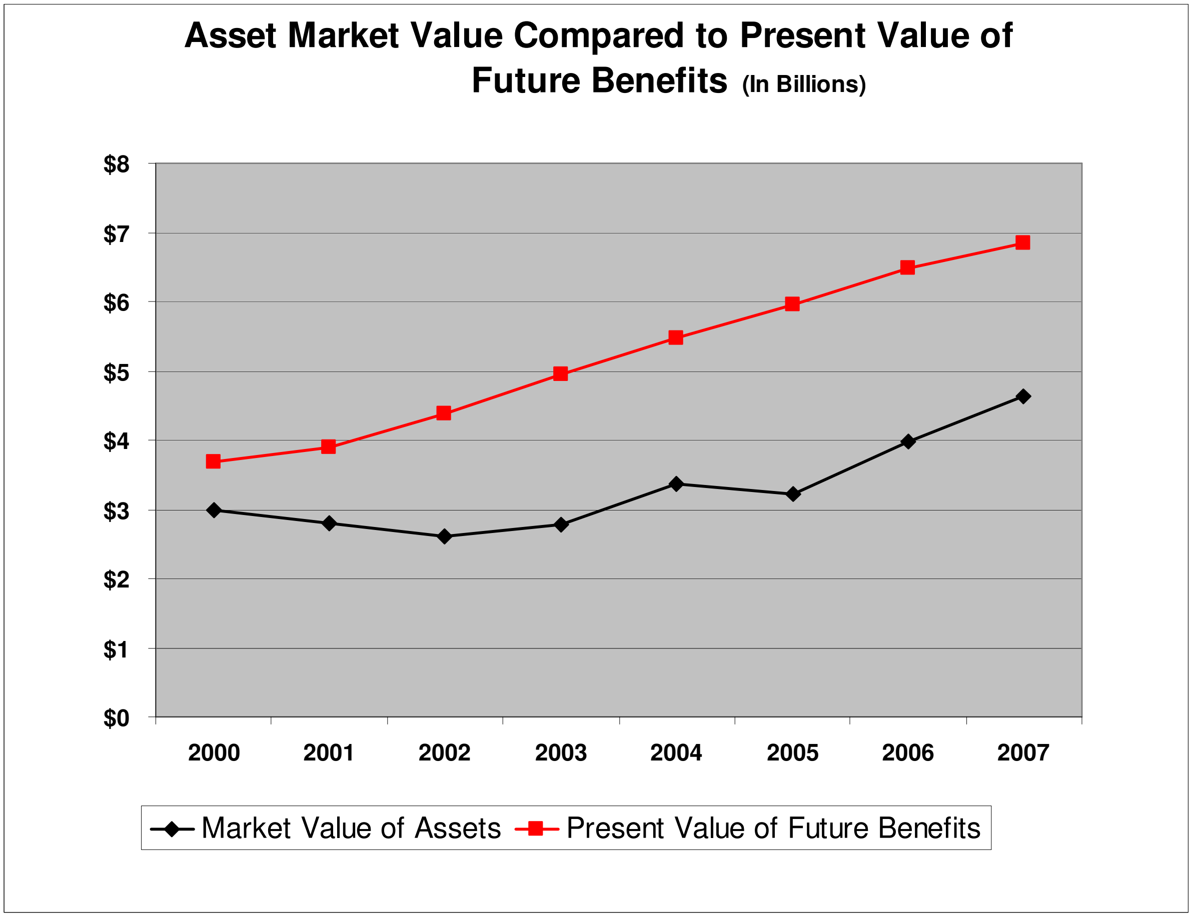
K. Market Value of Pension Assets

One way to avoid having current and future taxpayers bear the burden of the pension's under-funding is to increase pension assets through investment income. However, SDCERS' data shows that the growth of the market value of the pension plan's assets has not kept pace with the growth of the pension plan's liabilities. The market value of pension assets in 2007 was $4.6 billion. The present value of future benefits for 2007 was $6.4 billion. Table 15 and Chart 12 illustrate the growth (and decline) in the market value of pension assets since 2000 and the relationship to present value of future benefits.

Table 15 - Growth (and Decline) in Market Value of Pension Assets

Year	Market Value of Assets	Present Value of Future Benefits
2000	$2,999,010,145	$3,681,800,000
2001	$2,807,446,618	$3,890,000,000
2002	$2,609,623,272	$4,382,900,000
2003	$2,780,080,397	$4,941,000,000
2004	$3,368,239,286	$5,467,447,943
2005	$3,210,721,975	$5,957,900,719
2006	$3,981,931,694	$6,475,469,077
2007	$4,641,340,923	$6,844,230,197

Chart 12 – Market Value of Assets Compared to Present Value of Future Benefits



L. Actuarial Gains and Losses

The pension plan operates based upon actuarial assumptions. In four of the seven years between 2000 and 2006, the pension plan lost money as the market value of its assets declined. In other words, during those years, the pension plan was more expensive to operate than projected by the plan actuary.

Beyond actual gains and losses, another factor that can result in a gain or loss to the pension system is the effect of assumed investment returns. SDCERS' actuary assumes an 8 percent return on investment on a yearly basis. If returns exceed the assumed rate of 8 percent, the plan shows a gain; if returns are less than 8 percent, the plan shows a loss. Additionally, other factors affecting gains or losses involve assumptions such as the mortality rate, increases in payroll levels and the age at which one retires.

Table 16 and Chart 13 show that pension actuarial losses for the period 2000 to 2007 exceed gains by <u>$355 million</u>:

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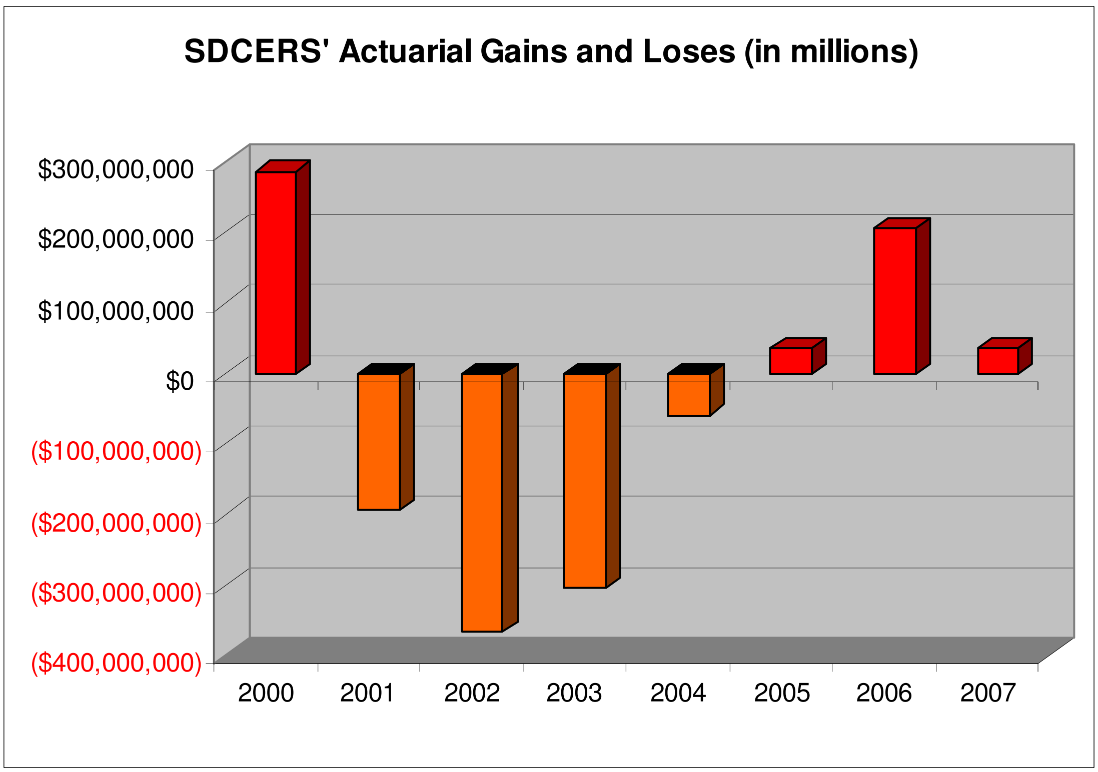
Table 16 - Pension Plan Actuarial Gains and Losses

Year	Gain or (Loss)
2000	$286,639,160
2001	($193,168,984)
2002	($364,815,155)
2003	($303,699,305)
2004	($58,123,874)
2005	$36,775,882
2006	$205,249,486
2007	$35,968,398

Chart 13 - Actuarial Gains or Losses



M. Analysis of Trends

Assets of the pension plan are not keeping pace with the pension plan's liabilities and expenditures. The present value of pension benefits has increased 65 percent since 2000. Deductions from the plan have increased 140 percent. Even though the City's contributions since 2000 have increased 807 percent, the unfunded liability during the same period has increased 1,600 percent. In other words, taxpayers are worse off today than they were in 2000.

The City has no funds available to pay down this debt. The City's 2005 financial statement shows that the City has negative current assets of $215 million - i.e., no available funds. The Mayor and City Council must address and resolve the City's underlying financial problems if the City is to again enter the financial market. The pension debt is massive and growing, affecting the City's ability to repay other debts.

N. Elected Officials Retirement Plan

On 12 September 2000, the City Council adopted modifications to Legislative Officers' Retirement Plan [LORP] that increased benefits for members who were in office on or after 12 September 2000, as follows: (1) change in the formula for calculating benefits to increase from "5% of the first $500/month compensation plus 3% of any additional monthly compensation" to "3.5% of total monthly compensation"; and (2) a lowering of the age at which an elected member could draw retirement benefits from 60 to 55. [10]

On 8 October 2001, the City Council made a further change to LORP by adopting Ordinance No. 0-18994 to include the City Attorney as a member of the retirement program. [11] The program was renamed the Elected Officers Retirement Program [EORP].8 This change similarly defied the Charter's requirements by allowing the City Attorney to receive benefits after only four years of service and before age 62, and was made without a required vote of the people of San Diego.

On 8 January 2002, the EORP was changed by the City Council's adoption of Ordinance No. 0-19022 to extend the retroactive benefit increases granted on 12 September 2000, to elected officers who were in office before 12 September 2000. [12] Thus, former elected officers who were in office before 12 September 2002, would be allowed to retire at 55 and would receive a retroactive increase in their accumulated benefits to 3.5% of total monthly compensation. [13]

Moreover, the retroactive increase in pension benefits granted by the council on 8 January 2002 was, as the benefits above were, made without identifying a funding source. [14]

A final attempt to evade the requirements of the Charter and weaken the ten-year vesting requirement was made in 2002, when the City Council amended the San Diego Municipal Code [SDMC] to allow for purchase of service credit, also known as "air time," to count towards the vesting period.

The Council attempted to do this by amending SDMC section 24.1312, so that the clear prohibition against using "air time" for vesting was removed. [15] SDMC section 24.1312 now

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10 *See* City Manager's Report No. 01-258 (Nov. 20, 2001) "Modification of the Retirement Program for Former Elected Officers" [Manager's Report No. 01-258]; *See also* 6 November 2001, City Attorney memorandum to William Barber from Theresa C. McAteer re: "Retroactive Application of Changes to the Elected Officers Retirement Program; Query re: Mayor's Retirement Benefits Status."

11 *See* 8 October 2001, Minutes of the San Diego City Council, Item 50, pp. 11-12.

12 *See* Ordinance No. 0-19022 (Jan. 8, 2002); January 8, 2002, City Council Minutes for Item 51 pp. 9-10.

13 *See* City Manager's Report No. 01-258 (Nov. 20, 2001) (with attachments) (*See* footnote 4).

14 Charter §39; Charter §99 (*See* footnote 6).

reads, in part: “Any Member may purchase a maximum of five years of Creditable Service, in addition to any other Creditable Service the member is eligible to purchase.” The language deleted from the SDMC was: “[I]n no event shall the years purchased pursuant to this provision qualify to satisfy the ten year vesting requirements set forth in Section 141 of the San Diego City Charter.” [Emphasis added.] [16]

Almost 5,975 contracts for service were made to allow City employees to purchase service credits. SDCERS has improperly allowed City employees to use purchased service credits to satisfy the early retirement rule that allows City employees to retire at 55 after 20 years of service. As administered now City employees with 15 years can enter DROP or retire once they reach 55 years of age. Before, employees would have to work 20 years in order to retire at age 55.

While employees are permitted to retire early at 55 rather than at 62 the DROP program works on the other direction allowing City employees to work after they qualify for retirement. Thus, employees can enter DROP after 15 years of service after reaching the age of 55. These employees can stay in DROP for 5 years and retire at 60. Under the original rule employees had to work until they reached the age of 62.

Another irrationality of the pension system is that elected officials have been permitted to buy service years in addition to the 8 years of service they are permitted under term limits. The City Attorney has concluded that allowing elected officials to buy service credits in addition to the 8 years of service they are permitted under term limits is not permitted by law. Those elected officials who have purchased service credits are set forth in Table 17 as follows:

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15 *Compare* SDMC §24.1312 (current) *with* SDMC §24.1312 (prior to 2002).

16 SDMC §24.1312 (prior to 2002)

Table 17 Elected Officials Who Purchased Service Credits

	Member Name	Effective Date	Years Purchased	Contract Total	Estimated Under Payment	% of Unpaid Benefit
City Council member	MC CARTY, JUDY	2/16/2000	5.00000	$41,264.37	$61,439	61.16%
City Attorney	GWINN, CASEY	3/15/2000	5.00000	$94,995.84	$61,439	
Mayor	GOLDING, SUSAN	11/17/2000	5.00000	$57,096.00	$51,592	52.05%
City Council member	VARGAS, JUAN	11/28/2000	5.00000	$42,980.81	$51,592	
City Council member	KEHOE, CHRISTINE	11/29/2000	5.00000	$42,846.30	$51,592	
City Council member	INZUNZA, RALPH	5/24/2002	1.49334	$16,627.46	$15,409	
City Council member	INZUNZA, RALPH	5/30/2002	3.50666	$32,672.95	$36,183	
Mayor	MURPHY, RICHARD	6/12/2002	1.87090	$24,742.17	$19,305	
Mayor	MURPHY, RICHARD	6/12/2002	0.38685	$5,000.00	$3,992	
Mayor	MURPHY, RICHARD	6/12/2002	0.38685	$5,000.00	$3,992	
Mayor	MURPHY, RICHARD	6/12/2002	1.28976	$19,500.00	$13,308	
Mayor	MURPHY, RICHARD	6/12/2002	0.38685	$5,000.00	$3,992	
Mayor	MURPHY, RICHARD	6/12/2002	0.67879	$4,000.00	$7,004	
City Council member	MAIENSCHEIN, BRIAN	6/20/2002	0.91768	$8,911.97	$9,469	
City Council member	MAIENSCHEIN, BRIAN	6/20/2002	4.08232	$48,119.04	$42,123	
Mayor	MURPHY, RICHARD	9/6/2002	5.00000	$32,635.80	$35,400	
City Council member	ZUCCHET, MICHAEL	4/23/2003	2.12395	$22,786.00	$15,037	
City Council member	ZUCCHET, MICHAEL	9/16/2003	0.81238	$8,715.31	$3,518	30.28%
City Council member	ATKINS, TONI	9/23/2003	5.00000	$56,106.96	$21,653	
City Council member	ZUCCHET, MICHAEL	10/14/2003	2.06367	$24,999.62	$8,937	

IV.
CONCLUSION

San Diego City taxpayers have a right to know about the financial burdens they are facing. If the granting of unfunded benefits is allowed to go uncorrected it will result in further deterioration of the City's financial condition.

As stated above, SDCERS unpaid bill for past benefits is $1.2 billion. Future benefits will cost taxpayers nearly $1.4 billion, for a total of almost $2.6 billion. SDCERS most recent actuarial study shows it has enough assets to pay only 41 percent of the future benefits. Ridding taxpayers of unearned and unpaid pension benefits is imperative to the City's financial recovery.

Michael J. Aguirre, City Attorney
CITY OF SAN DIEGO