

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO
MICHAEL J. AGUIRRE
CITY ATTORNEY

CIVIL DIVISION
1200 THIRD AVENUE, SUITE 1100
SAN DIEGO, CALIFORNIA 92101-4100
TELEPHONE (619) 533-5800
FAX (619) 533-5856

October 12, 2007

Macias Gini & O'Connell LLP
Mr. James V. Godsey
402 West Broadway
Suite 400, Room 7A
San Diego, CA 92101

Dear Mr. Godsey:

This letter is in response to the concerns and questions raised in your October 4, 2007 letter. You sought clarification of certain issues discussed in my September 28, 2007 FAS 5 Attorney Representation Letter for the Fiscal Year 2005 financial statements.

Macias Gini & O'Connell LLP has the responsibility to design and conduct its audit in accordance with U.S. generally accepted auditing standards to be able to express an opinion as to whether the City's financial statements are fairly presented, in all material respects, in conformity with GAAP. In designing your audit procedures, you necessarily determine whether and to what extent you can rely upon the internal controls of the City and its related entities. In addition, you rely upon representations of management as well as information gleaned from documents and/or discussion with employees. The investigations conducted by various outside parties and the City Attorney are available for review and presumably you have considered such reports when designing your audit procedures. The City Attorney Interim Reports can be obtained at www.sandiego.gov/cityattorney/, at the icon for *City Attorney Interim Investigative Reports*.

Presently, I know of no new issues that have not been previously disclosed or discussed. That being said, there exist significant differences of opinion regarding the financial reporting compliance by the City, including SDCERS, which my September 28, 2007 letter addressed. For clarity, this letter uses the same order and numbering system used in your October 4, 2007 letter.

You requested the attachment to the September 28 letter that was not included with the letter as received by you. For the sake of expedience and in order for your audit staff to complete their review, that attachment was sent earlier, on September 12, 2007, via email to your Engagement Manager, Mr. Anthony Neequaye, and was not included with the September 28, 2007 letter. For documentation purposes, enclosed are the September 12, 2007 list as well as the current list. Here are the responses to your enumerated questions:

1. Internal Controls – While internal controls are comprised of five specific components – Control Environment, Risk Assessment, Control Activities, Information and Communications, and Monitoring – I am principally concerned with the control environment at SDCERS. Management attitude, or “tone at the top” is critical to creating an effective control environment, and essential component of internal control. Unfortunately, the Mayor, the Chief Operating Officer/Chief Financial Officer, certain members of the City Council and the SDCERS Board of Administration (Board) have not exhibited the integrity, honesty and openness that is necessary to establish the appropriate control environment. As examples, the Board has thus far refused to recognize the 15-year amortization of the City’s Unfunded Actuarially Accrued Liability (UAAL) mandated by the City Charter. Officials of SDCERS regularly decline to answer questions from the City Attorney regarding pension-related issues before the City Council. The Mayor in his January 12, 2006 State of the City address, pledged to replace SDCERS Board members. He has yet to do so. In addition he stated that the City Attorney should be reinstated as the Retirement System’s Chief Legal Advisor. See January 12, 2006, the State of the City Address of the Mayor attached hereto as Exhibit 1. Most strikingly, in correspondence regarding the SDCERS VCP submission to the Internal Revenue Service, SDCERS made material misrepresentations about the City. SDCERS did not consult with City Officials prior to making this submission. See my letter dated October 3, 2007, wherein these concerns are addressed, (see Exhibit 7 hereto).

These issues alone raise concerns about the quality of internal controls at SDCERS and some of them implicate other areas such as risk assessment and control activities. However, as stated above, my concerns principally relate to the control environment.

2. Material Misstatements in the 2005 SDCERS Financial Statements – SDCERS has used outdated assumptions in their financial statements and notes, with the consequence that the resulting actuarial valuation and related disclosures are misleading. This valuation represents a major component of the City’s annual required contribution (ARC). For instance, even though the mandatory 15 year amortization period for the UAAL does not take effect until fiscal year 2009, SDCERS is aware that the change is coming and the ARC should be presented using a blended calculation, which would have the effect of increasing the ARC. Similarly, SDCERS will be returning to the entry age normal cost method for calculating the City’s liability and the ARC, which will also have the effect for increasing the City’s payment. Failure to disclose these two factors in the SDCERS financial reports and notes makes them misleading.

Below are responses to your questions regarding items specified and enumerated in your letter. Please note that this numbering scheme differs from my September 28 letter.

Item 1. Rescind MP-1 and MP-2 Benefits

- (a) Litigation continues in the effort to rescind MP-1 and MP-2. The case is entitled, San Diego Employees’ Retirement System v. San Diego City Attorney Michael J. Aguirre, et al. (GIC

841845). The Court has segregated the case into three phases; Phase I is on appeal at present. See Notice of Appeal, filed on September 26, 2007, Exhibit 2.

(b) The likelihood of an unfavorable outcome for the City is remote.

(c) Potential losses are limited to legal fees and costs, which cannot be estimated.

Item 2. Actual Value of Purchased Service Credits

There is no past or current litigation specifically seeking to reduce the value of purchased service credits to cost. On October 5, 2007, the City Attorney issued a memorandum to the Mayor and City Council Members, entitled *Council Approval Needed for Pension Reform that Would Save the City \$500 Million* (Exhibit 3) explaining the MP-1 and MP-2 revisions to Purchased Service Credits and DROP. This includes an August 14, 2007 letter to the SDCERS Administrator from the SDCERS actuary, Cheiron (Exhibit 8 to the memorandum), informing him that the net actuarial deficiency related to these programs is \$146 million. The City Actuary's estimate (Exhibit 9 to the memorandum) calculated that the difference between the accrued liability with DROP and without DROP is \$193 million.

Article XIII B of the California Constitution established Government Spending Limitations. California Government Code Sections 7900 – 7914 provide implementing legislation. Both the Constitution and the Legislation are provided as Exhibits 4 and 5, respectively.

Item 3. Actual Value of DROP

See the response to Item 2 above.

Item 4. Purchase of Service Credits 10 year and 20 year vesting

There is no past or current litigation specifically challenging the relationship between vesting periods and the purchase of service credits. See City Attorney Interim Report # 12, *Report on Scheme to Price San Diego City Employees' Retirement System Pension Service Credits Below Cost in Violation of California Law.*

Article IX of the City Charter establishes the City Employees Retirement System. Municipal Code Chapter 2, Article 4 provides implementing Ordinances to guide the System. When reviewing charter and ordinance language one must be cognizant of the supporting reports and presentations proffered at the time of passage. Often the meaning of a charter section or ordinance, if unclear or ambiguous, is determined by reference to such extra-legislative documentation.

Item 5. Reform Management of Pension System

There is no past or current litigation seeking to correct statements regarding the City made to the Internal Revenue Service (IRS) by SDCERS. My understanding is based upon the correspondence between the law firm of Ice Miller, on behalf of SDCERS, and the IRS dated March 14 and March 20, 2007. In the March 20 letter the IRS stated that the money diverted to pay for employee healthcare "must be described as an immediate obligation." Ice Miller placed that obligation at \$97,199,539, inclusive of interest as of that date.

Item 6. Remove Surplus Earnings

There is no past or current litigation specifically seeking to remove the concept of "surplus earnings" from the pension system. City Council action has been repeatedly sought to remove this from the municipal code but the Council has thus far rejected these efforts.

Item 7. Misrepresentation in IRS 5300 Determination Letter

I am not aware of any action by the IRS to either file suit or seek additional penalties/fees because of SDCERS' errors and omissions. By letter dated October 3, 2007, to Paul C. Hogan of the IRS (Exhibit 6) I disclosed the erroneous and missing information and requested that the City not be held responsible for the errors and omissions of SDCERS.

Item 8. Confirm DROP and Purchase of Service Credit Ended 2005

Three of the City's unions voluntarily agreed (and the fourth union had the terms imposed) that beginning on July 1, 2005, any new City employees hired on or after July 1, 2005 are not entitled to purchase service credits, enter DROP or be eligible for retiree health benefits. Each of these three unions' memorandums of understanding ("MOU") codify this agreement, (Exhibit 7). Thus, legal contract principles make these agreements enforceable. The Council agreed to the terms of these MOUs, including the elimination of these pension benefits, pursuant to R-300600, RR-300600-1, RR-300600-2 and RR-300600-3, (Exhibit 8). However, SDCERS has stated that only employees hired after February 17, 2007 are ineligible for these benefits. The City Attorney's office disagrees with this opinion. On October 9, 2007, the City Council passed a resolution authorizing the Mayor and the City Council to file a declaratory relief action to determine if SDCERS position is correct.

Item 9. Reduce or fund pension deficit of \$1 billion within a 15-year amortization schedule

There is no past or current litigation seeking to impose a 15 year amortization schedule on SDCERS. Proposition D passed by the voters in 2004 requires the City to use a 15-year amortization period beginning with fiscal year 2009. Knowing that the amortization period will be reduced from 20 years to 15 years the actuary should calculate the amount required to amortize the unfunded liability on a blended 20-year and 15-year basis. This blended calculation would result in a greater annual required contribution from the City. By not using a blended calculation, SDCERS is breaching its fiduciary duty to retirees by arbitrarily requiring a lower contribution, thus allowing the City to lower its real contribution. The impact on the FY 2005 financial statements is to lower receipts, cash flow and investment potential of SDCERS, while lowering the actual liability of the City and preserving cash, or reducing borrowings, in the City. The difference between the use of the 20-year amortization schedule and the use of a blended 20/15-year amortization would need to be calculated by an actuary.

See also, City Attorney Interim Report # 19, *Need for Individual Accountability Regarding City's Violations of the Federal Securities Laws*

Item 10. Reduce and Fund Retiree Health Care Deficit

Separate litigation on the issue has not commenced. However, in *SDCERS v. San Diego City Attorney Michael J. Aguirre, et al* (GIC 841845) SDCERS has claimed for reimbursement of

approximately \$82 million that was diverted from the System to pay for retiree health premiums. Charter section 141 established the City Employees Retirement System and provides for health insurance benefits for retired employees. Council has enacted various ordinances providing health insurance benefits for retired employees, yet, SDCERS claims not to be the Administrator of the benefit Plan. See City Attorney Opinion Number 2007-04, Post-Retirement Health Care Benefits Administration, Exhibit 9.

Item 11. Continue Litigation to Remove Illegal Pension Benefits

Litigation is ongoing to rescind the benefits granted by MP-1 and MP-2. Please see the response to Item 1 above.

Item 12. False or Misleading Statements about City Financial Condition

I am not aware of any false or misleading statements about the City's financial condition as presented in the financial statements. However, the Mayor continues to make public statements regarding the City's financial condition that appear contrary to the facts. See my letter of September 7, 2007, footnote 15, attached as Exhibit 10.

Item 13. City Investigation into improper charges to the Wastewater and Water Utility Funds

The scope of the original investigation was limited to the use of Memorandums of Understanding and/or Service Level Agreements as vehicles to charge General Fund department expenses to the Enterprise Funds. All City departments should be subjected to detail scrutiny to uncover any misuse of funds and to stop illegal business practices. However, I am not aware of any further investigations being conducted.

Item 14. Kroll Report

The Office of the City Attorney has completed its review of the Kroll Report. I am not aware of any issues that would have an impact on the FY2005 financial statements that has not already been addressed in an Interim Report or other public discussion. In August 2007, the City filed suit against Willkie Farr & Gallagher LLP, one of the principal authors of the Kroll Report, seeking not less than \$9.7 million for breach of contract, negligence and fraud, as well as under the False Claims Act and for unfair business practices. The likelihood of an unfavorable outcome is remote as this is a plaintiff's action to recover money.

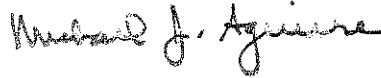
Item 15. \$40 million claim regarding land movement in/near Mt. Soledad due to broken water mains. Litigation has not commenced. However, Schroeder & Associates, a law corporation, has filed a claim with the City's Risk Management Department on behalf of the Colony Hills Homeowners Association and its 40 homeowners. The claim states \$40 million in damages. At present, the City Attorney's Office has not evaluated the claim and therefore, we have no basis for providing an estimate of loss, if any. The transmittal letter of August 6, 2007 and the claim forms are attached as Exhibit 11.

- (b) N/A
- (c) N/A

I appreciate the time and effort you have expended on these issues and I want to reiterate that I am not aware of any issues that have not been addressed in the various investigations, including the City Attorney Interim Reports, which are attached as Exhibits 12 through 31.¹

Very truly yours,

MICHAEL J. AGUIRRE, City Attorney

By 
Michael J. Aguirre
City Attorney

MJA:lv:
Attachments

cc: Jay Goldstone, Chief Operating Officer, Acting Chief Financial Officer, and Acting Auditor and
Comptroller, City of San Diego
Greg Levin, Deputy Comptroller, City of San Diego

¹ The Exhibits to the City Attorney Interim Reports can be obtained at www.sandiego.gov/cityattorney/, at the icon for *City Attorney Interim Investigative Reports*