SAN DIEGO CITY ATTORNEY

REPORT TO THE PEOPLE OF SAN DIEGO REGARDING THE SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM

<u>DRAFT VERSION FOR COMMENT ONLY</u>

14 December 2007

I.

INTRODUCTION

San Diego taxpayers have a right to know about the financial crisis facing their city. This report is written to ensure that San Diegans better understand the financial consequences they will face if the problems associated with the San Diego City Employees' Retirement System (SDCERS) are not properly addressed.

The current financial problems of the San Diego City Employees' Retirement System date back to 1996 when the funding method was tampered with to allow the City to contribute less than legally required in exchange for City employees getting increased and additional pension benefits.

City officials have not only committed taxpayers to pay $6.5 billion for employee pension benefits, they have diverted hundreds of millions of dollars 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's most recent financial statement reports that the money available to pay the City's bills is short by $215 million. The financial statement explains that this $215 million deficit is due mainly to the City's pension debt. The financial statement also discloses that City officials had already committed $215 million of the City's future taxing power.

II.

DISCUSSION

A. The Amount of Pension Benefits

The amount of the benefits to be paid is staggering. The present value of benefits for just one current retiree reaches as high as $2,354,565. More than 417 people have pension benefits with a present value greater than $1 million. This means that if they 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 the table above in perspective, Table 2, below, details the annual benefit that 20 current retirees presently receive for life.

Table 2 - Examples of Annual Pension Benefits

Retiree No.	Total Annual Benefit
City Retiree 1	$251,414
City Retiree 2	$242,228
City Retiree 3	$224,292
City Retiree 4	$221,407
City Retiree 5	$206,212
City Retiree 6	$204,988
City Retiree 7	$193,659
City Retiree 8	$191,776
City Retiree 9	$190,291
City Retiree 10	$188,639
City Retiree 11	$186,937
City Retiree 12	$185,520
City Retiree 13	$183,241
City Retiree 14	$182,357
City Retiree 15	$182,280
City Retiree 16	$173,770
City Retiree 17	$172,234
City Retiree 18	$169,426
City Retiree 19	$168,017
City Retiree 20	$164,671

The out-of-control costs for the 417 retirees whose benefits are presently valued above $1 million tell only part of the story. Taxpayers face 11,247 additional current and former employees (former employees who are vested, but have yet to reach retirement age) who will retire over the next several years. Waiting to retire are 8,887 active employees, 2,359 former employees (terminated vested) who have a financial interest in the pension plan, 1,237 disabled (about 40% of public safety retirees on disability), 1,046 beneficiaries (who receive benefits through a plan participant) and 959 in the Deferred Retirement Option Program ("DROP"). The following table shows the breakdown of plan participants as of June 2006.

Breakdown of Plan Participants

City Employee Status	Number
Current Employees	8,887
Terminated Vested Employees	2,359
Disabled	1,237
Retirees	4,118
Beneficiaries	1,046
Total City Members	**17,647**

These 11,247 future retirees will add to the 4,118 who are already retired and are receiving benefits from SDCERS. Last year, the number of people retiring increased by 390, from 3,728 to 4,118, while pension liabilities increased from $5.9 billion to $6.4 billion, an additional $500 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 the City in sound condition.

B. Present Value of Future Benefits

The present value of future benefits ("PVFB") is the total amount, expressed in today's dollars, of (1) all benefits the pension plan pays to current retirees; plus (2) all benefits the plan will have to pay to people who are eligible for retirement benefits, but have yet to retire. The present value of future pension benefits is currently nearly $6.5 billion, according to SDCERS' actuary, and growing.

Three specific benefits given to employees without proper funding represent a significant part of the total growth of the PVFB. The three benefits are: (1) retroactive benefit increases; (2) 8,268 years of purchased service credits that were never paid for by the employees; and (3) the non-cost neutral Deferred Retirement Option Program ("DROP"). The City created the benefits without identifying a corresponding funding source. Future generations will have to pick up the cost of these unfunded benefits.

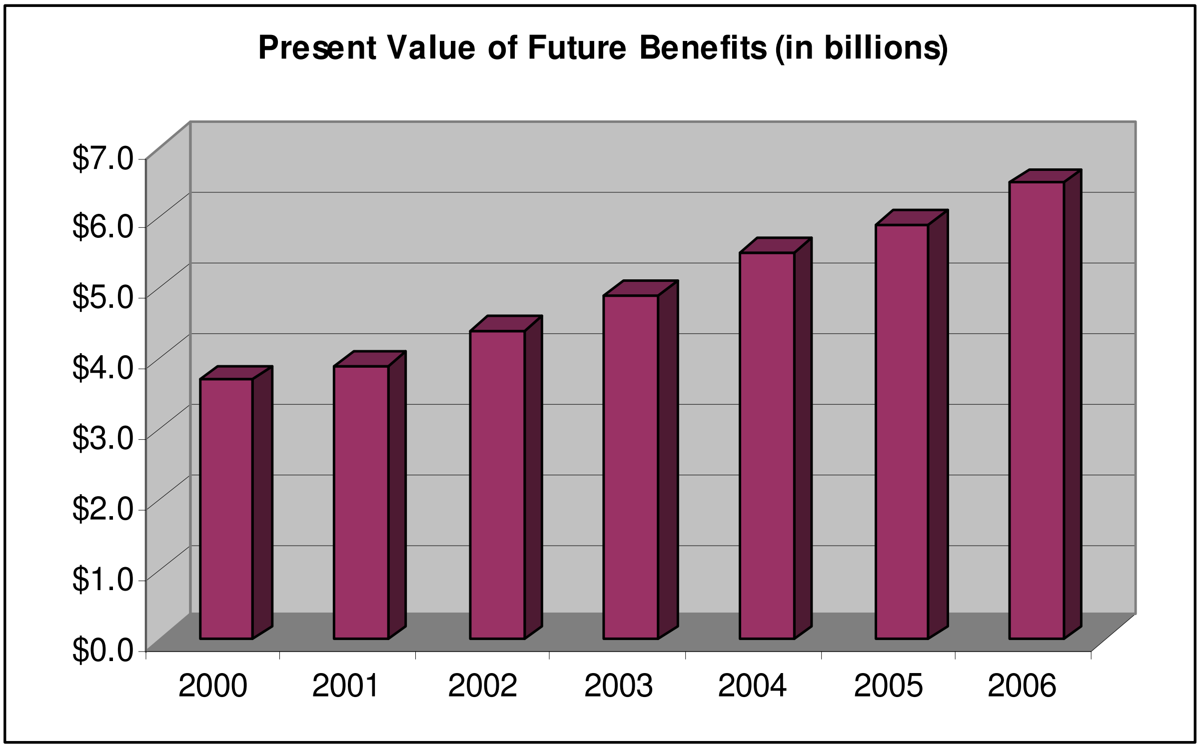
The increase in the PVFB is staggering. The continued growth of the PVFB, at the rate seen between 2000 and 2006, threatens to financially debilitate the system. Specifically, the value of the present value of benefits increased from $3.7 billion in 2000 to nearly $6.5 billion in 2006 – a jump of more than 75 percent. Table 3 and Chart 1, below, document the rapid growth in the PVFB:

Table 3 - Growth in Present Value of Future Benefits 2000-2006

YEAR	Present Value of Future Benefit
2000	$3,681,800,000
2001	$3,890,000,000
2002	$4,382,900,000
2003	$4,941,000,000
2004	$5,467,447,943
2005	$5,957,900,719
2006	$6,475,469,077

The yearly increases in the present value of future benefits are detailed here: In 2001, the present value increased from 2000 by $208 million; from 2001 to 2002 it increased by $492 million; from 2002 to 2003 it increased by $558 million; from 2003 to 2004 it increased by $526 million; from 2004 to 2005 it increased by $490 million; from 2005 to 2006 it increased by $517 million.

Chart 1 - Increase in Present Value of Future Benefits 2000-2006



C. Unpaid Service Years

One of the benefits that taxpayers will now have to pay for are the 8,268 years of purchased service credits ("PSC") that were given away to plan participants at a cost to taxpayers of $146 million. Purchased service credits are years of service that plan participants did not earn by working, but rather purchased. City employees, prior to July 2005, could purchase up to five years of service credits to increase their pension benefits. For example, a City employee who worked 20 years and purchased five years of service credits would retire with 25 years of service.

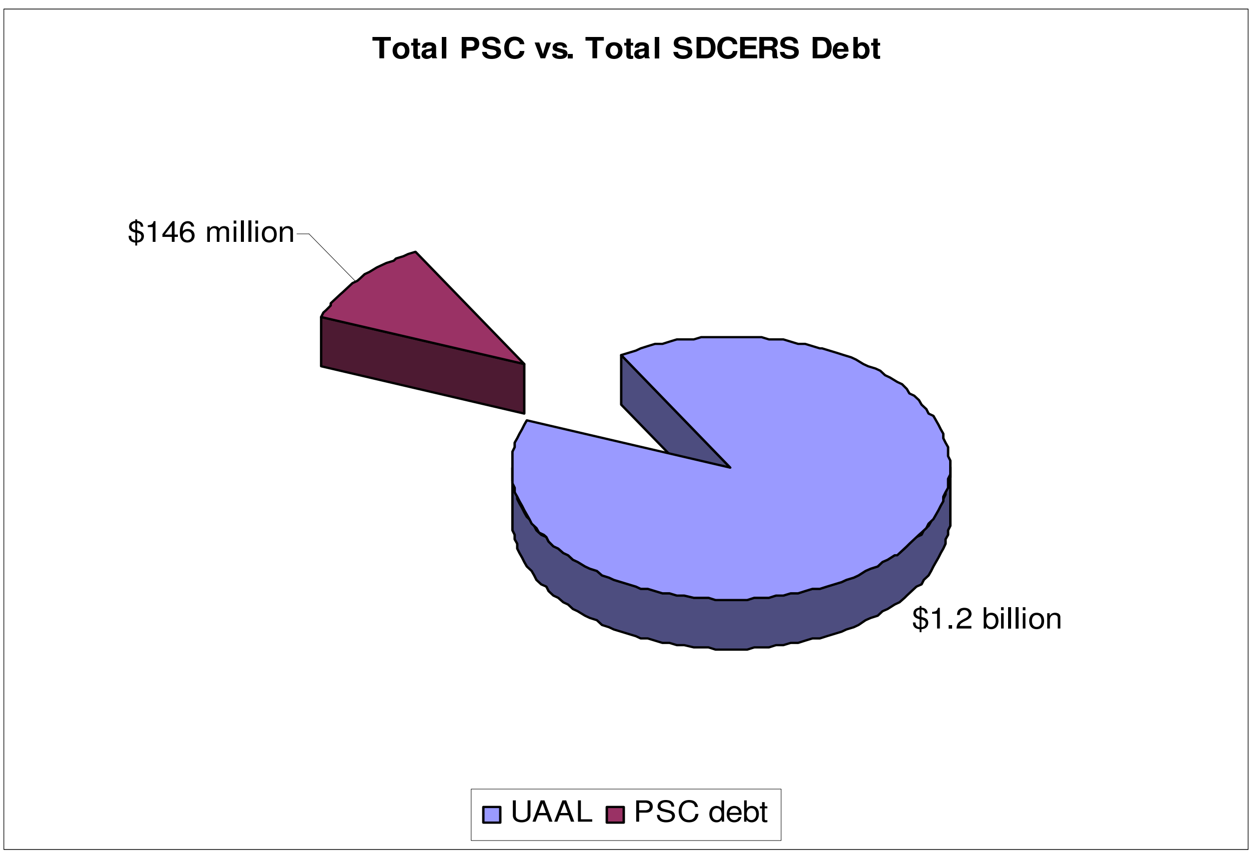
Employees were supposed to pay the full cost (employer and employee cost) of the service credits they purchased. However, SDCERS under-priced the service credits by $146 million, according to SDCERS' actuary. Table 4 and Chart 2 show when the 8,268 unpaid years were accumulated:

Table 4 - Itemization of Unpaid Service Years

Date Range	Service Credits Not Paid For	Years Not Paid For
Pre-2000	$20,000,000	1,031

7/1/2000 - 6/30/2002	$63,000,000	3,157
7/1/2002 - 8/15/2003	$29,000,000	1,674
8/16/2003 – 10/31/2003	$34,000.000	2,374
11/1/2003 – 6/30/2006	$425,000	32
TOTAL	$146,000,000	8,268

In order to understand the magnitude of how much money has been given away at the expense of taxpayers, the below chart 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.



The above graph makes clear that the size of the pension debt could be drastically reduced if the City were to require that the years of service be re-calculated using the true cost of the service years purchased.

Just recently, SDCERS considered the options available to it to correct the under pricing of these unpaid for service credits. SDCERS' outside legal counsel informed the SDCERS Board of Administration that it had the option of marking down the amount of purchased service credits to the actual value purchased, asking employees to contribute the difference in the amount paid and the amount that should have been paid and/or refunding the purchase of service credits altogether. Despite having these options, on 16 November 2007, SDCERS voted to do nothing. SDCERS' decision now requires current and future San Diego City taxpayers to pay the $146 million shortfall.

D. DROP Operating Above Cost

Another benefit that is contributing to the pension's underfunded status is the Deferred Retirement Option Program ("DROP"). Under the terms of DROP, employees receive their retirement allowance while they continue to work for the City for up to five additional years. The purpose of DROP was to retain experienced employees for up to five additional years beyond the time they would have retired on the assumption that this was more cost effective than hiring and training replacement employees.

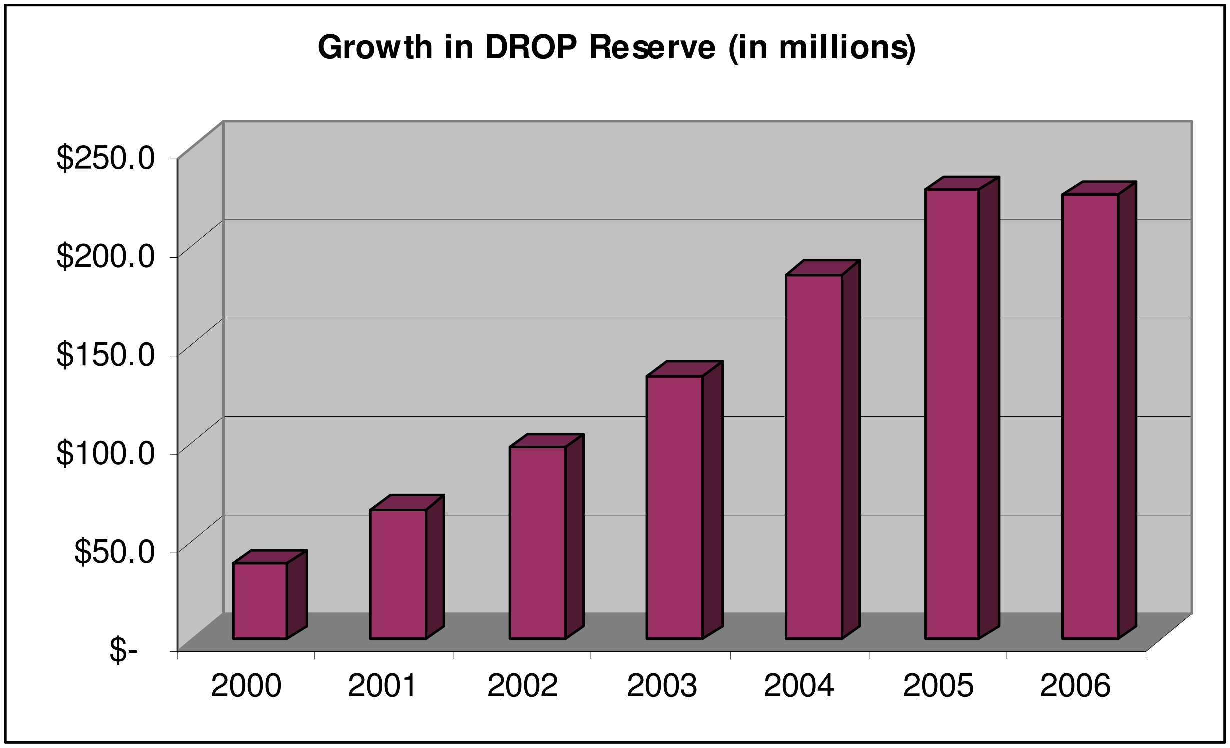
SDCERS maintains a DROP reserve account to pay for the retirement benefits of DROP members. The amount in this DROP reserve has increased 492% since 2000. With 9,000 plus active employees still eligible to participate in DROP, the cost of DROP may almost be bottomless. Table 5 and Chart 3 show the growth in the funds transferred to the DROP reserve account, which is used to pay the DROP benefit.

Table 5 - Growth in DROP Reserve Account

Year	DROP Reserve Account
2000	$38,187,621
2001	$66,373,564
2002	$97,430,035
2003	$134,169,637
2004	$185,107,857
2005	$228,514,263
2006	$225,570,127

The following table illustrates the growth of the reserve for DROP participants. Noteworthy is the fact that when DROP was created, this benefit was supposed to be cost neutral to the City; and when it was shown to be non-cost neutral, the City has so far taken no corrective action.

Chart 3 - 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. However, beyond the basic DROP payments to its participants, the City is also responsible for paying into each DROP account 8 percent interest, compounded quarterly. Thus, each DROP member, during their participation in DROP, receives their normal salary; their monthly retirement benefit with a guaranteed 8 percent interest compounded quarterly, a 3.2% match, and the 13th check.

A requirement of the DROP program by the City was that it was to be cost-neutral. However, according to the City's actuary, DROP is and has been operating at a deficit. DROP accounts for nearly $200 million of the pension's $1 billion of underfunding. Additionally, by retaining older employees instead of hiring new employees, DROP costs the City as much as $200 million in additional payroll costs for a total cost to the City and its taxpayers of $400 million ($200 million of the pension's underfunding plus $200 in additional payroll costs).

E. Retroactive Benefits

City officials awarded employees retroactive pension benefit increases in 1996, 2000, and 2002. From these increases, the pension multiplier, the yearly percentage used to determine one's pension benefit amount, was increased from less than 2% to 2.5% for general employees and to 3% for public safety employees. For example, for every year of service a safety employee works or purchase, he/she will receive a pension benefit that is equal to 3 percent of his/her highest one year salary times the total amount of years of service.

The pension increases granted in 1996, 2000 and 2002 were made retroactive to the date of each employees' original hire date. In other words, as the pension multiplier was increased from 1996 to 2002, each employee's total pension benefit is calculated using the higher multiplier for all years worked and even though these employees had already 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%, by 2002, their multiplier was 2.5%, thus creating an instantaneous shortfall.

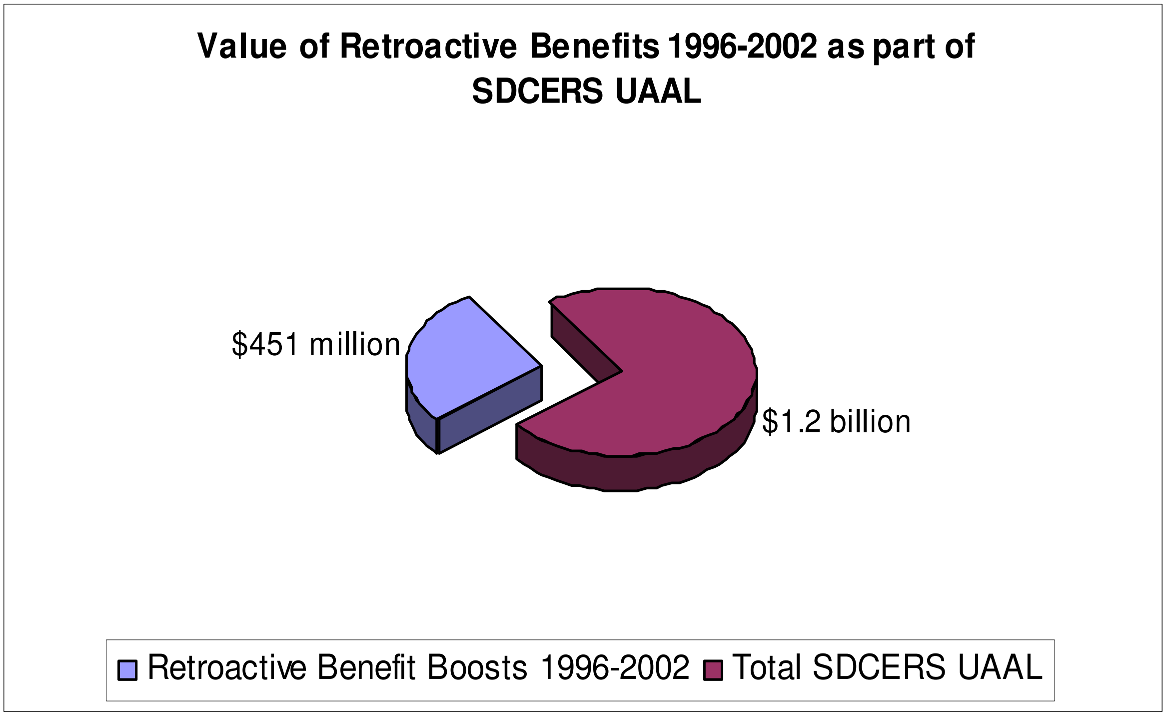
The employees were not made to contribute any additional funds to pay for this increased benefit. Nor has the City identified any funding identified to pay for these substantial increases in pension benefits. Therefore, the current and future taxpayers of the City of San Diego are now liable for these costs. Table 6 and Chart 4 show the amount of the current under funding attributable to the granting of these retroactive benefit increases.

Table 6 - 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 has resulted in a $451 million debt to the City and its taxpayers. This amount represents nearly 40 percent of the current underfunded amount. 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 4 - Comparison of Debt Created by Retroactive Benefits as part of SDCERS' Current Underfunding



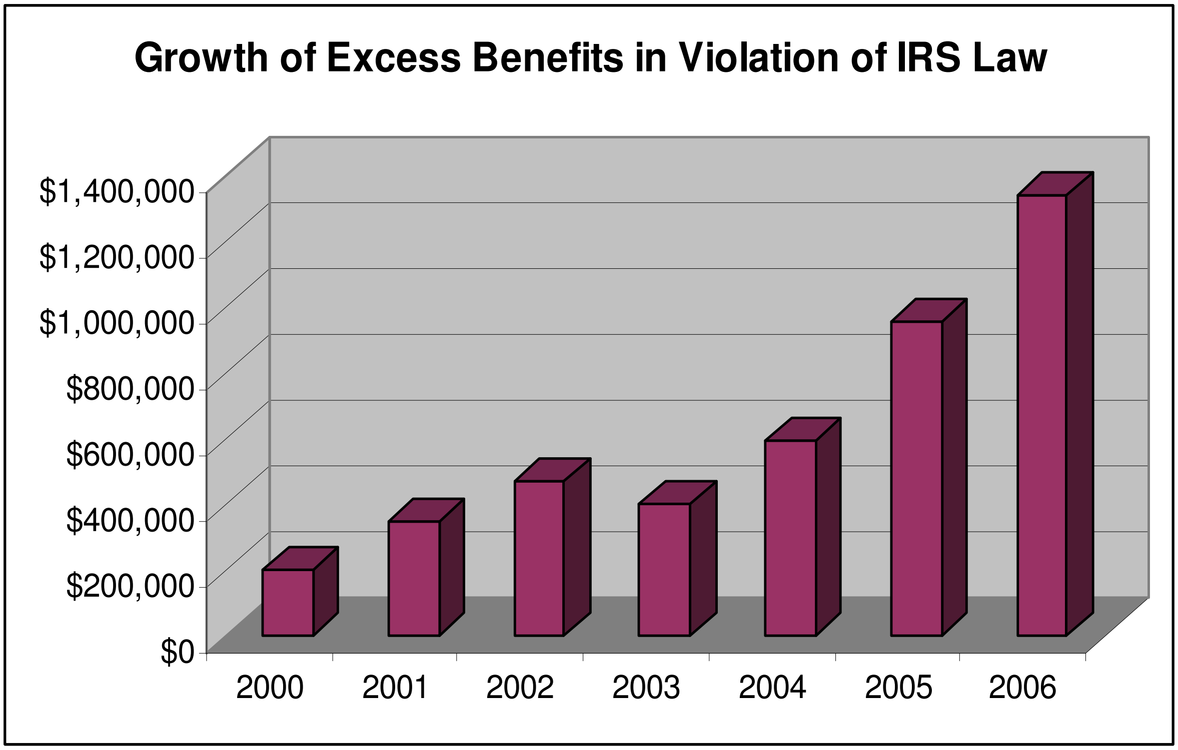
F. Excess Benefits

For at least the past six years, SDCERS officials have made $8,160,027 in payments to retirees in excess of the amounts permitted under Internal Revenue Code ("IRC") Section 415. IRC Section 415 places an upper limit on the amount a retiree may annually receive in order to prevent people from receiving preferential tax benefits for monies received in retirement. The number of retirees to whom excess payments were made has increased from 14 in 2000 to 102 in 2007. Table 7 and Chart 5 provide details about these excessive payments.

Table 7 - 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	14	$1,571,286	$1,386,173	$202,063	$346,301
2001	20	$2,210,206	$1,885,426	$351,117	$557,178
2002	32	$4,125,799	$3,834,024	$470,299	$691,023
2003	41	$5,282,725	$5,333,216	$400,341	$530,674
2004	53	$7,133,446	$7,040,171	$595,839	$750,586
2005	68	$9,191,694	$8,860,414	$959,893	$1,118,450
2006	93	$12,482,772	$11,912,484	$1,346,053	$1,453,445
2007	102	$13,693,639	$13,295,096	$1,345,660	$1,345,660

Chart 5 - Growth in Excessive Benefits



Currently, the extent of the City's liability for these excessive benefits is unknown. However, based on current trends, it would appear that more and more individuals will have pension benefits greater then those allowed by IRC Section 415.

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 underfunding have led to a 1600% increase in the deficit between pension assets and pension liabilities in just six short years.

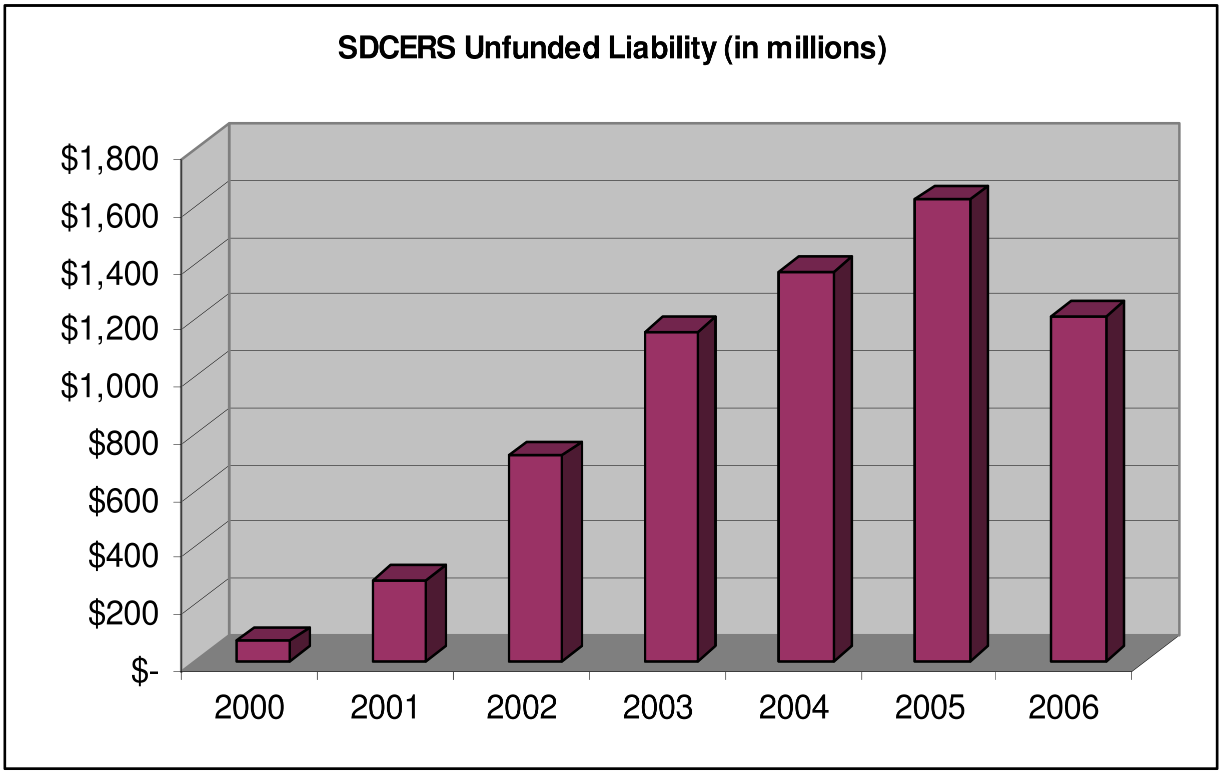
The total unfunded actuarially accrued liability in 2000 was $68.9 million and it has grown to $1.2 billion in 2006. Table 8 and Chart 7 show the dramatic growth in the unfunded liability:

Table 8 - 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

Chart 7 - Growth in Unfunded Liability



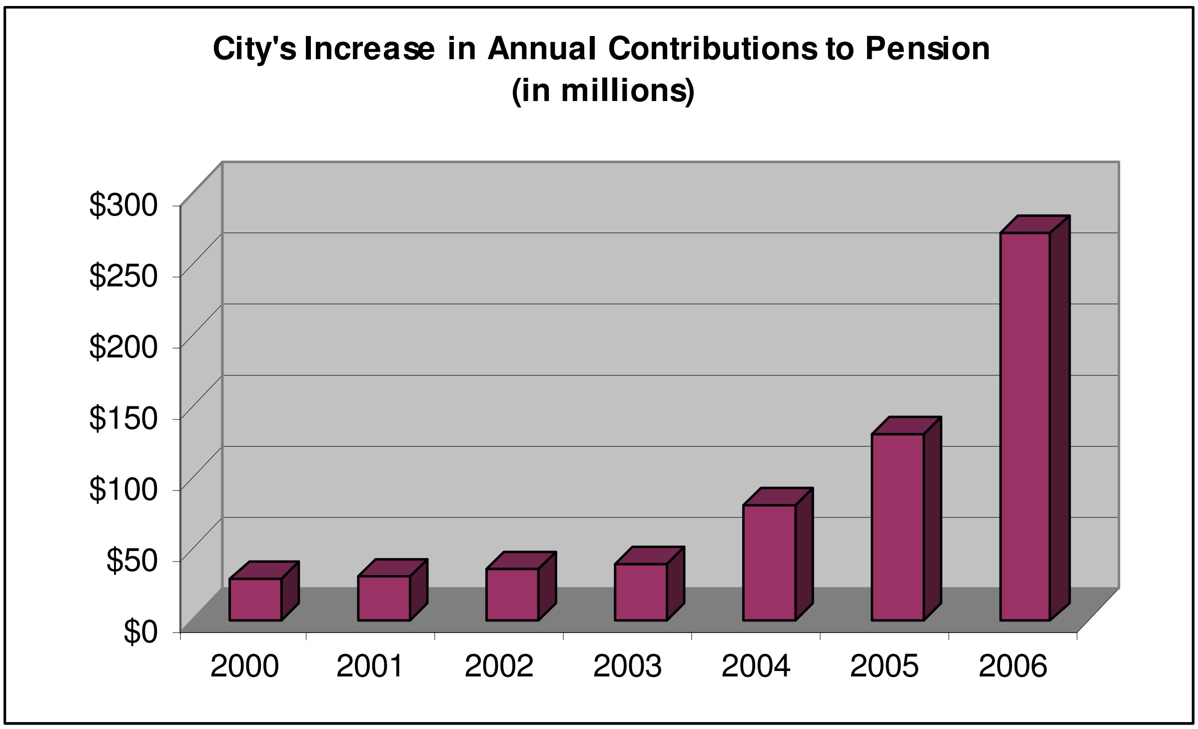
H. Contributions

The pension system is funded by contributions from both the employee and the City. Since 2000, the City has seen its contributions to the pension plan increase 807%. In 2000, the City contributed $29 million to the pension plan; however, by 2007 the City's contribution had grown to $271 million. (The $271 million contribution in 2007 includes a one-time contribution of $100 million.) Unless City revenues are increased, every dollar contributed by the City to the pension plan is a dollar not available for other City services. Table 9 and Chart 8 show the growth in the City's contributions to the pension system.

Table 9 - Growth of the City's Contributions to the Pension Plan

Year	Amount
2000	$29,908,000
2001	$31,426,737
2002	$35,254,746
2003	$39,988,927
2004	$80,937,000
2005	$130,000,000
2006	$271,298,430

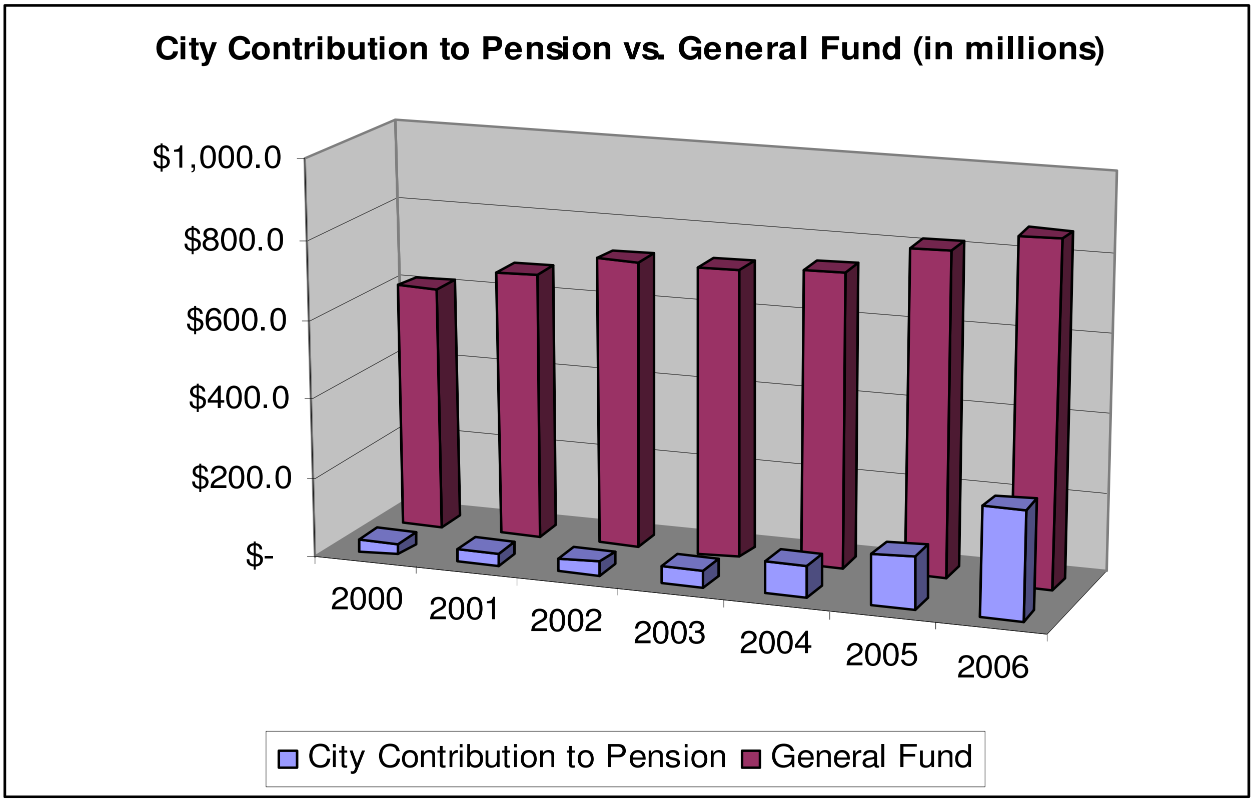
Chart 8 - Growth of the City's Contributions to the Pension Plan



The growth in the pension contributions the City must make each year has begun to take a toll on the City's budget priorities, and citizens are beginning to witness a decline in the quality of services received from the City. The City pays for the majority of services to residents through its General Fund. These services include police, fire departments, lifeguards, and the equipment these agencies use, maintenance for parks and recreations, and libraries. The concern is that as the City continues to pay more annually to the pension, less money will be available for other services.

This fear is beginning to come to fruition because the growth of the General Fund, or the money the City makes every year, is not keeping up with the cost of the pension. The means that more services will be cut in order to pay for the pensions of City employees. The table below illustrates the problem:

Chart 9: City Contribution to Pension vs. General Fund



The above chart illustrates the alarming growth of the City's contribution to the pension system, as represented by the blue line. One can see the upward growth of the General Fund, as represented by the dark bars, 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 eroding of the quality of these services. In other words, there will be a reduction of the quality of life for San Diego residents.

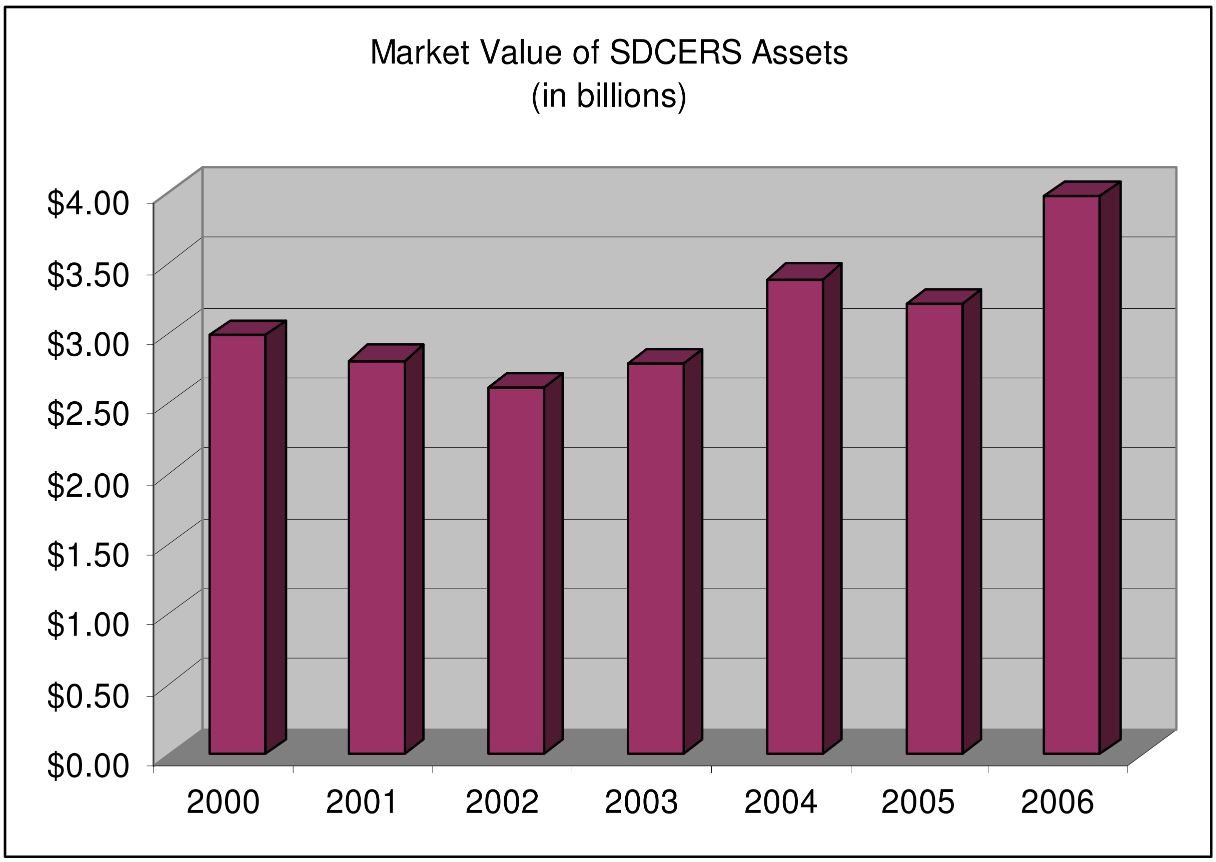
I. Market Value of Pension Assets

One way to avoid having current and future taxpayers bear the burden of having to shoulder the pension's underfunding 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 2006 was $3,981,931,694. The present value of future benefits for 2006 was $6,475,469,077. Table 9 and Chart 9 illustrate the growth (and decline) in the market value of pension assets since 2000.

Table 10 - Growth (and Decline) in Market Value of Pension Assets

Year	Market Value of Assets
2000	$2,999,010,145
2001	$2,807,446,618
2002	$2,609,623,272
2003	$2,780,080,397
2004	$3,368,239,286
2005	$3,210,721,975
2006	$3,981,931,694

Chart 9 - Growth (and Decline) in Market Value of Reported Assets



J. 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 its market value of assets declined.

In other words, during those years, the pension plan was more expensive to operate than projected by the plan actuary.

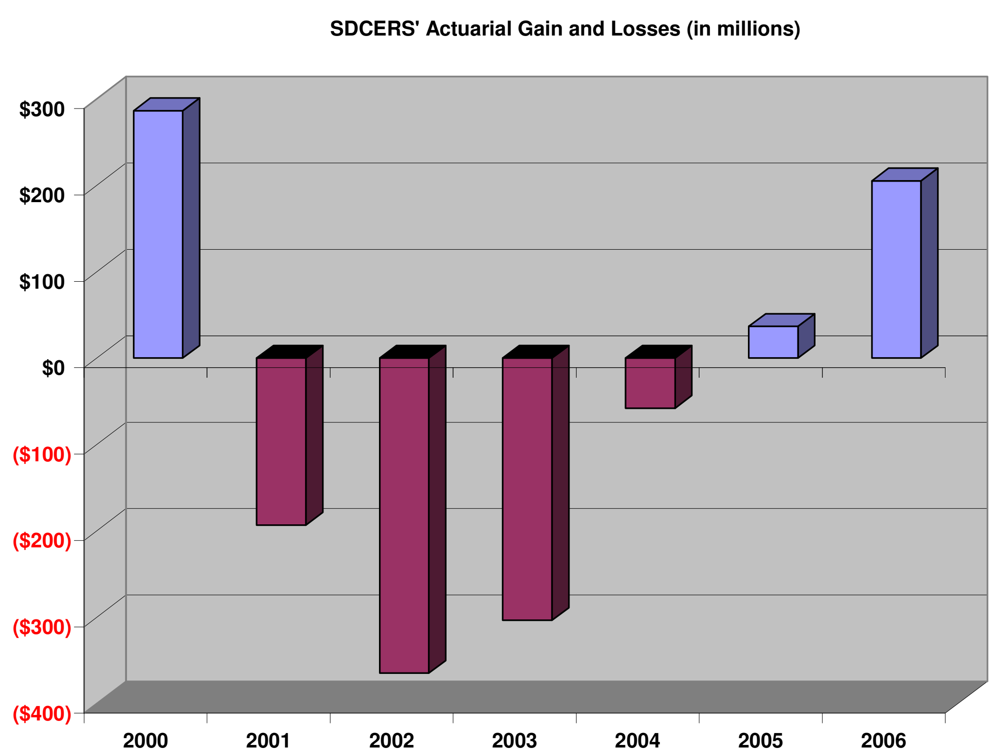
Beyond actual gains and losses, another factor that can result in a gain or loss to the pension system is the effect of assumed investment returns. SDCERS' actuary assumes an 8 percent return on investment on a yearly basis. If returns exceed the assumed rate of 8 percent, the plan shows a gain; if returns 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 11 and Chart 10 show that pension actuarial losses for the period 2000 to 2006 exceed gains by $391,142,790:

Table 11 - 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

Chart 10 - Actuarial Gains or Losses



K. 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 75% since 2000. Deductions from the plan have increased 145%. Even though the City's contributions since 2000 have increased 807 percent, the unfunded liability during the same period has increased 1600%. 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.

III.

CONCLUSION

San Diego City taxpayers have a right to know about the financial condition of their city. One of the central financial problems faced by the City arises out of the SDCERS.