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February 2, 2007

REPORT TO THE HONORABLE  
MAYOR AND CITY COUNCIL

AMENDMENTS TO THE SAN DIEGO MUNICIPAL CODE ELIMINATING THE  
“WATERFALL”

The history of the “Waterfall”, presently codified in San Diego Municipal Code Section 24.1502, is set forth in both the Vinson & Elkins report dated September 16, 2004 and Kroll report dated August 8, 2006.<sup>1</sup> Quoting from those reports:

“In 1980, the City passed Ordinance 0-15353 to increase benefits to retirees, whose pensions were deteriorating in value due to significant inflation. At the same time, SDCERS investments had produced more income than the 8% of assets that it assumed to be its long-term average return on assets. Rather than simply enacting an enhanced retirement benefit, the cost of which would be included in the SDCERS actuarial accrued liability (AAL) and eventually paid through increased City contributions to SDCERS, the City council passed Ordinance 0-15353 defining all investment earnings in excess of 8% as “Surplus Earnings” and directing that 50% of Surplus Earnings be used to pay enhanced retiree benefits.

In subsequent years, the City turned with increasing frequency to Surplus Earnings to fund a succession of benefits that it did not pay for directly. For example, in 1982, the City withdrew from the Social Security System. Under federal law, this required that it provide certain comparable benefits to retired employees, including medical benefits. Rather than pay insurance premiums from its own budget, however, the City enacted Ordinance 0-15758 (N.S.) (June 1, 1982) directing that the premiums be paid from SDCERS’ Surplus Earnings. The retiree health benefit was paid directly out of Surplus Earnings from 1983 until 1992, when a determination was made that this violated federal tax regulations by improperly paying non-pension benefits from dedicated pension assets. In an attempt to avoid this compliance problem, the City and SDCERS developed a complicated mechanism of “bifurcated payments” to fund the healthcare benefit while continuing to avoid any outlay from the City

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<sup>1</sup> Attached hereto.

budget. Thus, each year, the City paid the basic annual required contribution (ARC), with no additional amount for the post-retirement healthcare benefit.

This succession of benefits came to be known as the “Waterfall.” The funding of the Waterfall is codified in San Diego Municipal Code § 24.1502, in which the order of these benefits is currently laid out as follows: (i) interest is credited to the contribution accounts of the Members, the City, and the Unified Port District at an interest rate determined by the Board; (ii) operating costs of SDCERS are paid; (iii) reserves are maintained at the discretion of the Board on the advice of its actuary; (iv) a proportional amount of Surplus Undistributed Earnings are credited to the Unified Port District; (v) post-retirement health care premiums are paid for the next fiscal year provided that in the next fiscal year the City contributes an equal amount into the 401(h) reserve and that this contribution is part of their normal employer contributions; (vi) the 13<sup>th</sup> check is paid if there is more than \$100,000 available for the purpose (if there is not enough, this amount is rolled over into subsequent years until the rolled-over amount combined with the current year’s available funds exceed \$100,000); (vii) the contingent portion of the *Corbett* settlement is paid; and finally (viii) the Supplemental COLA is paid. In the event that there are Surplus Earnings remaining after the distribution listed above is completed, the remaining funds are credited to the Reserve for Employer Contributions for the sole and exclusive purpose of reducing the Retirement System Liability. The Ordinance treats Surplus Earnings as a windfall. Prior to the adoption of the Ordinance, all cash returns generated by SDCERS assets went to a reserve account.”

In detailing the impropriety of the foregoing, the Vinson & Elkins report further stated: “[a] pension system derives its ability to pay benefits from three sources: employer contributions, employee contributions and earnings generated from such contributions when retained within the system and productively invested. In determining the level of employer and employee contributions necessary to achieve the goal of “generational equity” in a pension system, a critical component is the assumed rate of return on fund assets. The greater that rate, the less must be contributed by system participants to fund projected retirement benefits on a basis that remains stable over time as a percentage of payroll. Obviously, no one can predict with certainty the future returns that will be generated by a particular category of assets. Projected rates of returns, like many other actuarial calculations, are educated guesses derived from historical experience. They recognize the market performance will vary significantly from year to year but assume that returns from specific asset

categories will average out over time at close to historical levels. This, of course, means that above-average returns in some years will offset below-average returns in other years.

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 the approximate 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.”

Eventually, the bill comes due in the form of additional required contributions. The diversion of amounts that would otherwise be added to system assets increases the gap between those assets and the system’s projected liabilities: in actuarial terminology the “Unfunded Actuarial Accrued Liability” (UAAL). An amount calculated to amortize the UAAL is a component of the “actuarially required contribution [ARC] that must be paid each year by the plan sponsor (here the City) to avoid a funding shortfall. Thus, any increase in system underfunding must be paid back (with interest) by the plan sponsor over the amortization period of the UAAL.”

As the above indicates, the very concept of Surplus Earnings is fundamentally flawed. Such a concept is contrary to the pension administration tenet that earnings in any given year generated in excess of actuarial assumptions are system assets, to be retained to offset years in which investment returns decline. Usage of these assets also increases the UAAL. Further, an increase in the UAAL in turn increases the “Actuarially Required Contribution” [ARC], which is designed to pay off the amortized debt of the UAAL. Even though this substantial danger of using pension earnings as a spending or funding vehicle is widely known, it was nonetheless made clear to both the City and the SDCERS Board<sup>2</sup>. However, maintenance of the Waterfall to determine “Surplus Earnings” and its usage as a funding vehicle for payment for increased benefits and even contingent benefits continues unabated to this date.

In addition to violating fundamental actuarial principles, the concept of “Surplus Earnings” and maintenance of the Waterfall as a spending vehicle is violative of federal

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<sup>2</sup> See letter dated April 16, 2002 from SDCERS outside counsel to SDCERS General Counsel and letter dated December 31, 2002 from Diann Shipione to P. Lamont Ewell. See also letter dated August 22, 1995 from Morrison & Foerster to Lawrence Grissom.

law. Federal tax law prohibits paying non-pension benefits from dedicated pension assets. (See *Internal Revenue Code § 401*). Section §24.1502 illegally earmarks system funds for payment of non-pension benefits such as healthcare benefits. Therefore, Municipal Code § 24.1502's diversion of retirement funds to pay for benefits outside the SDCERS retirement plan violates federal tax law.

In addition to violating fundamental actuarial principles and federal law, § 24.1502 also violates the California Constitution. The California courts have held that the California Constitution guarantees an "actuarially sound retirement system." (*Board of Administrators v. Wilson*, 52 Cal. App. 4th 1109, 1135 (1997)). Section 24.1502 relies on the concept of "Surplus Earnings," which is not only actuarially unsound, but it unlawfully diverts pension assets to pay for non-pension benefits. Accordingly, Section 24.1502 violates the constitutional requirement of an "actuarially sound retirement system."

In light of the foregoing, the "Surplus Earnings" concept and Waterfall vehicle must be eliminated by repealing Section 24.1502 in its entirety. Further, all references to "Surplus Earnings" and "Waterfall" must be deleted from other Sections of the Municipal Code.

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MJA:ap  
RC-2007-2  
(Re: O-2007-94)