OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: October 18, 2010 **IBA Report Number:** 10-84

Rules Committee Date: October 20, 2010

Item Number: 2

Response to Grand Jury Report Titled "San Diego City's Financial Crisis – The Past, Present, and Future"

OVERVIEW

On June 8, 2010, the San Diego County Grand Jury issued a report to the Mayor, City Council, San Diego City Employees Retirement System (SDCER), the City's Audit Committee, and the City's Auditor. The purpose of the Grand Jury's report was to assess the financial issues facing the City and also determine what brought the City to its current financial condition. The report also proposed strategies to mitigate the City's budgetary deficits.

The Grand Jury Report included twenty seven findings and sixteen recommendations. Of these, the City Council is required to respond to all of the findings and nine of the recommendations. The Mayor, City Council, SDCERs, and the City's Audit Committee and Auditor are required to provide comments to the Presiding Judge of the San Diego Superior Court on each of their respective findings and recommendations in the Grand Jury Report within ninety days. Due to the demands of the legislative calendar, the Presiding Judge granted an extension to the date for the City's responses to December 1, 2010. This report presents the City Council's response as recommended by the IBA.

The IBA has reviewed a copy of the Mayor's draft responses to each of the findings and recommendations. For each finding and recommendation, the City Council may 1) join the Mayor's response; 2) respond with a modification to the Mayor's response; or 3) respond independently of the Mayor.

In responding to each Grand Jury finding, the City is required to either 1) agree with the finding or 2) disagree wholly or partially with the finding. Responses to Grand Jury recommendations must indicate that the recommendation 1) has been implemented; 2) has not yet been implemented, but will be in the future; 3) requires further analysis; or 4) will not be implemented because it is not warranted or is not reasonable. Explanations for responses are requested when applicable.

Of the 43 items included in the Mayor, Audit Committee, and Auditor's responses, the IBA recommends that the City Council respond with a modification to the Mayor's responses for 12 items, and respond independently of the Mayor for 7 items.

The table below provides a summary of the IBA's recommendations:

Recommendations: Findings:	10-128, 10-129, 10-131, 10-132, 10-137 01, 02, 05, 06, 08, 09, 11, 13, 14, 15, 16, 17, 20, 21, 23	***Join the Mayor's and/or Audit Committee & City Auditor Response***
Recommendations: Findings:	10-125, 10-127, 10-130, 10-138, 10-139 03, 04, 07, 12, 18, 19, 24	***Respond with a Modification to the Mayor's Response***
Recommendations: Findings:	10-130, 10-140 10, 22, 25, 26, 27	***Respond Independently of Mayor***

The full text of the Mayor's responses, and the IBA's recommended responses on behalf of the City Council, can be found in Attachment A to this report.

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Attachments:

A. Recommended City Council Responses to Findings and Recommendations in San Diego County Grand Jury Report entitled "San Diego City's Financial Crisis – The Past, Present, and Future."

B. San Diego County Grand Jury Report entitled "San Diego City's Financial Crisis - The Past, Present, and Future."

C. San Diego City Employees' Retirement System Responses to the San Diego County Grand Jury Report entitled "San Diego City's Financial Crisis - The Past, Present, and Future."

Draft Responses to 2009/2010 Grand Jury Report
Entitled "San Diego's City Financial Crisis: The Past, Present and Future"

FINDINGS

Finding #01: General Fund revenues for FY 2010 is at least $11 million short of expectations due primarily to shortfalls in projected property, sales and transient occupancy taxes.

Proposed Mayor's Response: Partially Disagree. As reported in the Mayor's Fiscal Year 2010 Mid-Year Budget Monitoring Report, issued February 24, 2010, General Fund revenues were projected to come in $59.3 million under budget. Of this total, $36.5 million, or 61.5%, of the performance below budget was related to shortfalls in major revenues such as sales and transient occupancy taxes. In the report, it was projected that this shortfall would be largely offset by expenditure reductions and the release of previous year budget, bringing the Mayor's projected General Fund year-end budget shortfall to $11.2 million. The budget shortfall was mitigated by General Fund expenditure and appropriation adjustments at the conclusion of FY 2010.

<u>IBA Recommendation:</u> Join the Mayor's Response

Finding #02: The required pension contribution by the City for FY 2011 is $231 million, approximately $19 million more than the anticipated $212 million contribution, necessitating potential additional service cuts in General Fund departments.

Proposed Mayor's Response: Agree. While the final pension number came in at $229 million, the $231 million number was the estimate at the time of the release of the Grand Jury Report. The $212 million referenced in this Finding was the amount included in the City's Five Year Financial Outlook at the time of the report and based upon information obtained by SDCERS.

<u>IBA Recommendation:</u> Join the Mayor's Response

Finding #03: Absent an increase in General Fund revenue, the projected increases in the required annual pension contribution in future fiscal years will necessitate even more service cuts in General Fund departments.

Proposed Mayor's Response: Partially Disagree. Balancing the budget can be accomplished through additional revenues or additional reductions. Reductions do not necessarily have to come solely from service cuts. Over the past couple of years, the City's labor unions have made many concessions which have reduced costs without a reduction in service. In addition, through business process reengineering and other efficiency studies, the City has reduced its costs without cutting services. However, at some point, as we saw in fiscal year 2011, services will be impacted.

<u>IBA Recommendation:</u> Respond with the following modification of the Mayor's Response:

> Partially Disagree. Balancing the budget can be accomplished through additional revenues, savings from reforms such as Managed Competition, or additional reductions. Reductions do not necessarily have to come solely from service cuts. Over the past couple of years, the City's labor unions have made many concessions which have reduced costs without a reduction in service. In addition, through business process reengineering and other efficiency studies, the City has reduced its costs without cutting services. However, at some point, as we saw in fiscal year 2011, services will be impacted.

Finding #04: Switching to the Teeter method of receiving property tax allocation from the County may stabilize that source of revenue and may result in an increase of about $2 million per year for the City's General Fund.

Proposed Mayor's Response: Partially Disagree. While the Teeter method may result in a more stabilize revenue stream, it could also mean that the City receives less revenues in the long run.

IBA Recommendation: Respond with the following modification of the Mayor's Response:

> Partially Disagree. While the Teeter method may result in a more stabilized revenue stream, it could also mean that the City receives less revenue in the long run. It should be noted that the City is currently conducting a study that will examine this alternative. The study is expected to be completed by the end of the year.

Finding #05: The City's Finance Office has the expertise to select an alternate for the replacement of SDCERS, if need be.

Proposed Mayor's Response: Agree.

IBA Recommendation: Join the Mayor's Response

Finding #06: All of the above pay-down projections are actuarial estimates based on an analysis of the pension fund's fiscal condition at the close of FY 2009. In projecting the financial reconciliation, various officials indicated this is a dynamic economic condition that the City and the pension fund are facing. If it is examined at a different point in time, the unfunded liability and the projected ARC payments may differ.

Proposed Mayor's Response: Agree.

IBA Recommendation: Join the Mayor's Response

Finding #07: These pay-down projections are based partially on the assumption by SDCERS that its pension fund portfolio will earn at least 7.75% each and every year. Earnings over the past three years have been a negative 1.84%

Proposed Mayor's Response: Partially Disagree. The 7.75% assumed rate of return is an assumed average over time. It is recognized that there will be years where SDCERS will earn in excess of the 7.75% assume rate and years in which SDCERS will earn less.

<u>IBA Recommendation:</u> Respond with the following modification of the Mayor's Response:

> Partially Disagree. The 7.75% ~~assumed~~ rate of return is ~~an~~ <u>the</u> assumed ~~average~~ <u>investment return</u> over time. It is recognized that there will be years where SDCERS will earn in excess of the 7.75% assume<u>d</u> rate and years in which SDCERS will earn less.

Finding #08: The supposition that pension underfunding can be paid down by amortizing the unfunded pension obligation of $2.2 billion over thirty years is unrealistic, according to top City officials.

Proposed Mayor's Response: Disagree. While it is a more lenient approach to paying down the unfunded liability, it is an acceptable approach under Governmental Accounting Standards and is the practice in most California cities.

<u>IBA Recommendation:</u> Join the Mayor's Response

Finding #09: SDCERS indicated that investment losses in FY 2009 were approximately 19.2% of its portfolio while the average for investment losses in the United States was 25%-30%.

Proposed Mayor's Response: Agree.

<u>IBA Recommendation:</u> Join the Mayor's Response

Finding #10: For every year SDCERS does not reach an investment return of 7.75%, the City is required to increase its contribution to the retirement fund.

Proposed Mayor's Response: Disagree. Investment gains and losses are only one factor that goes into the calculation of the Annual Required Contribution**.**

<u>IBA Recommendation</u>: Do not join the Mayor's Response and respond independently with the following:

> Partially Disagree. Investment returns below 7.75% would produce investment experience losses to the pension system, increasing subsequent contribution amounts. However, returns above 7.75% would reduce future contributions.
>
> Investment returns below 7.5% would produce investment experience losses to the pension system.

Finding #11: The rate of return on SDCERS investments has been a negative 1.84% over the past three fiscal years, FY 2007- FY 2009.

Proposed Mayor's Response: Disagree. The annualized total investment return for FY 2007 to FY 2009 was negative 3.5%, per the June 30, 2009 SDCERS Comprehensive Annual Financial Report.

IBA Recommendation: Join the Mayor's Response

Finding #12: SDCERS reduced the guaranteed interest rate for DROP employees from 7.75% to 3.54% effective July 2009; there was a further reduction to 2.91% effective January 1, 2010. In order to maximize their benefits, some seventy to eighty veteran fire fighters and a like number of senior police officers locked in the then existing 7.75% interest rate on their DROP accounts by leaving the work force on or before June 30, 2009, rather than accepting the reduced interest rate. This negated some of the expressed effect of keeping experienced personnel on staff.

Proposed Mayor's Response: Partially Disagree. This statement may or may not be true. The City cannot contradict or affirm this statement without additional information.

IBA Recommendation: Respond with the following modification of the Mayor's Response:

> Partially Disagree. ~~This statement may or may not be true.~~ ~~The City cannot contradict or affirm this statement without additional information.~~There was also a change in the DROP annuity rate, which was reduced from 7.75% to 5% for DROP participants retiring after June 30, 2009. There were 421 City employees who retired from DROP during June 2009. DROP interest rates were likely among a number of factors considered by affected employees prior to making this major life decision.

Finding #13: DROP is not deemed to be a vested benefit for those employees who have not yet entered the program, according to San Diego City Attorney Opinion Number 2010-11, dated January 21, 2010.

Proposed Mayor's Response: Agree. This is the City Attorney's Opinion as written in opinion number 2010-1, dated January 21, 2010.

IBA Recommendation: Join the Mayor's Response

Finding #14: No actuarial study confirming the cost neutrality of DROP has been published to date.

Proposed Mayor's Response: Agree. The City is in the process of completing this study and it will be published by the end of the year.

IBA Recommendation: Join the Mayor's Response

Finding #15: For FY 2011, the City's contribution is more than three times the contributions of City elected officials.

Proposed Mayor's Response: Agree.

<u>IBA Recommendation:</u> Join the Mayor's Response

Finding #16: The concept of "substantially equal" contributions, shared by the City and its employees, to date has not been applied when determining responsibility for increased ARC payments resulting from SDCERS investment losses. For example, for FY 2011, the City's ARC payment includes over $70 million it alone is paying to make up for SDCERS investment losses in FY 2009.

Proposed Mayor's Response: Disagree. It is unknown whether the concept of "substantially equal" has ever been applied to actuarial gains or losses, including investment losses. The concept of "substantially equal" is currently the subject of litigation.

<u>IBA Recommendation:</u> Join the Mayor's Response

Finding #17: These aforementioned obligations, liabilities and debts amount to $7 billion.

Proposed Mayor's Response: The Mayor disagrees with the aforementioned obligations, liabilities and debts and thus cannot substantiate the $7 billion claim.

<u>IBA Recommendation:</u> Join the Mayor's Response

Finding #18: Proposed methods of enhancing revenue fall far short of satisfying these obligations, debts and liabilities; revenue enhancements may be insufficient to address budget shortfalls resulting from the projected increases in the City's ARC payments over the next five years.

Proposed Mayor's Response: Partially Disagree. The actual future ARC payments over the next five years are unknown. The current proposed revenue enhancement would be sufficient to cover modest growth in the City's ARC payment.

<u>IBA Recommendation</u>: Respond with the following modification of the Mayor's Response:

> Partially Disagree. The actual future ARC payments over the next five years are unknown. The current proposed revenue enhancement <u>and savings from reforms</u> ~~would~~<u>may</u> be sufficient to cover modest growth in the City's ARC payment.

Finding #19: The implementation of a hybrid pension system for employees hired on or after July 1, 2009 will do little to reduce the burden on the taxpayers for decades, at which time these employees will reach retirement age.

Proposed Mayor's Response: Disagree. The new second tier pension system saves the City approximately $1 million the first year of implementation, $2 million the second year, $3 million the third year and so on until it reaches approximately $20 million annually.

<u>IBA Recommendation</u>: Respond with the following modification of the Mayor's Response:

> Disagree. The new second tier pension system saves the City approximately $500,000~~$1 million~~ in the first year of implementation, $1~~$2~~ million the second year, $1.7~~$3~~ million the third year, ~~and so on until it reaches approximately~~ climbing to an estimated $28~~$20~~ million ~~annually~~in the thirtieth year of implementation. The total estimated savings over 30 years is projected at $394 million.

Finding #20: Performance audits of the major City departments may identify operational efficiencies and expenditure reductions.

Proposed Mayor's Response: Agree.

<u>IBA Recommendation:</u> Join the Mayor's Response

Finding #21: There are desirable City owned parkland properties such as Mission Bay Park, Balboa Park and Torrey Pines Park.

Proposed Mayor's Response: Agree.

<u>IBA Recommendation:</u> Join the Mayor's Response

Finding #22: By charging minimal fees for each book, DVD, or other service provided, hours of operation could be increased to generate more revenue; library hours may not have to be reduced from forty-one to thirty-six hours per week, as they have in recent budget cuts.

Proposed Mayor's Response: Partially Disagree. Some libraries have tried charging when new formats of materials are introduced (i.e. videos, DVDs, etc.). While this had the potential to generate revenue it created unanticipated consequences in service satisfaction and expenses. Patrons expected the newer formatted items to be readily available and did not want to pay to borrow items that have traditionally been free of charge. As a result, an increase in expense occurred due to the necessity of purchasing additional copies of recently released items. There was a further unanticipated consequence experienced in that patrons who did not want to pay to borrow no longer did so which reduced the number of loans and the program ultimately did not achieve the goal of generating enough revenue.

<u>IBA Recommendation:</u> Do not join the Mayor's Response and respond independently with the following:

> Disagree. Any new or increased general fund revenue option implemented in future budget processes could be considered as a potential funding source for increased hours for library operations.
>
> The FY 2011 Library Department budget was reduced approximately $1.3 million as a result of reducing weekly operating hours to 36 for the branch libraries. An additional

$1.1 million has been saved this year due to a reduction in the Central Library operating hours from 52 to 44 hours per week, and by consolidating service points. Currently the Library Department estimates it will generate revenues of $1.3 million from its fees, fines, and meeting room rentals for FY 2011 at all 36 library locations, decreased from its FY 2010 estimates of $1.5 million.

The creation of a new library fee is not likely to generate sufficient revenue to fully reinstate recent reductions. Any proposed fee increase would require a legal analysis of any applicable laws and grant conditions that might impact the ability of the City to impose a fee for library services. Finally, instituting a fee for basic library services could have a harmful effect on ensuring access to important resources to all citizens, especially those who are least able to pay and may have the greatest needs.

Finding #23: Charging a fee for residential trash collection could save the City approximately $54 million per year.

Proposed Mayor's Response: Disagree. The $54 million estimate is not accurate. Operational efficiencies implemented since FY 2009 have resulted in budget reductions. The FY 2011 budgeted cost to the City is approximately $29.5 million for refuse collection, $8.1 million for recyclable commodities collection, and $5.7 million for yard waste collection, for a total of $43.3 million.

<u>IBA Recommendation:</u> Join the Mayor's Response

Finding #24: Cost savings could be achieved by consolidation of various functions performed by both the City and the County.

Proposed Mayor's Response: Agree.

<u>IBA Recommendation:</u> Respond with the following modification of the Mayor's Response:

Agree. <u>However, additional study of what services could be performed by both the City and the County, the legal ramifications, and the actual savings would need to occur prior to any consolidation being considered.</u>

Finding #25: City Hall acted improvidently in cutting the public safety workforce for FY 2010 and FY 2011.

Proposed Mayor's Response: Disagree. There is no one at the City that got pleasure out of recommending or approving the cuts that were made to public safety; however, under State and local laws the Mayor must present and the City Council must adopt a balanced budget. Given all of the reductions in staffing and services made by the City over the past several years, the magnitude of the deficit projected for fiscal year 2011 and the fact that public safety represents over 50% of the City's General Fund budget, there was absolutely no other viable alternative short of shutting down libraries and recreation centers or spending down the City's limited reserves which would have had other cost consequences to the City. In addition, the use of reserves instead of taking real cost reductions would have only increased the projected deficit for fiscal year 2012.

<u>IBA Recommendation:</u> Do not join the Mayor's Response and respond independently with the following:

> Disagree. One of the key duties of the City Council is to adopt an annual budget that is balanced and fiscally responsible. The budget must be balanced using very limited resources while addressing numerous critical needs and financial obligations. Passing an annual budget that is balanced and fiscally sound is a top priority of the City Council. The City of San Diego's budget process includes a number of checks and balances, which brings transparency and objectivity to the process. Both the Executive and Legislative branches are involved, as well as analysis by the Office of the Independent Budget Analyst. The public is a key part of the process with hundreds of citizens participating at budget hearings conducted by the City Council's Budget and Finance Committee and the full City Council.
>
> Given the significant reductions in non-public safety staffing and services made by the City over the past several years, and the fact that public safety represents over 50% of the City's General Fund budget, the City was limited in options to close the significant budget deficits for Fiscal Years 2010 and 2011. Once the City has the financial resources to do so, public safety will be the number one priority for restorations.

Finding #26: A proactive dialogue as to the efficacy of a Chapter 9 reorganization cannot be removed from any discourse as to the City's financial health.

Proposed Mayor's Response: Strongly Disagree.

<u>IBA Recommendation:</u> Do not join the Mayor's Response and respond independently with the following:

> Strongly Disagree. The Mayor and City Attorney have both publicly advised the City Council and citizenry that municipal bankruptcy is not an effective option for the City of San Diego for a variety of reasons, both financial and legal. Moreover, in a public financial training to the City Council on October 11, 2010, a representative of Fitch Ratings, one of the three major rating agencies, indicated that discussion of bankruptcy raises concerns for both rating agencies and investors regarding the ability and willingness of an issuer, such as the City, to repay its obligations. Premature discussion of Chapter 9 reorganization could adversely impact the City's near and medium term financial position due to negative rating agency action, such as a ratings downgrade, and the related market responses. The City believes there are options available for reducing its liabilities that are both less costly and more certain than bankruptcy and that any formal action by the City to investigate the efficacy of municipal bankruptcy, even as an academic exercise, is not in the best interests of the City.

Finding #27: A Chapter 9 filing would result in a federal determination of which fringe benefits and collective bargaining agreements could be restructured. The fringe benefit total is $423.7 million, according to the FY 2011 Proposed Budget.

Proposed Mayor's Response: Partially Disagree. The amount of money the City currently spends on fringe benefits is accurate. This is out of a $3 billion budget. It is estimated by outside experts that the City may spend tens of millions of dollars and it could take several years to wind its way through the courts before the City would ever have a final answer to this question. The courts would have to first determine whether or not the City qualified for Chapter 9, and even with the current projected deficit, it would be highly unlikely that finding would be made.

<u>IBA Recommendation:</u> Do not join the Mayor's Response and respond independently with the following:

> Disagree. While the cited fringe benefit total is correct, as noted in the response to Finding 26 the Mayor and City Attorney have both publicly advised the City Council and citizenry that municipal bankruptcy is not an effective option for the City of San Diego for a variety of reasons, both financial and legal. A Chapter 9 filing is likely to take several years to wind its way through the courts before the City would have a final answer regarding the restricting of agreements and most, if not all, of the current collective bargaining agreements may have expired. Finally, there can be no certainty that a Chapter 9 filing would result in a determination that fringe benefits could be restructured.

RECOMMENDATIONS

10-125: Analyze the impact of the City's opting in to the Teeter Plan for receiving its allocation of property tax revenue and switch to that method for FY 2012 if the analysis reveals financial benefits for the City.

Proposed Mayor's Response: This recommendation has not yet been implemented. This approach is currently under study and the results will be reported to the City Council this fall.

<u>IBA Recommendation:</u> Respond with the following modification of the Mayor's Response:

> This recommendation has not yet been implemented. This approach is currently under study and the results will be reported to the City Council ~~this fall~~ <u>by the end of the year.</u>

10-126: Consider alternative methods of selecting investment advisors, including competitive bidding or reverse auction processes.

NOTE: The City Council is not required to respond to this recommendation.
See Attachment C for SDCERS responses to the Financial Crises Grand Jury Report.

10-127: Investigate alternate retirement systems to determine whether the San Diego City Employees' Retirement System (SDCERS) should be dissolved in favor of another system, a purely outsourced operation, or retention of the current system.

Proposed Mayor's Response: This recommendation will not be implemented because it is not warranted or reasonable. At this time, the City Charter essentially provides for two alternatives for the administration of the City's retirement plan. These are either SDCERS or CalPERS. To move the administration of the plan to CalPERS would require a majority approval of all active members of SDCERS. In addition, the City's retirement factors would have to conform to one of the options currently offered by CalPERS.

IBA Recommendation: Respond with the following modification of the Mayor's Response:

> Disagree. This recommendation will not be implemented because it is not warranted or reasonable. At this time, the City Charter essentially provides for two alternatives for the administration of the City's retirement plan. These are either SDCERS or CalPERS. To move the administration of the plan to CalPERS would require a majority approval of all active members of SDCERS. In addition, the City's retirement factors and system requirements would have to conform to one of the options currently offered by CalPERS. This may not be possible because vested rights of active and retired members would have to be protected.

10-128: Conduct a performance audit of SDCERS' administration of the City's pension system.

Audit Committee and Independent Auditor Response: Agree to implement. This recommendation is planned to be implemented in Fiscal Year 2010-11. Aside from the Grand Jury report, Council members Tony Young and Carl DeMaio requested that the City Auditor audit SDCERS' administration of the City's pension system. The SDCERS administration of the City's pension system is a high-risk activity that merits outside review. As result, the City Auditor added this audit to the FY 2010-11 Annual Audit Work Plan.

IBA Recommendation: Join the Audit Committee and Independent Auditor Response

10-129: Approve and fund an actuarial analysis of DROP which would confirm or refute the fact that it is cost neutral.

Proposed Mayor's Response: This recommendation has not yet been implemented. The City is in the process of completing this study and it will be published by the end of the year.

IBA Recommendation: Join the Mayor's Response

10-130: Consider taking the steps necessary to declare an immediate moratorium on all new DROP entrants pending the completion of the cost neutrality analysis.

Proposed Mayor's Response: This recommendation requires further analysis.

<u>IBA Recommendation</u>: Do not join the Mayor's Response and respond independently with the following:

> This recommendation requires further analysis. This recommendation involves legal issues related to labor negotiations and application of San Diego Charter section 143.1. The City has taken initial steps to amend the Municipal Code to eliminate eligibility for new DROP entrants who are unrepresented unclassified and unrepresented classified General Members who have not yet entered the program (except Council Assistants or Council Representatives). Concurrently, actions for elimination of DROP eligibility for unrepresented unclassified Lifeguards and Police are also underway. The first reading of an ordinance with regard to elimination of DROP eligibility for these employees was held on June 15, 2010. However, the City Council has not adopted the ordinance because SDCERS has stated that the ordinance requires a Charter section 143.1 vote of City employees, who are members of the retirement system. The vote is pending, and anticipated after the completion of the DROP cost neutrality study, which is expected to be completed by the end of the year.

10-131: Consider taking the steps necessary to discontinue DROP for all new entrants should the actuarial analysis demonstrate that it is not cost neutral.

Proposed Mayor's Response: This recommendation requires further analysis. The City will examine several alternatives to the DROP program should the actuarial analysis demonstrate that it is not cost neutral. If an analysis is necessary, it will be conducted after the finding that the program is not cost neutral.

<u>IBA Recommendation:</u> Join the Mayor's Response

10-132: Evaluate each department of the City to determine potential cost savings, operational efficiencies and revenue enhancements.

Audit Committee and Independent Auditor Response: Requires Further Analysis. Based on the results of the Citywide Risk Assessment, the City Auditor issues an Annual Audit Work Plan that documents proposed audits based on financial risk factors. Performance audit objectives can include reviewing the efficiency and effectiveness of government resources; assessing the reliability of financial information; assessing compliance with applicable laws and regulations, determining the attainment of goals and objectives; and assessing if government assets are appropriately safeguarded. Performance audits are conducted on department specific components, for example the Public Utility Department's Bid-2-Goal program, as opposed to auditing an entire department. Comprehensive audits of entire departments would require significant commitment of audit resources.

This recommendation requires further analysis because implementation would significantly impact the FY 2010-11 Annual Audit Workplan and would necessitate the involvement of the Audit Committee. Depending on the time frame for the review, additional audit resources may be needed. I will request that the Audit Committee Chairman place this issue on a future audit committee agenda.

IBA Recommendation: Join the Audit Committee and Independent Auditor Response

10-133: Direct the City's Department of Real Estate Assets to explore marketing aggressively to developers long term leasing (not sales) of desirable City owned properties, such as parkland in Mission Bay, Balboa Park, Torrey Pines and the Qualcomm Stadium area, as well as other parcels deemed appropriate for leases of 50-60 years.

Proposed Mayor's Response: This recommendation has been implemented to the extent reasonable. The Real Estate Assets Department (READ) is constantly looking to increase revenues by leasing desirable, marketable properties to developers or users for new development or redevelopment. However, conditions exist that inhibit development in the areas mentioned in the Grand Jury Report.

- Mission Bay – The amount of land available for commercial development is limited to a percentage of the total land in Mission Bay Park. Currently, the land available for commercial development is at its maximum limit. Unless the percentage of land for commercial development is increased or an existing tenant surrenders its leasehold, no opportunities for long term ground leases exist.
- Balboa Park – Council Policy 700-04 encourages non-profit uses in this area that provide cultural, recreational and educational services and the maintenance of a higher proportion of noncommercial uses than commercial uses. There are currently no significant opportunities for ground leases in Balboa Park.
- Torrey Pines – The City currently has long term ground leases with hotels, office buildings, and Scripps Hospital on its property at Torrey Pines. There is only one vacant parcel City owned parcel in this area which is more suited for a sale than a ground lease.
- Qualcomm Stadium Area - This area will require a significant planning effort prior to any change in use or future commercial development. Commercial development is not feasible until a master plan for the site has been completed.

IBA Recommendation: The City Council is not required to respond to this recommendation.

10-134: Explore the feasibility of outsourcing the City's entire library system.

Proposed Mayor's Response: The recommendation has been implemented. A pre-competition assessment for library services was conducted in June 2008 at which time only one potential independent contractor was identified that possessed the capability of running the City's library system. In the City's Managed Competition Guide, the Managed Competition Independent

Review Board cannot recommend outsourcing unless they have at least two independent contractor proposals to consider. This pre-competition assessment would need to be updated and further analysis conducted to determine whether or not the feasibility of outsourcing has changed. Currently the Managed Competition staff time is devoted to actively pursue other services/systems, and this further analysis could not be conducted within the six month time frame allowed in Grand Jury reports.

IBA Recommendation: The City Council is not required to respond to this recommendation.

10-135: Draft a ballot measure calling for the repeal of the People's Ordinance.

Proposed Mayor's Response: This recommendation will not be implemented at this time as other revenue sources are being explored.

IBA Recommendation: The City Council is not required to respond to this recommendation.

10-136: In addition, consider the benefits of outsourcing the entire trash collection operation.

Proposed Mayor's Response: This recommendation has been implemented. On September 30, 2010, the Mayor announced the first two city services to be put out to bid under managed competition. This announcement follows approval by the City Council of the first reading of an ordinance that will allow the city to move forward with managed competition. The timetable for moving forward with consideration of additional competitive procurements will be developed.

IBA Recommendation: The City Council is not required to respond to this recommendation.

10-137: Conduct an analysis of City services that are also provided by the County and neighboring cities, with the objective of cutting costs by consolidation.

Proposed Mayor's Response: This recommendation requires further analysis. In March, 2010, the City of San Diego began preparation of a survey on regionalization of services within the County. The survey was sent to all of municipalities in the County, the State and Federal governments, local school districts, and other public organizations in San Diego such as the Port Authority and San Diego Association of Governments on June 21, 2010. It listed the services provided by the City of San Diego, and elicited interest from those surveyed as to which services they are interested in either purchasing from another entity, providing to other entities, or entering into a joint powers delivery of services. We received responses from the County and seven municipalities, and plan to meet with the interested parties to discuss next steps in assessing regionalization opportunities for the selected services of interest. It is not feasible to conduct an analysis of consolidation options without willing partners, and the City is hopeful that these discussions will be fruitful. We anticipate that the initial joint discussion will occur in November, 2010, at which time next steps and responsible parties will be identified.

IBA Recommendation: Join the Mayor's Response

10-138: **Eliminate redundant positions and extraneous levels of management and supervision as middle managers leave City service through attrition.**

Proposed Mayor's Response: This recommendation has been implemented. The City has eliminated over 1,400 full-time equivalent positions over the past four years. This has included the elimination of many positions through consolidation and through the flattening of the organization.

IBA Recommendation: **Respond with the following modification of the Mayor's Response:**

> This recommendation has been implemented and will continue to be a part of every reduction process. The City has eliminated over 1,400 full-time equivalent positions over the past four years. This has included the elimination of many positions through consolidation and through the flattening of the organization.

10-139: **Restore the cut to public safety personnel as a priority.**

Proposed Mayor's Response: This recommendation has not yet been implemented. Once the City's has the financial resources to do so, public safety will be the number one priority. Until then, so long as the City faces future projected deficits, restoring any service that has been previous reduced is not financial responsible.

IBA Recommendation: **Respond with the following modification of the Mayor's Response:**

> This recommendation has not yet been implemented. Once the City has the financial resources to do so, public safety will be the number one priority. ~~Until then, so long as the City faces future projected deficits, restoring any service that has been previous reduced is not financial responsible.~~

10-140: **Convene a panel of bankruptcy experts to discuss the legal and financial ramifications of a Chapter 9 declaration of bankruptcy, in the context of a publicly noticed City Council or Council Committee meeting.**

Proposed Mayor's Response: Strongly disagree. The Mayor does not support bankruptcy and does not feel that the City would even qualify for bankruptcy under Chapter 9. The citizens of San Diego would not be well served and any discussion of Chapter 9 sends the wrong message to both the San Diego community and to the financial markets. It would be irresponsible to convene a panel of bankruptcy experts.

IBA Recommendation: **Do not join the Mayor's Response and respond independently with the following:**

> Recommendation will not be Implemented. The Mayor and City Attorney have both publicly advised the City Council and citizenry that municipal bankruptcy is not an effective option for the City of San Diego for a variety of reasons, both financial and

legal. Moreover, in a public financial training to the City Council on October 11, 2010, a representative of Fitch Ratings, one of the three major rating agencies, indicated that discussion of bankruptcy raises concerns for both rating agencies and investors regarding the ability and willingness of an issuer, such as the City, to repay its obligations. Premature discussion of Chapter 9 reorganization could adversely impact the City's near and medium term financial position due to negative rating agency action, such as a ratings downgrade, and the related market responses. The City believes there are options available for reducing its liabilities that are both less costly and more certain than bankruptcy and that any formal action by the City to investigate the efficacy of municipal bankruptcy, even as an academic exercise, is not in the best interests of the City.

SAN DIEGO CITY'S FINANCIAL CRISIS
THE PAST, PRESENT, AND FUTURE

INTRODUCTION

The 2009/2010 San Diego County Grand Jury undertook an investigation to research and analyze the financial issues facing the City of San Diego (City) and to determine what brought the City to its current financial condition. Also, the Grand Jury will propose strategies that could mitigate the huge deficits that now plague the City and its taxpayers, amounting to $7,000,000,000 ($7 billion.)

In February 2008, the City Independent Budget Analyst (IBA) Report 08-14 noted: "The structural imbalance confronting the City is, by its nature, persistent. The City cannot continue to use temporary or one-time solutions to combat its financial challenges effectively. Structural deficits require structural solutions." The City has yet to articulate structural solutions to close the multi-million dollar budget deficit in fiscal year (FY) 2010. More than 50% of this gap in financing was filled by using one-time solutions, such as skipping reserve payments and deferring projects.

One of the underlying causes of the current structural budget imbalance is the underfunding of the City's pension obligation by previous City administrations. The City Council determines the extent of retirement benefits. The San Diego City Employees' Retirement System (SDCERS) administers the pension fund and manages its investments. The SDCERS actuary calculates the amount of money that the City is required to contribute each year to fund the obligated pension benefits adequately (San Diego City Charter Article IX, §143).

Until 1996, the City made payments to the SDCERS pension fund according to the SDCERS actuary's determination of the Annual Required Contribution (ARC). At that time, the system was 92.3% funded. As of June 30, 2009, the system was only 66.5% funded.

In a sequence of events in 1996, 2000 and 2002, SDCERS adopted proposals, advanced by City officials as a strategy to balance the City's budget that enabled the City to contribute less money to the pension system than was required to keep it adequately funded. The 1996 proposal was known as City Manager's Proposal 1 [MP1] and the 2002 proposal was known as City Manager's Proposal 2 [MP2]. In some years, the City underfunded the pension plan by as much as $100 million. During this same time frame, the City negotiated new labor agreements that increased retirement benefits for City workers. This was the genesis of the current unfunded pension obligation of $2.2 billion and unfunded retiree health care liability of $1.3 billion (SDCERS June 30, 2009 Actuarial Valuation for the City of San Diego, p. 18) (FY 2011 Proposed Budget Executive Summary).

The City leadership should acknowledge the financial crisis the City is facing and make fundamental changes in how our government operates in order to avoid future crises. The City officials, who are responsible for resolving the past misjudgments by SDCERS and City officials, should move toward a comprehensive reevaluation of the City's financial structure. It would then be up to the public to assure that changes are implemented through the ballot initiative process. Not until the City of San Diego reasserts itself as a viable financial entity will it be able to reclaim the title of America's Finest City.

INVESTIGATION

The Grand Jury interviewed:

- Employees and Board members of the San Diego City Employees' Retirement System (SDCERS)
- Taxpayer advocates
- San Diego City and County financial officers
- San Diego City and County elected officials
- Representatives of labor organizations
- Legal professionals from the Offices of the District Attorney, County Counsel and City Attorney

The Grand Jury also reviewed thousands of pages of documents relating to local government financing, including the following reports:

- City Council reports
- Budget review hearings
- Revenue audits
- County Counsel opinions
- Past reports of the San Diego County Grand Jury which made recommendations of potential savings to the City of San Diego
- Past reports of Grand Juries in other counties concerning financial issues faced by those governmental entities within their respective jurisdictions
- Bankruptcy filings of Orange County and the City of Vallejo, California
- Reports of the Office of San Diego's Independent Budget Analyst
- City of San Diego Budgets for the Fiscal Years 2006 through 2010
- The report by Navigant Consulting, Inc., *Investigation for the Board of Administration of the San Diego City Employees' Retirement System,* January 20, 2006
- SDCERS *Comprehensive Annual Financial Report, Fiscal Year 2008*
- The City's FY 2011 Five Year Financial Plan
- The Citizens' Fiscal Sustainability Task Force, *Report on the City of San Diego Fiscal Outlook,* December 15, 2009
- San Diego City Attorney reports and legal opinions
- Numerous other related documents about the fiscal status and structure of City departments.

Suggested solutions to the fiscal crisis of the City were analyzed. These solutions emanated from confidential interviews and document reviews. Other means to cut budget deficits include such items as outsourcing, managed competition, business process re-engineering, reverse auctions, and the "piggy-backing" of various purchases and contracts with other local government entities. A 2009-2010 San Diego Grand Jury concurrent report (*Efficiency in Government*) identifies those activities that could produce substantial savings for the City.

San Diego City officials state publicly that, in these hard economic times for the City, employee layoffs may be necessary. The Grand Jury does not endorse such a direction as a final solution to the City's deficit. Layoffs will result in the reduction or elimination of many vital City services, including public safety services such as police and fire/rescue. Layoffs, or not filling vacant positions caused by attrition, do not positively serve the community interest and adversely impact the safety of City residents, businesses and visitors. This solution is not one that resolves the City's financial crisis.

In summary, this investigation is presented to the City and its citizens because the *status quo* is not going to resolve the crisis of financial instability, unbalanced budgets and reduction of the City's obligations, liabilities and debts. Nor will business as usual resolve the City pension deficit issues. Hard decisions face our elected officials and exacting measures are needed to rescue the City from its eventual financial collapse and/or declaration of bankruptcy, as other jurisdictions in the State have experienced.

Fact—Set One

General Fund Reserves

Fact: The City's General Fund revenue comes from four main sources: property tax, transient occupancy tax, sales tax and franchise taxes.

Fact: These four main sources of revenue contribute approximately 66.5% of all General Fund revenue.

Fact: Other General Fund sources include revenue from licenses, permits, forfeitures, penalties, enterprise funds, and government grants.

Fact: The City's General Fund budget for FY 2010 is projected to be $1.13 billion (IBA FY 2010 First Quarter Budget Report, p. 2). Of that amount, approximately 50% is allocated to police and fire/rescue. The other half is divided between funding the retirement system and providing community services such as libraries, parks and recreation, refuse collection and vital support functions such as finance, legal, and human resources (Budget Executive Summary FY 2010).

Fact: An alternative method of property tax allocation called the Teeter Plan allows counties to allocate property tax to local cities based on the total tax billed rather than the amount actually collected. In exchange, the counties receive the penalties and interest on the delinquent taxes when collected.

FINDINGS

Finding 01: General Fund revenue for FY 2010 is at least $11 million short of expectations due primarily to shortfalls in projected property, sales and transient occupancy taxes.

Finding 02: The required pension contribution by the City for FY 2011 is $231 million, approximately $19 million more than the anticipated $212 million contribution, necessitating potential additional service cuts in General Fund departments.

Finding 03: Absent an increase in General Fund revenue, the projected increases in the required annual pension contribution in future fiscal years will necessitate even more service cuts in General Fund departments.

Finding 04: Switching to the Teeter method of receiving property tax allocations from the County may stabilize that source of revenue and may result in an increase of about $2 million per year for the City's General Fund.

RECOMMENDATION

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego and the City Council of the City of San Diego:

10-125: **Analyze the impact of the City's opting in to the Teeter Plan for receiving its allocation of property tax revenue and switch to that method for FY 2012 if the analysis reveals financial benefits for the City.**

Fact—Set Two

San Diego City Employees' Retirement System (SDCERS)

The City Council determines retirement benefits and SDCERS administers the fund and its investments.

Fact: The City offers its employees a defined benefit retirement plan. By providing this benefit, the City is obligated by the California Constitution to maintain a retirement board that has plenary authority and fiduciary responsibility for the investment of moneys and administration of the system. The retirement board also has responsibility for investing the funds and administering the benefits of the fund. (San Diego City Charter Article IX, Section 143)

Fact: SDCERS was established by the City of San Diego in 1927 to administer the City's retirement system. Employees of the Unified Port District became members of SDCERS in 1963, and employees of the San Diego County Regional Airport Authority became members in 2003. Of the retirees receiving allowances from SDCERS, over 90% are former City employees.

Fact: The Port District and the Airport Authority have made sufficient contributions to SDCERS to make their pension systems financially stable.

Fact: The Board of Administration (Board) of SDCERS is composed of thirteen members. The SDCERS Board is a fiduciary charged with administering the City's pension fund in a manner that preserves its long term solvency. It must ensure that, through actuarially sound contribution rates and prudent investment, principal is conserved, income is generated, and the fund is able to meet its ongoing disbursement obligations (California Constitution, Article XVI, §17; San Diego City Charter Article IX, §144).

Fact: The City Council determines the retirement benefits and SDCERS administers the fund and its investments.

Fact: An actuarial firm contracted by SDCERS determines the City's Annual Required Contribution (ARC) to the pension fund [San Diego City Charter, Article IX, §143].

Fact: Until 1996, the City made required contributions to the pension fund according to the SDCERS actuary's annual calculation of the ARC. At that time, the retirement system was 92.3% funded.

Fact: In 1996, 2000 and 2002, SDCERS adopted City proposals to put less money into the pension fund than was required to keep it adequately funded. This enabled the City to address budget shortfalls.

Fact: During that time, City Hall and SDCERS negotiated increased pension benefits for themselves and their employees.

Fact: City employees, including elected officials and SDCERS staffers, were also granted retroactive increases in the rates at which their retirement allowance is calculated. Thus, there was an adjusted higher compensation for work for which retirees had already been paid.

Fact: Some former SDCERS Board members were union leaders who also worked for the City. They voted for enhanced pension benefits for themselves and their constituencies without requiring increased contributions by the City to the pension fund. These actions put the retirement system in jeopardy by not ensuring its financial support and placing unsustainable burdens on the pension system. To date, no one has been held accountable in that regard.

Fact: On November 18, 2002, a letter to the then Mayor, from a whistle blower who served on the SDCERS Board of Administration, pointed out the wrongfulness of increasing benefits while decreasing the City's Annual Required Contribution. Subsequently, this informant was removed from a Board meeting on November 19, 2004. This informant was not re-appointed to the Board.

Fact: Today's pension underfunding is estimated at $2.2 billion. [SDCERS June 30, 2009 Actuarial Valuation for the City, p. 18]. (FY 2011 Proposed Budget Executive Summary).

Fact: Typically, pension funds are supported by the return produced by their investments, which pays approximately 80 % of the pension's obligation. For example, if $100 is deposited now to the pension's fund, in ten years it compounds to $214, assuming a 7.0% return. If no money is deposited now, the unfunded obligation ultimately comes from taxpayer bailout.

Fact: SDCERS administers a defined benefit retirement plan. In a defined benefit plan, pension benefits are determined by a member's age at retirement, number of years of service and final compensation based on the highest salary earned over a consecutive twelve month period. Ultimately, these benefits are guaranteed by the taxpayers regardless of how SDCERS investments perform. In a 401(k) plan, and other similar plans, the employee generally has to make up any investment losses by contributing more to the fund or absorbing the loss.

Fact: Prior to 1996, most City employees were limited to pensions not exceeding 90% of their highest annual salary. On average, this far exceeded benefits accorded the private sector. The City's retirement benefits were among the highest in the nation for municipal governments. (*California Foundation for Fiscal Responsibility Memorandum*, February 13, 2009, p. 2). Although admittedly not a typical case, one City retiree is currently drawing a pension of approximately $17,000 per month. It is worth noting that 50% of Americans do not have any work-related pension and must subsist on Social Security benefits and their savings.

Fact: About 80% of the City's contribution to fund the retirement system comes primarily from the General Fund.

Fact: In 1994, the City's budget for pension expense was 6% of payroll cost. Today, sixteen years later, the cost is 28% of payroll, and growing.

Fact: For FY 2009, the City's fringe benefit rate was 52.5% of budgeted salaries of $728 million (IBA Report #09-10 issued February 24, 2009, p. 2). On average, privately operated companies spend 35% of budgeted salaries on fringe benefits.

Fact: Of its $42 million annual budget, SDCERS spends $28 million for investment advice, spread among twenty-six different firms. This money comes primarily from the City's General Fund.

Fact: The City's Financial Office engages accountants, actuaries and financial advisors to manage its General Fund of approximately $1 billion annually.

Fact: Article IX, §141 of the City Charter provides the authority for the City Council to establish a retirement system for City employees. Because City Charter §141 is permissive, the City Council may adopt an ordinance abolishing the SDCERS retirement system. As long as the City provides retirement benefits to its employees, there must be some sort of Retirement Board to invest the funds of the retirement system and to administer its benefits.

FINDINGS

Finding 05: The City's Finance Office has the expertise to select an alternate for the replacement of SDCERS, if need be.

RECOMMENDATIONS

The 2009/2010 San Diego County Grand Jury recommends that the Board of Administration of the San Diego City Employees' Retirement System:

10-126: **Consider alternative methods of selecting investment advisors, including competitive bidding or reverse auction processes.**

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego and the City Council of the City of San Diego:

10-127: **Investigate alternate retirement systems to determine whether the San Diego City Employees' Retirement System (SDCERS) should be dissolved in favor of another system, a purely outsourced operation, or retention of the current system.**

The 2009/2010 San Diego County Grand Jury recommends that the Audit Committee of the City of San Diego and the Independent Auditor of the City of San Diego:

10-128: **Conduct a performance audit of SDCERS' administration of the City's pension system.**

Fact—Set Three

The Unsustainable Pension Debt

The pension debt continues to increase.

Fact: The previous SDCERS board and previous City elected officials allowed the City to underfund ARC payments.

Fact: With respect to the pension deficit of $2.2 billion, SDCERS now claims it can be amortized (spread) over thirty years.

Fact: In the first five years of the projected pay down, the General Fund contribution will amount to a total of $1.46 billion owed in the following fiscal years:

- $232.4 million in 2011
- $258.8 million in 2012
- $282.9 million in 2013
- $305.3 million in 2014
- $326.5 million in 2015

Fact: Based on the point in time snapshot taken by the SDCERS actuary on June 30, 2009, for the years 2015 to 2025, the City's ARC payment will continue to increase by $20 million each year. In year 2025, the ARC is projected to reach $523.9 million. After the year 2025, the ARC payment is projected to decrease each year until it bottoms out in 2040. (Actuarial Projection, as presented to the SDCERS Board on Jan 22, 2010).

Fact: The projected figures of the pay-down assume there will be no change in the current economic situation.

Fact: In 2025, the City is projected to have an ARC payment of $523.9 million or about 50% of the City's annual General Fund budget, which is consistently about $1 billion.

Fact: City officials conceded the City could not possibly pay the projected $523.9 million.

Fact: The Securities and Exchange Commission filed a complaint in April, 2008 alleging fraud against certain City officials based, in part, upon allegations that the City conducted five separate municipal bond offerings in 2002 and 2003, raising more than $260 million, without disclosing deficiencies in its current and future pension and health care obligations to the investing public, but it appears the officials will be adjudged merely negligent.

FINDINGS

Finding 06: All of the above pay-down projections are actuarial estimates based on an analysis of the pension fund's fiscal condition at the close of FY 2009. In projecting the financial reconciliation, various officials indicated this is a dynamic economic condition that the City and the pension fund are facing. If it is examined at a different point in time, the unfunded liability and the projected ARC payments may differ.

Finding 07: These pay-down projections are based partially on the assumption by SDCERS that its pension fund portfolio will earn at least 7.75% each and every year. Earnings over the past three years have been a negative 1.84%.

Finding 08: The supposition that pension underfunding can be paid down by amortizing the unfunded pension obligation of $2.2 billion over thirty years is unrealistic, according to top City officials.

Fact—Set Four

SDCERS Investment Portfolio Performance

Fact: The majority of SDCERS pension fund portfolio was, and still is, in equities rather than fixed income.

Fact: For the period from June 2001 through June 2004, in part because of the "Dot.com" stock market crash, SDCERS earnings fell significantly. By October 31, 2001, the fund's portfolio lost $900 million of its value. (See Perry, "Fall From Frugality Puts San Diego on Fiscal Brink", *L.A. Times*, Sept 1, 2004, p. 1).

Fact: During 2008-2009, SDCERS experienced an unanticipated drop in the value of its $3.5 billion portfolio. Stocks fell to a twelve year low in early 2009. The Standard & Poor's 500 Index fell 42% from June 2008 through June 2009. SDCERS pension assets fell $1.3 billion or 30% during that same period. (SDCERS June 30, 2009 Actuarial Valuation for City of San Diego, p. 19).

Fact: SDCERS indicates that in the year since its last snapshot of debt due to the economic factors impacting investments, as of June 30, 2009, a 15% return on investment has been recouped, equating to an addition of $600 million into the pension fund.

FINDINGS

Finding 09: SDCERS indicated that investment losses in FY 2009 were approximately 19.2% of its portfolio while the average for investment losses in the United States was 25%-30%.

Finding 10: For every year SDCERS does not reach an investment return of 7.75 %, the City is required to increase its contribution to the retirement fund.

Finding 11: The rate of return on SDCERS investments has been a negative 1.84% over the past three fiscal years, FY 2007- FY 2009.

Fact—Set Five

Enhanced Retirement Fringe Benefits

DROP, SPSP, COLA, 13th Check, Pick-up, Purchase Service Credit, Retiree Health Care

THE DROP PROGRAM

Fact: In 1997, MP1 ushered in the Deferred Retirement Option Plan [DROP Program] on a trial basis. DROP became permanent on April 1, 2000. This program allowed certain designated City employees, including employees of SDCERS and City staff, to retire at a fixed pension. Under DROP, employees defer collecting a pension, return to work up to five more years at their salary rate [plus any raises in salary given], and simultaneously deposit a maximum of five years of retirement allowance in an interest bearing account at SDCERS.

Fact: Salary increases earned by DROP participants are not factored into the calculation of retirement allowances.

Fact: From its inception DROP was intended to be cost neutral.

Fact: The reason given for the implementation of the DROP program is that it would keep experienced workers on the payroll, resulting in more efficient and effective service delivery, while reducing the costs associated with providing benefits and training to new employees.

Fact: According to SDCERS, as of January 31, 2010, there were 1,992 individuals enrolled in the DROP program: 812 were on the job; 1,180 were retired.

FINDINGS

Finding 12: SDCERS reduced the guaranteed interest rate for DROP employees from 7.75% to 3.54% effective July 2009; there was a further reduction to 2.91% effective January 1, 2010. In order to maximize their benefits, some seventy to eighty veteran fire fighters and a like number of senior police officers locked in the then existing 7.75% interest rate on their DROP accounts by leaving the work force on or before June 30, 2009, rather than accepting the reduced interest rate. This negated some of the expressed effect of keeping experienced personnel on staff.

Finding 13: DROP is not deemed to be a vested benefit for those employees who have not yet entered the program, according to San Diego City Attorney Opinion Number 2010-1, dated January 21, 2010.

Finding 14: No actuarial study confirming the cost neutrality of DROP has been published to date.

RECOMMENDATIONS

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego and the City Council of the City of San Diego:

10-129: **Approve and fund an actuarial analysis of DROP which would confirm or refute the fact that it is cost neutral.**

10-130: **Consider taking the steps necessary to declare an immediate moratorium on all new DROP entrants pending the completion of the cost neutrality analysis.**

10-131: **Consider taking the steps necessary to discontinue DROP for all new entrants should the actuarial analysis demonstrate that it is not cost neutral.**

Supplemental Pension and Savings Plan (SPSP)

Fact: The Supplemental Pension and Savings Plan (SPSP) is a 401(k) type defined contribution plan wherein City employees may contribute 3% of annual salary, while receiving a matching contribution of 3% from the City, and can voluntarily contribute up to an additional 3.05% for employees hired after July 1, 1986, or 4.5% for employees hired on or before July 1, 1986. Both the amount deducted from employees' paychecks and the City's matching contribution of up to 6.05% are deposited into the employee's SPSP account.

Fact: The FY 2011 Proposed Budget for SPSP is $16.2 million. Due to labor concessions in FY 2010, some employee groups have the option to waive the City's match to employee mandatory contributions or take a 3% salary reduction. The Fiscal Year 2011 budget reflects the selections made by employees.

Fact: SPSP is a secondary retirement or savings type plan option extended to City workers in 1981 as an alternative benefit when the City opted out of the Social Security system. The City administers the SPSP, not SDCERS.

Fact: This benefit is deemed vested but can be amended or eliminated by a majority vote of the active participating employees. As of July 1, 2009, new employees who are General Members of the SDCERS plan receive a 401(a) defined contribution plan and are not eligible to participate in SPSP.

Cost of Living Adjustment (COLA)

Fact: Retirees may receive cost of living adjustments (COLA) of up to a 2% increase or decrease based on the Consumer Price Index. This benefit has been applied consistently since its inception in 1971, and California courts have held that it is vested.

13th Check

Fact: SDCERS indicates that should its annual stock portfolio returns exceed 7.75%, retirees receive a "13th check" (not to exceed $900 per year). In 1980, when the pension plan's investments were doing well, the City Council created the 13th check to share the plan's unexpectedly high rate of earnings with the retirees, rather than depositing the funds in the pension plan's reserve account.

Fact: Due to a 1983 legal settlement, the Retirement Board must make this additional payment to the employees in years where the plan has net earnings in excess of $100,000; however, those payments are capped at $30 per year of service. Thus, a retiree with thirty years of service will typically receive $900.

Fact: In years when there are no earnings, 13th checks are not issued. Each year stands on its own, and there is no forward accumulation if there are no earnings in a particular year. As this payment is made to all retirees, it is an expanding population.

Fact: The City Attorney opines that the 13th check is a vested benefit for employees hired before July 1, 2005, after which the benefit was eliminated.

Pick-up or Offset

Fact: The City Charter indicates that the cost of normal pension contributions be "substantially equal" between the City and the individual employee (City Charter Article IX, §143). Under labor contracts negotiated in recent years, the City has agreed to "pick-up" or "offset" a larger portion of the City match for some of the employee union groups in exchange for salary concessions. During the FY 2010 budget process most "pickups" were either reduced or eliminated. Those pickups that are left are subject to negotiation with labor organizations. They are not deemed to be vested benefits.

Fact: According to the SDCERS actuarial report for FY 2009, the City's elected officials pay 9.06% of salary as their pension contribution, while the City picks up 30.53%.

FINDINGS

Finding 15: For FY 2011, the City's contribution is more than three times the contributions of City elected officials.

Fact: The projected FY 2011 budget allows for $7.9 million for retirement offset payments.

Finding 16: The concept of "substantially equal" contributions, shared by the City and its employees, to date has not been applied when determining responsibility for increased ARC payments resulting from SDCERS investment losses. For example, for FY 2011, the City's ARC payment includes over $70 million it alone is paying to make up for SDCERS investment losses in FY 2009

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Purchase Service Credit Program

Fact: City employees are offered the opportunity to purchase up to five years of additional service credits. This additional purchased service time can raise an employee's pension percentage rate and gross pension dollars because the allowance is based on years of service.

Fact: City Council members and other elected officials are allowed to buy five years of service credits even though under term limits they are limited to eight years of service. This allowed elected officials to be paid pensions as if they had served thirteen years rather than eight years.

Fact: On August 14, 2007, SDCERS actuarial consultants reported a $146 million actual cash loss to the Purchase Service Credit Program because the liability created by those purchases from 2000 to 2006 was based on an incorrect rate structure that did not cover the actual cost that should have been charged to City employees. (Letter from SDCERS Actuary to SDCERS' Retirement Administrator). The City has yet to recoup its loss.

Retiree Health Care

Fact: For FY 2011, $32.8 million is budgeted on a "pay-as-you-go" basis to cover the healthcare costs of over 4,700 City retirees; an additional $25 million is budgeted to pre-fund a retiree health benefit trust.

Fact: The full ARC payment for retiree health care for FY 2011 is $120.3 million; the City is funding only about 27% of that amount. (This ARC for retiree health care is not to be confused with the ARC for the pension system, which the City funds at 100%).

Fact: In addition to the unfunded pension obligation of $2.2 billion, the taxpayers are faced with an unfunded liability of $1.3 billion for retiree health care.

Fact: The unfunded liability for retiree health care coverage stands at $1.3 billion dollars as of June 30, 2009. The City's funding ratio for health care was only 3% at that time. These payments are made from the City's General Fund, not from the retirement fund administered by SDCERS.

Fact: In the "State of the City" address on January 31, 2010, it was asserted that: "No one will again receive pensions that take advantage of the taxpayers". However, the DROP Program, Healthcare Coverage, the Supplemental Pension and Savings Plan, the Purchase Service Credit Program, the 13th Check Program, Pick-Ups and Offsets continue, despite the fact that certain of these benefits are additional employee benefits granted by the City, at taxpayer expense, through labor negotiations and are not deemed to be vested.

Fact—Set Six

Additional City Structural Deficits

Fact: There is a backlog of deferred maintenance projects conservatively estimated at $1 billion.

Fact: Cities typically issue bonds to borrow money for large and costly projects such as sewer and water treatment plants, pump stations and pipe replacement or rehabilitation, and street maintenance. San Diego recently borrowed $1.3 million to fund deferred maintenance projects, such as filling potholes.

Fact: The City's bonded indebtedness totals $2.6 billion.

Fact: The following areas must also be addressed in order to restore or preserve the fiscal integrity and meet the legal obligations of the City:

(1) funding the reserves for each City department,
(2) funding new obligations under storm water runoff permits of approximately \$25-\$30 million,
(3) funding the Americans with Disabilities Act (ADA) obligations of approximately \$50-70 million,
(4) funding the City (self-insured) worker's compensation fund against outstanding claims, currently estimated at \$161 million, and
(5) funding of the City's (self-insured) public liability fund against lawsuits that could drain the General Fund for years to come. As of June 30, 2009, the City faces \$129 million in claims. (IBA Report #09-10 issued Feb 14, 2009)

FINDINGS

Finding 17: These aforementioned obligations, liabilities and debts amount to \$7 billion.

Finding 18: Proposed methods of enhancing revenue fall far short of satisfying these obligations, debts and liabilities; revenue enhancements may be insufficient to address budget shortfalls resulting from the projected increases in the City's ARC payments over the next five years.

Fact: In an effort to reduce the pension deficit, there was a recent reduction in pension benefits for new hires after July 1, 2009. The City imposed a hybrid pension plan with a cap of 80% of pensionable salary on retirement allowances.

Finding 19: The implementation of a hybrid pension system for employees hired on or after July 1, 2009 will do little to reduce the burden on the taxpayers for decades, at which time these employees will reach retirement age.

Fact: In the State of the City address on January 30, 2010, it was indicated that the public would have to wait eighteen months to hear the plan to resolve the City's structural deficit.

Fact: It has been suggested that the City should fire 1,500 City workers saving millions of dollars in personnel costs and/or slash the budget of all City departments by 10%-15%.

Finding 20: Performance audits of the major City departments may identify operational efficiencies and expenditure reductions.

RECOMMENDATION

The 2009/2010 San Diego County Grand Jury recommends that the Audit Committee of the City of San Diego and the Independent Auditor of the City of San Diego:

10-132*:* **Evaluate each department of the City to determine potential cost savings, operational efficiencies and revenue enhancements.**

Real Estate Leases

Fact: From December, 2007 to October, 2009 the City sold twenty-five properties for over $37.1 million. Proceeds from these sales were used predominantly (95%) for capital improvements.

Fact: Ten additional properties have been approved for sale by the City Council, but have not been sold due to the current downtrend in the real estate market.

Fact: Revenue from sold property is used for capital improvements; revenue from leased property goes in to the General Fund.

FINDING

Finding 21: There are desirable City owned parkland properties such as Mission Bay Park, Balboa Park and Torrey Pines Park.

RECOMMENDATION

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego:

10-133: **Direct the City's Department of Real Estate Assets to explore marketing aggressively to developers long term leasing (not sales) of desirable City owned properties, such as parkland in Mission Bay, Balboa Park, Torrey Pines and the Qualcomm Stadium area, as well as other parcels deemed appropriate for leases of 50-60 years.**

Fact—Set Seven

Library System

Fact: The City and County currently maintain separate library systems though both share borrowing privileges.

Fact: The City's library system consists of a central downtown library and thirty-five branches. In FY 2007, there were more than six million visits to City libraries, over seven million items were borrowed and an additional two million items were used in the library. More than one and one-half million customers used the library internet facilities.

Finding 22: By charging minimal fees for each book, DVD, or other service provided, hours of operation could be increased to generate more revenue; library hours may not have to be reduced from forty-one to thirty-six hours per week, as they have in recent budget cuts.

Fact: Riverside County, California outsources its library system and reports substantial cost saving and improved service.

RECOMMENDATIONS

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego:

10-134: **Explore the feasibility of outsourcing the City's entire library system.**

Fact—Set Eight

Residential Trash Collection

Fact: San Diego Municipal Code section 66.0123, known as the People's Ordinance, prohibits the City from imposing a fee for residential trash pick-up for most single family residences in the City.

Fact: The 2007/2008 Grand Jury, in a report entitled *Waste Not, Want Not- Recycle Now*, and the 2008/2009 Grand Jury, in a report entitled *Time for the Repeal of the People's Ordinance*, recommended repeal of the People's Ordinance, which would allow the City to charge for residential trash pick-up.

Fact: The FY 2009 budgeted cost to the City was approximately $38 million for refuse collection, $9 million for recyclable commodities collection, and $7 million for yard waste collection, for a total of $54 million. Refuse collection services are funded by the General Fund, while recycling and yard waste collection is provided by the Recycling Fund.

Fact: When the City of Phoenix, Arizona went to private trash collection, the cost of its solid waste pickup service dropped 38%.

FINDING

Finding 23: Charging a fee for residential trash collection could save the City approximately $54 million per year.

RECOMMENDATION

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego:

10-135: **Draft a ballot measure calling for the repeal of the People's Ordinance.**

10-136: **In addition, consider the benefits of outsourcing the entire trash collection operation.**

Fact—Set Nine

Consolidation

Fact: Currently, the City and County maintain separate agencies for the following functions:

- Disaster Preparedness
- Purchasing and Contracting

- Information Technology
- Zoning/Planning
- Building Permits and Inspection
- Street Maintenance
- Employment and Economic Development
- Forensic Laboratories
- Libraries
- Parks and Recreation
- Police
- Fire Protection/Rescue

Fact: The fire departments of El Cajon, La Mesa and Lemon Grove recently entered into a Joint Powers Agreement that is projected to save taxpayers $500,000 each year. Standardization of equipment and purchasing economies may cut costs even further.

Fact: There are sixty fire agencies in San Diego County, each with their own command staff. Every dollar saved by amalgamation means one dollar less taken from other vital programs.

FINDING

Finding #24: Cost savings could be achieved by consolidation of various functions performed by both the City and the County.

RECOMMENDATION

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego and the City Council of the City of San Diego:

10-137: **Conduct an analysis of City services that are also provided by the County and neighboring cities, with the objective of cutting costs by consolidation.**

Fact—Set Ten

Personnel Layoffs

The layoff of any City employees in these uncertain times is not the solution to resolving the structural budget deficit. Presently, there are some 70,000 unemployed workers in San Diego (Executive Summary of City's FY 2010 annual report). Adding to the unemployment numbers only puts more overall economic burden on the community and government agencies.

Fact: A document prepared by a City's employee union for the San Diego City Council's Budget and Finance Committee indicates that there are now anywhere from seven to nine layers of costly management between the Mayor and a blue-collar worker in the field.

Fact: Typically, the City loses about 250 workers through attrition each year.

Fact: In the first half of 2008, nearly 620 employees (among them a large group of seasoned police officers and veteran firefighters) retired prior to July 1, 2009 to avoid a reduction of over 4% in the DROP interest rate formerly at 7.75% and also to avoid a two-year 6% reduction in salary.

Fact: In 2009, City payroll increased by $42 million. Despite a hiring freeze imposed on August 6, 2008, 873 employees, including 527 full time workers, were hired to fill positions deemed "critical." At least three new full-time members were added to mayoral staff, along with three interns. The overall budget for the eight members of the City Council increased by $1.6 million, or 21%, since 2006.

Reductions in Public Safety Work Force

Fact: The City's firefighter's union called upon City officials to rescind the "brownout" plan. This plan idles up to eight fire engines a day to cut overtime pay costs.

Fact: Reducing the number of lifeguards puts lives at risk. In 2008, there were 5,000 water rescues from Point Loma to Black's Beach in La Jolla.

Fact: The Police equestrian teams in Balboa Park were instrumental in reducing such previously existing criminal activities as illegal lodging by transients establishing permanent encampments, illicit sexual activities, and drug trafficking. Experience shows that horseback officers can disburse fractious political demonstrators and large inebriated crowds with ease.

Fact: Cuts in the Police Departments Canine (K-9) Unit create hazards for officers on the street as well as for members of the public.

FINDING

Finding 25: City Hall acted improvidently in cutting the public safety workforce for FY 2010 and FY 2011.

RECOMMENDATIONS

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego and the San Diego City Council:

10-138: **Eliminate redundant positions and extraneous levels of management and supervision as employees leave City service through attrition.**

10-139: **Restore the cuts to public safety personnel as a priority.**

Fact—Set Eleven

Chapter 9 Reorganization

Fact: The San Diego Pension Reform Committee in 2003-2004, reported: "Public pensions have become dangerously out of control as they gobble up entire budgets, leaving nothing for services."

Fact: Of sixty-four public pension systems in the State, fifty-four have fewer assets than liabilities.

Fact: Presently the City of San Diego's obligations, liabilities and debts exceed $7 billion.

Fact: Chapter 9 proceedings under federal bankruptcy law allow municipalities to restructure and reorganize their assets and debts while providing relief from current and future obligations. This enables municipalities to have a "fresh start."

Fact: A City official wrote on Jan 31, 2010 decrying "bankruptcy hucksters who were spinning their nonsense... bankruptcy is a con job... its baloney."

Fact: To be eligible to file bankruptcy under Chapter 9, the City must be insolvent on a cash-flow basis: unable to pay its debts now or as they become due in the future [11 U. S. Code, Section 101 (32) (C) (i) and (ii)].

Fact: In 1994, Orange County declared bankruptcy after stock market investments resulted in a $1.6 billion loss.

Fact: The federal judge in the Orange County bankruptcy proceeding acknowledged that Orange County's bankruptcy cost was $100 million, most of which was paid to accountants, not lawyers, to restructure the County's accounting and financial system

Fact: In 2008, the City of Vallejo, California, a waterfront suburb with 120,000 residents located on San Francisco Bay, was driven into bankruptcy by its unsustainable personnel costs. Some 76% of Vallejo's operating budget went to salaries and benefits. The norm is 50%. Pensions were not an immediate issue since Vallejo had funded its pension obligation. Vallejo's most significant liability was $135 million of unfunded health care. Vallejo officials brought the unions back to the bargaining table after the federal bankruptcy judge ruled collective bargaining agreements can be voided.

Fact: Vallejo reduced its budget by laying-off one-third of its safety workers. Any discussion of pensions was postponed for a year. (City of Vallejo Response to Solano County 2003-2004 Grand Jury Report, p. 4) (City of Vallejo bankruptcy workout plan presented to the Vallejo City Council on Dec 22, 2009).

Fact: As of October 2009, Vallejo's bankruptcy costs had reached $5 million.

Fact: The federal bankruptcy judge declared the City of Vallejo insolvent, commenting "...with no reserves and a multimillion dollar deficit, the General Fund would not have sufficient funds and cash flow to pay its debts as they become due."

Fact: At a seminar hosted on Oct 22, 2009 by the San Diego County Taxpayers Association, the federal bankruptcy judge who presided over Orange County's bankruptcy was joined on the panel by two experienced bankruptcy attorneys.

Fact: A speaker at the seminar said that municipalities are not required to raise taxes or cut costs to the bone before filing for reorganization under Chapter 9. In Orange County, to avoid filing a bankruptcy petition under Chapter 9, the County had earlier proposed a tax that the people voted down.

Fact: It is still untested whether or not the vested rights clause pertaining to pension benefits prevails in bankruptcy proceedings

FINDINGS

Finding 26: A proactive dialogue as to the efficacy of a Chapter 9 reorganization cannot be removed from any discourse as to the City's financial health.

Finding 27: A Chapter 9 filing would result in a federal determination of which fringe benefits and collective bargaining agreements could be restructured. The fringe benefit total is $423.7 million, according to the FY 2011 Proposed Budget.

RECOMMENDATION

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego and the San Diego City Council:

10-140: **Convene a panel of bankruptcy experts to discuss the legal and financial ramifications of a Chapter 9 declaration of bankruptcy, in the context of a publicly noticed City Council or Council Committee meeting.**

COMPLETE RECOMMENDATIONS

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego and the City Council of the City of San Diego:

10-125: **Analyze the impact of the City's opting in to the Teeter Plan for receiving its allocation of property tax revenue and switch to that method for FY 2012 if the analysis reveals financial benefits for the City.**

The 2009/2010 San Diego County Grand Jury recommends that the Board of Administration of the San Diego City Employees' Retirement System:

10-126: **Consider alternative methods of selecting investment advisors, including competitive bidding or reverse auction processes.**

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego and the City Council of the City of San Diego:

10-127: **Investigate alternate retirement systems to determine whether the San Diego City Employees' Retirement System (SDCERS) should be dissolved in favor of another system, a purely outsourced operation or remain in place.**

The 2009/2010 San Diego County Grand Jury recommends that the Audit Committee of the City of San Diego and the Independent Auditor of the City of San Diego:

10-128: **Conduct a performance audit of SDCERS' administration of the City's pension system.**

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego and the City Council of the City of San Diego:

10-129: **Approve and fund an actuarial analysis of DROP which would confirm or refute the fact that it is cost neutral.**

10-130: **Consider taking the necessary steps to declare an immediate moratorium on all new DROP entrants pending the completion of the cost neutrality analysis.**

10-131: **Consider taking the necessary steps to discontinue DROP for all new entrants should the actuarial analysis demonstrate that it is not cost neutral.**

The 2009/2010 San Diego County Grand Jury recommends that the Audit Committee of the City of San Diego and the Independent Auditor of the City of San Diego:

10-132: **Evaluate each department of the City to determine potential cost savings, operational efficiencies and revenue enhancements.**

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego:

10-133: **Direct the City's Department of Real Estate Assets to explore marketing aggressively to developers long term leasing (not sales) of City owned properties, such as parkland in Mission Bay, Balboa Park, Torrey Pines and the Qualcomm Stadium area, as well as other parcels deemed appropriate for leases of 50-60 years.**

10-134: **Explore the feasibility of outsourcing the City's entire library system.**

10-135: **Draft a ballot measure calling for the repeal of the People's Ordinance.**

10-136: **In addition, consider the benefits of outsourcing the entire trash collection operations.**

The 2009/2010 San Diego County Grand Jury recommends that the Mayor of the City of San Diego and the City Council of the City of San Diego:

10-137: **Conduct an analysis of City services that are also provided by the County and neighboring cities, with the objective of cutting costs by consolidation.**

10-138: **Eliminate redundant positions and extraneous levels of management and supervision as middle managers leave City service through attrition.**

10-139: **Restore the cuts to public safety personnel as a priority.**

10-140: **Convene a panel of bankruptcy experts to discuss the legal and financial ramifications of a Chapter 9 declaration of bankruptcy, in the context of a publicly noticed City Council or Council Committee meeting.**

REQUIREMENTS AND INSTRUCTIONS

The California Penal Code §933(c) requires any public agency which the Grand Jury has reviewed, and about which it has issued a final report, to comment to the Presiding Judge of the Superior Court on the findings and recommendations pertaining to matters under the control of the agency. Such comment shall be made *no later than 90 days* after the Grand Jury publishes its report (filed with the Clerk of the Court); except that in the case of a report containing findings and recommendations pertaining to a department or agency headed by an elected County official (e.g. District Attorney, Sheriff, etc.), such comment shall be *within 60 days* to the Presiding Judge with an information copy sent to the Board of Supervisors.

Furthermore, California Penal Code §933.05(a), (b), (c), details, as follows, the manner in which such comment(s) are to be made:

(a) As to each grand jury finding , the responding person or entity shall indicate one of the following:

  (1) The respondent agrees with the finding

  (2) The respondent disagrees wholly or partially with the finding, in which case the response shall specify the portion of the finding that is disputed and shall include an explanation of the reasons therefor.

(b) As to each grand jury recommendation, the responding person or entity shall report one of the following actions:

  (1) The recommendation has been implemented, with a summary regarding the implemented action.

  (2) The recommendation has not yet been implemented, but will be implemented in the future, with a time frame for implementation.

(3) The recommendation requires further analysis, with an explanation and the scope and parameters of an analysis or study, and a time frame for the matter to be prepared for discussion by the officer or head of the agency or department being investigated or reviewed, including the governing body of the public agency when applicable. This time frame shall not exceed six months from the date of publication of the grand jury report.

(4) The recommendation will not be implemented because it is not warranted or is not reasonable, with an explanation therefor.

(c) If a finding or recommendation of the grand jury addresses budgetary or personnel matters of a county agency or department headed by an elected officer, both the agency or department head and the Board of Supervisors shall respond if requested by the grand jury, but the response of the Board of Supervisors shall address only those budgetary or personnel matters over which it has some decision making authority. The response of the elected agency or department head shall address all aspects of the findings or recommendations affecting his or her agency or department.

Comments to the Presiding Judge of the Superior Court in compliance with the Penal Code §933.05 are required from the:

Responding Agency	Recommendations	Date
Mayor, City of San Diego	**10-125, 10-127, 10-129, 10-130, 10-131, 10-133, 10-134, 10-135, 10-136, 10-137, 10-138, 10-139, 10-140**	**9/6/10**
City Council, City of San Diego	**10-125, 10-127, 10-129, 10-130, 10-131, 10-137, 10-138, 10-139, 10-140**	**9/6/10**
San Diego City Employee's Retirement System Board of Administration	**10-126**	**9/6/10**
City of San Diego Audit Committee	**10-128, 10-132**	**9/6/10**
City of San Diego Independent Auditor	**10-128, 10-132**	**9/6/10**

ATTACHMENT C

SDCERS
San Diego City Employees' Retirement System

Mark A. Hovey
Chief Executive Officer

August 17, 2010

Honorable Kevin A. Enright
Presiding Judge
Superior Court of the State of California
For the County of San Diego
Hall of Justice
220 West Broadway
San Diego, CA 92101

Re: Grand Jury Report of June 8, 2010

Dear Judge Enright:

The San Diego Grand Jury issued a report entitled "The City's Financial Crisis: Past, Present, and Future" on June 8, 2010, a copy of which is attached. Several of the Grand Jury's comments pertained to the San Diego City Employees' Retirement System (SDCERS). Also attached is a copy of SDCERS' response to the Grand Jury report.

Sincerely,

Mark A. Hovey
Chief Executive Officer

cc: SDCERS' Board of Administration
Honorable Mayor Jerry Sanders
San Diego City Council
Eduardo Luna, City Auditor
City Audit Committee
Victoria Stubblefield, Foreperson of the Grand Jury

Enclosures

SDCERS
San Diego City Employees' Retirement System

Fact/Finding/Recommendation	SDCERS Response
Fact – Set Two (Page 5)	
Fact: During that time, City Hall and SDCERS negotiated increased pension benefits for themselves and their employees.	Only the City negotiated with its bargaining units. SDCERS does not participate in the negotiation process (meet and confer) with the City or the City's bargaining units.
Fact: City employees, including elected officials and SDCERS staffers, were also granted retroactive increases in the rates at which their retirement allowance is calculated. Thus, there was an adjusted higher compensation for work for which retirees had already been paid.	The City negotiated the retroactive increase with its active employees, not retirees, to provide for increased benefits.
Fact: Some former SDCERS Board members were union leaders who also worked for the City. They voted for enhanced pension benefits for themselves and their constituencies without requiring increased contributions by the City to the pension fund. These actions put the retirement system in jeopardy by not ensuring its financial support and placing unsustainable burdens on the pension system. To date, no one has been held accountable in that regard.	Certain Board members in their capacity as union leaders negotiated with the City for enhanced benefits. As Board members, however, they did not vote for enhanced benefits. Rather, they voted to approve an agreement regarding the payment of the City's Annual Required Contribution ("ARC"). City employees and former Board members were indicted with an ultimate finding as to all members and employees, except Ronald Saathoff, that they did not commit a violation of law. (See, *Lexin v. Superior Court*, 47 Cal.4th 1050 (2010); *U.S. vs. Saathoff*, 2007 U.S. Dist. LEXIS 34779)
Fact: Today's pension underfunding is estimated at $2.2 billion.	The Unfunded Actuarial Liability at June 30, 2009 was $2.1 billion. This liability is comprised of several components, including the City's prior contribution underfunding. It also includes investment losses and actuarial experience losses.
Fact-Set Two (Page 6)	
Fact: Prior to 1996, most City employees were limited to pensions not exceeding 90% of their highest annual salary.	In fact, prior to 1996, there was no percentage limit on pensions relative to an employees' highest annual salary. However, based on the calculation factor in place at the time, it would have taken at

SDCERS
San Diego City Employees' Retirement System

Fact/Finding/Recommendation	SDCERS Response
	least 32 years of service to reach 90%. After 1996, most City employee pensions are limited to 90% of their highest annual salary. San Diego Municipal Code (SDMC) §§24.0402(g) and 24.0403(e)
Fact: Of its $42 million annual budget, SDCERS spends $28 million for investment advice, spread among twenty-six different firms. This money comes primarily from the City's General Fund.	All fees are paid out of the SDCERS portfolio, not the City's General Fund. Fees are a reflection of assets under management, and support over $300 million of annual investment earnings.
Fact: Article IX, §141 of the City Charter provides the authority for the City Council to establish a retirement system for City employees. Because City Charter §141 is permissive, the City Council may adopt an ordinance abolishing the SDCERS retirement system. As long as the City provides retirement benefits to its employees, there must be some sort of Retirement Board to invest the funds of the retirement system and to administer its benefits.	The City Council does not have authority to abolish the System by ordinance. Once the system has been established, the California Constitution and San Diego City Charter provide mandatory provisions as to the make-up of the System established to administer the benefits and any alterations of that System. There is no provision in the City Charter that would allow the City Council to outsource management of the System to any entity other than the State Retirement System (CALPERS) or the U.S. Government (Social Security).
Recommendation 10-126: Consider alternative methods of selecting investment advisors, including competitive bidding or reverse auction processes.	The recommendation will not be implemented because it is not warranted and is not reasonable. SDCERS actively negotiates competitive fee arrangements with all of its investment managers. A recent review of fees paid indicated that SDCERS fees are at or below the median fee paid as measured by the Callan Investments Institute. Fees are not a driver of investment manager selection. Rather, fees are the last step in the selection process and also reflect the manager skill needed to effectively manage a particular investment strategy. Reverse auctions and competitive bidding are usually used in industrial business-to-business procurement. This does not occur in

SDCERS
San Diego City Employees' Retirement System

Fact/Finding/Recommendation	SDCERS Response
	the investment industry as buyers are not procuring commodities but rather paying for skill and results.
Recommendation 10-127: Investigate alternate retirement systems to determine whether the San Diego Employees' Retirement System (SDCERS) should be dissolved in favor of another system, a purely outsourced operation, or retention of the current system.	There is no provision in the City Charter that would allow the City Council to outsource management of the System to any entity other than the State Retirement System (CALPERS) or the U.S. Government (Social Security).
Fact – Set Three (page 7-8)	
Fact: With respect to the pension deficit of $2.2 billion, SDCERS now claims it can be amortized (spread) over thirty years.	Amortizing the City's UAL over 30 years is not a new claim. In recent years, the SDCERS Board has implemented shorter amortization schedules with the majority of the City's pension deficit being amortized over 20 years, with 18 years remaining as of the June 30, 2009 valuation. Nearly all of the remaining deficit is being amortized over 15 years. Only the UAL layer attributed to changed actuarial assumptions or methods (evaluated once every 3-5 years) may be amortized over 30 years.
Fact: In the first five years of the projected pay down, the General Fund contribution will amount to a total of $1.46 billion owed in the following fiscal years: • $232.4 million in 2011 • $258.8 million in 2012 • $282.9 million in 2013 • $305.3 million in 2014 • $326.5 million in 2015	The five annual amounts shown add to $1.41 billion, not $1.46 billion; the figures shown are before taking into account savings from new general and police plans for members hired after June 30, 2009, and the figures shown are not the General Fund amounts but the total Citywide payment, with the General Fund amounts approximately 20% less.

Fact/Finding/Recommendation	SDCERS Response
FINDINGS	
Finding 06: All of the above pay-down projections are actuarial estimates based on an analysis of the pension fund's fiscal condition at the close of FY 2009. In projecting the financial reconciliation, various officials indicated this is a dynamic economic condition that the City and the pension fund are facing. If it is examined at a different point in time, the unfunded liability and the projected ARC payments may differ.	SDCERS agrees with this finding.
Finding 07: These pay-down projections are based partially on the assumption by SDCERS that its pension fund portfolio will earn at least 7.75% each and every year. Earnings over the past three years have been a negative 1.84%	SDCERS partially disagrees with this finding. The earnings assumption is exactly 7.75%, not "at least 7.75%," which implies the system will need to earn more than that to support the pay-down projections. Also, SDCERS does not expect earnings each and every year of exactly 7.75%, but rather that over our long term investment timeline, the fund will earn more than 7.75% in some years, and less in others averaging over time to 7.75%. Using a three-year return citation is misleading, insufficient and out of context with SDCERS' long-term strategy.
Finding 08: The supposition that pension underfunding can be paid down by amortizing the unfunded pension obligation of $2.2 billion over thirty years is unrealistic, according to top City officials.	SDCERS partially disagrees with this finding, in that the system is not using a thirty year amortization period for the $2.1 billion Unfunded Actuarial Liability (UAL). The UAL as of June 30, 2007 is being paid down over a closed period of 20 years, and each successive annual UAL layer, be it a net gain or net loss, is being amortized over 15 years.
Fact – Set Four (page 8)	
Fact: During 2008-2009, SDCERS experienced an unanticipated drop in the value of its $3.5 billion portfolio. Stocks fell to a twelve year low in early 2009. The Standard & Poor's 500 Index fell 42% from June 2008 through June 2009.	The June 30, 2009 Actuarial Valuation for the City of San Diego, on page 15, shows that market value of assets declined from $4.7 billion at June 30, 2008 to $3.7 billion at June 30, 2009, or $1.0 billion (21%). This change in asset values reflects the change in all cash flows,

Fact/Finding/Recommendation	SDCERS Response
SDCERS pension assets fell $1.3 billion or 30% during that same period. (SDCERS June 20, 2009 Actuarial Valuation for City of San Diego, p. 19)	including contribution in and benefit payments out, as well as investment performance. Page 19 of the valuation deals with changes in liabilities, not assets.
FINDINGS	
Finding 09: SDCERS indicated that investment losses in FY 2009 were approximately 19.2% of its portfolio while the average for investment losses in the United States was 25%-30%.	SDCERS agrees with the finding.
Finding 10: For every year SDCERS does not reach an investment return of 7.75%, the City is required to increase its contribution to the retirement fund.	SDCERS partially agrees with this finding, although it fails to acknowledge that returns above 7.75% will reduce the City's contributions.
RECOMMENDATIONS	
Recommendation 10-130: Consider taking the steps necessary to declare an immediate moratorium on all new DROP entrants pending the completion of the cost neutrality analysis.	Neither the City nor SDCERS should implement this recommendation, because "a moratorium" on new DROP entrants, absent an amendment to the plan, would violate the Plan document and risk plan disqualification by the IRS with adverse tax consequences to the City and SDCERS' members.
Recommendation 10-131: Consider taking steps necessary to discontinue DROP for all new entrants should the actuarial analysis demonstrate that it is not cost neutral.	If the City decides to implement this recommendation, it should do so in a manner that does not violate the vested rights of Members and does not violate SDMC §24.1004(k) or Internal Revenue Code Section 411(e). The City passed an ordinance that discontinues the DROP option for all new hires effective July 1, 2005.
Fact (pages 10-11)	

Fact/Finding/Recommendation	SDCERS Response
Fact: SDCERS indicates that should its annual stock portfolio returns exceed 7.75%, retirees receive a "13^{th} check" (not to exceed $900 per year).	There is no limitation on the total amount of a Retiree's 13th Check. Generally, each recipient receives $30 per year of qualifying service, so if a Retiree had 30 years of service credit their 13^{th} check would be $900. If a Retiree had 35 years of service credit they would receive $1,050.
Fact: (13^{th} check). As this payment is made to all retirees, it is an expanding population.	The eligible 13^{th} check population is a closed group of active and retired members. The 13^{th} check benefit has been eliminated for employees hired after July 1, 2005.
Fact: According to the SDCERS actuarial report for FY 2009, the City's elected officials pay 9.06% of salary as their pension contribution, while the City picks up 30.53%.	The Elected Official's normal cost rate is 9.06%, of which the City offsets (pays on the official's behalf) 5.89%, leaving a net contribution by the Elected Official of 3.17%. The 30.53% is the City's normal cost contribution plus a portion of the UAL attributed to past City underfunding, investment losses and actuarial experience losses.
FINDINGS	
Finding 15: For FY 2011, the City's contribution is more than three times the contributions of City elected officials.	SDCERS partially disagrees with this finding. As noted in the fact directly above, including the offset paid by the City, their contribution for Elected Officials is 36.42%, which is more than 11 times the Elected Official net contribution.
Finding 16: The concept of "substantially equal" contributions, shared by the City and its employees, to date has not been applied when determining responsibility for increased ARC payments resulting from SDCERS investment losses. For example, for FY 2011, the City's ARC payment includes over $70 million it alone is paying to make up for SDCERS investment losses in FY 2009.	SDCERS disagrees with this finding, to the extent that it implies that the investment losses should be shared equally between the City and its employees. SDCERS has undertaken a comprehensive study of the issue through its General Counsel, Fiduciary Counsel and Actuary and has determined that the substantially equal requirement does not apply to investment losses and gains.
Fact (page 12): On August 14, 2007, SDCERS actuarial consultants reported a $146 million actual cash loss to the	SDCERS disagrees with this fact to the extent it is misleading. The SDCERS actuary did not report "an actual cash loss." In its August 14,

SDCERS
San Diego City Employees' Retirement System

Fact/Finding/Recommendation	SDCERS Response
Purchase Service Credit Program because the liability created by those purchases from 2000 to 2006 was based on an incorrect rate structure that did not cover the actual cost that should have been charged to City employees.	2007 letter, Cheiron stated the net actuarial deficiency for pre-2000 Purchase of Service Credit (PSC) contracts through October 31, 2003 was $146 million. The rate structure for PSC contracts has since been revised.