



THE CITY OF SAN DIEGO
MANAGER'S REPORT

DATE ISSUED: September 8, 2005 REPORT NO. 05-190

ATTENTION: Honorable Mayor and City Council
Docket of September 12, 2005

SUBJECT: Options to Increase the Funded Ratio of the San Diego City Employees' Retirement System.

SUMMARY

Issues

- (1) Should the City Council accept the report on options to increase the funded ratio of the San Diego City Employees' Retirement System?
- (2) Should the City Council direct the City Manager to develop proposals to achieve an 80-85% funded ratio by Fiscal Year 2008?
- (3) Should the City Council direct the City Manager to proceed with the evaluation of pension solutions, including but not limited to, the leveraging of approximately \$17 million to securitize City revenues during Fiscal Year 2006, and provide quarterly status reports to the City Council on the implementation of pension solutions?

Manager's Recommendations

- (1) Accept the report of the City Manager.
- (2) Direct the City Manager to develop proposals to achieve an 80-85% funded ratio by Fiscal Year 2008.
- (3) Direct the City Manager to proceed with the evaluation of pension solutions, including but not limited to, the leveraging of approximately \$17 million to securitize City revenues during Fiscal Year 2006, and provide quarterly status reports to the City Council on the implementation of pension solutions.

Other Recommendations

None.

Fiscal Impact

To be determined based on the pension solutions implemented. In addition, initial consultant contracts have been established with Public Financial Management, Inc. for \$10,000 and Towers Perrin for \$22,000. Funds are to be encumbered and paid in Fiscal Year 2006.

BACKGROUND

Annually, an actuarial valuation of the Retirement System's assets and liabilities is performed by the Retirement System's actuary and a report is presented to the San Diego City Employees' Retirement System (SDCERS) Board. The valuation relies on the SDCERS Board's approved actuarial assumptions and is intended to provide a measure of the funding status of the pension fund and actuarially computed contribution rates. As of June 30, 2003, the SDCERS' annual actuarial valuation reflected an Unfunded Actuarial Accrued Liability (UAAL) of \$1.157 billion and the plan was determined to be 67.2% funded.¹ As of June 30, 2004, the UAAL increased to \$1.369 billion and the funded ratio decreased to 65.8%.² The Retirement System's actuary advised in public testimony on April 11, 2005, that the unfunded liability could in fact be approximately \$1.7 billion, if a different mix of actuarial assumptions were used such as: (1) investment returns are assumed to be 7.75% rather than the 8% used in the 2004 Valuation, (2) the Entry Age Normal (EAN)³ rather than the Projected Unit Credit (PUC)⁴ cost method is used, and (3) contingent Corbett Settlement payments are included in the valuation.

Much has been said as to the root causes of the unfunded liability in the pension system. The final report issued by the Pension Reform Committee (Committee) on September 15, 2004 attributes the causes of the increase in the UAAL and decrease in the funded ratio from July 1, 1996 to June 30, 2003 to the following factors: underfunding by the City, benefit improvements, net actuarial losses, use of SDCERS earnings for contingent benefits, and average investment performance below expectations.

For further background information and opinions on the Retirement System's unfunded liability, please refer to the Voluntary Report of Information dated January 27, 2004, the Audit of Actuarial Work Report issued by Mercer Human Resource Consulting (Mercer) on May 11, 2004, the Vinson and Elkins Report issued on September 16, 2004 or the City Attorney's Interim Reports One through Six.

¹ San Diego City Employees' Retirement System Annual Actuarial Valuation report, Gabriel, Roeder, Smith & Company, June 30, 2003.

² San Diego City Employees' Retirement System Annual Actuarial Valuation report, Gabriel, Roeder, Smith & Company, June 30, 2004.

³ The EAN funding method allocates the total value of a member's expected benefit liability as a level percent of payroll from the age of entry until retirement.

⁴ The PUC funding method allocates the total value of a member's expected benefit liability by a consistent formula for each valuation year.

DISCUSSION

Because of the concerns about the funding status of the Retirement System, the City has implemented and accomplished actions to enhance the funding ratio of the Retirement System. Below is a summary of these accomplishments:

- Commencing in July 1996, the City was making annual contributions to the Retirement System that were below the actuarially required rates. The City entered into the “Gleason Settlement” in July 2004. The settlement provided that the City contributed a fixed amount of \$130 million for Citywide contributions in Fiscal Year 2005, which was less than the full actuarial amount but \$45 million more than the Fiscal Year 2004 contribution amount. Beginning with the June 30, 2004 Annual Actuarial Valuation, the UAAL amortization period was reset to a new 30-year fixed amortization period; for Fiscal Years 2006, 2007 and 2008, the City’s contribution will be based on the actuarially determined funding level with the new 30-year fixed amortization period commencing with Fiscal Year 2005.
- Proposition G, a Charter amendment approved by the San Diego voters on November 2, 2004, required that the amortization period for the UAAL be shortened to no longer than 15 years beginning with Fiscal Year 2009. Shortening the amortization period will increase the annual cost to amortize the UAAL and enhance the funded ratio
- Proposition H, approved by the voters on November 2, 2004, changed the composition of the SDCERS’ Board to include seven citizens without personal interest in the Retirement System. The remaining seats are filled as follows: two elected by general members, one elected by fire safety members, one elected by police safety members, one elected by retiree members, and one appointed by the City Manager or designee.
- Public Disclosure Ordinance, approved by the Mayor and City Council on October 11, 2004, will help improve the accuracy of all information disclosed.
- Beginning in Fiscal Year 2005, the City paid \$14.9 million for the total Citywide payment for retiree health. Of that amount, \$7.9 million was paid from the health care trust taken from the Retirement System and the balance of \$7.0 million was paid from City funds. The Fiscal Year 2006 Annual Budget provides \$16.5 million for retiree health care benefits, which will be paid by the City and no Retirement System funds will be used.
- Included in the Fiscal Year 2005 and Fiscal Year 2006 Annual Budget was a net reduction of 172.89 and 238.37 budgeted positions Citywide respectively. By downsizing the organization, the liabilities in the Retirement System and the City’s full actuarial contributions have decreased.
- Commencing in Fiscal Year 2005, unclassified employees paid more to the Retirement System, thereby relieving the City of that obligation and saving the City approximately \$1.4 million in Fiscal Year 2005.
- Major economic changes to the labor agreements between the City and each of the labor organizations occurred during the most recent labor negotiations. The negotiated wage freezes for Fiscal Years 2006 and 2007 are projected to have an approximately \$151 million positive impact on the pension liability. Also, the use of the City “pick-up” of

the employee pension toward the unfunded liability will help enhance the funding ratio of the Retirement System.

All the actions performed by the City have created a positive impact on the funded ratio; however to continue enhancing the funding ratio of the Retirement System the City Manager has formed a pension solutions working group to study and assist in developing a menu of pension solution proposals. The group is comprised of representatives from the Financial Management, City Treasurer, City Auditor and Comptroller, Risk Management, Real Estate Assets, and Human Resources departments. Although the working group also included a representative from the City Attorney's Office, representation was withdrawn after the working group briefed the City Attorney on July 29, 2005 using an earlier draft of this report. Subsequently, the City Attorney released his Plan to Resolve the City's Legal, Accounting and Financial Crisis on August 16, 2005. In addition, the City of San Diego has retained Public Financial Management, Inc., an independent financial advisory firm that has extensive expertise in advising municipal entities in the development of recovery plans and assisting localities in the identification of fiscal solutions, including providing independent financial advice on Pension Obligation Bonds (POBs) transactions. The City has also retained an independent actuary from Towers Perrin to provide consultation services to the group.

Note that this report only addresses proposed solutions for the Retirement System, and does not include proposed solutions for Retiree Health Care, a liability that has been estimated at between \$450-675 million by Gabriel, Roeder, Smith & Company (GRS), and could be greater based upon variable assumptions. This issue will be addressed separately. In addition, the report does not address the issue of rolling back certain pension benefits. That matter must be settled in a court of law and therefore is not under the purview of this report for use as a potential pension solution.

1. Actuarial Analysis

Staff requested the actuarial firm, Towers Perrin, to provide actuarial projections for this report. Towers Perrin started with a baseline projection of funded status and contributions for SDCERS. Those projections were completed by GRS, SDCERS actuary, and were based on the actuarial valuation as of June 30, 2003. In order to provide projections based on updated information, Towers Perrin implemented modifications to the June 30, 2003 valuation and made additional assumptions as described below:

- Updated the projections based on the published June 30, 2004 actuarial valuation results and successfully replicated the June 30, 2004 actuarial valuation prepared by GRS
- Recognized in the projected actuarial valuation for the following five years, the \$218 million deferred investment gain that existed as of June 30, 2004
- Recognized an expected actuarial loss estimated by GRS of \$40 million as of June 30, 2005 for service purchase
- Included the actuarial liability estimated by GRS of \$63 million for contingent Corbett benefits for the June 30, 2005 actuarial valuation
- Recognized actuarial gains estimated by GRS to total \$151 million, attributable to the Fiscal Year 2006 and 2007 salary freezes in the actuarial valuation projections as of June 30, 2006 and June 30, 2007
- Used estimated Citywide payroll for Fiscal Years 2006-2008 provided by City staff

- Assumed a 4.25% annual payroll growth for Fiscal Years 2009-2014
- Used a 30-year declining amortization for Fiscal Years 2005 through 2008 as established by Gleason Settlement
- Used a 15-year declining amortization for Fiscal Years 2009-2014 for Declining Scenario. A "declining" (fixed) amortization means that the actuarially required contribution in a particular year would be the UAAL amortized over the remaining years in the fixed period, for example from 15 to 14 to 13, decreasing to zero. When actual experience matches actuarial assumptions, a declining amortization period will result in a decreasing UAAL.
- Used a 15-year rolling amortization for Fiscal Years 2009-2014 for Rolling Scenario. A "rolling" (non-declining) amortization period means that each year, the UAAL is re-amortized over a set number of years to determine the amount of the annual employer contribution that is due toward the UAAL portion of the contribution. When a rolling 15-year amortization period is used, the payment is larger than the interest cost and the unfunded liability decreases if there are no net actuarial losses. However, the unfunded liability is never completely paid off because the 15-year period is reestablished every year.

Note that Mercer audited the June 30, 2003 actuarial valuation and concluded “that the methods and assumptions used by GRS are reasonable and conform to accepted actuarial practices.”⁵ However, Mercer also recommended “alternative methods for SDCERS and its actuary to explore in order to better represent the funded status of the system.”⁶ In addition, the City’s Audit Committee advised that it has “substantial questions as to the soundness of current and future actuarial valuations” and in fact, the funded ratio may be considerably lower and the UAAL considerably higher if significant changes in actuarial assumptions are implemented. The Audit Committee also recommended that SDCERS’ Board hire a new actuary. The Board is currently in the process of hiring a new actuary. As a caveat, if in fact there are changes to the current actuarial assumptions, then the projections presented herein will differ from these estimates.

As mentioned previously, Towers Perrin provided projections assuming both a 15-year declining amortization and a 15-year rolling amortization schedule for Fiscal Years 2009-2014. These projections include changes in the actuarial assumptions introduced by the recent passage of Proposition G. Proposition G, a City Charter amendment approved by San Diego voters on November 2, 2004, requires that the amortization period of the UAAL be shortened to no longer than 15 years beginning with Fiscal Year 2009, resulting in significant increases in funding requirements. Nonetheless, the amendment to the City Charter does not specify the amortization method. It is up to SDCERS’ Board to determine which method will be used. For these purposes, both a more conservative application of the proposition, defining the amortization period as a fixed 15-year term (with the remaining term declining each year), and a rolling 15-year term, which provides a lower contribution towards the UAAL, are shown.

⁵ “Audit of Actuarial Work San Diego City Employees’ Retirement System,” Mercer Human Resource Consulting, May 11, 2004.

⁶ “Audit of Actuarial Work San Diego City Employees’ Retirement System,” Mercer Human Resource Consulting, May 11, 2004.

The Base Case Declining Scenario projection assumes there are no additional contributions above and beyond the actuarially required employer contributions that cover the normal cost and amortization cost of the UAAL.

BASE CASE DECLINING SCENARIO	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14
Normal Cost Rate			13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%
Amortization of UAAL			13.7%	15.7%	15.8%	23.6%	25.7%	27.8%	31.6%	35.4%	38.9%
Total Annual Employer Contribution Rate	13.4%	\$130M⁽¹⁾	26.9%	28.9%	29.0%	36.8%	38.8%	40.9%	44.7%	48.5%	52.1%
Normal Cost (\$M)			\$75.3	\$75.2	\$78.6	\$82.0	\$85.5	\$89.1	\$92.8	\$96.8	\$100.9
Amortization Cost of UAAL (\$M)			\$87.7	\$90.1	\$94.7	\$147.2	\$166.8	\$188.3	\$223.1	\$260.6	\$298.9
Total Annual Employer Contribution (\$M)	\$73.2	\$130.0	\$163.0	\$165.3	\$173.3	\$229.2	\$252.3	\$277.4	\$315.9	\$357.4	\$399.8
UAAL (\$M)	\$1,369	\$1,540	\$1,546	\$1,576	\$1,695	\$1,806	\$2,007	\$2,185	\$2,317	\$2,450	\$2,588
Funded Ratio	65.8%	65.6%	67.9%	69.6%	70.0%	70.7%	70.2%	70.3%	71.0%	71.8%	72.5%
Net Total Operating Budget ⁽²⁾ (\$M)	\$1,800	\$1,901	\$2,017	\$2,077	\$2,140	\$2,204	\$2,270	\$2,338	\$2,408	\$2,480	\$2,555
% of Net Total Operating Budget	4.1%	6.8%	8.1%	8.0%	8.1%	10.4%	11.1%	11.9%	13.1%	14.4%	15.6%

⁽¹⁾ Fixed amount per Gleason Settlement terms.
⁽²⁾ Assumes 3% growth rate from FY07 through FY14.

The projections reflect that the funded ratio gradually improves from approximately 66% as of 6/30/2004 to approximately 73% over the projection period (Fiscal Year 2014) as the estimated City contributions grow from about 27% of payroll for Fiscal Year 2006 to over 52% of payroll for Fiscal Year 2014. Moreover, the projections reflect that the City Contributions as a percentage of the City net total operating budget are estimated to grow from about 8% for Fiscal Year 2006 to approximately 16% for Fiscal Year 2014, with the assumption that the net total operating budget for the City grows 3% annually after Fiscal Year 2006.

The Base Case Rolling Scenario projection assumes there are no additional contributions above and beyond the actuarially required employer contributions that cover the normal cost and amortization cost of the UAAL.

BASE CASE ROLLING SCENARIO	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14
Normal Cost Rate			13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%
Amortization of UAAL			13.7%	15.7%	15.8%	23.6%	24.3%	24.9%	26.6%	28.1%	29.0%
Total Annual Employer Contribution Rate	13.4%	\$130M⁽¹⁾	26.9%	28.9%	29.0%	36.8%	37.5%	38.0%	39.8%	41.2%	42.2%
Normal Cost (\$M)			\$75.3	\$75.2	\$78.6	\$82.0	\$85.5	\$89.1	\$92.8	\$96.8	\$100.9
Amortization Cost of UAAL (\$M)			\$87.7	\$90.1	\$94.7	\$147.2	\$158.2	\$168.5	\$188.3	\$206.9	\$223.0
Total Annual Employer Contribution (\$M)	\$73.2	\$130.0	\$163.0	\$165.3	\$173.3	\$229.2	\$243.7	\$257.6	\$281.1	\$303.7	\$323.9
UAAL (\$M)	\$1,369	\$1,540	\$1,546	\$1,576	\$1,695	\$1,806	\$2,017	\$2,216	\$2,388	\$2,585	\$2,816
Funded Ratio	65.8%	65.6%	67.9%	69.6%	70.0%	70.7%	70.1%	69.9%	70.1%	70.2%	70.1%
Net Total Operating Budget ⁽²⁾ (\$M)	\$1,800	\$1,901	\$2,017	\$2,077	\$2,140	\$2,204	\$2,270	\$2,338	\$2,408	\$2,480	\$2,555
% of Net Total Operating Budget	4.1%	6.8%	8.1%	8.0%	8.1%	10.4%	10.7%	11.0%	11.7%	12.2%	12.7%

⁽¹⁾ Fixed amount per Gleason Settlement terms.
⁽²⁾ Assumes 3% growth rate from FY07 through FY14.

The projections reflect that the funded ratio gradually improves from approximately 66% as of 6/30/2004 to approximately 70% over the projection period (Fiscal Year 2014) as the estimated City contributions grow from about 27% of payroll for Fiscal Year 2006 to over 42% of payroll for Fiscal Year 2014. Moreover, the projections reflect that the City Contributions as a percentage of the City net total operating budget are estimated to grow from about 8% for Fiscal Year 2006 to approximately 13% for Fiscal Year 2014, with the assumption that the net total operating budget for the City grows 3% annually after Fiscal Year 2006.

2. Potential Pension Solution Scenario

The focus of this report is to identify viable options to increase the funded ratio of the Retirement System to help restore fiscal stability to the system. Accordingly, this report discusses the use of labor concessions, POBs issuance, sale of under-utilized City lands, securitizing lease income or other City revenues, and additional solutions. Thus, this report presents a list of potential solutions for the City Council to consider and provide further direction to the City Manager to amend and/or implement select solutions or identify new options for consideration.

By combining different pension solution sources as presented below, projections reflect that by Fiscal Year 2008, the pension funded ratio can be significantly increased.

Solution (\$M)	FY 06	FY 07	FY 08	Total
Securitization	\$100	\$0	\$0	\$100
Land Sales	50	-	50	100
POBs	-	300	100	400
Total	\$150	\$300	\$150	\$600

The Pension Solution Scenarios (Declining and Rolling) below show the actuarial results with a total of \$600 million additional contributions as specified in the above table. These additional contributions are over and above the actuarially required contributions that cover both the normal cost and amortization cost of the UAAL. Note also that the timing of the additional contributions in each fiscal year plays a major role on the amortization of the resulting UAAL. In other words, the sooner the additional contributions are infused into the Retirement System, the greater the positive impact on the funded ratio. If in fact there are any changes to the contributions or the assumed timing, the projected results would differ from these estimates.

The Pension Solution Declining Scenario is shown below:

PENSION SOLUTION DECLINING SCENARIO	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14
Normal Cost Rate			13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%
Amortization of UAAL			13.7%	15.7%	14.3%	16.3%	15.5%	17.4%	21.2%	25.1%	28.7%
Total Annual Employer Contribution Rate	13.4%	\$130M⁽¹⁾	26.9%	28.9%	27.4%	29.5%	28.6%	30.5%	34.3%	38.2%	41.8%
Normal Cost (\$M)			\$75.3	\$75.2	\$78.6	\$82.0	\$85.5	\$89.1	\$92.8	\$96.8	\$100.9
Amortization Cost of UAAL (\$M)			\$87.7	\$90.1	\$85.5	\$101.8	\$100.5	\$117.6	\$149.8	\$184.6	\$220.4
Total Annual Employer Contribution (\$M)	\$73.2	\$130.0	\$163.0	\$165.3	\$164.1	\$183.8	\$186.0	\$206.7	\$242.6	\$281.4	\$321.3
Additional City Contribution (\$M)	-	-	\$150.0	\$300.0	\$150.0	-	-	-	-	-	-
Total Employer and Additional Contribution (\$M)	\$73.2	\$130.0	\$313.0	\$465.3	\$314.1	\$183.8	\$186.0	\$206.7	\$242.6	\$281.4	\$321.3
UAAL (\$M)	\$1,369	\$1,540	\$1,396	\$1,090	\$1,022	\$1,128	\$1,347	\$1,548	\$1,708	\$1,875	\$2,052
Funded Ratio	65.8%	65.6%	71.0%	79.0%	81.9%	81.7%	80.0%	79.0%	78.6%	78.4%	78.2%
Net Total Operating Budget ⁽²⁾ (\$M)	\$1,800	\$1,901	\$2,017	\$2,077	\$2,140	\$2,204	\$2,270	\$2,338	\$2,408	\$2,480	\$2,555
% of Net Total Operating Budget	4.1%	6.8%	8.1%	8.0%	7.7%	8.3%	8.2%	8.8%	10.1%	11.3%	12.6%

⁽¹⁾ Fixed amount per Gleason Settlement terms.
⁽²⁾ Assumes 3% growth rate from FY07 through FY14.

The actuarial projections recognize the higher assets resulting from these additional contributions, which are in addition to the anticipated regularly scheduled contributions based on the normal cost and amortization of the UAAL. The estimated funded ratio improves from approximately 66% currently to approximately 82% as of 6/30/2008 due to these additional contributions and then declines gradually to approximately 78% as of 6/30/2014. Under the Pension Solution Declining Scenario, City annual contributions toward normal cost and

amortization cost are estimated to grow from approximately 27% of payroll for Fiscal Year 2006 to approximately 42% of payroll by Fiscal Year 2014 (compared to over 52% in the Base Case Declining Scenario). Moreover, the projections reflect that the City Contributions as a percentage of the City net total operating budget are estimated to grow from about 8% for Fiscal Year 2006 to approximately 13% for Fiscal Year 2014, with the assumption that the net total operating budget for the City grows 3% annually after Fiscal Year 2006.

Alternatively, the Pension Solution Rolling Scenario is shown below:

PENSION SOLUTION ROLLING SCENARIO	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14
Normal Cost Rate			13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%	13.1%
Amortization of UAAL			13.7%	15.7%	14.3%	16.3%	14.7%	15.5%	17.9%	19.9%	21.3%
Total Annual Employer Contribution Rate	13.4%	\$130M⁽¹⁾	26.9%	28.9%	27.4%	29.5%	27.8%	28.7%	31.0%	33.0%	34.5%
Normal Cost (\$M)			\$75.3	\$75.2	\$78.6	\$82.0	\$85.5	\$89.1	\$92.8	\$96.8	\$100.9
Amortization Cost of UAAL (\$M)			\$87.7	\$90.1	\$85.5	\$101.8	\$95.3	\$105.3	\$126.3	\$146.3	\$163.8
Total Annual Employer Contribution (\$M)	\$73.2	\$130.0	\$163.0	\$165.3	\$164.1	\$183.8	\$180.8	\$194.4	\$219.1	\$243.1	\$264.7
Additional City Contribution (\$M)	-	-	\$150.0	\$300.0	\$150.0	-	-	-	-	-	-
Total Employer and Additional Contribution (\$M)	\$73.2	\$130.0	\$313.0	\$465.3	\$314.1	\$183.8	\$180.8	\$194.4	\$219.1	\$243.1	\$264.7
UAAL (\$M)	\$1,369	\$1,540	\$1,396	\$1,090	\$1,022	\$1,128	\$1,353	\$1,568	\$1,754	\$1,966	\$2,211
Funded Ratio	65.8%	65.6%	71.0%	79.0%	81.9%	81.7%	79.9%	78.7%	78.1%	77.4%	76.5%
Net Total Operating Budget ⁽²⁾ (\$M)	\$1,800	\$1,901	\$2,017	\$2,077	\$2,140	\$2,204	\$2,270	\$2,338	\$2,408	\$2,480	\$2,555
% of Net Total Operating Budget	4.1%	6.8%	8.1%	8.0%	7.7%	8.3%	8.0%	8.3%	9.1%	9.8%	10.4%

⁽¹⁾ Fixed amount per Gleason Settlement terms.
⁽²⁾ Assumes 3% growth rate from FY07 through FY14.

The actuarial projections recognize the higher assets resulting from these additional contributions, which are in addition to the anticipated regularly scheduled contributions based on the normal cost and amortization of the UAAL. The estimated funded ratio improves from approximately 66% currently to approximately 82% as of 6/30/2008 due to these additional contributions and then declines gradually to approximately 77% as of 6/30/2014. Under the Pension Solution Rolling Scenario, City annual contributions toward normal cost and amortization cost are projected to grow from approximately 27% of payroll for Fiscal Year 2006 to approximately 35% of payroll by Fiscal Year 2014 (compared to over 42% in the Base Case Rolling Scenario). Moreover, the projections reflect that the City Contributions as a percentage of the City net total operating budget are projected to grow from about 8% for Fiscal Year 2006 to approximately 10% for Fiscal Year 2014, with the assumption that the net total operating budget for the City grows 3% annually after Fiscal Year 2006.

Note that a different set of actuarial assumptions and methods would generate different results. And, if plan design changes are adopted, or if the covered population, rates of investment return, salary changes, or other demographic experience are different than projected, the projected results would also differ from these estimates.

After additional cash infusions in Fiscal Years 2006-2008, the funded ratio may decrease slightly each year, as described in both the Declining and Rolling Pension Solution Scenarios. This projected decline is due to the delay in making the annual actuarially required contribution based on a prior year valuation with lower contribution requirements (For example, the Fiscal Year 2006 actuarial contribution is determined based on Fiscal Year 2004 actuarial valuation results).

Another potential contributing factor for the decline in funded ratio after Fiscal Year 2008 is that the Actuarial Accrued Liability projected by GRS (which was relied on by Towers Perrin) may include some assumed continued actuarial losses in future years. In order to continue

maintaining a funded ratio at approximately 80% level or to enhance it further, additional pension solutions, over and above the City's annual actuarial contributions, are required.

3. Budgetary Impacts

Citywide budgetary impact analyses (Declining and Rolling), depicted below, show that the total City budget is anticipated to need an additional \$8.6 million in Fiscal Year 2007 and approximately \$15 million in Fiscal Year 2008 to implement the Pension Solution Scenario as compared to the Base Case Scenario.

The Citywide budgetary declining impact analysis is shown below:

DECLINING (\$M)	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14
Total Annual Employer Contribution with Solutions ⁽¹⁾	\$163.0	\$165.3	\$164.1	\$183.8	\$186.0	\$206.7	\$242.6	\$281.4	\$321.3
Debt Payments for POBs ⁽²⁾	-	8.6	24.1	28.3	28.3	28.3	28.3	28.3	28.3
Securitization (Pledged Revenue) ⁽³⁾	17.3	17.3	17.3	17.3	17.3	17.3	17.3	17.3	17.3
Employee Pick-Up Savings	(17.3)	(17.3)	(17.3)	(17.3)	(17.3)	(17.3)	(17.3)	(17.3)	(17.3)
Total Budgetary Requirement: Solution Scenario	163.0	173.9	188.2	212.1	214.3	235.0	270.9	309.7	349.6
Total Budgetary Requirement: Base Case Scenario	163.0	165.3	173.3	229.2	252.3	277.4	315.9	357.4	399.8
Net Savings Declining	-	(\$8.6)	(\$14.9)	\$17.1	\$38.0	\$42.4	\$45.0	\$47.7	\$50.2

⁽¹⁾ Assuming additional contribution of \$150M by FY06, \$300M by FY07, and \$150M by FY08
⁽²⁾ Assuming \$300M in POBs issuance by FY07 and \$100M by FY08
⁽³⁾ Assuming \$17.3M in Revenue Securitization for more than 10 years depending on securitization option

Alternatively, the Citywide budgetary rolling impact analysis is shown below:

ROLLING (\$M)	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14
Total Annual Employer Contribution with Solutions ⁽¹⁾	\$163.0	\$165.3	\$164.1	\$183.8	\$180.8	\$194.4	\$219.1	\$243.1	\$264.7
Debt Payments for POBs ⁽²⁾	-	8.6	24.1	28.3	28.3	28.3	28.3	28.3	28.3
Securitization (Pledged Revenue) ⁽³⁾	17.3	17.3	17.3	17.3	17.3	17.3	17.3	17.3	17.3
Employee Pick-Up Savings	(17.3)	(17.3)	(17.3)	(17.3)	(17.3)	(17.3)	(17.3)	(17.3)	(17.3)
Total Budgetary Requirement: Solution Scenario	163.0	173.9	188.2	212.1	209.1	222.7	247.4	271.4	293.0
Total Budgetary Requirement: Base Case Scenario	163.0	165.3	173.3	229.2	243.7	257.6	281.1	303.7	323.9
Net Savings Rolling	-	(\$8.6)	(\$14.9)	\$17.1	\$34.6	\$34.9	\$33.7	\$32.3	\$30.9

⁽¹⁾ Assuming additional contribution of \$150M by FY06, \$300M by FY07, and \$150M by FY08
⁽²⁾ Assuming \$300M in POBs issuance by FY07 and \$100M by FY08
⁽³⁾ Assuming \$17.3M in Revenue Securitization for more than 10 years depending on securitization option

Budgetary benefits from contributing additional funds and the higher funded ratio are not anticipated to be achieved until Fiscal Year 2008 and later, primarily because higher assets within the Retirement System are only recognized in that year's valuation which is published the following year, and actuarial rates are then paid by the City one additional year later. In other words, benefits achieved through a cash infusion in year one are not fully realized until year three. Although savings will not be realized in the City's budget during the first two years, the proposed Pension Solution Scenario will still enhance the pension funded ratio of the Retirement System. A potential mitigating factor, however, is the expiration of the ERAF III agreement with the State, which should result in a State return of approximately \$16.9 million in Property Tax revenue in Fiscal Year 2007 and thereafter which can be used to address additional pension related expenditures in those years. The benefit of implementing the Pension Solution Declining Scenario will provide a savings of \$17-50 million annually from Fiscal Years 2009-2014 or a savings of \$17-31 million annually by implementing the Pension Solution Rolling Scenario, thus

further allowing the City to use these resources to further enhance the system or meet other policy objectives.

4. Exclusions

As mentioned above, this report excludes consideration of the following:

a. Elimination of Certain Benefits

The City Attorney has indicated that negotiated improvements in City employee pension benefits since 1996 are unlawful and must be rolled back. Due to the complexity of the issue; the fact that the City cannot predict the timing or outcome of any such legal action; and because benefits may be considered to be vested to each member and, if vested, benefits cannot be renegotiated, this is not assumed as an immediate solution to help resolve the funding of the Retirement System. If the pension benefits are found unlawful by a court of law, the elimination of these benefits could have a positive impact on the funded ratio of the Retirement System.

b. Retiree Health Care Solutions

This report only focuses on pension solutions. Retiree health care solutions will be addressed separately. The issue of retiree health care solutions includes the unfunded liability, is estimated at \$447-672 million by Gabriel, Roeder, Smith & Company, but could be higher depending on variable assumptions. In addition, other items to be addressed include: (1) the effect of the health-eligible retiree definition, which states that employees must have 10 years of service with the City of San Diego to receive 100% of the retiree health benefit and five years of service to receive 50% of the retiree health benefit, (2) the establishment of a defined contribution plan for retiree medical benefits for employees hired on or after July 1, 2005, and (3) the review of existing retiree health benefits to explore the consolidation of health care options to help manage the cost of health care for employees hired before July 1, 2005 and current retirees. It is important to emphasize that for Fiscal Year 2005 the total Citywide payment for retiree health was \$14.9 million. Of that amount, \$7.9 million was paid from the health care trust taken from the system assets and the balance of \$7.0 million was paid from City funds. The Fiscal Year 2006 Annual Budget provides \$16.5 million for retiree health care benefits, which will be paid by the City and no Retirement System funds will be used.

WORKING GROUP APPROACH

In developing the proposed Pension Solution Scenario described above, the working group first spent time reviewing the City's current position, consulting on potential pension solutions, and developing a reasonable funding target to propose to the City Council. This section provides the background on the research discussion and analysis performed and reviewed by the group.

1. Benchmarking Against Comparable Municipalities

In order to quantify an appropriate level of pension funding and to compare the City against other comparable municipalities, a benchmark between the City of San Diego and other local and state government agencies was prepared. The following table compares the funded ratio of various California municipalities.

Retirement System ¹	Actuarial Valuation Date	Funding Method ²	Investment Rate of Return	Benefit Formula ³	DROP ⁴	Funded Ratio ⁵
San Diego County Agencies						
SAN DIEGO General Safety	6/30/2004	PUC	8.00%	2.5% @ 55 3.0% @ 50	Yes	65.8% 65.8%
OCEANSIDE General Safety	6/30/2003	EAN	7.75%	2.0% @ 55 3.0% @ 50	No	100.5% 83.2%
ESCONDIDO General Safety	6/30/2003	EAN	8.25%	2.0% @ 55 3.0% @ 50	No	93.8% 83.4%
NATIONAL CITY General Safety	6/30/2003	EAN	7.75%	3.0% @ 60 3.0% @ 50	No	86.4% 83.8%
EL CAJON General Safety	6/30/2003	EAN	7.75%	3.0% @ 60 3.0% @ 50	No	82.7% 80.0%
COUNTY OF SD General Safety	6/30/2004	EAN	8.25%	3.0% @ 60 3.0% @ 50	No	81.1% 81.1%
CARLSBAD General Safety	6/30/2003	EAN	8.25%	2.0% @ 55 3.0% @ 50	No	81.0% 86.1%
CORONADO General Safety	6/30/2003	EAN	7.75%	3.0% @ 60 3.0% @ 50	No	83.8% 86.9%
CHULA VISTA General Safety	6/30/2003	EAN	8.25%	3.0% @ 60 3.0% @ 50	No	77.5% 92.6%
LA MESA General Safety	6/30/2003	EAN	7.75%	2.0% @ 55 3.0% @ 50	No	94.2% 88.1%
California Ten Largest Cities						
OAKLAND General Safety	7/1/2003	EAN	8.25%	2.0% @ 55 3.0% @ 50	No	84.4% 72.0%
SANTA ANA General Safety	6/30/2004	EAN	8.25%	2.0% @ 55 3.0% @ 50	No	101.9% 91.1%
ANAHEIM General Fire Police	6/30/2003	EAN	7.75%	2.0% @ 60 3.0% @ 50 3.0% @ 50	No	101.7% 88.1% 84.3%
SAN JOSE General Safety	6/30/2003	EAN	8.25% 8.00%	2.25% @ 55 3.0% @ 50	No	98.0% 100.0%
SAN DIEGO General Safety	6/30/2004	PUC	8.00%	2.5% @ 55 3.0% @ 50	Yes	65.8% 65.8%
LOS ANGELES General Safety	6/30/2004	PUC EAN	8.00% 8.50%	2.16% @ 50 3.0% @ 50	Yes	82.5% 103.0%
SAN FRANCISCO General Safety	7/1/2003	EAN	8.25%	2.0% @ 60 3.0% @ 55	No	109.0% 109.0%
LONG BEACH General Safety	6/30/2003	EAN	8.25%	2.7% @ 55 3.0% @ 50	No	99.0% 103.7%
SACRAMENTO General Safety	6/30/2003	EAN	7.50%	2.5% @ 55 3.0% @ 50	No	85.3% 89.1%
FRESNO General Safety	6/30/2004	PUC EAN	8.25%	2.0% @ 55 2.0% @ 50	Yes	127.7% 117.6%

1. Information provided is from the respective agency's 2003 & 2004 Comprehensive Annual Financial Report (CAFR). Note that the funded ratios are determined by actuarial analyses that rely on a variety of actuarial assumptions which may differ among the retirement systems that are presented above. Also, note that some of the entities reflected here may have utilized pension solutions such as POB issuance to achieve and/or maintain a higher funded ratio.

2. Definition: EAN = Entry Age Normal and PUC = Projected Unit Credit actuarial cost methods.

3. Benefit Formula: This defines the core benefit. The first number is called the "multiplier", and it is multiplied by the total number of years of credited service. This will provide the percentage of the final salary that will constitute the pension. The second number is the earliest age at which the full pension can be taken.

4. DROP: The deferred retirement option that allows an employee to retire, receive the pension in a tax deferred account, and continue working at regular salary.

5. Funded Ratio: The ratio of the retirement funds' assets to the funds' accrued actuarial liabilities.

As shown, comparable municipalities, subject to many of the same legal requirements and economic impacts, have a notably higher funded ratio for their respective retirement systems.

The Public Fund Survey (Attachment A), published in September 2004, indicates the importance of a well-funded pension plan. This survey, sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement, covers 101 public retirement systems and 125 plans. The survey represents 85% of the nation's entire public retirement system with 12.7 million active members and \$1.86 trillion in assets. According to its results, a majority of the public pension plans surveyed have a funded ratio between 80% and 100%. In addition, there are plans funded at greater than 100%, and the survey found that 74% of the plans in the Public Fund Survey have a funded ratio of 80% or greater. The average funded level for Fiscal Year 2003 for 117 plans (excluding those plans in which liabilities always equal assets) that were evaluated is 88.2%, with the median at 91.5%.

These findings are consistent with those of a similar study by Wilshire Associates published in October 2004 (Attachment B). This study surveyed 104 city and county retirement systems across the country representing over \$309 billion in assets. Of the 63 systems reviewed that reported actuarial values on or after June 30, 2003, the average funded ratio was 83% and those that were underfunded (less than 100% funding ratio) maintained an average funded ratio of 79%. In addition, only 13 of the 63 systems had funded ratios lower than 80% and six systems had a funded ratio below 70%.

Based on comparative data from the Public Fund Survey, the Wilshire study, and other local and state agencies, it is clear that San Diego's funded ratio falls well below the average for other public retirement systems. To bring its system in line with these experiences, the City must make a significant effort to enhance the retirement system's funding level.

2. Funding Goal

The objective is to propose solutions that will enhance the funded ratio of the Retirement System and implement a mix of solutions at the direction of the City Council. It is important for the City to consider adopting a pension funding goal. Based on comparative data discussed above, the suggested short-term goal is to achieve an 80% to 85% funded ratio by Fiscal Year 2008. This is consistent with Councilmembers Peters', Atkins', and Madaffer's goal of achieving an 80% funded ratio within two years as stated in their June 13, 2005 memorandum on "Additional Steps to Reduce Pension Deficit" (Attachment C).

Reaching this funding target would not only bring the City in line with comparable systems and stability to the Retirement System in the short term, but would also achieve a funded ratio that is considered by the credit rating agencies to be "adequately funded from a credit perspective." Pension plans with a ratio below 70%-80% may have "a potentially significant impact" on the municipality, according to Fitch Ratings, "particularly in cases where the annually required contribution is a significant and growing part of the sponsor's budget," as is the case with the City of San Diego.⁷ Moody's Investors Service has noted that it "expects municipal entities with

⁷ "Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits," Fitch Ratings Special Report, September 18, 2003.

large unfunded obligations to have, or develop, a plan to reduce them.”⁸

This funding target, and the plans adopted to achieve it, will lay a strong foundation for renewed fiscal strength for the City of San Diego.

3. Labor Concessions

Major economic changes to the labor agreements between the City and each of the labor organizations occurred during the most recent labor negotiations. Agreements with labor unions resulted in the reduction of City “pick-up” of the employee pension contribution by 3% for the Municipal Employees’ Association (MEA), the International Association of Fire Fighters Local 145, and the Deputy City Attorney Association (DCAA) and a unilaterally imposed reduction of 3.2% for the San Diego Police Officers Association (POA). In addition, AFSCME Local 127 negotiated a 1.9% salary reduction in lieu of additional employee pension contribution and a benefit freeze. The agreements with the bargaining units explicitly indicate that savings to the City must be used to address the UAAL within the timeframe of the respective contracts. The labor contract with Local 127 specifically states that “By June 30, 2008, if the City has not dedicated a total of \$600 million or more to the UAAL reduction, including the amount achieved by leveraging employee salary reduction and pension contribution monies, the AFSCME salary reduction monies with interest will revert to CERS Employee Contribution Rate Reserve for benefit of Local 127 unit members to defray employee pension contributions. The City will be excused from meeting the above obligation if the funded ratio reaches 100% by June 30, 2008.” Also, since the labor agreements with Local 145 and DCAA are one-year terms, it is critical to leverage all the employee pension contributions or salary reductions in Fiscal Year 2006. The projected amount from labor concessions that is committed to address the pension’s unfunded liability is approximately \$17.3 million (General Fund and Non-General Fund) in Fiscal Year 2006.

Also as part of the agreements with the labor unions, several benefits were eliminated for employees hired on or after July 1, 2005 for all bargaining units. These changes include the elimination of the following benefits: the Deferred Retirement Option Plan (DROP), the 13th Check, the option to purchase years of service credits (“air-time”), and the elimination of all formulae except 2.5% at 55 for General Members and 3.0% at 50 for Safety Members. Also for employees hired on or after July 1, 2005, it was agreed to establish a trust vehicle for a defined contribution plan to fund and determine retiree medical benefits. The employer/employee contributions for such a plan were not discussed during the labor negotiations and a joint study between the City and each labor union to be completed in Fiscal Year 2006; will determine the contribution amounts. The City is also exploring the consolidation of health care options to help manage the cost of health care for both current and retired employees and, as part of the agreements with the labor unions, the new definition of “health-eligible retiree” states that employees must have 10 years of service with the City of San Diego to receive 100% of the retiree health benefit and five years of service to receive 50% of the retiree health benefit. The economic benefits from the labor agreements have created an incentive for the City to begin addressing the unfunded liability issue of the Retirement System.

⁸ “Increased Borrowing by Local Wisconsin Governments to Fund Pension Liabilities Not Expected to Adversely Impact Credit Quality,” Moody’s Investors Service Special Comment, February 2003.

4. Planning Horizon

Restoring the funding level of the City's Retirement System is a priority for the City. Since the labor contracts encourage the City to move as soon as possible on resolving the pension deficit, the short-term goal should be to fulfill the requirements discussed above for leveraging their retirement offset contributions and salary reduction for pension solutions. It is the responsibility of the City to honor the contractual agreement it has made with the employees by pursuing solutions that will have a positive and significant impact on the pension's funded ratio. Within Fiscal Year 2006, City staff will propose to the City Council one or more pension funding approaches that can be implemented expeditiously to fulfill labor bargaining units' requirements to leverage their contributions.

5. Summary of Considerations for Selection and Evaluation of Solutions

While identifying solutions to increase the pension funded ratio, the following criteria were considered:

a. Fulfilling Labor Contracts

The labor union agreements contain economic concessions and sacrifices from the employees and ensure that savings from net offset or salary reduction will be applied to the Retirement System in Fiscal Year 2006 and not made available for the City's operations. It is critical that any pension solutions implemented fulfill the intent of the labor contracts in order to maximize available resources and honor the commitment of City employees. Labor contract specifications such as the requirement to leverage employee pension contributions or salary reductions were considered in evaluation of each potential pension solution.

b. Economic Benefit of Each Solution

The aim is to maximize the effect of the resources applied to addressing the pension deficit. When analyzing each potential solution, an assessment needs to occur on the relative benefit of the approach versus other alternatives, as well as, in the case of the leveraged approaches, the cost of borrowing to fund the Retirement System versus annual cost of amortizing the UAAL. The intent is to achieve the greatest possible increase of the funded ratio of the Retirement System while maintaining fiscal obligations within City funds and providing City services.

c. Impact of the City's Current Credit Situation

Currently, the City is not able to access the public financing markets, primarily due to the lack of audited financial statements for recent fiscal years. The completion of the audits is critical in regaining the confidence of the financial markets. The implementation of some of the pension solution proposals relies on the City's ability to access those markets. Since raising capital to deposit in the Retirement System is likely to be more efficient and less costly when it can be achieved via the public markets, maximum flexibility to refinance or restructure any interim borrowings after release of the financial audits should be retained. This may mean leveraging available revenues over a short-term horizon, for instance, and/or maintaining the ability to pre-pay and restructure the borrowing.

d. City Charter Section 77

Section 77 requires that all money received from the sale of City-owned real property shall be placed in the Capital Outlay Fund. The funds, as required under City Charter Section 77, “shall be used exclusively for the acquisition, construction, and completion of permanent public improvements, real property, water and sewer mains and extensions and shall not be used for other purposes except with the consent of two-thirds of the electors of the City of San Diego voting at a general or special election.” Thus, real property sale proceeds may only be available to the extent they supplant General Fund contributions to the Capital Outlay Fund or for possible redemption of outstanding General Fund debt issued for capital outlays. This proposal could therefore result in savings to the General Fund by releasing existing appropriations for capital outlay, or in the form of relief on debt service that could be used for funding the Retirement System. In considering the options of using the proceeds from the sale of City lands to increase the funded ratio, the City Charter limitations on uses need to be taken into account.

POTENTIAL PENSION SOLUTIONS

Below is a description of potential pension contribution sources that the City Council could consider. As shown above in the Pension Solution Scenario, a combination of these options should be pursued to enhance the funded ratio of the Retirement System. The options include:

1. Revenue Securitization

Significant one-time cash infusions may be able to be generated through the leveraging of ongoing General Fund lease revenues or other stable revenue streams. The City may be able to leverage specific future General Fund revenue streams (“receivables”) in several ways, most notably through the issuance of revenue bonds or the securitization of those certain receivables. As a pension funding solution, though current circumstances preclude the City from participating in the traditional public offering forum, securitization of certain General Fund revenue streams over a defined period is believed to be a viable option.

See Attachment D for a detail discussion on the securitization structure. Note that the amount of up-front proceeds that can be generated from a securitization option is dependent upon the size and type of revenue stream that is pledged, duration of the pledge, and the interest rate at which the revenue stream is discounted. Also, certain revenue coverage requirements need to be met for all securitization scenarios discussed below. However, revenues from the securitized revenue stream in excess of the annual debt service requirement associated with the securitization will flow back to the City.

Based on a summary review of some of the major revenue categories within the General Fund and upon preliminary assessment of the market interest to underwrite this debt category, the following securitization options were identified:

- a. Franchise fee collections, primarily from Cox Communications and Time Warner Cable television franchises, equal approximately \$14.9 million (Fiscal Year 06 budgeted estimate) per year over a 5 -10 year period. It is estimated that this revenue stream, including required coverage, could generate approximately \$38-

48 million in upfront proceeds when securitized over 5 years and approximately \$66-84 million over 10 years. Based on current market conditions, the estimated discount rate may range between 4.60%- 5.75% for these options. In order to meet the previously stated goal of \$100 million through securitization, additional years of pledge could increase the up-front proceeds. If securitized for 14-19 years, estimated upfront proceeds under this scenario could generate \$99-106 million; the borrowing rate would be higher than the 10 year estimate under this scenario due to the extended duration. Note that the pledge of franchise fees beyond Fiscal Year 2019 would require an extension to the current franchise agreement.

- b.** Tobacco Settlement Revenues. A portion of or the entire future tobacco settlement revenues (Fiscal Year 06 budgeted estimate is \$10.3 million), securitized over a 15-20 year period. If the total anticipated tobacco revenue is pledged, this revenue stream is estimated to generate approximately \$53-77 million in upfront proceeds when securitized over 15 years and \$61-92 million over 20 years. Based on current market conditions, the estimated borrowing rate may range between 5.54%- 6.75% depending on the financing term identified.
- c.** Specified set of lease revenues from long-term ground leases⁹ equaling approximately \$23.8 million in lease income securitized for a duration of 5-10 years. It is estimated that this revenue stream (\$17.3 million, an amount equivalent to the employee offset saving for debt service, plus \$6.5 million for required revenue coverage) could generate approximately \$51-65 million in upfront proceeds when securitized over 5 years and approximately \$88-112 million over 10 years. Based on current market conditions, the estimated discount rate may range between 5.25%- 6.25% for the financing terms discussed above. In order to achieve the previously stated goal of \$100 million through securitization process, it is estimated that the duration of the lease revenue pledge needs to be between 9 and 13 years depending on the borrowing rates.

Note that the estimated revenue streams from the Franchise Fee scenario (option a) and the Tobacco Settlement Revenues (option b), \$14.9 million and \$10.3 million respectively, on a stand alone basis, will not generate a debt service expenditure equal to the employee offset savings equaling \$17.3 million. In order to fully leverage the employee offset savings, a combination of options will be necessary in order to fully leverage the annual savings.

2. Employee Pick-Up Savings/Labor Concessions

A three year labor agreement was reached with MEA and Local 127, a one year labor contract for Local 145, and DCAA and the City unilaterally imposed terms on POA for Fiscal Year 2006. Simply put, the terms of these new labor agreements will provide the City with a revenue stream of approximately \$17.3 million in Fiscal Year 2006, which has been committed to improve the Retirement System's funded ratio. This money comes from the savings the City realizes by

⁹ Estimates assume leases selected will be "blue chip" credit tenants, i.e. high performing leaseholds with proven track records.

employees contributing a greater percentage to the pension plan beginning July 1, 2005, or a salary reduction in the case of Local 127. As mentioned in each respective Memorandum of Understanding (MOU), "All City savings....shall be designated exclusively for payment to support a leveraged mechanism to reduce SDCERS UAAL, such as POBs, lease capitalization or a similar mechanism selected by the City." City staff is currently evaluating the highest and best use of this money, including the use of these funds to reimburse the General Fund for the securitization of other General Fund revenue streams.

These contracts also resulted in a negotiated wage and benefit freeze for MEA, Local 145, Local 127, and DCAA, and unilaterally imposed on POA. The negotiated and imposed wage and benefit freezes are projected to have an approximately \$151 million positive impact on the pension liability within the next two years, comprising an estimated \$75 million reduction of actuarial liability in Fiscal Year 2006 and an estimated \$76 million reduction in Fiscal Year 2007, according to the Retirement System's actuary.

3. City Property

City staff has developed a list of City property for consideration at a future closed session meeting of the City Council. The identified properties proposed for sale are held for investment purposes rather than for the City's core mission and have a preliminary estimate of value potentially in excess of \$250 million. Staff believes that it is reasonable to assume that \$100 million in land sales could be consummated over a 3 year period to achieve the goals stated in this report.

The properties would not be part of the City's core assets or public amenities such as open space land, or dedicated park land, but investment property that could be sold and developed to further a number of important policy objectives such as affordable housing, recreational opportunities, and economic development objectives including job creation and business recruitment and retention. Sound asset management strategies include constantly assessing an existing portfolio to determine what properties should be considered for potential disposition and identifying opportunities for acquisition to ensure the portfolio's key objectives are being addressed.

The City also owns hundreds of income producing leaseholds which generate in excess of \$40 million annually. A very limited number of these properties may be candidates for disposition as they are encumbered by leases approved decades ago whose terms have not kept pace with appreciation. In terms of timing, this may prove the most expedient option, as the most logical buyer, who will pay the highest price, is the existing lessee. However, in the medium to longer term, the best prospects are the investment properties. It would take some time to obtain the land use entitlements which would provide the basis for obtaining the highest value. Most of these properties currently pose a maintenance liability, and putting them back into productive use would implement some of the policy objectives listed above.

Additionally, the City may wish to consider retaining investment properties, but leasing them for valuable development opportunities. While there may be numerous development opportunities on investment and under-utilized City owned properties, most will take a significant amount of time and resources before an economic return could be realized. Each site has unique attributes and restrictions and must be carefully researched. Significant staff time and resources would be

devoted to ensure the development potential prior to soliciting interest for development partners. As part of a sound asset management strategy, certain parcels would be best suited for ground leases and/or joint ventures, while others may be best suited for sale. Land sales, as described above, provide one-time, short term revenue. Leases or joint ventures provide an ongoing long-term revenue stream and retain City assets. As such, development opportunities on investment land can best address the longer term objectives. Staff will provide updates and analyses on lease development opportunities during future reports.

Consideration has also been given to transferring City land directly to the Retirement System. However, the administration of the system has indicated that this would not be desirable. Transferring land assets would significantly modify the system's investments portfolio, and may require the system to begin managing land, property and leases.

4. Pension Obligation Bonds (POBs)

By means of a private placement or a public offering, a \$200-600 million multi-phase issuance of POBs as one of the strategies for addressing the outstanding UAAL is currently being studied. To the extent a portion of the outstanding UAAL is funded with POBs, the debt service on POBs would closely approximate the portion of the City's employer contribution attributable to the amortization of that portion of the UAAL. In addition to improving the funded ratio of the pension system through the deposit of POB proceeds, the City would also benefit from the issuance of POBs if the projected annual debt service on the POBs were less than the annual payment required to amortize the UAAL, thus potentially generating cash flow savings. Under present market conditions, POBs are expected to reduce the present value cost of funding the system due to the fact that the interest rates on these bonds are currently lower than the actuarial cost of amortizing the UAAL.

Many municipal pension funds, including SDCERS, assume a long-term rate of return of 8% on their investments, and the current interest rate on POBs is less than 8.0%. By using POBs, there is a potential for lowering the interest costs incurred in paying off the UAAL. For the purpose of comparing estimated projected costs of borrowing under current market conditions, a traditional public sale of 30-year insured POBs is expected to have a cost of borrowing of approximately 5.80%. The interest cost on a public offering of 30-year uninsured POBs is currently estimated at approximately 6.15%.

While the City cannot proceed with a public offering of POBs in advance of the release of the Fiscal Year 2003 and Fiscal Year 2004 financial statements, preliminary discussions with underwriters active in the POB market indicate that the City could issue POBs on a private placement basis in the meantime. As with publicly sold POBs, completion of a successful validation action would be a prerequisite to the sale of POBs through a private placement. Also, similar to the recent private placements of the City's tax anticipation notes for Fiscal Year 2005 and Fiscal Year 2006, some limited disclosure regarding the City's financial condition (such as unaudited financial results) would need to be provided to the underwriter and potential investors for a privately placed POB. Depending upon the structure and maturity of such privately placed POBs, the interest rate on such a financing may be higher or lower than the expected rates noted above for a 30-year public offering. If a private placement were pursued, it could be structured to maintain the flexibility to refinance via a public offering of POBs when that becomes feasible.

Structuring the financing as variable rate bonds, as a short-term borrowing, or with an early redemption feature would be some potential mechanisms to provide the City with future flexibility.

Most municipalities issue general obligation or General Fund backed POBs, capitalizing on the credit of the sponsoring entity of the pension system. The issuance of POBs can often be viewed as involving a series of tradeoffs, including: exchanging one type of debt for another; reducing the short-run need to allocate an increasing share of discretionary revenues to provide for UAAL amortization, while increasing pressures for increased employee benefits if the system is fully funded and increasing the probability of a future UAAL. Since these tradeoffs are expected to often balance out in the long-term, the rating agencies perceive them to be neutral in terms of their net impact on a municipality's credit. See Attachment D for projected impacts on the City's debt position from issuing additional debt, including POBs.

Essentially, POBs replace a "soft liability" (the unfunded pension liability) with a "hard liability" (the debt service on the taxable pension bonds). Once POBs are issued, the bond proceeds are deposited in the pension fund with the objective that the fund will earn a higher return than the interest cost on the bonds. Critics of the POB instrument believe that the government, by issuing a POB, would be bonding out costs that would otherwise be paid out of current period revenues thereby increasing the total cost to the government. Proponents note that an unfunded pension liability represents a general obligation and that the POB represents a true commitment to fund the pension. The ultimate risk is that the pension fund loses a portion of the new capital infusion due to lower or negative return on pension fund investments, while still having to make its required future debt payments and pay the unfunded pension liability.

It should be noted that a significant POB issuance will result in a sudden increase in the Retirement System's assets, increasing exposure during a market downturn with below average investment returns, or even negative returns as in the past 2-3 years. An investment underperformance over an extended period of time will lead to actuarial losses and new unfunded liabilities, resulting in the need to increase contribution levels to bring the pension systems into balance. While POBs can be viewed as either a positive or negative option in the light of short term market fluctuations, a final assessment of a POB performance can only be made following the full amortization of the issuance and as its final maturity is approached. If there are net savings after full amortization of the POB obligation, the POB strategy is considered successful.

It is also important to note that although POBs have the immediate effect of lowering the UAAL, they should not, as a stand alone strategy, be regarded as providing a long-term solution to underlying pension funding requirements. Unless POBs are part of a more comprehensive strategy to address structural funding requirements, either in the form of increased contributions to match them with actuarial requirements and/or reduced growth in benefit costs, they will not guarantee a positive credit evaluation by credit rating agencies.

The issuance of POBs, via public offering or private placement, may require a validation process. The judicial validation process has potential for legal challenges and delays. However, a history of successful validations of POBs in California, and the County's successful issuance of multiple series of POBs in the recent past by adopting a similar process, would seem to

indicate that the risk of legal challenges is reduced.

Under the conventional structure for a POB, the municipality issues its POBs and simultaneously issues a debenture (essentially a promissory note) to the pension system equal to the amount of the bonds, which is equal to all, or a portion of, the UAAL. Upon the sale of the bonds, the proceeds of the bonds are deposited with a Trustee, who transfers an amount equal to the debenture to the Retirement System to retire all, or a portion of, the UAAL. In effect, the UAAL, which is an internal statutory obligation of the municipality, is replaced by an external debt. In California, since 1993, local governments have issued over \$10 billion in POBs, including various refundings. The issuers have included 20 counties including Los Angeles, San Diego, and Sacramento, and over 12 cities including Oakland, Fresno, and Long Beach.

See Attachment D for additional detail on the POB option. Also included in Attachment D is the debt affordability analysis that outlines credit impacts from additional debt issuance backed by the City General Fund.

5. Re-Engineering City Services

In developing the Fiscal Year 2006 Annual Budget, the City Manager proposed a budget that prioritized structural balance. Reductions, both in services and personnel, were identified to bring General Fund expenditures in line with General Fund revenues. The net reduction of budgeted positions Citywide included in the final Fiscal Year 2006 Annual Budget was 238.37, which reflects the restoration of approximately 42 positions. The City Council voted to use approximately \$7 million for various restorals that were funded primarily with one-time revenues. Moody's Investor Services wrote that this action "did not appear to be prioritizing structural balance" particularly when "the budget for Fiscal Year 2006 includes significant expenditure reductions in part to offset a previously agreed increase in the City's pension contributions."¹⁰ In other words, this particular action was seen as a modest step taken to rebuild the fiscal strength of the City.

The City needs to ensure that it is delivering services in the most efficient manner possible, through continued diligence in attaining structural balance. In the coming years, the City should seek ways to optimize the provision of all services to citizens. The City cannot continue to operate and provide services in the same manner as in the past, but must seek to utilize current resources in new, more effective ways, without the restoral of additional positions. By further evaluating the organizational structure and shifting the focus to core services, the future liabilities in the Retirement System and the City's full actuarial contributions will also decrease.

6. Pension Tax

On July 1, 1978, Proposition 13 of the California Constitution took effect. Proposition 13 limits local agencies' taxing power, but exempts from those limits a tax to pay back indebtedness approved by the voters before Proposition 13 took effect. Under current case law, this exemption includes a city's pension obligation up to the level of benefits approved by the voters before July 1, 1978. Section 76 of the San Diego City Charter further authorizes the City to levy a tax

¹⁰ "Moody's Downgrades City of San Diego GO Bonds to A3 from A1; Lease Ratings Correspondingly Downgraded," Moody's Investors Service Rating Update, August 2, 2005.

“sufficient to meet the requirements of the SDCERS’ pension funds.” On September 1, 1982 the Office of the City Attorney issued Legal Opinion No. 82-3 on the Legality of the Property Tax Levy to Meet City Pension Plan Obligations. This letter opines that the City of San Diego may levy a tax in excess of the 1% limitation of Proposition 13 to meet the City’ obligation to fund the Retirement System. Based on this analysis, the City Manager requested an updated opinion from the City Attorney on July 22, 2005. In addition, the City Manager may request an actuarial analysis for a possible pension tax for current system membership at the benefit level that was in place as of June 30, 1978, to estimate the amount that could be generated.

7. Transfer to CalPERS

Although not expected to provide a financial gain to the City or its Retirement System, transferring the administration of the City’s Retirement and Disability programs to an independent agency merits analysis. The California Public Employees’ Retirement System (CalPERS) administers earned retirement, disability, death and health benefits programs for participating public employees, retirees and beneficiaries. CalPERS membership consists of employees of the State, non-teaching school employees, and the employees of over 1,200 public agencies which are under contract with CalPERS. The public agency membership basically includes a safety category and a miscellaneous category. CalPERS is a defined benefit plan. Benefits are based on the member’s age, service and final compensation at retirement.

The City is in the very preliminary stages of exploring CalPERS as an option for administering the City’s Retirement and Disability programs. The City has contacted CalPERS representatives and has begun gathering basic data. There are several legal and financial questions that need to be answered as the City considers this option. Those questions include: 1) Can the City join CalPERS without a vote of the public? 2) Does the City Retirement System funding ratio need to be at a certain level prior to the transfer of the City’s program to CalPERS? 3) Since retirement is an individually vested right, is it up to each individual which retirement system they join? These are just a few of the questions that need to be explored. City representatives will continue to work with CalPERS representatives as well as the City Attorney’s Office to resolve these questions. A legal opinion from the Office of the City Attorney was requested on July 22, 2005 to address the legal considerations.

REVENUE ENHANCEMENTS

As presented in the 2002 Blue Ribbon Committee Report on City of San Diego Finances, and more recently in a report by the Center on Policy Initiatives, the City of San Diego has a relatively low revenue base when compared to other major cities in California and the nation. The City of San Diego does not charge for residential trash collection, and has never imposed a utility user tax, as nearly every other major city in California has done. Furthermore, the City of San Diego has one of the lowest Transient Occupancy Tax (TOT) rates among the ten largest cities in California, and generally has one of the lowest business license tax structures. In 1995 and 1996, the City even lowered business license fees in an effort to retain existing businesses and encourage business growth. As a low revenue base city, San Diego lacks flexibility to provide high level core services to citizens, as well as reduced flexibility to address a long-term pension deficit in just a few years.

In 1996, California voters limited the ability to raise revenue with the passage of Proposition 218.

Based on Proposition 218, all new taxes or tax increases require voter approval. New taxes that are proposed to be used for general purposes (“General Taxes”) require a simple majority vote, or approval by 50% of the voters. New taxes that will be earmarked for specific purposes (“Special Taxes”) require a two-thirds voter approval. The voter approval requirements set forth by Proposition 218 would apply to all the potential revenue sources except the trash collection fee. Trash collection fee levy is not subject to voter requirement under Proposition 218. However, the People’s Ordinance under the City Charter requires that the City provide free trash collection to single-family residences; as such, in order to implement a trash collection fee, it would first require amendment to the People’s Ordinance with a majority vote of the electorate and after approval, a majority protest procedure (set by Proposition 218) is required to implement the fee. The table below summarizes the list of potential revenues that, if voter approved, could create significant revenue growth for the City of San Diego, which could help the City achieve structural balance and address the City’s priorities more effectively.

POTENTIAL REVENUE ENHANCEMENT OPPORTUNITIES

REVENUE OPTION	ANNUAL REVENUE	ASSUMPTIONS
Trash Collection Fee	\$35.5M	Based on the FY06 Annual Budget, a monthly charge of \$9.24 per household would recover the costs associated with refuse collection.
TOT Increase	\$30.6M	Based on the FY06 Annual Budget and a TOT increase of 2.5% to 13%.
Property Transfer Tax Increase	\$59.6M	Based on the FY06 Annual Budget and a non-conforming Property Transfer Tax rate of \$2.75 per \$1,000.
Business License Tax Increase	\$5.2M	Based on the FY06 Annual Budget. Assumes a doubling of the current business license tax rate structure.

The City Manager will work with the Council’s Revenue Committee to facilitate further discussion regarding revenue enhancement opportunities.

CONCLUSION

Restoring the funding level of the City’s Retirement System is a top priority for the long-term fiscal health and stability of San Diego. Thus, as part of the ongoing effort to alleviate the unfunded liability to the Retirement System, the City Manager has identified multiple potential solutions. The goal is to increase the funded ratio of the Retirement System through solutions such as the use of employee contribution offset formerly paid by the City, issuance of Pension Obligation Bonds, sale of under-utilized City lands, securitization of general revenues, and other solutions that may be identified. City staff seeks City Council direction on which of these potential solutions are acceptable and should be analyzed in more detail.

Completely resolving the pension deficit is a long-term process and there is no single solution. Reaching that goal will require diligence by the City and a focused, dedicated effort by the City Council in adopting and implementing multiple solutions that will have significant positive impacts on the Retirement System. The City Manager will continue to identify and propose

long-term solutions via quarterly reports that will build upon the more immediate efforts that are implemented, maximizing the impact of our resources and creating long-term stability in the Retirement System.

Respectfully submitted,

Ronald H. Villa
Financial Management Director

Charles E. Mueller, Jr.
Acting City Treasurer

APPROVED: Lisa Irvine
Deputy City Manager

Attachment: [Attachment "A", Public Fund Survey](#)
[Attachment "B", 2004 Wilshire Report on City and County Retirement Systems](#)
[Attachment "C", Memorandum on Additional Steps to Reduce Pension Deficit](#)
[Attachment "D", Memorandum on the Preliminary Analysis of Retirement System Funding Options](#)