THE CITY OF SAN DIEGO

REPORT TO THE CITY COUNCIL

DATE ISSUED: February 1, 2006 REPORT NO. 06-012

ATTENTION: Council President and City Council
Docket of February 6, 2006

SUBJECT: Pension Solutions

REFERENCE: City Manager's Report No. 05-190, dated September 8, 2005

SUMMARY

Issues:

(1) Should the City Council authorize the Mayor to leverage approximately $10.3 million in annual employee pick up savings by securitizing in FY 2006 an equivalent amount of the City's tobacco settlement revenues starting with CY 2006 receipts to generate up to $100 million in net proceeds for the Pension System?

(2) Should the City Council authorize the Mayor to establish a tobacco bond issuance vehicle, a new Special Purpose Entity (SPE), in order to execute the proposed securitization transaction provided that the governing body of the SPE consist of the City's Chief Financial Officer, the City's Chief Operating Officer, and an independent outside member appointed by the Mayor and confirmed by the City Council?

(3) Should the City Council authorize the City Attorney to retain Hawkins Delafield & Wood LLP to serve as bond counsel and disclosure counsel for the proposed tobacco securitization transaction provided that the fees and expenses of the bond counsel and disclosure counsel shall not exceed $300,000, and be payable contingent upon the sale of the bonds?

(4) Should the City Council authorize the Chief Financial Officer, in consultation with the City Attorney, to proceed with the preparation of the bond documents, including the preparation of an official statement, and documents related to the formation of a SPE in order to execute the securitization transaction in FY 2006; provided the Chief Financial Officer shall (i) provide such documentation to the Disclosure Practices Working Group for its review,

and (ii) return to this City Council for final approval of any bond documents, including any official statement, and other documents related to the formation of a SPE?

Staff Recommendations:

(1) Authorize the Mayor to leverage approximately $10.3 million in annual employee pick up savings by securitizing in FY 2006 an equivalent amount of the City's tobacco settlement revenues starting with CY 2006 receipts to generate up to $100 million in net proceeds for the Pension System.

(2) Authorize the Mayor to establish a tobacco bond issuance vehicle, a new SPE, in order to execute the proposed securitization transaction, provided that the governing body of the SPE consists of the City's Chief Financial Officer, the City's Chief Operating Officer, and an independent outside member appointed by the Mayor and confirmed by the City Council.

(3) Authorize the City Attorney to retain Hawkins Delafield & Wood LLP to serve as bond counsel and disclosure counsel for the proposed tobacco securitization transaction provided that the fees and expenses of the bond counsel and disclosure counsel shall not exceed $300,000, and be payable contingent upon the sale of the bonds.

(4) Authorize the Chief Financial Officer, in consultation with the City Attorney, to proceed with the preparation of the bond documents, including the preparation of an official statement, and documents related to the formation of a SPE in order to execute the securitization transaction in FY 2006; provided the Chief Financial Officer shall (i) provide such documentation to the Disclosure Practices Working Group for its review, and (ii) return to this City Council for final approval of any bond documents, including any official statement, and other documents related to the formation of a SPE.

Other Recommendations:

None.

Fiscal Impact:

Any loss of the Tobacco Settlement Revenues (TSRs) to the General Fund from securitizing the revenue stream will be substituted by an equal amount of the annual employee offset savings achieved during the most recent labor negotiations. To eliminate adverse financial impacts on the General Fund from pledging up to $10.3 million in TSRs, for the duration of the securitization term, it is expected and required that the pledged TSRs will be fully substituted by the employee offset savings achieved from the existing labor contracts and any future labor contracts. Lack of employee offset savings to backfill the TSR pledge in any year over the life of the financing will adversely affect General Fund ability to fund the programs listed above or meet other General Fund priorities.

Public Resources Advisory Group (PRAG) was selected from the City's

Financial Advisor (FA) List to serve as the independent financial advisor for a fee of $170,000 through a City Manager's action. Funds to support the FA fees will be reimbursed from bond proceeds when the transaction is completed. The City Attorney's Office identified Hawkins Delafield & Wood LLP through a competitive selection process to serve as bond and disclosure counsel for this transaction, and the fee of not to exceed $300,000 for bond and disclosure counsel services will be contingent upon the execution of the transaction. No initial funding will be necessary as the compensation will be made to Hawkins Delafield & Wood LLP from the bond proceeds when the transaction is completed.

BACKGROUND

On September 12, 2005, the City Council was presented with City Manager's Report No. 05-190 (CMR 05-190), titled: "*Options to Increase the Funded Ratio of the San Diego City Employees' Retirement System"*. This report discussed several funding scenarios, described the results of the research performed by the working group, and presented proposed funding options to increase the funded ratio of the San Diego City Employees' Retirement System (SDCERS).

The potential funding strategies included revenue securitization (proposed target amount of $100 million) utilizing the employee pick-up savings/labor concessions (currently estimated at $18.3 million), sale of City property (proposed target amount of $100 million over 3 years), pension obligation bonds (proposed target amount of $400 million over 3 years), re-engineering city services, analysis of a pension tax, and possible transferring of the City's Retirement and Disability program administration to the California Public Employees' Retirement System.

The City Council directed the City Manager to proceed with the evaluation of pension solutions, including leveraging of up to approximately $17 million per year, an amount equivalent to the employee savings offset estimated as of September 2005, through securitizing a City revenue during FY 2006, and to provide status updates to the City Council on the implementation of pension solutions.

DISCUSSION

As described in CMR 05-190, the lack of current audited financial statements precludes the City from offering securities to the public capital markets. However, securitization of certain anticipated City revenues is a viable option. A significant one-time cash infusion could be generated by leveraging/selling an ongoing stable revenue stream through a securitization transaction. Based on further analysis of the three identified revenue sources (TSRs, franchise fees, and long-term ground leases) presented in CMR 05-190 and the immediate need to initiate the transaction (due to the requirement to leverage employee offset savings before the end of FY 2006 per the labor agreements), it is recommended that the City's TSRs be securitized as the first step to infuse additional funds into the Pension System and to meet the expectations set for the City by the FY 2006 labor agreements. The legal precedent for securitizing TSRs, the established marketability of the tobacco settlement revenue stream, and constraints associated with the securitization of other revenue streams support the strategy of leveraging TSRs as the first option to increase the funded ratio of the Pension System.

In general, when a public entity proposes to sell an ongoing revenue stream, such revenue stream is "securitized" (i.e. the right to receive the revenue over time is sold to a SPE, which in turn sells the right to investors, for a defined period at a determined discount rate in exchange for an upfront payment). The ability to receive an upfront payment makes this an attractive pension funding solution. The present value of the revenue stream is determined by applying a discount rate to the pledged anticipated revenue stream for the defined period. Logistically, the “buyer” of the future revenue stream offers to buy the bonds secured by the anticipated revenue at the agreed upon discount rate (interest rate). The amount of the up-front proceeds that can be generated is dependent upon the size and type of revenue that is pledged, the anticipated maturity dates of the bonds, and the interest rate at which the revenue stream would be discounted. The proposed pledge of the revenue stream and anticipated maturity dates of the proposed bonds are discussed below.

A securitization transaction is a stand-alone transaction that does not require a back-stop, credit backing, or disclosure of any City financial information and instead relies solely on the sale of the revenues and the pledge of the revenues until the bonds are paid off. Because there would be no recourse to the City’s General Fund, such a transaction would not affect the City’s existing debt levels. Additional benefits from securitizing the TSRs include reduction of exposure to the potentially volatile tobacco cash flows due to possible future litigation against tobacco companies or decline in tobacco consumption resulting in lower revenue to the City, and strong current market interest in tobacco bonds based on several recent tobacco bond transactions.

It is expected that a tobacco settlement revenue transaction can be implemented relatively quickly since the securitization structure for this revenue is well-tested. It will be necessary to create a new issuance vehicle, a stand-alone SPE (see the description below) to establish a “true sale” of the revenue stream and effectuate the transaction.

In order to execute the proposed transaction, it will be necessary for the City to establish a SPE that will be created for the sole purpose of engaging in the business of acquiring, owning, and selling receivables, which, for this transaction will be tobacco settlement revenues. The SPE will be required to have a governing body, usually consisting of three members, one of which must be an independent board member outside of the legislative body creating the SPE to satisfy standard rating agency requirements and other concerns (as addressed below). For this transaction, it is proposed that the three member governing body will consist of the City’s Chief Operating Officer, the City’s Chief Financial Officer, and an independent outside member appointed by the Mayor and confirmed by the City Council. The SPE will be restricted in various ways from entering into voluntary bankruptcy and other prohibited acts pursuant to its formation documents. Upon approval of the incorporation of the SPE by the City Council, the City will be required to file the Articles of Incorporation with the Secretary of State.

SPEs are used to address two critical structuring needs: establishment of the “true sale” of the TSRs and creation of a “bankruptcy remote” entity. The securitization transaction will be structured to ensure that the sale of the TSRs to the SPE is a “true sale” rather than a financing device. This will have a two-fold benefit: (1) from the investors’ perspective, the true sale will insulate the pledged TSRs from the City’s estate in the event of a City bankruptcy, and (2) from the City’s perspective, the structure will establish a non-recourse nature of the transaction, alleviating the City from the risk that the stream of tobacco revenues secured by the bonds is not sufficient to generate enough monies to pay principal and interest with respect to the bonds when due.

Additional information regarding the financing structure is described in the *"Memorandum on the Preliminary Analysis of Retirement System Funding Options"* attached to CMR 05-190, issued September 8, 2005.

Tobacco Settlement Revenues - Background

The Master Settlement Agreement ("MSA"), entered into in November 1998, resolved certain cigarette smoking-related litigation between what were then the four largest United States tobacco manufacturers, 46 states and six other U.S. territories (collectively the "Settling States"). In exchange for a release from past, present and future smoking-related claims, the cigarette manufacturers agreed to make payments to the Settling States. The MSA provides for additional cigarette manufacturers to become parties to the agreement and to date, there are 46 participating manufacturers.

The State of California is entitled to receive approximately 12.76% of the MSA payments made each year. Pursuant to the terms of the Memorandum of Understanding ("MOU") and the Agreement Regarding Interpretation of Memorandum of Understanding ("ARIMOU") between the State, its counties and certain cities, including the City of San Diego (collectively the "Participating Jurisdictions"), 50% of the State's share goes to the Participating Jurisdictions. The City of San Diego receives, in perpetuity, 2.50% of the settlement revenue going to the Participating Jurisdictions, or 1.25% of the total tobacco settlement revenues ("TSRs") due to the State. To date (CY 2000 – 2005), the City has received approximately $66 million in TSRs. The amount received in April 2005 and budgeted for FY 2006 was approximately $10.1 million and the City expects to receive approximately $10.3 million in April 2006 when the next settlement payment is due.

The TSRs were unexpected and represented a new, ongoing revenue source to the Settling States. Many states and localities have already monetized their TSRs through a securitization transaction to generate up-front funding for a variety of purposes, including capital projects, budget relief, debt reduction, and capitalizing investment trust funds to provide ongoing revenue for programs such as health care.

To date, nationwide, there have been approximately 51 un-enhanced tobacco transactions with a combined par amount of more than $20 billion. In addition, there have been four enhanced tobacco transactions, where a back-up general fund pledge of the issuer was provided, totaling a par amount of approximately $9.8 billion. Among the total tobacco financings (55) are three transactions executed by the State of California and over a dozen transactions executed by several California counties, including the County of San Diego, which completed a $466 million securitization in 2001. The table below lists the California municipalities that have securitized their TSRs.

State of California and California Counties	Date	Amount	State of California and California Counties	Date	Amount
Tulare	12/99	$45mm	Marin	06/02	$34mm
Sacramento	08/01	$199mm	CSFA (Pool)	07/02	$197mm
San Diego	12/01	$466mm	Fresno	07/02	$93mm
Stanislaus	03/02	$67mm	Alameda	10/02	$220mm
Merced	03/02	$31mm	State of California*		$8.7b
Sonoma	04/02	$67mm	Merced (ref)	10/05	$39mm
Kern	05/02	$105mm	Sonoma (ref)	10/05	$83mm
Placer	06/02	$42mm	Sacramento	12/05	$256mm
			18 TOTAL CA deals		**$10.6b**

*State of California completed 3 transactions: 01/03, 09/03, and 07/05 (refunding).

City TSRs - Background and Current Budgetary Allocations

In accordance with the "Smart and Healthy San Diego Plan", adopted in 1999, the annual tobacco settlement revenues are appropriated for a variety of uses, including the "6 to 6" Extended School Day Care Program, the Healthy Kids Park and Open Space Fund, the Multiple Species Conservation Program (MSCP), enforcement of the City's anti-smoking and anti-substance abuse laws, the Library System Improvements Program, and contributions to the Unappropriated Reserve. Budgetary allocations (subject to annual appropriation) for FY 2004 – 2006 for tobacco settlement funds are as follows:

Allocation of Tobacco Settlement Funds			
Allocation	**FY 2004**	**FY 2005**	**FY 2006**
Healthy Kids (6 to 6 Program)	$1,000,000	$500,000	$500,000
Parks/MSCP	2,214,000	200,000	200,000
Enforcement	250,000	250,000	250,000
Library System Improvements Program	1,405,705	2,231,345	-
Unappropriated Reserve Contribution*	-	-	-
Transfer to General Fund	7,258,717	6,836,861	9,164,461
	$12,128,422	$10,018,206	$10,114,461

*Allocations to Unappropriated Reserve occurred in FY 2000 – FY 2002.

It is estimated that the City will receive $10.3 million as its annual share of the MSA settlement in April 2006. Loss of TSRs due to the securitization will be fully substituted by the employee offset savings or salary reductions achieved during the most recent labor negotiations. Also see the Fiscal Impact section on page 2.

A three year labor agreement was reached with the Municipal Employees Association (MEA) and the American Federation of State, County and Municipal Employees Local 127 (Local 127) for Fiscal Years 2006-2008, a one year labor contract was agreed upon with the International Association of Fire Fighters Local 145 (Local 145) and the Deputy City Attorney Association (DCAA), and the terms unilaterally imposed by the City on the San Diego Police Officers Association (POA) for FY 2006. The agreements with MEA, Local 145, and DCAA and the imposed terms on POA resulted in the reduction of City "pick-up" of the employee pension contribution and a negotiated salary reduction for Local 127. The reductions and pension contributions provided by the employees are projected to provide the City with expenditure savings of approximately $18.3 million (General Fund and Non-General Fund) in FY 2006. Below is a breakdown of the estimated expenditure savings by fund:

Fund	FY 2006
General Fund	$11.8
Non-General Fund	6.5
Total	**$18.3 mil**

The expenditure savings have been committed to improving the Pension System's funded ratio by leveraging the employee offset savings and salary reductions as specified in the requirements of the labor contracts. The Mayor is proposing to use $10.3 million of the expenditure savings to reimburse the General Fund or other programs for the diversion of TSRs for securitization purposes. This will comply with the labor contracts which require the City to leverage the expenditure savings, otherwise the funds must be deposited into the Employee Contribution Rate

Reserve and be used to defray the pension contribution obligation of the bargaining units. It is critical to leverage the employee pension contributions in FY 2006 in order to comply with the contract terms within the contract period.

The Proposed Plan of Finance

The Mayor is proposing to securitize up to $10.3 million (equal to the expected settlement payment in CY 2006 to be received in April 2006) in annual future TSR receipts and use the upfront proceeds (after paying the financing costs) to reduce the City's outstanding pension fund liability. Taxable bonds will be issued and, based on current market rates and including available CY 2006 TSRs projected to be used to fund the debt service reserve fund, a total bond size of approximately $105 million would be required to produce net proceeds of $100 million. The proposed bonds are expected to have a final maturity of FY 2027 (22 years). While the transaction needs to be closed no later than the end of FY 2006, the goal is to complete the transaction as quickly as possible to ensure access to the tobacco bond market.

The core assembled financing team is comprised of firms that have extensive tobacco securitization experience. The City Attorney's Office selected Hawkins Delafield & Wood LLP to serve as bond and disclosure counsel and Public Resources Advisory Group will serve as financial advisor. In July 2004, through a competitive selection process, a syndicate of underwriters comprised of Citigroup Global Markets, Lehman Brothers, E.J. De la Rosa, and M.R. Beal was assembled to facilitate the pension obligation bond (POB) financing. Since the TSR securitization is now planned to close before the POB transaction, since the TSR securitization achieves the same objective of increasing the funding ratio of the Pension System, and since the firms identified for a POB sale also possess extensive experience and expertise in structuring and marketing tobacco bonds, the same syndicate has been maintained to underwrite the proposed transaction. Citigroup Global Markets is identified to serve as the senior managing underwriter, with Lehman Brothers, E.J. De La Rosa, and M.R. Beal serving as co-managers.

The City's future TSRs are capable of generating more than $100 million in bond funds. Under current market conditions, it may be possible to produce an additional $18 million of net proceeds while still limiting the annual TSRs pledge to $10.3 million by extending the maturity of the bonds by an additional ten years. The above estimates are based on current market conditions and the actual proceeds available could be more or less depending on changes in the level of interest rates and investor demand for taxable tobacco bonds, particularly for those having longer maturity dates.

The tobacco bonds are to be sold through a public offering. Similar to other tobacco securitizations, the City will sell its future TSRs to the SPE in exchange for the upfront bond proceeds and any residual amounts available after paying debt service. If the City Council authorizes proceeding with this transaction, the relevant legal documents concerning the SPE and the financing documents will be presented to the City Council for review and approval.

Timing and Risks

If the City Council approves proceeding with the proposed transaction, staff and the selected financing team will begin work on structuring and creating the relevant legal documents for the financing and the SPE that will actually issue the bonds. Those documents will be put before the City Council in March 2006. Although the City only requires the upfront proceeds for the Pension System sometime before the end of the current fiscal year per the labor agreement requirements, there is a clear benefit to act as quickly as possible. Factors beyond the City's control could affect its ability to access the tobacco bond market in a cost-effective manner.

For many years, tobacco manufacturers have been targets for lawsuits alleging adverse health effects caused by smoking. Since the MSA only relieved the participating tobacco manufacturers from healthcare cost recovery claims of the Settling States and not from individual and class action lawsuits, investors and the credit rating agencies have been concerned that a large judgment could adversely affect one or more of the major manufacturers' ability to make their annual MSA payments. In the spring of 2003, this concern became a near-reality when an Illinois court awarded damages of approximately $10 billion against Philip Morris and required the firm to post a $12 billion appeals bond. After the award, the firm stated publicly that it may not be able to post the bond and that enforcement of the judgment could cause it to declare bankruptcy. It also corresponded with the State Attorneys General of the Settling States and indicated that it may not be able to make its April 2003 settlement payment.

As of result of those statements, the credit rating agencies downgraded all tobacco bonds. Yields on tobacco bonds spiked significantly, and one tobacco bond sale priced at the time even failed to close. The ability to issue un-enhanced tobacco bonds (*i.e.*, bonds with no pledge of additional security) was effectively curtailed. Although the actual and perceived legal risks eventually subsided and issuers started bringing un-enhanced tobacco bond transactions to market by the spring of 2005, there is always the potential for a similar occurrence before the end of FY 2006 that could preclude the City's access to the tobacco bond market.

In addition to the litigation risks discussed above, there is also the risk of higher interest rates lowering the amount of proceeds that can be generated through a securitization. There are two aspects to this risk. First, buyers of tobacco bonds have always required some yield premium over most other municipal bonds to compensate for the tobacco risk and, when the City implements its securitization, there is the possibility this premium could be higher as compared to today's market. The second aspect is the potential for increases in general market interest rates, regardless of the type of financing.

Although a true sale transaction would relieve the City of providing any additional credit backing, there are certain risks associated with the amount of residual payment the City would receive annually and the length of period the pledge has to remain in effect. Although the financing plan will estimate the final maturity of the tobacco bonds at the time the bonds are issued, the revenue will be pledged until the bonds are fully paid. Unanticipated actions delaying or suspending the MSA payments may cause the anticipated final maturity of the bonds to be extended. Additionally, any anticipated annual residual amounts of TSRs available to the City in any given year, after payment of the debt service on the tobacco bonds, may also be affected by actions delaying or suspending the MSA payments.

Preliminary Sizing Detail

The following table illustrates the scenario of $10.3 million (estimated CY 2006 TSRs to be received by the City) being pledged annually to generate an anticipated $100 million in net proceeds with the residual amounts of TSR receipts (amount of TSR receipts received in excess of the annual pledge) flowing to the City. This scenario estimates a final bond maturity of 2027 taking into account the TSR annual coverage requirements to obtain credit ratings on the securitization. However, the bonds are expected to be fully amortized/repaid by 2022 assuming each year the pledged $10.3 million is realized to accelerate the pay down of the debt. The following table shows the expected amortization assuming the projected revenue pledge (TSR receipts) is received as anticipated. Any fluctuations in the projected TSRs (adverse or beneficial) would first affect the residual amount of TSRs expected to flow to the City as the residual amounts are subordinate to the annual pledged amount for the securitization. Based on current interest rates, the cost of borrowing for this scenario is estimated to be 6.45%.

The current cost of amortizing the outstanding Unfunded Actuarial Accrued Liability (UAAL) is equal to the SDCERS assumed investment return rate at 8.00%.

TSRs Estimated Projections for $10.3 million pledged annually for the Tobacco Securitization(1)

Calendar Year	Total Projected City TSR receipts(2)	TSRs sold for Tobacco Bond	Projected Residual Amounts to City(3)
2006	$10,300,000	$10,300,000	$0(4)
2007	$10,500,000	$10,300,000	$200,000
2008	$10,800,000	$10,300,000	$500,000
2009	$11,000,000	$10,300,000	$700,000
2010	$11,100,000	$10,300,000	$800,000
2011	$11,200,000	$10,300,000	$900,000
2012	$11,400,000	$10,300,000	$1,100,000
2013	$11,500,000	$10,300,000	$1,200,000
2014	$11,600,000	$10,300,000	$1,300,000
2015	$11,800,000	$10,300,000	$1,500,000
2016	$11,900,000	$10,300,000	$1,600,000
2017	$12,000,000	$10,300,000	$1,700,000
2018	$13,700,000	$10,300,000	$3,400,000
2019	$13,800,000	$10,300,000	$3,500,000
2020	$14,000,000	$10,300,000	$3,700,000
2021	$14,100,000	$10,300,000	$3,800,000
2022	$14,300,000	$0(5)	$14,300,000
2023	$14,500,000	$0	$14,500,000
2024	$14,700,000	$0	$14,700,000
2025	$14,900,000	$0	$14,900,000
2026	$15,000,000	$0	$15,000,000
2027	$15,200,000	$0	$15,200,000

(1) This scenario anticipates a final bond maturity of 2027, however, the TSRs pledge will only remain until the bonds are fully paid off.
(2) Preliminary TSR projections prepared by Citigroup based on Global Insight Cigarette Consumption forecast and other structuring assumptions.
(3) In the event that the TSRs received in a calendar year are equal to or less than the amount pledged to the tobacco bonds in that calendar year the City will not receive any residual amount.
(4) Cash contribution of CY 2006 TSR receipts (approx. $10.3 mil.) to be received in April 2006 assumed to fund the debt service reserve fund.
(5) Final year debt payment to be paid with the funds from the release of the debt service reserve fund.

Source: Citigroup Global Markets

Transaction Timeline

In order to reduce the exposure of market volatility and leverage the employee pick up savings within Fiscal Year 2006, an aggressive timeline is proposed for this transaction. The following are key milestones:

February	Present financing proposal to the City Council to authorize transaction, Form the bond issuance vehicle (Special Purpose Entity)
End March	First reading of financing/bond documents to the City Council
Early April	Second reading of financing/bond documents to the City Council, Approval of necessary bond documents by the Special Purpose Entity
End of May	Price bonds*
Mid-June	Close transaction, Transfer funds to Pension System

* Assumes 60-day validation period is observed. Policy call, not a requirement for bond execution. Bonds could be priced and closed within the validation period, if necessary.

Pension Solutions – Other updates

Pension Obligation Bonds
In July 2004, the City Manager received authorization from the Mayor and City Council to assemble a financing team to assess the issuance of POBs and develop a multi-phased POBs issuance plan. The financing team consisting of staff from the Office of the City Manager, City Attorney, and City Auditor & Comptroller was assembled. In addition, in July 2004, the City engaged the services of Public Financial Management, Inc. as financial advisor, Hawkins Delafield and Wood LLP as bond and disclosure counsel, and a syndicate of underwriters with Citigroup Global Markets and Lehman Brothers acting as co-senior managers.

While the City cannot proceed with a public offering of POBs in advance of the release of the Fiscal Years 2003-2005 financial statements, preliminary discussions with underwriters indicate that the City could issue POBs on an interim basis using a private placement option. As with publicly sold POBs, however, completion of a successful validation action would also be a prerequisite to the sale of POBs through a private placement. Assuming that the Fiscal Years 2003-2005 City financial statements will be released by the third quarter of the Calendar year 2006, the Mayor recommends that the legal validation and issuance process for Phase I of the POB transaction via a public offering be pursued in tandem with the release of the financial statements, with the closing of the transaction to occur in late FY 2007.

City Property
Environmental Systems Research Institute, Inc. and DW Consulting are conducting an independent audit of the City's property inventory data. The audit will focus on a comparison between the City's five main datasets of City property to produce a more accurate representation of City land. It is anticipated that the City-owned property inventory audit could be completed within 8 to 12 weeks of commencing the audit. Additionally, an in-depth and comprehensive discussion by the City Council is necessary to implement an asset management policy. The on-going nature of these two items precludes further decisions at this time regarding the sale of City property or securitizing the leased property revenues.

Re-Engineering City Services
The Mayor will review current City services and staffing and determine if further changes are necessary. The City needs to ensure that it is delivering services in the most efficient manner possible, through continued diligence in attaining structural balance. By further evaluating the

organizational structure and shifting the focus to core services, the future liabilities in the Pension System and the City's full actuarial contributions will also decrease.

Pension Tax

In July 2005, a legal opinion regarding the legality of a pension related property tax levy (Pension Tax) to meet City pension plan obligations was requested from the City Attorney. The request is pending.

CalPERS Eligibility

In order to explore the alternative of transferring the administration of the City's Retirement System and Disability programs to CalPERS, a legal opinion was requested from the Office of the City Attorney to address the legal considerations before further evaluating this option. The legal opinion "CalPERS Eligibility" states that the City has the ability to enter into a contract of membership with CalPERS upon: (1) City Council action and a vote of the majority of all active members of SDCERS as stated in the City Charter Section 148.1, and (2) meeting the requirements set forth in the Public Employees' Retirement Law (PERL), which depend on the benefits for which the City contracts.

Upon successful completion of requirement number one above, the City would need to decide upon the system that administers its benefits. With regards to requirement number two, there are several considerations that must be addressed before seeking CalPERS membership. Among these considerations are:

- **Nature and Level of Benefits:** The City must determine the level of benefits and any changes in benefits must be addressed through the "meet and confer" process.
- **Extent of Membership:** The City must determine what member type and/or employee groups could be included in a transfer to CalPERS.
- **Unfunded Actuarially Accrued Liability (UAAL):** Assuming membership would include current SDCERS members, the City can either pay off the UAAL or obtain approval to amortize the UAAL over a negotiated period between the City and CalPERS.
- **Disability Retirement:** Assuming membership would include the safety employee group, the City must maintain responsibility of disability determination for this classification.
- **Vesting Results:** CalPERS members are vested after five years of full-time equivalent service and cannot be altered by contract. Since SDCERS members are vested after 10 or 20 years of creditable service depending on retirement age and employee classification, a potential increase in cost must be taken into account before contracting for CalPERS membership.

City Staff will continue to research the experience of other government agencies that have joined CalPERS membership such as the City of Oakland and, based on the information obtained, further recommendations will be brought to the City Council regarding this option.

CONCLUSION

Restoring the funding level of the City's Retirement System is a high priority for the long-term fiscal health and stability of the City. 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 impact on the Pension System. Leveraging a portion of the employee offset savings through a securitization of the City's tobacco settlement revenues is a positive step in identifying significant additional funding for the Pension System. The pension solutions working group will continue to evaluate solutions that were previously identified and offer periodic updates to the City Council that are built upon the more immediate efforts that are implemented including the proposed tobacco revenue bond transaction.

ALTERNATIVES

Do not securitize tobacco securitization revenues. Assess alternative financing mechanisms to fund the Pension System and implement the financing within FY 2006 in compliance with the labor agreement requirements.

Respectfully submitted,