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OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO

MICHAEL J. AGUIRRE
CITY ATTORNEY

CIVIL DIVISION
1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
TELEPHONE (619) 236-6220
FAX (619) 236-7215

December 4, 2007

James Godsey
Anthony Neequaye
Macias, Gini & O'Connell LLP
402 West Broadway, Suite 400
San Diego, CA 92101

Dear Mssrs. Godsey and Neequaye:

## I.
## INTRODUCTION

The practice of using surplus undistributed earnings to pay for conditional pension benefits administered by the San Diego City pension board is a discredited practice. The San Diego City Attorney has requested San Diego City Council President Scott Peters schedule a hearing to consider revocation of the San Diego Municipal Code provisions related to the use of surplus undistributed earnings. No such hearing has been held. Moreover, an issue has now arisen about whether the City is continuing to use surplus undistributed earnings to pay conditional pension benefits and related expenses. There is also an issue about whether the City's outside auditor, Macias & Gini, has provided a certification of surplus undistributed earnings for the City's pension board.

## II.
## DISCUSSION

The City Attorney discovered facts today suggesting that that the City's outside accounting firm Macias & Gini had "prepared a Certification of Surplus Undistributed Earnings for fiscal year 2005." Mark Hovey, the San Diego City Employees Retirement System's (SDCERS) Chief Financial Officer, wrote a related memorandum on 2 November 2007 stating:

> Macias Gini & O'Connell LLP (MGO) has prepared a Certification of Surplus Undistributed Earnings for Fiscal Year 2005. With this Certification, the Board can approve the transfer of $186,095,249 from the Undistributed Earnings Reserve to the appropriate Reserves for Employer Contributions for Fiscal

> Year 2005. MGO, acing under provisions of its audit contract with the City, has provided the attached Certification.[1]

The past practice of using "Surplus Undistributed Earnings" is a discredited practice because the practice is inconsistent with SDCERS' actuarial assumptions. The actuarial assumptions of the pension system are based upon an assumed 8% rate of return. SDCERS 2006 actuarial report explained:

> In the charts that follow, we project the SDCERS-City of San Diego assets and liabilities, the pay down of UAL, and the City's contributions as a percent of payroll on six different bases: 1) Assuming 8% returns each and every year, and the continuation of the pay down of the UAL over 27 years as a level percent of payroll, and as of June 30, 2006, 2) Assuming returns that vary each year but over the projection period equals on average the assumed 8% return, and the continuation of the 27-year UAL paying it down, 3) Assuming 8% returns each and every year, but moving to 20-year level percent of payroll amortization as of July 1, 2008, and paying it down until 2028,[2]

The assumed rate of return of 8% was also built into the projections in the 2006 actuarial report as so stated:

> The actuarial value of assets is a weighted average giving 25% weight to the current market value and 75% weight to the prior year's actuarial value increased by expected interest and contributions and decreased by benefit payments and expenses. This is mathematically equivalent to recognizing 100% of the actuarially assumed interest rate, plus contribution, less payment each year and 25% of the portion of each year's returns that have not already been reflected in asset values.[3]

Even the law firm retained by the San Diego City Council to represent the City of San Diego in connection with the Securities & Exchange Commission (SEC) investigation into fraud by City officials involving the pension plan found the use of surplus undistributed earnings untenable.

> A pension system derives its ability to pay benefits from three sources: employer contributions, employee contributions and earnings generated from such contributions when retained within the system and productively invested. In determining the level of employer and employee contributions necessary to

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[1] 2 November 2007 SDCERS Staff Report to Business and Governance Committee, Exhibit 1.

[2] SDCERS 2006 Actuarial Report p. 9, Exhibit 2.

[3] SDCERS 2006 Actuarial Report p. 58, Exhibit 3.

> achieve the goal of "generational equity" in a pension system, a critical component is the assumed rate of return on fund assets. The greater that rate, the less must be contributed by system participants to fund projected retirement benefits on a basis that remains stable over time as a percentage of payroll.[4]

The use of Surplus Undistributed Earnings is absurd in light of the pension plan's $1 billion deficit. As a practical matter you cannot have an earnings surplus when the pension plan has a deficit. A supplemental benefit or 13th check is payable on the condition if there are surplus undistributed earnings. Finding there is surplus undistributed earnings implies there is extra money to pay the conditional benefit.

When funds are diverted from the pension, which is in deficit, less is available to make up the deficit. In fact, the deficit grows by the amount diverted to pay additional benefits. Again, the outside firm explained the impact of the diversions on the financial integrity of the pension:

> The surplus earnings concept ignores this long-term dynamic of actuarial projections. It evaluates returns on a year-by-year basis and treats all cash generated by system assets (beyond assumed rates of return) as free money. This, of course, flies in the face of the basic premise of actuarially assumed returns: they are rarely met for any individual year, but are expected to average out over time to approximate the projections. Therefore, the concept of "surplus earnings" is a misnomer. Unless and until it can be demonstrated that the actuary's projections are unrealistically conservative, *all* earnings are necessary to support the long-term viability of the system – none are truly "surplus" or "excess."[5]

Again, the outside law firm explained what eventually happens to pension plans that rely on surplus undistributed earnings: "*Any diversion of earnings from system assets should therefore be seen as a financing arrangement, requiring repayment over time*."[6] Even SDCERS own past administrator Lawrence Grissom advised the board in April 2002: "[I] believe there has come a perception over the years that earnings are cash in pocket, which is not the case.[7]

The Council's outside counsel further noted that SDCERS fiduciary counsel advised that: "Defining Surplus on a cash basis leads to draining off liquid assets and reducing future earnings power. It also undercuts actuarial assumptions about earnings. An assumption of earnings is

[4] 16 September 2004 Vinson & Elkins Report on Investigation, p. 32, Exhibit 4.

[5] 16 September 2004 Vinson & Elkins Report on Investigation, p. 33, Exhibit 5.

[6] 16 September 2004 Vinson & Elkins Report on Investigation, p. 33, Exhibit 5.

[7] 16 September 2004 Vinson & Elkins Report on Investigation, p. 33, Exhibit 5.

based on expected averages over a long period of time. By draining off cash in good years, the structure makes it harder to meet the long-term earnings assumption."[8]

The Council's outside law firm said that using surplus undistributed earnings raised an important legal issue: "As a legal matter, the use of surplus earnings to pay various contingent benefits is also dependent on the view that these funds, until designated as "inside" System assets by the pension board, are not necessary for the actuarial soundness of the System. This, too, contains an element of fiction in that it fails to recognize that projected returns on fund assets are fundamental to the sound funding of any pension system."[9]

The City Attorney's office has repeatedly requested Council President Scott Peters to calendar for council action to consider revocation of the surplus undistributed earnings provisions of the Municipal Code (§§ 24.1501, 24.1502). During the time Council President Scott Peters was deferring consideration of the proposal to revoke the surplus undistributed earning provisions in the Municipal Code SDCERS has continued to divert pension funds to pay conditional benefits under the shield the Municipal Code.

During discussions today with your office Macias & Gini represented it did not provide a certification of surplus earnings to SDCERS. Rather, the claim was made that Macias & Gini only performed agreed upon procedures. However, the SDCERS staff memorandum mentioned above suggests that Macias & Gini did provide such a certification. Would you please provide a clarification of your position, did Macias & Gini certify surplus undistributed earnings for SDCERS?

## III.
## CONCLUSION

The practice of using surplus undistributed earnings to pay for conditional pension benefits administered by the San Diego City pension board is a discredited practice. The San Diego City Attorney has requested San Diego City Council President Scott Peters schedule a hearing to consider revocation of the San Diego Municipal Code provisions related to the use of surplus undistributed earnings. No such hearing has been held. Moreover, an issue has now arisen about whether the City is continuing to use surplus undistributed earnings to pay conditional pension benefits and related expenses. There is also an issue about whether the City's outside auditor, Macias & Gini, has provided a certification of surplus undistributed earnings for the City's pension board. This letter has been written to you for clarification.

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[8] 16 September 2004 Vinson & Elkins Report on Investigation, p. 33-34, Exhibit 6.

[9] The Council's lawyer cited *Claypool v. Wilson* (1992) 4 Cal. App. 4th 646.

Further, we wrote you last week regarding questions arising over apparent conflicts in financial statements certified by Macias & Gini regarding payments of pension benefits above the Internal Revenue Code limits. We would like to add the issue of whether your firm certified surplus undistributed earnings for the SDCERS board. Please let me know at your earliest convenience when we may arrange the meeting sought.

Very truly yours,

Michael J. Aguirre
City Attorney

MJA:meb

Cc: Ms. Joyce Kahn, Manager, EP Voluntary Compliance, Internal Revenue Service
Mr. Joseph Grant, Director of Employee Plans, Internal Revenue Service
Mr. James E. Holland, Manager, EP Technical, Internal Revenue Service
Ms. Maxine B. Terry, Program Coordinator, Internal Revenue Service
Mr. Andrew Zuckerman, Director of Rulings and Agreements, Internal Revenue Service
Councilmember Kevin Faulconer