

Interview by Vinson & Elkins
with Richard Vortmann
at footnote(s):

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M E M O R A N D U M

June 9, 2004

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TO: Paul S. Maco
Richard C. Sauer

FROM: Maria E. Bickerton

RE: *City of San Diego; Interview of Dick Vortmann*

This memorandum summarizes the interview of Dick Vortmann, a member of the CERS board since early 2002 and a member of the Blue Ribbon Committee that reported to the City Council in 2002, conducted by Rick Sauer and Maria Bickerton. Also, in attendance was Jerry Coughlan, serving as legal counsel to Dick. The interview took place on the afternoon of June 8, 2004.

This memorandum does not contain a verbatim or a near-verbatim transcription of this interview, but rather is a general summary of thoughts and mental impressions regarding the discussion. Significantly, it is organized to summarize issues thematically and, although it does chronologically follow the interview to an extent, it does not necessarily reproduce the order in which the interview actually occurred. There was no stenographer present at this interview, and given the nature of summarizing this type of discussion after the fact, this memorandum does not attempt to describe every statement or exchange, and it is possible that there are errors in this account. It also assumes familiarity with the facts of this case and does not provide context or explanation of every factual reference. It also does not attempt to completely describe or explain the complex retirement system issues discussed. Nor does it address issues of credibility or attempt to reconcile any differences between this interview and the accounts of other individuals.

This memorandum is subject to the attorney client and the attorney work product privileges, as it was prepared in connection with our providing legal advice to the City of San Diego (the "City") in connection with a potential SEC investigation regarding some of the matters discussed in this memorandum.

I. General Introduction

Rick opened the interview by explaining to Dick that we had been hired by the City to do an independent investigation having to do with its public disclosure, particularly in connection with its pension liabilities and related issues. Rick explained that we were interviewing a number of people to get the most informed report possible. Rick also informed Dick that our notes of the interview would be reduced to memorandum form and that he would have an opportunity to correct the memorandum.

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II. Blue Ribbon Committee

A. *Selection Process and Staff*

Rick began a discussion regarding Dick's role on the Blue Ribbon Committee ("BRC"). Rick asked how Dick was selected to be on the BRC. Dick said he did not recall exactly but that it was probably through a connection with the mayor's campaign staff. Dick indicated that the BRC began its work at least one year and possibly two years before the report was issued. Dick explained that the various topics discussed in the BRC Report were divided among the Committee members. His topic was the retirement liabilities. Rick asked how Dick ended up with this topic, and Dick explained that he believes everyone picked the areas in which they were interested. He had been involved in pension issues as an employer in the private sector, so the pension issues were of interest to him.

Rick asked if the BRC had a staff to assist them in their investigations. Dick explained that City employees, specifically Terri Webster and Ed Ryan, were assigned to assist the BRC. Dick said they assisted all the Committee members, and they helped him with the pension issues.

B. *Recommendations in Report*

Rick referred Dick to page six of the BRC report, which contains the BRC's recommendations regarding the pension liabilities. The first recommendation suggested changing the City's funding strategy to one that results in the City fully funding its future obligations earned today, which includes the pension benefits as well as health benefits. Dick said that he initiated this recommendation and the other BRC members concurred. He did not recall anyone on the BRC disagreeing with the recommendation.

Rick inquired about the role of City staff members regarding the recommendation. Dick explained that their role was primarily to provide information; it was not really their place to concur or disagree with the BRC's recommendation. Sometimes they may have indicated that the BRC was going in a wrong direction and tried to make sure the BRC was not misunderstanding the information it was given. Dick said that the City staff members gave him a lot of information on the accounting requirements, but he was interested in the financial substance of the pension liabilities, not the technical accounting requirements.

The second recommendation suggested that the City obtain a current and comprehensive analysis of projected pension expenses and revenue sources, which includes the current present value of retiree health benefits to determine the impact on future City finances. Dick explained that this too was his recommendation, and he said that he still agrees with it as a matter of financial substance (not accounting). Dick encountered a dearth of information on the City's retiree health benefits that concerned him.

Rick asked whether Dick also perceived a lack of information with respect to pension as opposed to retiree medical benefits. Rick noted that the second recommendation referred generally to "pension expenses" as well as specifically to retiree medical benefits. Dick said that the lack of

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information with respect to the retiree health benefits was the most glaring, and this was his focus. At the time the BRC report was issued, Dick noted, the BRC had only seen the surface of the underfunding problems with respect to the pension benefits. He became aware of the extent of the problem only later. Rick asked Dick to elaborate on what the BRC did not understand at the time of the report. Dick responded that the BRC did not understand the affect of Manager's I and the actuarial assumptions involved. He felt there was miscommunication due to the BRC's lack of understanding of the morass that existed with regard to the pension system.

Rick asked whether Dick thought the San Diego pension system was particularly hard to understand. Dick responded that he is not sure how it compares to others but that he finds it to be a complicated system. Dick explained that this made it hard for him to know what he did not know. For example, Dick noted that Manager's I and the waterfall distribution of surplus earnings were pieces of system's the complexity. From his past experience, the waterfall distributions were not normal. Rick inquired whether Dick believed the people on the CERS board understand the waterfall process, and Dick said he did not believe that anyone on the board fully understands it. Rick asked whether Dick thought anyone in San Diego, including anyone in the City auditor's office, understands it. Dick said that he was unable to answer this but speculated that Terri Webster or Ed Ryan might (be able to answer).

C. Opinions in Report Regarding Payments on Pension Liabilities

Rick then turned to page 20 of the BRC report and referred Dick to the section entitled "Pension Benefits." Rick quoted the following sentence from this section:

The potential risk is that policy makers grant benefit enhancements today (to satisfy employee concerns, to negotiate trade offs with unions, etc.) but avoid recognizing the actual annual cost of such by actuarially spreading the cost over years far out in the future, long after the individuals who made the policy decisions are gone.

Dick confirmed that these were his words. Rick asked Dick how he reached this conclusion. Dick explained that it was simply an observable fact that was not unique to this branch of government. Dick said that he saw some evidence of liabilities being pushed off to the future. In response to Rick's questioning, Dick explained that he was not speaking of any specific individual liabilities because, in his mind, they were aggregated.

D. Terri Webster and Ed Ryan's Reaction to BRC's Views

Rick asked whether Dick discussed the underfunding issue with Terri or Ed. Dick said that they had general discussions about it. Generally, from what Dick remembers, Terri and Ed were in agreement with the thrust of Dick's conclusions on the pension side. He noted that there was disagreement on the retiree medical side because Terri and Ed kept focusing on the fact that the City was not required to account for or fund retiree medical benefits under GASB. Dick also explained that he was not aware of GASB before his work on the BRC; he knew only of FASB, which does require the recognition of retiree health liabilities.

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Rick asked whether, aside from the GASB issues, Terri and Ed supported the view that the City should provide additional disclosure on the pension liabilities. Dick responded that his issue was not disclosure; his issue was funding. Dick explained that Terri and Ed did agree that the City should fully fund the pension on an actuarial basis.

Rick inquired whether Terri or Ed expressed any opinion on the contribution schedule under Manager's 1. Dick said he did not recall whether it was discussed at that time. He said they did discuss keeping track of the underfunding, which was the consequence of the lower rates in Manager's 1. Dick did not recall Terri and Ed's views. He said that, if he had to reach a conclusion, it would be that they were supportive of the idea of increased contributions by the City. He said he believes this was the case particularly because at least Terri, and possibly Ed, encouraged Dick to become a member of the CERS board. Rick asked if Terri thought Dick would be the voice of reform for the board, and Dick said she did not use those terms but that was the general nature of her encouragement.

Dick indicated that he felt that the way the underfunding was calculated was disingenuous. He explained that GASB requires that the City state the underfunding in its financial statements but that the figures used did not reflect the compounding of interest on the underfunding amount. Dick understood that this underfunding was reflected in some kind of reserve that was later closed. Rick asked if the reserve Dick referred to was the NPO reserve. Dick did not know. He said all he knew was that the reserve reflecting the underfunding was not a segregation of assets, rather it was just an accounting tool (i.e., these were inside assets). Dick did not know why this reserve was established but guessed that it may have been some confusion due to the fact that the actuary was supposed to come up with a figure for the amount of the underfunding. Dick explained that the existence of this reserve did not come to his attention until sometime after the BRC report was issued.

E. Conclusions in Report

Rick referred Dick to page 23 of the BRC report. Specifically, he highlighted the last sentence of the second paragraph, which stated that "[t]he Committee is very concerned whether the City fully appreciates the impact these increasing expenses have, and (particularly any future improvements in pension granted to employees will have) on future annual City budgets." Rick asked what raised concerns about whether the City properly appreciated these factors. Dick likened it to someone with credit card debt who is not even paying off the interest. Dick saw no evidence that the City really understood this.

Rick asked whether Dick understood the mechanism in Manager's 1 to increase the City's contribution by ½ a point each year. Dick said he does not recall understanding the workings of Manager's 1 at the time he was on the BRC. However, now he feels it was not an adequate mechanism if the policy was to have the current taxpayers pay for the current liability because the ½ point increase was not keeping pace with the increasing liability.

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F. City's Reaction to BRC Report

Rick inquired whether, when the BRC issued its report, it prepared a presentation to the City Council. Dick said that he believed they did and that he was there. He indicated that it would have been in open session. Rick asked Dick to review a PowerPoint presentation. Dick stated that he believed the PowerPoint was the retirement benefits portion of a presentation the BRC made to the City Council and possibly the Rules Committee. Rick asked what the function of the Rules Committee is. Dick said he did not know; his understanding was that it was a subcommittee of the City Council.

Rick wanted to know the City Council's reaction to the report. Dick said that, by the time the BRC report was finished, he felt it was pretty watered down in its totality (taking into account all of the various topics included in it) because it was a product of a committee. Dick said he personally felt that the City faced more serious problems than conveyed by the tone of the report. Dick clarified that the pension portion of the report was largely left as he wrote it – it was not so much watered down. Dick said he felt it made the points he believed were needed at the time.

Rick asked if Dick expected a response to the BRC report. Dick said he certainly did. In fact, he explained that the BRC was supposed to demand a response a year later and get an accounting from the City. However, this never happened. Dick said that he saw no evidence that the BRC report heightened awareness of the pension funding issues.

G. Reaction to BRC Report in Local Press

Rick wanted to know how the local press reacted to the BRC report. Dick said he had no recollection of a reaction in the press, particularly with regard to the pension subset.

III. Reserves

Rick initiated a discussion regarding the folding of a number of reserves into the employer contribution reserve in 2003. Dick confirmed that this was done. Rick asked if Dick remembered any discussions among the CERS board members when the idea of collapsing these reserves was raised. Yes, in general, he remembered that discussions took place. He could not recall the reason for the action. Rick asked if Dick understood the effect of collapsing the reserves into the employer contribution reserve. Dick said that it did not change the contribution rates for the employer or the employee because the assets were already "inside" (included in the actuarial valuation).

Dick pointed out that these reserves were another one of the complexities inherent in the San Diego CERS that make it very hard to fully understand.

Rick referred Dick to a document entitled "Questions for City Pension Manager," dated July 30, 2001. This document contained questions that Dick prepared during the BRC investigation of the retirement benefits. Rick read the following question 9 from the document:

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"What is the logic of all the 'reserves' which compose the total Trust Fund. . . . How are these reserves treated in the actuarial computation? I.e. do assets in 'reserves' and earnings on 'reserved assets' count as available to make pension payments."

Dick did not remember getting an answer to this question at the time he was preparing the BRC report. He explained that, while on the board, he has had a continuous learning experience regarding the reserves but just as issues came up. He said he had not done a concentrated study to understand the reserves.

Rick referenced a document containing CERS board meeting minutes from May 29, 2002. Rick noted a statement by Larry Grissom that the projected earnings for the fiscal year were far short of what they had been in the past ten years. Dick did not recall this statement in particular but recognized the subject matter. He did not recollect the board's discussions regarding how to deal with the situation.

On page 5 of the minutes, Rick noted that Mr. Saathoff stated that the board made a decision to set aside \$100 million a few years ago as a contingency reserve. Dick did not know anything about this reserve.

On page 6 of the minutes, Rick noted that Mr. Pierce commented that there had been discussions regarding whether it was a breach of fiduciary duty for the board to take money from the reserve accounts and move them outside plan assets for contingent benefits or other purposes that did not provide the funding of the benefits that the System is inherently responsible for paying. Dick did not recall this discussion or any other discussion specifically on this issue. However, he said he would not be surprised if he had been involved in such discussions.

Rick commented that Bob Blum had opined that the board could create certain reserves but that it could not spend them. Dick remembered this issue being raised. Rick asked if there was a resolution of this issue. Dick said there was an acceptance of Bob Blum's position that the money in the reserves could not be used to pay contingent benefits.

III. Estimates on Retiree Health Liability

Rick presented a document to Dick entitled "Additional Questions," which was dated July 23, 2001. Dick recognized the questions as those he prepared in doing the BRC investigations. He did not know to whom the document that Rick presented belonged. Rick indicated that he believed it was Terri's. Dick said he thought it would have been Larry Grissom's because he did not remember that Terri was at the meetings where these questions were discussed.

Rick referred to the following statement on the last paragraph of the first page: "Most critically, what is someone's (?) educated guess as to the unfunded present value of retiree health benefit 'earned' to date; i.e., for all years from service up to present?" Rick asked if Dick remembered who provided this information. Dick said he had no recollection. He thought the question was never scientifically (i.e., actuarially) addressed. The numbers indicated in the document in

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handwritten notes (i.e., > 100M, >200M, 145M) are grossly understated based on the understanding today. Dick had the impression that no actuarial study was ever done on the retiree health liability.

Rick noted that the BRC report on page 24 contained an estimate that the present value of the retiree medical benefits exceeded \$100 million. Dick did not recollect where this figure came from. Dick said he guesses that figure came from Larry Grissom, but he was not certain.

Rick turned again to the document entitled "Questions for City Pension Manager," dated July 30, 2001. The first question in the document asked what the estimated present value of retiree medical benefits was. Dick did not remember the answer he received to this question. He said he believes Larry Grissom answered the questions in the document, but Dick did not recall the specific conversation. Rick asked whether Dick had spoken with Larry Grissom since then regarding the amount of the retiree medical liability. Dick indicated that he had and that a range of numbers, some over a billion, have been discussed.

Rick referred Dick to a CERS memorandum dated February 5, 2003. Rick noted that this report estimates the present value of the liability for paying the health insurance premiums for current active members who have not yet retired to be approximately \$1.1 billion. Rick asked who calculated the \$1.1 billion figure. Dick said he believed it was the actuary. However, Dick said that he had not seen any document or report from the actuary. The figure did not surprise Dick, who had always suspected, based on his personal experience in the private sector, that the liability could be quite large. Dick noted that he understands that the retiree health liabilities are difficult to quantify due to fluctuating health care cost increases and a variety of other factors.

Rick next turned to the second question in the document entitled "Question for City Pension Manager." The second question asked for details on what the retiree medical benefits were. Rick brought to Dick's attention a handwritten notation next to this question that said "PUC - volitable to age." Dick did not know anything about this notation. He explained that he did not get into the issues regarding the cost methods used to determine contribution rates at the time he was working on the BRC report. These issues became known to him later when he joined the CERS board. When he was on the CERS board, Dick explained that he learned about the earlier move from EAN to PUC. He said he believes the change was implemented in order to lower the contribution obligations. He understands that they intend to switch back to EAN "when the good times return."

Rick wanted to talk about a statement in a preliminary draft of the portion of the BRC report regarding the retirement benefits. The preliminary draft was dated July 23, 2001. Rick turned to the second page in the draft and read the following sentence: "Nowhere (to my knowledge so far) is the amount of the total unfunded retiree medical liability estimated and acknowledged." Dick explained that, during his interactions with the City, it was never apparent to him that anyone had a reliable figure estimating the retiree health liability. Dick said that he felt it was important for the City to have this number. Rick noted that the final BRC report contained an estimate that the retiree health liability could exceed \$100 million. Dick said he believes this number came from

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Larry Grissom. He said it may have been Terri Webster or Ed Ryan, but he does not think it came from either of them.

Rick asked if there were other estimates of this liability between the \$100 million estimate in the BRC report and the \$1.1 billion estimate in the February 5, 2003, CERS report. Dick said he was not aware of any other estimates either in between the BRC report and the CERS report or after the CERS report. Dick said that no one seems to want to discuss the issue. In his view, the focus is on the pension benefits because it is quantified. Dick noted that some City staff members, specifically Chris Morris, are now expressing the view that some retiree medical benefits are not vested depending on the group of people at issue.

Rick asked whether the Pension Reform Committee is trying to recalculate the retiree medical liability. Dick said that he was not aware that this was being addressed by the Pension Reform Committee.

Rick inquired whether the CERS board has reacted to the GASB move toward requiring a retiree medical liability disclosure. Dick said he had never heard it mentioned and that this was a City, not a CERS board, issue.

Rick next asked Dick about certain e-mail exchanges he had with Terri Webster. In one dated July 31, 2001, Terri stated, "Generally Accepted Accounting Principles (GAAP)/Governmental Accounting Standards Board (GASB) does not require 'estimating and acknowledging' the health liability." Rick asked if this information is what Dick alluded to earlier regarding Terri's focus on the accounting principles. Dick confirmed that it was. Rick next read the following sentence in the e-mail: "Yes taking health 'out of earnings' indirectly impacts rates in the actuaries calculations but when you look at the numbers we're talking about assumptions versus experience . . . it would be a very, very small impact." Dick said that he believed she was acknowledging that paying retiree medical benefits out of surplus earnings would have an impact but only a small impact overall. Rick also noted the following sentence: "These are just some facts...you pointing out that health is increasing and should be watched is a good observation." Rick asked Dick if this was what he remembered Terri's position to be. Dick did not remember.

Rick then brought another e-mail from Terri Webster dated September 4, 2001, to Dick's attention. Rick quoted from the e-mail, "I support highlighting that there is a negative fiscal impact to the City when retiree benefits are increased and they need to be reminded that they are paying artificial low rates now and pushing liability out to the future." Rick asked if this comported with Dick's recollection of Terri's position. However, Dick said he had no recollection on this. Rick asked what Terri meant by "artificial low rates." Dick said he was not sure what it meant. Rick questioned whether she was referring to Manager's I. Dick did not know.

Rick quoted another sentence from Terri's e-mail: "This is timely since the labor side of the Board was successful in June in pulling \$100m out of FY00 earnings so they have a pot to bargain with in the upcoming labor negotiations." Dick said he had no understanding of what

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she meant by this statement. He said he had no knowledge of the \$100 million reserve she referenced.

IV. Manager's II

Rick began a discussion about Manager's II by asking whether Dick remembered Rick Roeder making a presentation on the subject. Dick said that Rick Roeder may have made a presentation, and he recognized Rick Roeder's "Which Way Ya Goin'?" slide. Rick asked if Dick remembered Rick Roeder's original position on Manager's II. Dick responded that Rick Roeder was against it for a variety of reasons, particularly because of the value he saw in having the protection of the floor in Manager's I and the fact that Manager's II, as originally proposed, lowered the floor to 75%. Rick asked whether Rick Roeder changed his position when Manager's II was modified to maintain the 82.3% floor. Dick said that Rick Roeder ultimately was agreeable to saying that Manager's II was acceptable. At the end of the day, it was Dick's impression that Rick Roeder was not opposed to Manager's II; essentially he acquiesced.

Rick asked if Bob Blum changed his position on Manager's II. Dick said he believes so. Bob Blum chose his words carefully, indicating that the decision was up to the board. He indicated that Manager's II was an acceptable alternative, although he did not say it was a better alternative.

Rick asked why the board agreed to Manager's II, specifically what factors convinced the board that it was acceptable. Dick said he thought it was very inappropriate initially, and he spoke out against it at the outset. He was the only board member who asked any questions initially, and Bruce Herring denied the basis of the questions. However, he left the meeting the vote was taken. Thus he did not participate in the first vote on Manager's II. As it turns out, modifications were made as a result of the discussions at the meeting. In a subsequent vote, Dick voted to confirm the deal only because it had already been approved by a majority of the board and it was better, with the modifications, than he thought it would be.

Rick inquired who on the board was pushing for it. Dick said he did not recall. He said that both labor and the Manager's office wanted it; they just wanted the board to basically rubber stamp it. Dick said he was incensed by being put in the middle of labor negotiations. Dick's understanding was that, if the board did not agree to the contribution relief in Manager's II, there would be no benefit increase. Dick felt this was an inappropriate role for the board.

Time permitted no further questions after this, and the interview was closed.

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