

REPORT OF THE AUDIT COMMITTEE OF THE CITY OF SAN DIEGO:

Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure

EXECUTIVE SUMMARY

Overview

Evidence made available in this investigation demonstrates numerous failures of San Diego City government – on the part of government officials and outside professional “gatekeepers” alike – to conform to the law, to adhere to principles of sound governance and financial reporting, and to protect the financial integrity of the City’s pension system and thereby the welfare of the City itself. In addition, the evidence demonstrates that City officials deliberately failed to obey legal requirements as to the allocation of costs with regard to the City’s sewage treatment with the effect that San Diego homeowners were improperly overcharged on their monthly sewage bills with the excess being unlawfully used to subsidize the sewage costs of large industrial users. The evidence demonstrates not mere negligence, but deliberate disregard for the law, disregard for fiduciary responsibility, and disregard for the financial welfare of the City’s residents over an extended period of time. Among the consequences, the City now faces an unfunded actuarial pension liability of \$1.4 billion and an inability to gain access to public financial markets. Among the laws violated were the California Constitution, the San Diego City Charter, the San Diego Municipal Code, and the federal securities laws.

In particular, the evidence demonstrates the following:

- The City’s pension system was not brought to a crisis merely as a result of abnormally low investment returns. Nor was the system brought to a crisis as a result of a “perfect storm” of unpredictable catastrophes. What brought the system to a crisis was a number of completely foreseeable financial challenges to a pension system debilitated by years of reckless and wrongful mismanagement involving any number of City and pension board officials.
- In enacting the pension system modification commonly referred to as “Manager’s Proposal 1” or “MP-1,” the City’s pension board and the City acted illegally and improperly and thereby allowed the City, with full knowledge and acquiescence of numerous participants in the approval process, to avoid financial obligations imposed by state and local law.
- In enacting MP-1, the City pension board, with the active encouragement of City officials, reduced the flow of funds to the City’s pension system in order to benefit the City while creating no compensating benefit for the pension system itself. In so doing, the City pension board violated its fiduciary responsibilities to protect

the financial stability of the system and its independence from political influence.

- With the active encouragement of City officials, the City pension board also violated its fiduciary duties with the passage of the pension system modification commonly known as “Manager’s Proposal 2” or “MP-2.”
- The passage of MP-2 was unlawful for a number of reasons including that it was predicated upon the fiction that the modification would provide some benefit to the City pension system. In fact, the effect of MP-2 was to further erode pension system viability and the supposed benefits to the pension system from MP-2 were illusory.
- The approval of MP-2 was obtained only through the award of new retiree pension system “benefits,” one of which, when stripped of its descriptive veneer, was made available only to a single individual then serving on the pension board whose support was viewed as critical to the passage of the MP-2 modification.
- The City further eroded the financial soundness of its pension system by using pension system assets to finance City retiree healthcare costs.
- Subsequent to the enactment of MP-1 and MP-2, the pension board made false and misleading public statements to disguise the extent to which pension system assets would be insufficient to pay the promised benefits to City retirees.
- Beyond violations of law as to its pension system, the City knowingly failed to comply with federal and state requirements applicable to its municipal wastewater system which mandated that sewer rates reflect the costs of treating sewage and be proportionately allocated to residential and industrial users. Not only did this result in City homeowners being overcharged on their monthly bills for sewage costs with the excessive payments being used to subsidize the City’s industrialized water users; the City thereby breached arrangements with the state and rendered itself liable for the return of \$265 million in state funds.
- The City’s derelictions as to both its pension and wastewater treatment systems resulted in numerous violations of the federal securities laws as the City repeatedly obtained money from public investors through financial statements and related disclosures that were false.
- Among its fraudulent misrepresentations to investors, the City (1) falsely claimed that it was making contributions to its pension system at actuarially determined rates, when in fact it was not; (2) falsely claimed that it was using an “excellent method” of pension funding when in fact its funding method was not in accordance with legal requirements; (3) falsely stated that the City had amended its municipal code to accommodate the pension system modification known as MP-1 when in fact it had not; (4) failed to

disclose the conflicts of interest resulting from the participation of members of the pension board in decisions that both threatened the pension system's soundness and increased their own individual benefits; (5) falsely stated that the cost of a settlement of a lawsuit calling into question the City's pension system funding would not be borne by the City's "general fund" thereby fraudulently implying that the settlement would have no impact on the City; (6) failed to disclose that the funding method used to pay for the retiree healthcare benefits was from the pension system's surplus earnings; and (7) falsely stated that the City believed it was "in compliance with all federal and state law" relating to its wastewater sewage treatment system.

The Underlying Causes

While this conduct was plainly unlawful, the evidence does not demonstrate that City officials set out with the objective of defying legal mandates. Rather, the evidence suggests that at root San Diego City officials fell prey to the same type of corruption of financial management and reporting that afflicted municipalities such as Orange County and such private sector companies as Enron, HealthSouth, and any number of other public corporations. That is, San Diego officials cultivated and accepted a culture of financial management and reporting premised upon non-transparency, obfuscation, and denial of fiscal reality. Under the pressure of short-term needs, City officials gave expedience a higher priority than fiscal responsibility and came to view the law as an impediment to be circumvented through artful manipulation. A rare and abrupt departure from that culture was found in a whistleblower who, contrary to prevailing attitudes at the time, explicitly pointed to governmental inadequacies and falsehoods regarding the City's pension system. Like whistleblowers at any number of public companies, her pronouncement that "the emperor has no clothes" was dismissed out of hand.

Exacerbating the City's culture was a deplorable lack of accountability and organization built within the structure of the City government itself. It seems that no one within City government viewed himself or herself as accountable for the accuracy of City financial disclosures. As to some financial information, responsibility for its preparation was placed upon the City's outside auditor, a structure that is completely at odds with the auditor's role as independent examiner, rather than preparer, of financial statements. This inadequate structure was compromised further by the fact that no one from the City took responsibility for seeing to it that information provided to, or prepared by, the auditor was actually correct. As to financial information the City prepared itself, statements were rendered false not only as a result of design but simply due to incompetence and neglect.

Professionals engaged by the City to serve as "gatekeepers" failed at critical junctures to fulfill their professional obligations. In fairness, some professionals at important points did seek to draw attention to the impropriety of City actions. However, little by little, such professionals were pressured into compliance with the prevailing culture of expedience. For example, pension fund actuary Rick Roeder to his

credit initially offered resistance to MP-2 in correctly asserting that the pension board's role should be independent of the establishment of pension benefits and that the proposal itself was "outside the norm for generally accepted actuarial funding policies." But under pressure from City officials, the clarity of this resistance melted away and, by the end, Roeder had not only given up his opposition but acquiesced in providing tepid endorsement. An outside law firm engaged by the City similarly expressed the opinion that the MP-2 pension system modification was unlawful. When the pension fund administrator decided the proposal should go forward nonetheless, the administrator obtained a differing legal opinion by simply directing the law firm to change its mind. One gatekeeper that did not surrender the strength of its convictions was law firm Morrison & Foerster, which refused to go along with the City's demands. Pension officials had it replaced.

Along the way, special committees were formed, reports issued, and public inquiry made, all creating an appearance of efforts to come to grips with the pension and other problems. However, these efforts too were compromised by the prevailing culture of political expedience. An important illustration was the City Council's formation of a Blue Ribbon Committee to evaluate, among other things, the pension system's problems. That pension review was headed by a business leader who, by all accounts, was determined to do his best to understand and report the underlying truth of the City's pension crisis. However, once the seriousness of the Blue Ribbon Committee's approach became clear, City officials undertook a concerted effort to water down the vividness of its determinations. The publication of even these watered-down determinations was thereafter delayed, as concern was expressed that disclosure of the truth would derail the City's efforts to issue bonds to build a new baseball stadium.

Nor were City officials entitled to believe that the requirements of the law placed upon them less rigorous standards of honesty and accountability than those applicable to comparable officials at public companies. In the wake of the bankruptcy of Orange County, the SEC issued a highly publicized report "to emphasize the responsibilities under the federal securities laws of local government officials who authorize the issuance of municipal securities and related disclosure documents and the critical role such officials play with respect to the representations contained in the Official Statements for those securities." The report stated:

[T]he antifraud provisions of the federal securities laws impose responsibilities on a public official who authorizes the offer and sale of securities. A public official who approves the issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading; nor may the public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading.

San Diego City officials cannot claim ignorance of these legal requirements. Not only were the events of Orange County the subject of high-profile news reports that would have been followed closely by leaders of municipal government; the legal consequences and lessons of Orange County were communicated both orally

and in writing to the San Diego City Council by its own outside lawyers, one of whom had represented the Orange County Board of Supervisors before the SEC.

Only when the City's new auditor, KPMG, refused to issue an audit report on the City's financial statements – thereby blocking City access to the municipal bond markets and accelerating the City's need to confront its looming financial crisis – did City officials begin to face reality. Even then, early investigative efforts were haphazard, poorly structured, and encountered steadfast resistance from various pockets of City government. Among those resisting, it bears mention, was *not* the City Council which, while acting too late, did ultimately recognize the need for a thorough and independent investigation as a critical step out of the City's fiscal woes. Alas, the same may not be said of the City Attorney's Office which, while publicly bemoaning the cost and length of investigative effort, behind the scenes and through public pronouncements created roadblocks that operated to increase cost and delay progress. Also offering steadfast resistance to the investigation was the City's pension board itself, which for months sought to keep the truth under wraps through an unwillingness to provide documents that it claimed were protected by the attorney-client privilege. In the end, the documents were provided (there would be no audit report without them), and the reason for the pension board's unwillingness to make them available then became clear. The secret documents readily acknowledged that the pension board had, in fact, violated the law.

As to the early investigations themselves, they predictably foundered. The City engaged the law firm Vinson & Elkins, but inexplicably gave the firm the conflicting responsibilities of serving as *independent investigator while at the same time seeking to defend the City's wrongful conduct before the SEC*. Its resulting report, which failed to reach conclusions as to culpability, was understandably found by KPMG to be inadequate as the predicate for an audit report. The City Attorney, for his part, had seemingly little difficulty making charges of illegality. However, so frequently was the City Attorney's support for his charges found to be superficial, in many respects the City Attorney's investigative efforts only served to harden the cynicism with which investigative efforts came to be more generally regarded.

Even today, there are serious indications that the City government has not completely come to grips with the depth of its problems and the need for fundamental reform. More than two years after the fact, the City still has not found a way to successfully perform such fundamental bookkeeping tasks as reconciling the balance in its cash accounts with the cash balance on its financial statements for the fiscal year 2003. The City continues to be months behind in assembling and providing to KPMG the schedules and other financial data necessary for KPMG to complete its 2003 audit. Even as to the \$1.4 billion pension deficit, City government does not seem prepared to face up to fiscal reality. It has been suggested that the City address the deficit through the issuance of pension obligation bonds which would use borrowings from investors to increase pension assets, but which would not reduce the City's underlying obligation to fund the pension liability. In so doing, the City would continue to push off the funding of these obligations to future generations of taxpayers while avoiding the difficult fiscal decisions that must be made.

Needed Reform

At the most basic level, fundamental reform is needed in the process by which the City budgets, monitors, and reports its finances.

Foremost, accountability for fiscal decision-making and disclosure must be built into the City's financial reporting system. To build in such accountability, the City must strengthen the role and accountability of its Chief Financial Officer. The CFO should be the individual primarily responsible and accountable for the accuracy and timeliness of the City's financial management, reporting, and disclosure functions. The CFO should have responsibility for the supervision of both a Comptroller, which should have experience in government accounting, and a Director of Financial Reporting, which should have specific responsibility for preparation of the City's financial statements. In addition, the CFO should supervise a Director of Budget and Planning, to be responsible for assisting the CFO in budget preparation and monitoring. Further, the CFO should see that the City attracts, hires, and retains qualified personnel into its finance and accounting functions.

To further build accountability into the system, both the Mayor and the CFO should annually include with the City's financial statements a statement of their responsibility for establishing and maintaining an effective system of internal control over financial reporting. In addition, the principal officer and executive of component units of the City, including its pension board, should be required to provide analogous certifications as to their standalone financial statements.

Beyond enhanced accountability, the City should protect the independence and integrity of its financial reporting system through the creation of a permanent Audit Committee. Audit Committees have been recommended by the Government Finance Officers Association for almost a decade. This committee should be comprised of three individuals, two of whom should be independent of the City and its government and possess significant financial expertise in accounting, auditing, and financial reporting. The third member should be a member of the City Council. The Audit Committee should have the power, in its sole discretion, to engage and fund outside advisors and to make inquiry into all aspects of City governance and financial reporting. Reporting to the Audit Committee should be a newly-created independent Auditor General. Also reporting to the Audit Committee should be the independent outside auditor of the City's financial statements.

As to the City's pension board, the City's unfortunate history – which arises against a backdrop of other failures of pension system financing in other municipalities – demands the installation of governance systems providing for increased pension system independence, accountability, and transparency. Pursuant to those ends, the independence and accountability of the pension system board should be strengthened by reducing its size to nine members, five of whom should be mayoral appointees. The

chairman of the pension board and its principal executive should include with the pension system's annual financial statements a signed management report on financial reporting internal control.

To minimize the extent to which future budgetary dislocations might create pressure resulting in short-term expedience and financial misreporting, the City's budgeting and planning process should also be strengthened. We credit and support the Mayor's initiative to develop a five-year financial plan for City government. *The five-year financial plan should specify such items as anticipated capital expenditures, deferred maintenance, debt payments, other major contractual expenditures, and expected major sources of revenues.* At the end of each successive year, the City Council should require a final budget that compares actual to budgeted performance and is accompanied by written explanations by each department manager for variances.

The installation of such an enhanced system of financial management and reporting should be overseen by a newly-appointed independent Monitor. The Monitor should possess oversight responsibility as to all aspects of the City's system of budget, finance, and internal control over financial reporting. The Monitor should also have the responsibility to evaluate the City's compliance with the laws and regulations applicable to financial reporting and the implementation of the remedial actions being recommended in this report. The Monitor should make quarterly reports both to the City's permanent Audit Committee and to the Division of Enforcement of the SEC. Those reports should simultaneously be made available to the citizens of San Diego.

The details of the factual determinations summarized in this Executive Summary, and the reform being recommended as a result, are set forth below.