DATE: March 14, 2017

TO: SDCERS Audit Committee

CC: SDCERS Board of Administration
    Mark Hovey, SDCERS Chief Executive Officer
    Marcelle Rossman, SDCERS Chief Benefits Officer
    Johnny Tran, SDCERS Chief Compliance Officer/General Counsel

FROM: Lee Parravano, SDCERS Internal Auditor

SUBJECT: Update on Finding #2 - Cost of Living (COL) Annuity Audit

On January 11, 2017 the Cost of Living Annuity Audit was released. Finding #2 and Recommendation #2a of that report stated the following:

Finding #2
“SDCERS has used incorrect interest rates to calculate COL Annuity benefits for the time period July 1, 2014 through August 2016 resulting in approximately 840 COL Annuity retirement benefits incorrectly setup.”

Recommendation #2a
“SDCERS’ Board should determine whether or not staff’s calculation of the COL Annuity is correct for the time period July 1, 2014 through August 2016. If the Board determines staff’s calculation of the COL Annuity is incorrect, for this time period, SDCERS should recalculate and correct the COL Annuity for all impacted Members.”

On January 13, 2017, subsequent to the Cost of Living Annuity audit release, SDCERS Board determined the calculations made by staff were correct for the time period July 1, 2014 through August 2016. As a result, no corrections are required.
DATE: January 11, 2017

TO: SDCERS Audit Committee

CC: SDCERS Board of Administration
Mark Hovey, SDCERS Chief Executive Officer
Marcelle Rossman, SDCERS Chief Benefits Officer
Johnny Tran, SDCERS Chief Compliance Officer/General Counsel

FROM: Lee Parravano, SDCERS Internal Auditor

SUBJECT: Cost of Living (COL) Annuity Audit

Enclosed is the COL Annuity Audit. Overall, SDCERS has procedures in place for the COL Annuity and control strengths were identified during the audit. Opportunities for improvement and consideration were also identified.

Based on this audit, there were nine total recommendations. The recommendations are directed to the parties as follows:

- Seven recommendations are directed to SDCERS’ Board of Administration.
- One recommendation is directed to SDCERS’ Board of Administration, Port, and Airport.
- One recommendation is directed to the Port and Airport.

Details can be found in the Audit Results section of the report. SDCERS’ management comments are attached to this report. The City, Port, and Airport were not asked to formally comment on these recommendations.

I would like to thank SDCERS’ management and staff for all of their assistance and cooperation provided during this audit. Everyone involved was very helpful and willing to provide the information needed. Their valuable time and efforts spent on this audit are greatly appreciated.
Internal Audit Report

Cost of Living Annuity

Prepared by:
Lee Parravano, Internal Auditor
TABLE OF CONTENTS

INTRODUCTION ............................................................................................................................... 1
   Background ................................................................................................................................. 1
   Priority Rating Process .............................................................................................................. 2
EXECUTIVE SUMMARY .................................................................................................................. 3
AUDIT OBJECTIVES, SCOPE & METHODOLOGY ...................................................................... 5
   Audit Objectives ....................................................................................................................... 5
   Audit Scope & Methodology ...................................................................................................... 5
AUDIT RESULTS ............................................................................................................................. 6
   Finding #1: The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL Annuity................................................................................................. 6
   Finding #2: SDCERS has used incorrect interest rates to calculate COL Annuity benefits for the time period July 1, 2014 through August 2016 resulting in approximately 840 COL Annuity retirement benefits incorrectly setup. ................................................................................................................. 16
   Finding #3: The Plan Documents state that SDCERS’ Board can adjust the COL Annuity Contribution percentage. Setting the COL Annuity Contribution percentage determines a Member’s benefit. Setting Member benefits is the responsibility of the Plan Sponsor not SDCERS. .......................................................................................................................................................... 19
   Finding #4: The Port and Airport are remitting offsets related to COL Annuity Contributions which do not fund the COL Annuity. ........................................................................................................................................... 21
   Finding #5: SDCERS could be prohibited from offering the COL Annuity to Port Safety and Airport PEPRA Members ........................................................................................................................................ 22
INHERENT LIMITATIONS ................................................................................................................. 24
CONCLUSION .................................................................................................................................. 24
APPENDIX I ......................................................................................................................................... 26
INTRODUCTION

BACKGROUND

All Members\(^1\) pay Cost of Living (COL) Annuity Contributions in addition to their Normal Contributions and Surviving Spouse or Domestic Partner Contributions. The components of a Member’s contribution account are separately accounted for within SDCERS and are shown below.

Member Contribution Components

Normal Contributions
Funds Retirement Allowance

COL Annuity Contributions
Funds COL Annuity

Surviving Spouse Contributions
Funds Surviving Spouse Annuity, Lump sum pay out, or Continuance

Total Member Contribution

Member contributions are used to fund the retirement benefits SDCERS provides. A Service Retirement Benefit, in general, is comprised of the three components as shown below.

Member Retirement Benefit Components

Retirement Allowance
Factor x Service Credit x Final Compensation
Example: 2.5% x 30 years x $50,000 = $37,500

COL Annuity
A Member’s Accumulated Cost of Living Annuity Contributions converted into an annuity

Surviving Spouse Annuity (If Applicable)
A Member’s Accumulated Surviving Spouse Contributions converted into an annuity

Retirement Benefit

In a traditional defined benefit, a Member is guaranteed a benefit based on a formula, generally reflecting the Member’s age, final compensation and years of service at retirement (See Retirement Allowance Above). In a hybrid benefit plan, a Member’s future retirement benefit is determined based on the balance of an account. A Member’s COL Annuity is determined based on a Member’s COL Annuity contribution account at retirement. Members receive both a Retirement Allowance and a COL Annuity at retirement as shown above. The average COL Annuity benefit for Fiscal Year 2016 retirees was $183.17 per month.

\(^1\)Excludes sworn San Diego Police Officers who began City Employment after July 31, 2012, Port non-PEPRA Miscellaneous Members, and City Elected Officers.
Calculating the COL Annuity

Generally there are three items needed to calculate a Member’s COL Annuity. They are as follows:

1) The balance of a Member’s COL Annuity Contribution account at retirement.
   - A larger COL Annuity Contribution account at retirement will result in a larger COL Annuity.
2) The time period over which the benefit is projected to be paid. This is the time between retirement and death.
   - A longer time period will result in a smaller monthly COL Annuity, but can result in a larger total amount paid.
3) An interest rate.
   - A higher interest rate will result in a larger COL Annuity benefit.

History of the COL Annuity

In 1971 SDCERS began collecting COL Annuity Contributions from Members. From 1971 to 1992 COL Annuity Contributions were initially used to fund a portion of a Member’s Cost of Living Adjustment (COLA). The COLA allows for a maximum increase to a Member’s retirement benefit up to 2%\(^2\). Beginning in 1992 the COLA was no longer partially funded with COL Annuity Contributions. COL Annuity Contributions continued to be collected and were now used to provide an additional benefit called the COL Annuity. The COL Annuity is added to a Member’s Retirement Allowance and is part of a Member’s Retirement Benefit as shown above. The COL Annuity is eligible to receive a COLA annually.

PRIORITY RATING PROCESS

To assist management and the Board in its evaluation, the findings have been assigned a qualitative assessment of the need for corrective action. Each item is assessed a high, medium, or low priority as follows:

High - Represents a finding requiring immediate action to mitigate risks associated with the process being audited.

Medium - Represents a finding requiring timely action to mitigate risks associated with the process being audited.

Low - Represents a finding for corrective action to mitigate risks associated with the process being audited.

Informational – Represents a finding to educate the Board or management.

\(^2\) Prior to Ordinance 16449 the maximum COLA increase was 1.5%.  

2
EXECUTIVE SUMMARY

SDCERS has procedures in place for Cost of Living (COL) Annuity Contributions and the COL Annuity. Control strengths identified during the audit period include:

- COL Annuity Contributions are reported to SDCERS consistent with the Plan and SDCERS’ management is correctly administering the collection of COL Annuity Contribution offsets.
- SDCERS has adopted Board Rules documenting the amount of interest credited annually to Member accounts.
- A certification for the Port’s Miscellaneous Plan was obtained from SDCERS’ actuary confirming the benefit formula provided to miscellaneous non-safety PEPRA Members has a lower normal cost and a lower factor at retirement age than the formula provided by PEPRA.

The following issues, however, were identified that should be addressed.

Appropriateness of the COL Annuity Interest Rate

The Plans require the COL Annuity to be the actuarial equivalent of a Member’s accumulated COL Annuity Contribution account. Per the Plan Documents, an actuarial equivalent is a benefit of equal value when computed upon the basis of mortality, interest and other tables adopted by the Board.

It is the Internal Auditor’s opinion that the interest rate used to calculate the COL Annuity is too high. SDCERS credits interest to COL Annuity Contribution accounts at the assumed rate of return on assets, currently 7.125% and calculates the COL Annuity using an interest rate of 7.125%. The interest rate used to calculate the COL Annuity of 7.125%, while not required, is not consistent with the interest rate used by SDCERS when calculating a Members DROP Annuity (2.8%) or an Active Death Benefit (2.8%) when paid as an annuity. Additionally, using the 7.125% as the interest rate to calculate a Member’s COL Annuity does not recognize: (1) the difference between the fund’s investment duration as a whole and the time period a Member is expected to collect a COL Annuity, (2) the appropriateness of calculating the COL Annuity with an interest rate that includes a risk premium when the Member is not taking the investment risk, and (3) the COL Annuity is eligible for up to a 2% COLA annually.

A reduction in the interest rate used to calculate the COL Annuity by 1% would result in an estimated $48,000,000 fewer COL Annuity payments over a payment period of approximately 23 years. A reduction in the COL Annuity interest rate to the current DROP annuity interest rate would result in an estimated $180,000,000 fewer COL Annuity payments. Increasing or decreasing the interest rate used to calculate the COL Annuity for the sole purpose of increasing or decreasing benefits is improper and the Board has a fiduciary duty to deal fairly and in good faith with its Members.

COL Annuity Calculations from July 1, 2014 through August 2016

It is the Internal Auditor’s opinion that SDCERS incorrectly calculated the COL Annuity for the time period July 1, 2014 to August 2016 because an incorrect interest rate was used. It is estimated by the Internal Auditor approximately 840 COL Annuity retirement benefits have been setup incorrectly. The average overpayment per Member, as estimated by the Internal Auditor, is between $3.65 and $5.46 per month. The total estimated overpayment to all Members as of August 2016 is approximately $45,000, not including interest, the COLA, or Members that no longer receive a benefit from SDCERS.

COL Annuity Contribution Percentage

The Plan Documents state that SDCERS’ Board can adjust the COL Annuity Contribution percentage. Setting the COL Annuity Contribution percentage determines a Member’s benefit. Setting Member benefits is the responsibility of the Plan Sponsor not SDCERS.
EXECUTIVE SUMMARY (Continued)

COL Annuity Contribution Offsets

The Plans require the COL Annuity to be the actuarial equivalent of a Member’s accumulated COL Annuity Contribution account. SDCERS does not credit a Member’s COL Annuity Contribution account for amounts that are offset by the San Diego Unified Port District (Port) or San Diego County Regional Airport Authority (Airport). Since SDCERS does not credit the offset to a Member’s COL Annuity Contribution account, the Member receives no retirement benefit from the offset. Because there are no additional benefits accumulated by the Member, or cost to the plan, the Airport and Port should not be required to fund COL Annuity Contribution offsets. Current Plan documents, however, require the Airport and Port pay into SDCERS the COL Annuity Contribution offsets. In 2015, $652,701.44 was collected by SDCERS related to Port and Airport COL Annuity Contribution offsets.

COL Annuity and PEPRA

SDCERS is prohibited from offering a supplemental defined benefit plan to PEPRA Members. The defined benefit plan offered to Port Safety and Airport PEPRA Members provides the defined benefit formula allowed by PEPRA and it provides a COL Annuity. The COL Annuity is a defined benefit that is calculated based on a Member’s balance in their COL Contribution Account at retirement. While not a separate defined benefit plan, the COL Annuity is a defined benefit that supplements the PEPRA defined benefit formula offered.

SDCERS’ General Counsel’s opinion is that the COL Annuity is probably not prohibited for PEPRA Members. It is the Internal Auditor’s opinion that offering the COL Annuity to PEPRA Members is probably not, but could be, prohibited by PEPRA. By continuing to offer the COL Annuity to PEPRA Members, SDCERS, the Airport and Port accept the risk a court could rule that offering the COL Annuity violates PEPRA.

SDCERS’ tax counsel believes the COL Annuity is not a separate defined benefit plan. Additionally, SDCERS’ fiduciary counsel does not believe the COL Annuity is a supplemental defined benefit plan.

SDCERS’ Board, Airport, and Port should be mindful of the COL Annuity benefit and the various PEPRA provisions.

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Based on this audit, there were nine total recommendations. The recommendations are directed to the parties as follows:

- Seven recommendations are directed to SDCERS’ Board of Administration.
- One recommendation is directed to SDCERS’ Board of Administration, Port, and Airport.
- One recommendation is directed to the Port and Airport.

Details can be found in the Audit Results section of this report. SDCERS’ management comments are attached to this report. The City, Port, and Airport were not asked to formally comment on these recommendations.

The information in this report is intended solely for the use of the City of San Diego (City), Port, Airport, SDCERS’ Audit Committee, Board of Administration, and management and is not intended to be, and should not be, used by anyone other than these specified parties.
AUDIT OBJECTIVES, SCOPE & METHODOLOGY

AUDIT OBJECTIVES

The objective of the audit was to determine:

1. If the correct interest rate was used to calculate the COL Annuity from Fiscal Year 2009 to August 2016.
2. The appropriateness of the interest rate used when crediting Member interest on COL Annuity Contributions and when calculating the COL Annuity.
3. The impact of PEPRA on the COL Annuity.
4. The appropriateness of funding the COL Annuity for Members with offsets.

Conclusions to these objectives are listed on page 24 and 25 of this report.

AUDIT SCOPE & METHODOLOGY

This audit was performed for the period from January 1, 2015 through December 31, 2015 by using the following methods:

- Reviewed the Plan and SDCERS’ Participation and Administration Agreement.
- Reviewed SDCERS’ Charters, Policies, Resolutions and Rules of the Board of Administration.
- Reviewed various documents and statutes related to the California Public Employees’ Pension Reform Act of 2013 (PEPRA).
- Reviewed policies and procedures utilized by staff to credit interest to Member accounts and to calculate the COL Annuity.
- Interviewed staff responsible for crediting interest to Member accounts and calculating the COL Annuity.
- Requested various Legal Opinions on the COL Annuity.
- Examined SDCERS’ Board and Committee meeting materials related to the COL Annuity.
- Examined PEPRA Member Contribution components.
- Discussed with SDCERS’ Actuary to determine if they have provided a recommendation to SDCERS’ Board regarding the COL Annuity Contribution rate.
- Examined interest rates used by public pension systems that offer either a cash balance plan or allow Members to annuitize contributions.
- Selected one Member each fiscal year to determine what interest rate was used to calculate the COL Annuity from Fiscal Year 2009 to August 2016.
- Selected five PEPRA Members to determine if COL Annuity Contributions are reported to SDCERS consistent with the Plan.

This audit was conducted in accordance with the International Standards for the Professional Practice of Internal Auditing. Those standards require that Internal Audit plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. Internal Audit believes the evidence obtained provides a reasonable basis for the findings and recommendations.

Internal Audit would like to thank SDCERS’ management and staff for their assistance and numerous courtesies extended during the completion of this audit.

3 The performance period was Fiscal Year 2009 to August 2016 for the determination of the COL Annuity interest rate used.
AUDIT RESULTS

Based on detailed testing, control strengths were identified, as well as issues that should be addressed. Listed below are the control strengths identified:

- COL Annuity Contributions are reported to SDCERS consistent with the Plan
- SDCERS’ management is correctly administering the collection of COL Annuity Contributions offsets.
- SDCERS has adopted Board Rules documenting the amount of interest credited annually to Member accounts.
- A certification for the Port’s Miscellaneous Plan was obtained from SDCERS’ actuary confirming the benefit formula provided to miscellaneous non-safety PEPRA Members has a lower normal cost and a lower factor at retirement age than the formula provided by PEPRA.

The following issues, however, were identified that should be addressed.

Finding #1: The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL Annuity.

Priority Rating: High

Background

COL Annuity Contributions are 20% of the sum of a Member’s Normal Contributions plus Surviving Spouse or Domestic Partner Contributions. COL Annuity Contributions are set aside into the Member’s account. At retirement a Member receives a COL Annuity that is a lifetime guaranteed defined benefit based on the balance of their COL Annuity Contribution account. Members receive both a Retirement Allowance and a COL Annuity. The average COL Annuity benefit for Fiscal Year 2016 retirees was $183.17 per month. Below is the life cycle of the COL Annuity.

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4As written by the City, Port and Airport
Finding #1 (Continued): The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL Annuity.

Priority Rating: High

The COL Annuity is based on accumulated COL Annuity Contributions made. This is similar to a hybrid plan that expresses future retirement benefits as account balances. Per the Government Finance Officers Association (GFOA) one of the most common hybrid plans are cash balance plans. The Internal Revenue Service classifies cash balance plans as defined benefit plans.

All or part of a non-PEPRA Member’s retirement contribution is subject to possible offset. An offset occurs when the City, Port or Airport pays a Member’s required contribution on a Member’s behalf. Offsets are credited to the Plan Sponsor’s account and not to a Member’s account. Offsets reduce the amounts that would have otherwise been credited to Member COL Annuity Contribution accounts. Beginning in 2014 the City no longer offsets Member contributions. Therefore, Member COL Contribution accounts are expected to increase, resulting in a larger COL Annuity benefit for future City retirees.

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5 See Appendix I for complete definition of the COL Annuity.
6 Outside tax counsel has stated that the COL Annuity is part of each defined benefit plan administered by SDCERS. Therefore, the COL Annuity is not a separate plan. Because the COL Annuity was not setup as a separate plan it is not a cash balance plan; however, the COL Annuity has attributes of a cash balance plan. The COL Annuity defines the promised defined benefit in terms of a stated account balance, similar to a cash balance plan.
7 Port and Airport Plans contain offsets for certain employees.
Finding #1 (Continued): The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL Annuity.

Priority Rating: High

COL Annuity Contribution Account Interest Rate

The COL Annuity Contribution account interest rate is applicable to Members prior to retirement. A Member’s COL Annuity contributions are separately accounted for and interest is credited annually to that account.

The interest rate applied to Member accounts is determined by the Board in Board Rules 2.40 and 2.41.

In Fiscal Year 2017, COL Annuity Contribution accounts will be credited with interest at 7.125%. A comparison of the COL Annuity Contribution account interest rate to other SDCERS’ programs and other Systems can be seen at the table titled Comparison to Other SDCERS Programs and Other Systems on page 11 of this report.

SDCERS is required to credit City Members accounts with an interest rate that relates to the assumed rate of return on Plan assets. This provision, however, is not included in the Airport or Port Plans.

In 2009, SDCERS credited interest to Member accounts at the Board approved rate of 7.75%; however, this rate did not match the assumed rate of return on Plan assets of 8.00%. Crediting interest at 7.75% instead of 8.00% would reduce the balance of a Member’s COL Annuity Contribution account at retirement, resulting in a lower COL Annuity. Based on a legal opinion from SDCERS’ General Counsel, no Member accounts are required to be corrected because the Plan language allows the Board’s actions.

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8 See Appendix I for complete definition of Crediting of Interest.
9 See Appendix I for more information on Board Rule 2.40.
10 See Appendix I for more information on Board Rule 2.41.
11 San Diego Municipal Code§24.0901 states, “From time to time, the Board will also determine by Rule the assumed rate of interest earnings for the Retirement Fund. The Rule adopted for this purpose will be used to determine interest rates for Member contribution accounts and is incorporated into this Article as part of the Plan Document.”
12 Additional information is contained in Appendix I comparing the assumed rate of return on assets from the actuarial valuation, the interest rate Member contributions are based upon, the interest rate in Board Rule 2.41 and the interest rate used by SDCERS to calculate the COL Annuity since Fiscal Year 2007.
13 Any additional impact is outside the scope of this audit.
**Finding #1 (Continued):** The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL Annuity.

**Priority Rating:** High

### COL Annuity Interest Rate

The COL Annuity interest rate is applicable for Members on the date of their retirement.

- **Employment**
  - Member makes COL Annuity Contributions to SDCERS
  - Member contributions are credited with interest annually

- **At Retirement**
  - COL Annuity is calculated based on:
    - Accumulated COL Contributions (Includes Member Contributions and Interest)
    - Interest Rate
    - Mortality Tables

- **Retirement to Death**
  - Member Receives COL Annuity
  - COL Annuity eligible to receive up to a 2% COLA.

The COL Annuity is calculated as the actuarial equivalent of a Member’s COL Annuity Contribution account. An actuarial equivalent\(^{14}\), as defined in the Plan Documents, is a benefit of equal value when computed upon the basis of mortality, interest and other tables adopted by the Board.\(^{15}\)

SDCERS has adopted Board Rule 2.90 to calculate an actuarial equivalent. Board Rule 2.90 was first introduced in 2008 and only included a mortality assumption. It did not include an interest assumption. As described above, an actuarial equivalent is a benefit of equal value when computed upon the basis of mortality, interest and other tables adopted by the Board. Board Rule 2.90 was revised in Fiscal Year 2013 to include updated mortality assumptions and, for the first time, included an interest assumption to calculate an actuarial equivalent. The interest assumption included in Board Rule 2.90 was now connected to Board Rule 2.41, requiring the COL Annuity to be calculated at the assumed rate of plan assets, currently 7.125%.

The Fiscal Year 2013 staff report, which recommended revising Board Rule 2.90 to include an interest assumption, mentioned Optional Settlements\(^{16}\) when discussing an actuarial equivalent, but did not discuss the impact the new interest assumption would have on the COL Annuity. It is unknown if the Board understood the impact Board Rule 2.90 would have on the COL Annuity when it was revised to include the interest assumption in 2013.

A comparison of the interest rate used to calculate the COL Annuity to other SDCERS programs and other Systems can be seen at the table titled Comparison to Other SDCERS Programs and Other Systems on page 11 of this report.

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\(^{14}\) See Appendix I for complete definition of Actuarial Equivalent.

\(^{15}\) The San Diego Municipal Code does not capitalize the words first letters in the term “Actuarial Equivalent”, therefore the formal definition in the Plan Document would not necessarily be used. Per Cheiron, there is no uniform definition for the term “actuarial equivalent” in the pension industry but the term generally means the measurement or present value of two benefits is sufficient equal on a given set of actuarial assumptions.

\(^{16}\) An Optional Settlement is applicable when a Member selects a benefit option other than “maximum benefit.” In these situations, a Member’s benefit is reduced so that the benefits paid to the Member and the continuance are the actuarial equivalent of what would have been paid to the Member had the Member not selected one of the Optional Settlements.
Finding #1 (Continued): The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL Annuity.

Priority Rating: High

Interest Rate Comparison to SDCERS’ Deferred Retirement Option Plan (DROP)

The interest rate applied to DROP\textsuperscript{17} accounts, while the employee is working, is determined by Board Rule 6.10. Since 2009, the DROP contribution interest rate has been less than the assumed rate of return on plan assets. Currently the DROP contribution interest rate is 1.50%.

When an employee exits DROP, the Member is allowed to receive the balance of their DROP account in a variety of ways including an annuity over 20 years. Board Rule 6.40 dictates the interest rate to be used when calculating a Member’s DROP distribution, when taken as an annuity. Since 2009, the DROP annuity interest rate has been less than the assumed rate of return on plan assets. Currently the DROP annuity interest rate is 2.8%.

DROP, when paid as an annuity, is not eligible for a 2% COLA.

A comparison of the DROP interest rate to other SDCERS programs and other Systems can be seen in the Table titled Comparison to Other SDCERS Programs and Other Systems on page 11 of this report.

Interest Rate Comparison to SDCERS’ Active Death Benefit

If a Member dies before they are eligible to retire, and the death is not work related, SDCERS pays an Active Death Benefit to the named beneficiary. The Active Death Benefit consists of the Member’s accumulated retirement contributions (which include COL Annuity Contributions) plus one month of pay for each year of service credit, not to exceed one-half of a Member’s final compensation.

A Member may elect to have all or part of the Active Death Benefit paid to their beneficiary in a lump sum or in equal monthly installments (i.e., an annuity) for up to 120 months. If the Active Death Benefit is paid out in equal monthly installments, the interest rate used to calculate the annuity is the DROP annuity interest rate, currently 2.8%.

The Active Death Benefit, when paid as an annuity, is not eligible for a 2% COLA.

A comparison of the Active Death Benefit annuity interest rate to other SDCERS programs and other Systems can be seen in table titled Comparison to Other SDCERS Programs and Other Systems on page 11 of this report.

\textsuperscript{17} DROP was a voluntary program to provide Members with an alternative way to accrue benefits in SDCERS. Members are eligible to participate in DROP when they are eligible for a service retirement. A DROP participant continues to work, up to a maximum of 5 years, for the plan sponsor and collect a regular paycheck; however, the participant’s retirement allowance is credited to the Member’s DROP account. The program is no longer available to employees hired on or after July 1, 2005 for the City, October 1, 2005 for the Port, and October 3, 2006 for the Airport.
Finding #1 (Continued): The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL Annuity.

Priority Rating: High

Comparison to Other SDCERS Programs and Other Systems

The table below compares the interest rates used by SDCERS to other Systems that allow a Member to annuitize contributions and governmental cash balance plans.

<table>
<thead>
<tr>
<th>Comparison to Other SDCERS Programs and Other Systems</th>
<th>Contribution Interest Rate</th>
<th>Annuity Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SDCERS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>COL Annuity</td>
<td>7.125%</td>
<td>7.125%</td>
</tr>
<tr>
<td>DROP</td>
<td>1.50%&lt;sup&gt;18&lt;/sup&gt;</td>
<td>2.80%</td>
</tr>
<tr>
<td>Active Death</td>
<td>N/A</td>
<td>2.80%</td>
</tr>
<tr>
<td>Normal Contributions</td>
<td>7.125%&lt;sup&gt;19&lt;/sup&gt;</td>
<td>7.125%&lt;sup&gt;19&lt;/sup&gt;</td>
</tr>
<tr>
<td><strong>SYSTEMS THAT ALLOW A MEMBER TO ANNUITIZE CONTRIBUTIONS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oregon Employees Retirement System&lt;sup&gt;20&lt;/sup&gt;</td>
<td>Market</td>
<td>Calculated as Account Balance / Life Expectancy&lt;sup&gt;21&lt;/sup&gt;</td>
</tr>
<tr>
<td>City and County of San Francisco Employees</td>
<td>4.00%&lt;sup&gt;23&lt;/sup&gt;</td>
<td>7.5%</td>
</tr>
<tr>
<td>Retirement System&lt;sup&gt;22&lt;/sup&gt;</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wisconsin Department of Employee Trust Funds&lt;sup&gt;24&lt;/sup&gt;</td>
<td>5.00% or Market&lt;sup&gt;25&lt;/sup&gt;</td>
<td>5%&lt;sup&gt;26&lt;/sup&gt;</td>
</tr>
<tr>
<td><strong>CASH BALANCE PLANS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nebraska State Employees and County Employees</td>
<td>Greater of 5% or the Fed mid-term rate plus 1.5%</td>
<td>Greater of 5% or the Fed mid-term rate plus 1.5%</td>
</tr>
<tr>
<td>Pension Plan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Texas County and District Retirement System</td>
<td>5.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Texas Municipal Retirement System</td>
<td>Member Contributions -5%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Employer Contributions - Market</td>
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<td></td>
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<tr>
<td>Kansas Public Retirement System</td>
<td>4.00%&lt;sup&gt;27&lt;/sup&gt;</td>
<td>4.00%&lt;sup&gt;27&lt;/sup&gt;</td>
</tr>
<tr>
<td>Kentucky Retirement System</td>
<td>4.00%&lt;sup&gt;28&lt;/sup&gt;</td>
<td>4.00%&lt;sup&gt;28&lt;/sup&gt;</td>
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<tr>
<td>California State Teachers’ Retirement System</td>
<td>3.00%&lt;sup&gt;29&lt;/sup&gt;</td>
<td>3.00%&lt;sup&gt;29&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

<sup>18</sup> Interest is applied quarterly to DROP accounts.

<sup>19</sup> Interest Rate does not impact the retirement benefit a Member will receive. Funds the Retirement Allowance as detailed on page 1 of this report.

<sup>20</sup> As of January 2, 2003 no new Members can participate.

<sup>21</sup> Value of Monthly Annuity Payment varies depending on market returns.

<sup>22</sup> Withdrawal benefit only – Available to Miscellaneous Members with less than 5 or 10 years of service credit. Can elect to take refund of Member Contributions with Interest OR Deferred retirement benefit equal to actuarial equivalent of 150% - 200% of Member Contributions after age 50 or 53.

<sup>23</sup> Minimum of 4%, Maximum of Actuarial Rate depending on Average Yield of 5 year CD.

<sup>24</sup> Member either receives the benefit formula (e.g.2% at 55) or the Money Purchase Method shown (Consists of Member and Employer Contributions, plus interest, converted to an annuity).

<sup>25</sup> 5.00% for Members employed 1981-1984, Market for all others.

<sup>26</sup> Initially calculated at 5% (adjusted based on actual returns).

<sup>27</sup> If the 5-year average of actual returns is greater than 6% employees get 75% of the excess.

<sup>28</sup> If the 5-year average of actual returns is greater than 4% employees get 75% of the excess.

<sup>29</sup> Interest Rate based on 30-year U.S. Treasury bond rate for the previous year (March to February). Only available to employees that made retirement contributions from 1/1/01 to 12/31/10.
Finding #1 (Continued):  The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL Annuity.

Priority Rating: High

When compared to SDCERS’ DROP program, SDCERS’ Active Death Benefit, other systems that allow a Member to annuitize contributions, and other governmental cash balance plans, only one system calculates an annuity at an interest rate that exceeds SDCERS’ COL Annuity interest rate. The interest rate used to credit COL Annuity Contribution accounts exceeds all other non-SDCERS guaranteed rates shown above.

Investment Information

The investment information is presented to illustrate SDCERS’ investment experience and risk premiums compared to the interest rate used to calculate the COL Annuity.

The table below shows SDCERS’ investment results as of June 30, 2016 compared to the Fiscal Year 2017 Board approved interest rate used to calculate the COL Annuity.

![SDCERS Investment Returns - Net of Fees](image)

**Finding #1 (Continued):** The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL Annuity.

**Priority Rating:** High

The table below shows SDCERS’ assumed rate of return on assets (COL Annuity Rate), yield on the 10-Year Treasury (considered a risk free investment) and the associated Implied Risk Premium.

<table>
<thead>
<tr>
<th>Year</th>
<th>Assumed Rate of Return on Assets</th>
<th>Yield on 10-Year Treasury</th>
<th>Implied Risk Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>8.00%</td>
<td>10.19%</td>
<td>-2.19%</td>
</tr>
<tr>
<td>1995</td>
<td>8.00%</td>
<td>6.21%</td>
<td>1.79%</td>
</tr>
<tr>
<td>2005</td>
<td>8.00%</td>
<td>4.06%</td>
<td>3.94%</td>
</tr>
<tr>
<td>2015</td>
<td>7.125%</td>
<td>1.980%</td>
<td>5.145%</td>
</tr>
</tbody>
</table>

*Source: Cheiron Presentation on the Actuarial and Investment Implications of SDCERS being a partially closed plan February 18, 2016*

**Additional Analysis**

In Fiscal Year 2017, SDCERS’ assets are expected to earn 7.125% net of investment expenses. This assumption is scheduled to change to 7.00% in Fiscal Year 2018.

The value of the COL Annuity is highly sensitive to the interest rate used. As of April 2016 there was approximately $149,000,000 in Member COL Annuity Contribution accounts. Based on an estimate by the Internal Auditor, as of June 2016, $575,000,000 in future COL Annuity payments will be made to current Members who have not yet retired for an average payment period of approximately 23 years for each current Member. A reduction in the COL Annuity interest rate by 1% would result in an estimated $48,000,000 fewer COL Annuity payments. A reduction in the COL Annuity interest rate to the DROP annuity interest rate would result in an estimated $180,000,000 fewer COL Annuity payments. The Internal Auditor’s estimated numbers contain many assumptions and do not account for future COL Annuity Contributions or any changes to the interest rate used to credit COL Annuity Contributions.

*A reduction in the COL Annuity interest rate to the DROP interest rate would result in $180,000,000 fewer COL Annuity payments.*
Finding #1 (Continued): The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL Annuity.

Priority Rating: High

The Board could consider a variety of options when setting the interest rate used to credit COL Annuity Contributions and the interest rate used to calculate a Member’s COL Annuity other than the assumed rate of return on plan assets. Using the assumed rate of return on plan assets as the interest rate to calculate a Member’s COL Annuity does not recognize: (1) the difference in investment duration between the fund as a whole and the Member’s COL Annuity, (2) the appropriateness of calculating the COL Annuity with an interest rate that includes a risk premium when the Member is not taking the investment risk, and (3) the COL Annuity is eligible for up to a 2% COLA annually. For example, SDCERS’ assumed rate of return on assets is based on long-term earnings expectations, presumably greater than 30 years, whereas the duration a Member is expected to collect a COL Annuity is approximately 23 years. The risk premium SDCERS must take to attempt to earn the assumed rate of return on assets is shown in the chart above titled Risk Premium.

Interest rate options include, but are not limited to: a fixed interest rate, a rate tied to an outside index, or a rate tied to actual investment returns. SDCERS currently uses a weighted composite of the twenty-year treasury, twenty-year HQC Bond Rate and twenty-year PBGC Immediate Annuity Rate to set the DROP Annuity interest rate.

While not required, the interest rate used by SDCERS to calculate a Member’s COL Annuity is not consistent with the interest rate used by SDCERS when calculating a Members DROP Annuity or an Active Death Benefit when paid as an annuity. It is unknown if this is the Board’s intent. Establishing a stand-alone Board Rule that details the interest rate to be used for Member COL Contribution accounts and the interest rate to be used when calculating a Member’s COL Annuity will clearly document the Board’s intent.

SDCERS’ actuary, Cheiron, states that they do not believe that the assumptions used for actuarial equivalence necessarily have to be the same as the valuation assumptions. Additionally, they note that a significant number of pension plans, both private and governmental, utilize actuarial equivalence factors that are not based on the actuarial assumptions as used in the actuarial valuations. Cheiron finds that giving a Board some discretion in setting the actuarial equivalence factors is preferable to having an automatic mandate that actuarial equivalence is always based on the actuarial valuation assumptions. Lastly, Cheiron notes that, providing this discretion allows for more flexibility in dealing with unique situations, such as DROP where the Board elected with good reason to credit such accounts with an interest rate more indicative of current interest rates available in the market place.

Non-governmental defined benefit plans that use lump-sum based benefit formulas, including hybrid plans, require that the interest crediting rate must not exceed a market rate of interest. The regulations provide that a fixed interest crediting rate of up to six percent satisfies this requirement. It is important to note that SDCERS is a governmental plan and is not subject to this requirement.

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30 For non-City Members
31 For all Members
32 Based on a December 2016 memo to Mark Hovey
Finding #1 (Continued): The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL Annuity.

Priority Rating: High

The granting of retirement benefits is a power resting exclusively with the Plan Sponsors whereas it is SDCERS’ Board’s responsibility to administer the benefits set by the Plan Sponsor. As stated above, increasing or decreasing the interest rate used to calculate the COL Annuity would increase or decrease benefits. The Plan, however, recognizes the Board may make decisions, to administer the Plan, that impact Member benefits.

It is SDCERS’ General Counsel’s opinion that the plan documents do not require the interest rate used to credit Members COL Annuity Contribution account for Port and Airport Members to match the assumed rate of return on plan assets. The interest rate is subject to actuarial and financial soundness and the Board’s fiduciary duties. He notes that increasing or decreasing the interest rate used to credit a Member’s COL Annuity Contribution account for the sole purpose of increasing or decreasing benefits would be improper and that the Board has a fiduciary duty to deal fairly and in good faith with its Members.

It is also SDCERS’ General Counsel’s opinion that the plan documents do not require the interest rate used to calculate the COL Annuity to match the assumed rate of return on plan assets. The interest rate is subject to actuarial and financial soundness and the Board’s fiduciary duties. The interest rate must also achieve actuarial equivalence. He notes that increasing or decreasing the interest rate used to calculate the COL Annuity for the sole purpose of increasing or decreasing benefits would be improper and that the Board has a fiduciary duty to deal fairly and in good faith with its Members.

Recommendation #1a: The Board should consider other interest rate options used to calculate the COL Annuity other than the assumed rate of return on plan assets such as using a fixed interest rate, a rate tied to an outside index, or a rate tied to actual investment returns.

Recommendation #1b: SDCERS’ Board should consider changing the interest rate used to credit Member’s COL Annuity Contribution accounts other than the assumed rate of return on plan assets such as using a fixed interest rate, a rate tied to an outside index, or a rate tied to actual investment returns for Port and Airport Members.
Finding #2: SDCERS has used incorrect interest rates to calculate COL Annuity benefits for the time period July 1, 2014 through August 2016 resulting in approximately 840 COL Annuity retirement benefits incorrectly setup.

Priority Rating: High

The COL Annuity is calculated as the actuarial equivalent of a Member’s COL Annuity Contribution account. An actuarial equivalent, as defined in the Plan Documents, is a benefit of equal value when computed upon the basis of mortality, interest and other tables adopted by the Board.

SDCERS has adopted Board Rule 2.90 to calculate an actuarial equivalent. Board Rule 2.90 was first introduced in 2008 and only included a mortality assumption. It did not include an interest assumption. As described above, an actuarial equivalent is a benefit of equal value when computed upon the basis of mortality, interest and other tables adopted by the Board. Board Rule 2.90 was revised in November 2012 (Fiscal Year 2013) to include updated mortality assumptions and, based on the Internal Auditor’s opinion, for the first time, included an interest assumption to calculate an actuarial equivalent.

SDCERS’ actuary, Cheiron, provides “factors” that are used by SDCERS to calculate an actuarial equivalent. A factor is the numerical value that is used to determine an actuarial equivalent based on mortality and an interest rate. The factor is multiplied to a Member’s COL Annuity Contribution account balance, at retirement, to determine the Member’s monthly benefit. As shown below, the interest rate used impacts the factor used to determine an actuarial equivalent, which then impacts the monthly benefit a Member receives:

<table>
<thead>
<tr>
<th>COL Annuity Contribution Account Balance at Retirement</th>
<th>Age</th>
<th>Class</th>
<th>Interest Rate</th>
<th>Factor</th>
<th>Monthly Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$23,000</td>
<td>60</td>
<td>General Healthy</td>
<td>7.5%</td>
<td>.0079342</td>
<td>$182.49</td>
</tr>
<tr>
<td>$23,000</td>
<td>60</td>
<td>General Healthy</td>
<td>7.25%</td>
<td>.0074984</td>
<td>$178.84</td>
</tr>
</tbody>
</table>

33 See Appendix I for complete definition of Actuarial Equivalent.
34 The San Diego Municipal Code does not capitalize the words first letters in the term “Actuarial Equivalent”, therefore the formal definition in the Plan Document would not necessarily be used. Per Cheiron, there is no uniform definition for the term “actuarial equivalent” in the pension industry but the term generally means the measurement or present value of two benefits is sufficient equal on a given set of actuarial assumptions.
**Finding #2 (Continued):** SDCERS has used incorrect interest rates to calculate COL Annuity benefits for the time period July 1, 2014 through August 2016 resulting in approximately 840 COL Annuity retirement benefits incorrectly setup.

**Priority Rating:** High

As stated above, prior to November 2012 (Fiscal Year 2013), there was no rule stating what interest rate to use when calculating an actuarial equivalent for the COL Annuity. When Board Rule 2.90 was revised in November 2012\(^ {35} \) the Board directed staff to use the interest rate in Board Rule 2.41 to calculate an actuarial equivalent for the COL Annuity. The interest rate in Board Rule 2.41 and the interest rate used by SDCERS to calculate the COL Annuity since Fiscal Year 2013 are shown below:

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Board Rule 2.41 Interest Rate</th>
<th>COL Annuity Interest Rate Used by SDCERS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013 - November 2012 and Prior</td>
<td>7.50%</td>
<td>8.00%</td>
</tr>
<tr>
<td>2013 - After November 2012</td>
<td>7.50%</td>
<td>7.50%</td>
</tr>
<tr>
<td>2014</td>
<td>7.50%</td>
<td>7.50%</td>
</tr>
<tr>
<td>2015</td>
<td>7.25%</td>
<td>7.50%</td>
</tr>
<tr>
<td>2016</td>
<td>7.25%</td>
<td>7.50%</td>
</tr>
<tr>
<td>2017 – August 2016 and Prior</td>
<td>7.125%</td>
<td>7.50%</td>
</tr>
<tr>
<td>2017 – After August 2016</td>
<td>7.125%</td>
<td>7.125</td>
</tr>
</tbody>
</table>

It is the Internal Auditor’s opinion that SDCERS incorrectly calculated the COL Annuity for the time period July 1, 2014 (Fiscal Year 2015) through August 2016 (Fiscal Year 2017) because the interest rate in Board Rule 2.41 and the interest rate used to calculate the COL Annuity did not agree. In August 2016, SDCERS correctly changed the interest rate used to calculate the COL Annuity to match the interest rate in Board Rule 2.41.

It is SDCERS’ General Counsel’s opinion that there is ambiguity and confusion in Board Rule 2.90 and that the Board should determine whether or not staff’s calculation of the COL Annuity is correct.

It is also the Internal Auditor’s opinion that SDCERS’ staff did not understand the connection between the interest rate and the calculation of the COL Annuity when Board Rule 2.90 was revised in 2013 to include an interest rate assumption because of the ambiguity and confusion as detailed in SDCERS’ General Counsel’s opinion.

It is estimated by the Internal Auditor approximately 840 COL Annuity retirement benefits have been setup incorrectly. The average overpayment per Member, as estimated by the Internal Auditor, is between $3.65 and $5.46 per month. The total estimated overpayment to all Members as of October 2016 is approximately $45,000, not including interest, the COLA, or Members that no longer receive a benefit from SDCERS.

\(^{35}\) For Fiscal Years 2008 through part of FY 2013 SDCERS calculated the COL Annuity using an interest rate of 8.00% even though the interest rate used for the assumed rate of return on assets was reduced below 8.00%. Based on a legal opinion from SDCERS’ General Counsel, SDCERS did not incorrectly calculate the COL Annuity for Fiscal Years 2008 to November 2012 because the Board did not provide an interest rate required to calculate an actuarial equivalent until Fiscal Year 2013.

\(^{36}\) Additional information is contained in Appendix I comparing the assumed rate of return on assets from the actuarial valuation, the interest rate Member contributions are based upon, the interest rate in Board Rule 2.41 and the interest rate used by SDCERS to calculate the COL Annuity since Fiscal Year 2007.
Finding #2 (Continued):  SDCERS has used incorrect interest rates to calculate COL Annuity benefits for the time period July 1, 2014 through August 2016 resulting in approximately 840 COL Annuity retirement benefits incorrectly setup.

Priority Rating: High

The Internal Auditor’s estimate above does not include Fiscal Year 2013 calculations that were performed prior to the Board adopting a specific interest rate used to calculate the COL Annuity (November 2012). It is the Internal Auditor’s opinion that it was staff’s intention to apply the new interest rate assumption prospectively. Board Rule 2.90, which was drafted by staff, however, states the interest rate was effective for all of Fiscal Year 2013.\(^{37}\)

It should be noted that in 2012 SDCERS asked Cheiron to determine if staff was appropriately using the Mortality tables described in Board Rule 2.90. Cheiron reviewed the annuity factors in use by Pension Gold, SDCERS’ former pension administration software. Cheiron stated that staff’s calculations were within a 2% margin and “adequately” applied Board Rule 2.90 as it applied to COL Annuity computations.

The factor IRIS uses to calculate a Member’s COL Annuity is based on a Member’s age at retirement broken down into quarter year increments. IRIS rounds a Member’s age down to the nearest quarter year to determine what factor to use. Rounding a Member’s age down to the nearest quarter year is consistent when calculating a Member’s Service Retirement Allowance. SDCERS’ Board Rules, however, are silent on how to round when calculating a Member’s COL Annuity.

Recommendation #2a:  SDCERS’ Board should determine whether or not staff’s calculation of the COL Annuity is correct for the time period July 1, 2014 through August 2016. If the Board determines staff’s calculation of the COL Annuity is incorrect, for this time period, SDCERS should recalculate and correct the COL Annuity for all impacted Members.

Recommendation #2b: SDCERS’ Board should consider establishing a stand-alone Board Rule that details the interest rate to be used when calculating a Member’s COL Annuity.

Recommendation #2c: SDCERS’ Board should clarify in Board Rule 2.90 the interest rate assumption that should be used to calculate the COL Annuity from July 1, 2012 to November 2012.

Recommendation #2d: SDCERS’ Board should consider including in either Appendix C, or in a Board Rule, direction on how to round a Member’s age to determine the retirement factor used to calculate the COL Annuity.

\(^{37}\) SDCERS’ General Counsel’s opinion is that staff’s FY 2013 calculation of the COL Annuity is correct because there is no evidence the Board adopted the specific interest rate assumption retroactively when 2.90 was amended.
Finding #3: The Plan Documents state that SDCERS’ Board can adjust the COL Annuity Contribution percentage. Setting the COL Annuity Contribution percentage determines a Member’s benefit. Setting Member benefits is the responsibility of the Plan Sponsor not SDCERS.

Priority Rating: Medium

In 1971, the City Council passed Ordinance 10479 granting a Cost of Living Adjustment (COLA) to retirees up to a maximum of 1.5%. The cost of the COLA benefit was shared between the Member and City and as a result Member contributions were increased by 15%. These additional contributions are referred to as COL Annuity Contributions.

Ordinance 10479 stated that a COL Annuity is added to the normal monthly retirement allowance of the retired Member. The COLA was not granted until the COLA amount exceeded the COL Annuity. For instance, in the first year of a Member’s retirement, if the Member’s COL Annuity was $15.00 and the COLA was $14.00, the Member would not receive a COLA. If the COL Annuity was $15.00 and the COLA was $16.00 the Member would receive $1 in COLA.

In 1985 and 1986 the City passed ordinances that increased the maximum COLA to 2%. Member Contributions were increased to 20% of the sum of a Member’s Normal Contributions plus Surviving Spouse or Domestic Partner Contributions.

In 1992 the connection between the COLA and the COL Annuity was eliminated. COL Annuity Contributions continued to be collected and the COL Annuity became a separate benefit.

As a result of the COL Annuity becoming a separate benefit, any increase or decrease in COL Annuity Contributions directly result in a benefit change. Increasing the COL Annuity Contribution percentage increases the dollar amount contributed to a Member’s COL Annuity Contribution account which results in a larger COL Annuity at retirement.

The San Diego Municipal Code and the Airport’s Plan state that until adjusted by the Board upon recommendation of the Actuary, the COL Annuity Contributions are 20% of the sum of the Member’s Normal Contributions plus the Member’s Surviving Spouse Contributions.

SDCERS’ actuary, Cheiron, has never made a recommendation to SDCERS’ Board to set the COL Annuity Contribution percentage at 20%. Additionally, Cheiron has stated they have no basis to recommend a different percentage.

The granting of retirement benefits is a power resting exclusively with the Plan Sponsors whereas it is SDCERS’ Board’s responsibility to administer the benefits set by the Plan Sponsor. As stated above, increasing or decreasing the COL Annuity Contribution percentage would increase or decrease benefits. The Plan, however, does recognize the Board may make decisions, to administer the Plan, that impact Member benefits. The COL Annuity Contribution rate has not changed since 1985.

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38 Ordinance 17770 eliminated the following sentence, “The cost of living adjustment provided for in Section 24.0531 will not be applied until the amounts required exceed the additional fixed sum the retired member is receiving from the annuity value of his cost of living contributions.”

39 SDMC §24.1507 and Airport Plan §202.5. The Port contribution rate is 20%; however this is not memorialized in the Plan document. See Plan Sponsor Contribution and Reporting Audit - San Diego Unified Port District for the period July 1, 2014 through June 30, 2015 for recommendation on including COL Annuity Contribution rate in the Plan document.
Finding #3 (Continued): The Plan Documents state that SDCERS’ Board can adjust the COL Annuity Contribution percentage. Setting the COL Annuity Contribution percentage determines a Member’s benefit. Setting Member benefits is the responsibility of the Plan Sponsor not SDCERS.

Priority Rating: Medium

Recommendation #3: SDCERS should request the City and Airport amend their respective Plan Documents to shift the responsibility for setting COL Annuity Contribution percentages from the Board and its Actuary to the Plan Sponsor.
**Finding #4:** The Port and Airport are remitting offsets related to COL Annuity Contributions which do not fund the COL Annuity.

**Priority Rating:** Medium

The COL Annuity is the actuarial equivalent of a Member’s COL Annuity Contribution account at retirement.

The Airport and Port Plans both allow the employer to pay for Member contributions on their behalf. These are known as offsets. The Airport Plan states, “The Airport Authority shall pay certain required employee contributions to the Plan, which payments shall be known as the Authority’s offset.” The Port’s Salary Ordinance states, “In addition to the employer and administrative contributions, the District will make an employee contribution into the retirement plan for all eligible employees. This amount is to be known as the offset or pickup. These amounts so paid and contributed shall be credited to the District’s account in the Retirement System and not to the account of any individual employees.” The Port’s Salary Ordinance states the offset is a percentage of a full time-time employee’s compensation subject to retirement contributions.

SDCERS does not credit a Member’s COL Annuity Contribution account for amounts that are offset by the Port or Airport.\(^{40}\) Offsets are credited to the Plan Sponsor’s account. Since SDCERS does not credit the offset to a Member’s COL Annuity Contribution account, the Member receives no retirement benefit from the offset. Because there are no additional benefits accumulated by the Member, or cost to the plan, the Airport and Port should not be required to fund COL Annuity Contribution offsets. The chart below details the COL Annuity Contribution offsets collected by SDCERS in 2015.\(^{41}\) The City currently does not offset any Member Contribution amounts.

<table>
<thead>
<tr>
<th>Plan Sponsor</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Port</td>
<td>$376,723.84</td>
</tr>
<tr>
<td>Airport</td>
<td>$275,977.60</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$652,701.44</strong></td>
</tr>
</tbody>
</table>

SDCERS’ pension administration system, IRIS, has been properly programmed to calculate an amount due for COL Annuity Contribution offsets as prescribed in the Plan documents.

**Recommendation #4:** The Airport and Port should consider amending their respective Plan documents removing the requirement to pay into SDCERS offsets related to COL Annuity Contributions. SDCERS should make modifications to IRIS as necessary if the Plan documents are amended.

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\(^{40}\) Airport Executive Members COL Annuity Contributions are funded by the Airport and credited to the Executive Member’s account. Port Miscellaneous non-PEPRA Members do not have a Member contribution amount and therefor no COL Annuity Contributions are calculated and available to be offset. See Plan Sponsor Contribution and Reporting Audit - San Diego Unified Port District for the period July 1, 2014 through June 30, 2015 for recommendation on miscellaneous non-PEPRA Members.

\(^{41}\) For the pay periods January 9, 2015 through January 7, 2016.
Finding #5: SDCERS could be prohibited from offering the COL Annuity to Port Safety and Airport PEPRA Members.

Priority Rating: Informational

Effective January 1, 2013, PEPRA impacted all Airport and Port Members. PEPRA also created a new tier of membership. Members of this new tier are commonly referred to as PEPRA Members. In general, a PEPRA Member is a Member who first became a Member of SDCERS or a reciprocal system on or after January 1, 2013.

PEPRA Members may only participate in the defined benefit formula that conforms to PEPRA or in a defined benefit formula that has been determined and certified by the retirement system’s chief actuary and the retirement board to have no greater risk and no greater cost to the employer than the defined benefit formula required by PEPRA.42

PEPRA also restricts what defined benefit formulas can be offered to new Members. PEPRA states, “Except as provided in subdivision (d) and (e) of Section 7522.02, each public employer and public retirement system that offers a defined benefit plan shall only offer the defined benefit formulas established pursuant to sections 7522.20 and 7522.25 to new members.”

PEPRA’s definition of a defined benefit formula is, “a formula used by the retirement system, to determine a retirement benefit based on age, years of service, and pensionable compensation earned by an employee up to the limit defined in Section 7522.10.” For example, a System may offer a retirement formula equal to 2.5% of a Member’s final compensation per year of service credit. The defined benefit formula offered to Port Safety45 and Airport PEPRA Members matches the maximum PEPRA formula allowed.

The defined benefit plan offered to Port Safety and Airport PEPRA Members provides the maximum defined benefit formula allowed by PEPRA and it provides a COL Annuity.

42 See Appendix I for additional information on California Government Code Section 7522.02.
43 Applicable for non-safety members. See Appendix I for information on Government Code Section 7522.20.
44 Applicable for safety members. See Appendix I for information on Government Code Section 7522.25.
45 Non-safety Port PEPRA Members (Miscellaneous Plan) begin to earn service credit the first day of his or her sixth year of employment. SDCERS’ Actuary, Cheiron, certified on December 12, 2012 at SDCERS’ Board of Administration meeting that the Port Miscellaneous Plan offers a benefit formula that results in a lower normal cost and has a lower factor at retirement age than the formula provided by PEPRA. SDCERS’ Board approved that recommendation.
**Finding #5 (Continued):** SDCERS could be prohibited from offering the COL Annuity to Port Safety and Airport PEPRA Members.

**Priority Rating:** Informational

The table below is an example of the annual retirement benefit a PEPRA Member is eligible to receive at age 52 or 62 from the Airport and Port.\(^46\)

<table>
<thead>
<tr>
<th>Retirement Age</th>
<th>Airpot PEPRA Member</th>
<th>Port Safety PEPRA Member</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defined Benefit Formula</td>
<td>52</td>
<td>62</td>
</tr>
<tr>
<td>(Retirement Allowance)</td>
<td>$ 15,445.00</td>
<td>$ 46,335.00</td>
</tr>
<tr>
<td>COL Annuity</td>
<td>$ 2,761.32</td>
<td>$ 7,795.80</td>
</tr>
<tr>
<td>Total Retirement Benefit</td>
<td>$ 18,206.32</td>
<td>$ 54,130.80</td>
</tr>
</tbody>
</table>

Since the COL Annuity is not based on age, years of service, and pensionable compensation earned by an employee, the COL Annuity is not included in PEPRA’s definition of a defined benefit formula. Therefore, while not a separate defined benefit plan, the COL Annuity is a defined benefit that supplements the PEPRA defined benefit formula offered.

PEPRA prohibits a public employer offering or providing a supplemental defined benefit plan to any employee hired on or after January 1, 2013. The term “supplemental defined benefit plan”, however, is not a defined term in PEPRA. The COL Annuity benefit is outlined in the San Diego Municipal Code in Division 15 which is titled “Investment Earnings, Supplemental Benefits and Adjustments.”

SDCERS’ General Counsel’s opinion is that the COL Annuity is probably not prohibited for PEPRA Members. He acknowledges that the COL Annuity supplements the PEPRA retirement formula. However, in his opinion the COL Annuity is a component of the existing defined benefit plan and is not a supplemental defined benefit plan as described in PEPRA. Additionally, he adds that the COL Annuity does not clearly violate any provisions of PEPRA. He does note that PEPRA puts the responsibility on the Port and Airport to revise their plans to conform to PEPRA, and it is their responsibility to eliminate the COL Annuity if they believe the COL Annuity violates PEPRA.

SDCERS’ tax counsel believes the COL Annuity is not a separate defined benefit plan. Additionally, SDCERS’ fiduciary counsel does not believe the COL Annuity is a supplemental defined benefit plan.

It is the Internal Auditor’s opinion that offering the COL Annuity to PEPRA Members is probably not, but could be, prohibited by PEPRA. By offering the COL Annuity, SDCERS, the Airport, and Port accept the risk a court could rule that offering the COL Annuity violates PEPRA.

**Recommendation #5:** SDCERS’ Board, Airport, and Port should be mindful of the COL Annuity benefit and the various PEPRA provisions. If any changes to the COL Annuity benefit are made, the Plan Documents should be amended accordingly.

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\(^{46}\) Numbers based on average pay per active member and Member Contribution Rates from the 2014 Actuarial Valuation with an Entry Age of 32 and 20 years of service credit. Assumed annual interest credited to COL Annuity Contributions equals 7%. Assumed life expectancy used 78.8. Does not assume any wage increases or actuarial changes.
INHERENT LIMITATIONS

Because of the inherent limitations of internal controls and because samples were selected, errors or irregularities may occur and may not be detected. Also, projections of any evaluation of the internal control structure to future periods are subject to the risk that procedures may become inadequate due to changes in conditions, or that the degree of compliance with the procedures may deteriorate.

CONCLUSION

I have concluded work on the audit objectives of the COL Annuity Audit. Based on the audit work performed, I have determined the following:

COL Annuity Calculations from Fiscal Year 2009 to August 2016

The accuracy of the calculation of the COL Annuity is broken down into the time periods as follows:

- Prior to November 2012 there was no rule stating what interest rate to use when calculating an actuarial equivalent for the COL Annuity; therefore, staff’s use of an interest rate that exceeded the rate of return on plan assets was not prohibited.
- From November 2012 to June 30, 2014 staff correctly calculated the COL Annuity because the interest rate used matched the Board approved rate.
- From July 1, 2014 through August 2016 staff incorrectly calculated the COL Annuity because the interest rate used did not match the Board approved rate.

Appropriateness of Interest Rate Used to Calculate the COL Annuity

The interest rate used to credit COL Annuity Contribution accounts exceeds all other guaranteed rates shown in Finding #1; however, the Board is prohibited from changing the interest rate credited to Member accounts to a rate that is more or less than the assumed rate of return on plan assets for City Members. For this reason, it is my opinion the interest rate used by SDCERS to credit Member COL Annuity Contribution accounts is correct for City Members. The Board should consider changing the interest rate used to credit COL Annuity Contribution accounts for Port and Airport Members.

It is the Internal Auditor’s opinion that the interest rate used to calculate the COL Annuity is too high and the Board should consider changing it. When compared against other systems (See Finding #1), only one system calculates an annuity at an interest rate that exceeds SDCERS’ COL Annuity interest rate. SDCERS is currently using the rate of return on plan assets to calculate the COL Annuity.

Using the assumed rate of return on plan assets as the interest rate to calculate a Member’s COL Annuity is not consistent with the interest rate used by SDCERS when calculating a Members DROP Annuity or an Active Death Benefit when paid as an annuity. Additionally, it does not recognize: (1) the difference in investment duration between the fund as a whole and the Member’s COL Annuity, (2) the appropriateness of calculating the COL Annuity with an interest rate that includes a risk premium when the Member is not taking the investment risk, and (3) the COL Annuity is eligible for up to a 2% COLA annually.

The Board could consider a variety of options when setting the interest rate used to credit COL Annuity Contributions and the interest rate used to calculate a Member’s COL Annuity other than the assumed rate of return on plan assets, which is currently used.
Impact of PEPRA on the COL Annuity

SDCERS is probably not, but could be, prohibited from offering Port Safety and Airport PEPRA Members a COL Annuity. SDCERS’ Board, Airport, and Port should be mindful of the COL Annuity benefit and the various PEPRA provisions.

Appropriateness of Funding the COL Annuity for Members with Offsets

Current Plan documents require the Airport and Port pay SDCERS’ COL Annuity Contribution offsets. Therefore, SDCERS is correctly administering the collection of those offsets. The Airport and Port, however, should consider amending their respective Plan documents removing this requirement because no additional benefits are accumulated by the Member.

*****

Implementation of the recommendations contained in this Audit Report will provide additional clarity to Members and the Plan Sponsors regarding the COL Annuity.
APPENDIX I

California Government Code Section 7522.02

PEPRA states, “If a public employer, before January 1, 2013, offers a defined benefit pension plan that provides a defined benefit formula with a lower benefit factor at normal retirement age and results in a lower normal cost than the defined benefit formula required by this article, that employer may continue to offer that defined benefit formula instead of the defined benefit formula required by this article, and shall not be subject to the requirements of 7522.10 for pensionable compensation subject to that formula. However, if the employer adopts a new defined benefit formula on or after January 1, 2013, that formula must conform to the requirements of this article or must be determined and certified by the retirement system’s chief actuary and the retirement board to have no greater risk and no greater cost to the employer than the defined benefit formula required by this article and must be approved by the Legislature. New members of the defined benefit plan may only participate in the lower cost defined benefit formula that was in place before January 1, 2013, or a defined benefit formula that conforms to the requirements of this article or is approved by the Legislature as provided in this subdivision.”

Senate Bill 24 removed the requirement to receive Legislature approval to offer a defined benefit formula with a lower benefit factor at normal retirement age that result in a lower normal cost than the PEPRA formula.

COL Annuity Definitions

City of San Diego
“Upon retirement, the System will pay a Cost of Living Annuity to Members who have made Cost of Living Annuity Contributions. The Cost of Living Annuity will be the actuarial equivalent to the Members accumulated Cost of Living Contributions on the date of the Member’s retirement.”

San Diego Regional Airport Authority
“means the payment described in §300(c)(3).”

San Diego Regional Airport Authority §300(c)(3)-
“the Cost of Living Annuity (the lifetime payment derived from the Member’s COL Annuity Contributions, which is added to the Member’s Basic Allowance, and calculated by computing the Actuarial Equivalent of the Member’s Accumulated Cost of Living Annuity Contributions).”

San Diego Unified Port District
“The Cost of Living Annuity is the lifetime payment derived from the Member’s Cost of Living Contributions, which is added to the Member’s Basic Allowance, and is calculated by computing the Actuarial Equivalent of the General Member’s Accumulated Cost of Living Contributions.”

47 Definition is the same for Miscellaneous Members and Safety Members.
California Government Code Section 7522.20

For a PEPRA nonsafety member, PEPRA states, “Each retirement system that offers a defined benefit plan for nonsafety members of the system shall use the formula prescribed by this section. The defined benefit plan shall provide a pension at retirement for service equal to the percentage of the member’s final compensation set forth opposite the member’s age at retirement, taken to the preceding quarter year, in the following table, multiplied by the number of years of service in the system as a nonsafety member.”

California Government Code Section 7522.25

For a PEPRA safety member 48 PEPRA states the defined benefit plan “shall provide a pension at retirement for service equal to the percentage of the member’s final compensation set forth opposite the member’s age at retirement, taken to the preceding quarter year, in the following table, multiplied by the number of years of service in the system as a safety member.”

Actuarial Equivalent Definitions

City of San Diego
“Actuarial Equivalent means a benefit of equal value when computed upon the basis of mortality, interest, and other tables adopted by the Board by Rule. These Board Rules, as the same may be amended or adopted by the Board from time to time, are incorporated into this Article as part of the Plan document. This definition is effective July 1, 1989.”

San Diego Regional Airport Authority
“Actuarial Equivalent means a benefit of equal value when computed based on the mortality, interest, and other tables duly adopted by the Administrator by Board Rule, which Board Rule is incorporated by reference into this Plan. This definition is effective January 1, 2003.”

San Diego Unified Port District
“Actuarial Equivalent means a benefit of equal value when computed based on the mortality, interest, and other tables adopted by the Administrator by rule, which rule is incorporated by reference into this Plan. This definition is effective January 1, 2003.”

Interest Crediting Definitions

City of San Diego
“The Board credits interest to the contribution accounts of Members and the City at a rate determined by the Board, compounded each June 30th.”

San Diego Regional Airport Authority
“The Administrator credits interest to the accounts for Employee Contributions and Employer Contributions at a rate determined by the Administrator, compounded each June 30th.”

San Diego Unified Port District
“The Administrator credits interest to the contribution accounts for Employee Contributions and Employer Contributions at a rate determined by the Administrator, compounded each June 30th.”

48 PEPRA contains three options a Basic Safety Plan, Safety Option Plan One, and Safety Option Two. These options contain a different % of final compensation depending on retirement age.
Board Rule 2.40

Board Rule 2.40 states, “[T]he Board will credit the contribution accounts of all Members and the employer with interest compounded annually at a rate to be determined by the Board.”

Board Rule 2.41

Board Rule 2.41 states, “The Board has adopted the following actuarially assumed investment returns per annum, compounded annually, for each of the following fiscal years for each of the City, the Unified Port District, and the Airport Authority plans. The Board will credit the contribution accounts of all Members and the employer with interest compounded annually at the rates stated below. SDCERS will continue to use the most recent interest rates specified below until this rule is amended by further action by the Board.” The chart is omitted.

Interest Rates

The assumed rate of return on assets from the actuarial valuation, the interest rate Member contributions are based upon, the interest rate in Board Rule 2.41 and the interest rate used by SDCERS to calculate the COL Annuity since Fiscal Year 2007 are shown below:

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Assumed Rate of Return on Assets from Actuarial Valuation</th>
<th>Member Contributions Based on</th>
<th>Board Rule 2.41 Interest Crediting Rate</th>
<th>COL Annuity Interest Rate Used by SDCERS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>2008</td>
<td>7.75%</td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>2009</td>
<td>7.75%</td>
<td>8.00%</td>
<td>7.75%</td>
<td>8.00%</td>
</tr>
<tr>
<td>2010</td>
<td>7.75%</td>
<td>7.75%</td>
<td>7.75%</td>
<td>8.00%</td>
</tr>
<tr>
<td>2011</td>
<td>7.50%</td>
<td>7.75%</td>
<td>7.75%</td>
<td>8.00%</td>
</tr>
<tr>
<td>2012</td>
<td>7.50%</td>
<td>7.50%</td>
<td>7.75%</td>
<td>8.00%</td>
</tr>
<tr>
<td>2013</td>
<td>7.25%</td>
<td>7.50%</td>
<td>7.50%</td>
<td>8.00% and later 7.5%</td>
</tr>
<tr>
<td>2014</td>
<td>7.25%</td>
<td>7.50%</td>
<td>7.50%</td>
<td>7.5%</td>
</tr>
<tr>
<td>2015</td>
<td>7.125%</td>
<td>7.25%</td>
<td>7.25%</td>
<td>7.5%</td>
</tr>
<tr>
<td>2016</td>
<td>7.00%&lt;sup&gt;49&lt;/sup&gt;</td>
<td>7.25%</td>
<td>7.25%</td>
<td>7.5%</td>
</tr>
<tr>
<td>2017</td>
<td>-</td>
<td>7.125%</td>
<td>7.125%</td>
<td>7.5% and later 7.125%</td>
</tr>
</tbody>
</table>

<sup>49</sup> Scheduled to decline to 7%. Fiscal Year 2016 Actuarial Valuation not received at time of report issuance.
DATE: January 11, 2017

TO: Lee Parravano, Internal Auditor

FROM: Marcelle Voorhies Rossman, Chief Benefits Officer

SUBJECT: Management’s Responses To The Findings And Recommendations In The Internal Auditor’s Report Regarding The Cost Of Living Annuity

Management appreciates the opportunity to respond to the Internal Auditor’s audit report regarding the Cost of Living Annuity (COL Annuity). Our responses to the Internal Auditor’s findings and recommendations are below.

Finding #1: The Plans do not provide specific guidance on the interest rate that should be used to calculate the COL annuity.

Recommendation #1a: The Board should consider other interest rate options used to calculate the COL Annuity other than the assumed rate of return on plan assets such as using a fixed interest rate, a rate tied to an outside index, or a rate tied to actual investment returns.

Recommendation #1b: SDCERS’ Board should consider changing the interest rate used to credit Member’s COL Annuity Contribution accounts other than the assumed rate of return on plan assets such as using a fixed interest rate, a rate tied to an outside index, or a rate tied to actual investment returns for Port and Airport Members.

Management’s Response: Management agrees with the finding and is supportive of any decision by the Board to review with the plan sponsors, its actuary, fiduciary counsel, and members the interest rates associated with the COL Annuity.

Finding #2: SDCERS has used incorrect interest rates to calculate COL Annuity benefits for the time period July 1, 2014 through August 2016 resulting in approximately 840 COL Annuity retirement benefits incorrectly setup.

Management’s Response: Management does not agree with the Internal Auditor’s finding. Management recognizes the ambiguity with the Board Rule cited by the Internal Auditor (Rule 2.90, Applicable Mortality Tables and Assumptions for Determining Actuarial Equivalence) and will address the matter at the January Board meeting.
**Recommendation #2a:** SDCERS’ Board should determine whether or not staff’s calculation of the COL Annuity is correct for the time period July 1, 2014 through August 2016. If the Board determines staff’s calculation of the COL Annuity is incorrect, for this time period, SDCERS should recalculate and correct the COL Annuity for all impacted Members.

**Management’s Response:** Management will address this matter at the January Board meeting and thanks the Internal Auditor for bringing this matter to our attention.

**Recommendation #2b:** SDCERS’ Board should consider establishing a stand-alone Board Rule that details the interest rate to be used when calculating a Member’s COL Annuity.

**Management’s Response:** Management will address this matter at the January Board meeting.

**Recommendation #2c:** SDCERS’ Board should clarify in Board Rule 2.90 the interest rate assumption that should be used to calculate the COL Annuity from July 1, 2012 to November 2012.

**Management’s Response:** Management agrees with this recommendation and will address this matter at the January Board meeting.

**Recommendation #2d:** SDCERS’ Board should consider including in either Appendix C, or in a Board Rule, direction on how to round a Member’s age to determine the retirement factor used to calculate the COL Annuity.

**Management’s Response:** Management will consider whether or not a Board Rule is needed to clarify the rounding of a member’s age in calculating the COL Annuity. The current practice is consistent with the calculation of benefit annuities.

**Finding #3:** The Plan Documents state that SDCERS’ Board can adjust the COL Annuity Contribution percentage. Setting the COL Annuity Contribution percentage determines a Member’s benefit. Setting Member benefits is the responsibility of the Plan Sponsor not SDCERS.

**Recommendation #3:** SDCERS should request the City and Airport amend their respective Plan Documents to shift the responsibility for setting COL Annuity Contribution percentages from the Board and its Actuary to the Plan Sponsor.

**Management’s Response:** Management supports the Board informing the City and Airport that their plans provide SDCERS with the authority to adjust the COL Annuity Contribution percentage. With that information, the plan sponsors can choose to take any action they deem necessary.

**Finding #4:** The Port and Airport are remitting offsets related to COL Annuity Contributions which do not fund the COL Annuity.

**Recommendation #4:** The Airport and Port should consider amending their respective Plan documents removing the requirement to pay into SDCERS offsets related to COL
Annuity Contributions. SDCERS should make modifications to IRIS as necessary if the Plan documents are amended.

**Management’s Response:** Management notes that SDCERS has been properly collecting the offsets related to the COL Annuity Contributions from the Port and Airport, as required by the Plan Documents. Those monies are credited to the Plan Sponsor accounts and reduce the UAL and ADC payments required. Management supports the Board informing the City and Airport of this matter. With that information, the plan sponsors can choose to take any action they deem necessary.

**Finding #5:** SDCERS could be prohibited from offering the COL Annuity to Port Safety and Airport PEPRA Members.

**Recommendation #5:** SDCERS’ Board, Airport, and Port should be mindful of the COL annuity benefit and various PEPRA provisions. If any changes to the COL Annuity benefit are made, the Plan Documents should be amended accordingly.

**Management’s Response:** SDCERS’ General Counsel and Fiduciary Counsel do not believe the COL Annuity is prohibited by PEPRA. Also, tax counsel believes the COL Annuity is a component of the defined benefit plan and not a supplemental defined benefit plan. The Port and Airport have already had their plans reviewed by outside counsel in order to comply with PEPRA. Notwithstanding, Management supports any decision by the Board to inform the Port and Airport of the Internal Auditor’s opinion.

Marcelle Voorhies Rossman  
Chief Benefits Officer