

FREDERICK WATER
COMMENTS ON INTERNAL CONTROL
AND OTHER SUGGESTIONS
FOR YOUR CONSIDERATION

June 30, 2018

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INDEPENDENT AUDITOR'S REPORT ON COMMENTS AND SUGGESTIONS

To the Board of Directors and Management
Frederick Water
Winchester, Virginia

In planning and performing our audit of the financial statements of Frederick Water (the "Authority") as of and for the year ended June 30, 2018, in accordance with auditing standards generally accepted in the United States of America, we considered its internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in circumstances for the purpose of expressing our opinion on the financial statements and to comply with any other applicable standards, such as *Government Auditing Standards*, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we do not express an opinion on the effectiveness of the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. In addition, because of inherent limitations in internal control, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected by such controls.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

If material weaknesses or significant deficiencies were identified during our procedures, they are appropriately designated as such in this report. Additional information on material weaknesses or significant deficiencies and compliance and other matters is included in the ***Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards*** which should be read in conjunction with this report.

Additionally, during our audit, we may have become aware of certain other matters that provide opportunities for improving your financial reporting system and/or operating efficiency. Such comments and suggestions regarding these matters, if any, are also included in the attached report, but are not designated as a material weakness or significant deficiency. Since our audit is not designed to include a detailed review of all systems and procedures, these comments should not be considered as being all-inclusive of areas where improvements might be achieved. We also have included information on accounting and other matters that we believe is important enough to merit consideration by management and those charged with governance. It is our hope that our suggestions will be taken in the constructive light in which they are offered.

We have already discussed these comments and suggestions with management, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

Where provided, the entity's responses to our recommendations are included in this report. The responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of the Authority, management, and the appropriate state and federal regulatory agencies and is not intended to be, and should not be, used by anyone other than these specified parties.

Brown, Edwards & Company, L.L.P.

CERTIFIED PUBLIC ACCOUNTANTS

Harrisonburg, Virginia
November 6, 2018

COMMENTS FOR YOUR CONSIDERATION

ACCOUNTING FOR UNIQUE CONTRACTS AND AGREEMENTS

The Authority is involved in a number of unique and complex contracts and agreements with other entities, some of which originated several years ago. In the current year, certain agreements were identified that were recorded incorrectly approximately fifteen years ago, resulting in a restatement to beginning net position and unearned revenues. To help ensure all transactions are properly accounted for, we recommend the Authority consider identifying classes of contracts and agreements that could potentially have material accounting implications, and then performing a comprehensive review of agreements deemed to be most risky for potential accounting implications. The result should be formal documentation of the key provisions of each significant agreement, the financial reporting treatment, and the basis for conclusions.

ACCOUNTING AND OTHER MATTERS

In this section, we would like to make you aware of certain confirmed and potential changes that are on the horizon that may affect your financial reporting and audit.

The GASB issued **Statement No. 83, *Certain Asset Retirement Obligations*** in November 2016. This Statement addresses accounting and financial reporting for certain asset retirement obligations (AROs). An ARO is a legally enforceable liability associated with the retirement of a tangible capital asset. A government that has legal obligations to perform future asset retirement activities related to its tangible capital assets should recognize a liability based on the guidance in this Statement.

This Statement establishes criteria for determining the timing and pattern of recognition of a liability and a corresponding deferred outflow of resources for AROs. This Statement requires that recognition occur when the liability is both incurred and reasonably estimable. The determination of when the liability is incurred should be based on the occurrence of external laws, regulations, contracts, or court judgments, together with the occurrence of an internal event that obligates a government to perform asset retirement activities. Laws and regulations may require governments to take specific actions to retire certain tangible capital assets at the end of the useful lives of those capital assets, such as decommissioning nuclear reactors and dismantling and removing sewage treatment plants. Other obligations to retire tangible capital assets may arise from contracts or court judgments. Internal obligating events include the occurrence of contamination, placing into operation a tangible capital asset that is required to be retired, abandoning a tangible capital asset before it is placed into operation, or acquiring a tangible capital asset that has an existing ARO.

This Statement requires the measurement of an ARO to be based on the best estimate of the current value of outlays expected to be incurred. The best estimate should include probability weighting of all potential outcomes, when such information is available or can be obtained at reasonable cost. If probability weighting is not feasible at reasonable cost, the most likely amount should be used. This Statement requires that a deferred outflow of resources associated with an ARO be measured at the amount of the corresponding liability upon initial measurement.

This Statement requires the current value of a government's AROs to be adjusted for the effects of general inflation or deflation at least annually. In addition, it requires a government to evaluate all relevant factors at least annually to determine whether the effects of one or more of the factors are expected to significantly change the estimated asset retirement outlays. A government should remeasure an ARO only when the result of the evaluation indicates there is a significant change in the estimated outlays. The deferred outflows of resources should be reduced and recognized as outflows of resources (for example, as an expense) in a systematic and rational manner over the estimated useful life of the tangible capital asset.

A government may have a minority share (less than 50 percent) of ownership interest in a jointly owned tangible capital asset in which a nongovernmental entity is the majority owner and reports its ARO in accordance with the guidance of another recognized accounting standards setter. Additionally, a government may have a minority share of ownership interest in a jointly owned tangible capital asset in which no joint owner has a majority ownership, and a nongovernmental joint owner that has operational responsibility for the jointly owned tangible capital asset reports the associated ARO in accordance with the guidance of another recognized accounting standards setter. In both situations, the government's minority share of an ARO should be reported using the measurement produced by the nongovernmental majority owner or the nongovernmental minority owner that has operational responsibility, without adjustment to conform to the liability measurement and recognition requirements of this Statement.

ACCOUNTING AND OTHER MATTERS (Continued)

In some cases, governments are legally required to provide funding or other financial assurance for their performance of asset retirement activities. This Statement requires disclosure of how those funding and assurance requirements are being met by a government, as well as the amount of any assets restricted for payment of the government's AROs, if not separately displayed in the financial statements.

This Statement also requires disclosure of information about the nature of a government's AROs, the methods and assumptions used for the estimates of the liabilities, and the estimated remaining useful life of the associated tangible capital assets. If an ARO (or portions thereof) has been incurred by a government but is not yet recognized because it is not reasonably estimable, the government is required to disclose that fact and the reasons therefore. This Statement requires similar disclosures for a government's minority shares of AROs.

The requirements of this Statement are effective for periods beginning after June 15, 2018.

The GASB issued **Statement No. 84, *Fiduciary Activities*** in January 2017. The objective of this Statement is to improve guidance regarding the identification of fiduciary activities for accounting and financial reporting purposes and how those activities should be reported.

This Statement establishes criteria for identifying fiduciary activities of all state and local governments. The focus of the criteria generally is on (1) whether a government is controlling the assets of the fiduciary activity and (2) the beneficiaries with whom a fiduciary relationship exists. Separate criteria are included to identify fiduciary component units and postemployment benefit arrangements that are fiduciary activities.

An activity meeting the criteria should be reported in a fiduciary fund in the basic financial statements. Governments with activities meeting the criteria should present a statement of fiduciary net position and a statement of changes in fiduciary net position. An exception to that requirement is provided for a business-type activity that normally expects to hold custodial assets for three months or less.

This Statement describes four fiduciary funds that should be reported, if applicable: (1) pension (and other employee benefit) trust funds, (2) investment trust funds, (3) private-purpose trust funds, and (4) custodial funds. Custodial funds generally should report fiduciary activities that are not held in a trust or equivalent arrangement that meets specific criteria.

A fiduciary component unit, when reported in the fiduciary fund financial statements of a primary government, should combine its information with its component units that are fiduciary component units and aggregate that combined information with the primary government's fiduciary funds.

This Statement also provides for recognition of a liability to the beneficiaries in a fiduciary fund when an event has occurred that compels the government to disburse fiduciary resources. Events that compel a government to disburse fiduciary resources occur when a demand for the resources has been made or when no further action, approval, or condition is required to be taken or met by the beneficiary to release the assets.

The requirements of this Statement are effective for periods beginning after December 15, 2018.

ACCOUNTING AND OTHER MATTERS (Continued)

The GASB issued **Statement No. 87, *Leases*** in June 2017. The objective of this Statement is to better meet the information needs of financial statement users by improving accounting and financial reporting for leases by governments. This Statement increases the usefulness of governments' financial statements by requiring recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the payment provisions of the contract. It establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under this Statement, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources, thereby enhancing the relevance and consistency of information about governments' leasing activities.

Definition of a Lease

A lease is defined as a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified in the contract for a period of time in an exchange or exchange-like transaction. Examples of nonfinancial assets include buildings, land, vehicles, and equipment. Any contract that meets this definition should be accounted for under the leases guidance, unless specifically excluded in this Statement.

Lease Term

The lease term is defined as the period during which a lessee has a noncancelable right to use an underlying asset, plus the following periods, if applicable:

- a. Periods covered by a lessee's option to extend the lease if it is reasonably certain, based on all relevant factors, that the lessee will exercise that option
- b. Periods covered by a lessee's option to terminate the lease if it is reasonably certain, based on all relevant factors, that the lessee will not exercise that option
- c. Periods covered by a lessor's option to extend the lease if it is reasonably certain, based on all relevant factors, that the lessor will exercise that option
- d. Periods covered by a lessor's option to terminate the lease if it is reasonably certain, based on all relevant factors, that the lessor will not exercise that option.

A fiscal funding or cancellation clause should affect the lease term only when it is reasonably certain that the clause will be exercised.

Lessees and lessors should reassess the lease term only if one or more of the following occur:

- a. The lessee or lessor elects to exercise an option even though it was previously determined that it was reasonably certain that the lessee or lessor would not exercise that option.
- b. The lessee or lessor elects not to exercise an option even though it was previously determined that it was reasonably certain that the lessee or lessor would exercise that option.
- c. An event specified in the lease contract that requires an extension or termination of the lease takes place.

ACCOUNTING AND OTHER MATTERS (Continued)

Short-Term Leases

A short-term lease is defined as a lease that, at the commencement of the lease term, has a maximum possible term under the lease contract of 12 months (or less), including any options to extend, regardless of their probability of being exercised. Lessees and lessors should recognize short-term lease payments as outflows of resources or inflows of resources, respectively, based on the payment provisions of the lease contract. Leases that are on a month-to-month basis are treated as short term.

Lessee Accounting

A lessee should recognize a lease liability and a lease asset at the commencement of the lease term, unless the lease is a short-term lease or it transfers ownership of the underlying asset. The lease liability should be measured at the present value of payments expected to be made during the lease term (less any lease incentives). The lease asset should be measured at the amount of the initial measurement of the lease liability, plus any payments made to the lessor at or before the commencement of the lease term and certain direct costs.

A lessee should reduce the lease liability as payments are made and recognize an outflow of resources (for example, expense) for interest on the liability. The lessee should amortize the lease asset in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset. The notes to financial statements should include a description of leasing arrangements, the amount of lease assets recognized, and a schedule of future lease payments to be made.

Lessor Accounting

A lessor should recognize a lease receivable and a deferred inflow of resources at the commencement of the lease term, with certain exceptions for leases of assets held as investments, certain regulated leases, short-term leases, and leases that transfer ownership of the underlying asset. A lessor should not derecognize the asset underlying the lease. The lease receivable should be measured at the present value of lease payments expected to be received during the lease term. The deferred inflow of resources should be measured at the value of the lease receivable plus any payments received at or before the commencement of the lease term that relate to future periods.

A lessor should recognize interest revenue on the lease receivable and an inflow of resources (for example, revenue) from the deferred inflows of resources in a systematic and rational manner over the term of the lease. The notes to financial statements should include a description of leasing arrangements and the total amount of inflows of resources recognized from leases.

Contracts with Multiple Components and Contract Combinations

Generally, a government should account for the lease and nonlease components of a lease as separate contracts. If a lease involves multiple underlying assets, lessees and lessors in certain cases should account for each underlying asset as a separate lease contract. To allocate the contract price to different components, lessees and lessors should use contract prices for individual components as long as they do not appear to be unreasonable based on professional judgment, or use professional judgment to determine their best estimate if there are no stated prices or if stated prices appear to be unreasonable. If determining a best estimate is not practicable, multiple components in a lease contract should be accounted for as a single lease unit. Contracts that are entered into at or near the same time with the same counterparty and that meet certain criteria should be considered part of the same lease contract and should be evaluated in accordance with the guidance for contracts with multiple components.

ACCOUNTING AND OTHER MATTERS (Continued)

Lease Modifications and Terminations

An amendment to a lease contract should be considered a lease modification, unless the lessee's right to use the underlying asset decreases, in which case it would be a partial or full lease termination. A lease termination should be accounted for by reducing the carrying values of the lease liability and lease asset by a lessee, or the lease receivable and deferred inflows of resources by the lessor, with any difference being recognized as a gain or loss. A lease modification that does not qualify as a separate lease should be accounted for by remeasuring the lease liability and adjusting the related lease asset by a lessee and remeasuring the lease receivable and adjusting the related deferred inflows of resources by a lessor.

Subleases and Leaseback Transactions

Subleases should be treated as transactions separate from the original lease. The original lessee that becomes the lessor in a sublease should account for the original lease and the sublease as separate transactions, as a lessee and lessor, respectively.

A transaction qualifies for sale-leaseback accounting only if it includes a sale. Otherwise, it is a borrowing. The sale and lease portions of a transaction should be accounted for as separate sale and lease transactions, except that any difference between the carrying value of the capital asset that was sold and the net proceeds from the sale should be reported as a deferred inflow of resources or a deferred outflow of resources and recognized over the term of the lease.

A lease-leaseback transaction should be accounted for as a net transaction. The gross amounts of each portion of the transaction should be disclosed.

The requirements of this Statement are effective for periods beginning after December 15, 2019.

The GASB issued **Statement No. 88, *Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements*** in March 2018. The primary objective of this Statement is to improve the information that is disclosed in notes to government financial statements related to debt, including direct borrowings and direct placements. It also clarifies which liabilities governments should include when disclosing information related to debt.

This Statement defines debt for purposes of disclosure in notes to financial statements as a liability that arises from a contractual obligation to pay cash (or other assets that may be used in lieu of cash) in one or more payments to settle an amount that is fixed at the date the contractual obligation is established.

This Statement requires that additional essential information related to debt be disclosed in notes to financial statements, including unused lines of credit; assets pledged as collateral for the debt; and terms specified in debt agreements related to significant events of default with finance-related consequences, significant termination events with finance-related consequences, and significant subjective acceleration clauses.

For notes to financial statements related to debt, this Statement also requires that existing and additional information be provided for direct borrowings and direct placements of debt separately from other debt.

The requirements of this Statement are effective for periods beginning after June 15, 2018.

ACCOUNTING AND OTHER MATTERS (Continued)

The GASB issued **Statement No. 90, *Majority Equity Interests, an amendment of GASB Statements No. 14 and No. 61*** in August 2018. This Statement improves the consistency and comparability of reporting a government's majority equity interest in a legally separate organization and improves the relevance of financial statement information for certain component units. It defines a majority equity interest and specifies that a majority equity interest in a legally separate organization should be reported as an investment if a government's holding of the equity interest meets the definition of an investment. A majority equity interest that meets the definition of an investment should be measured using the equity method, unless it is held by a special-purpose government engaged only in fiduciary activities, a fiduciary fund, or an endowment (including permanent and term endowments) or permanent fund. Those governments and funds should measure the majority equity interest at fair value.

For all other holdings of a majority equity interest in a legally separate organization, a government should report the legally separate organization as a component unit, and the government or fund that holds the equity interest should report an asset related to the majority equity interest using the equity method. This Statement establishes that ownership of a majority equity interest in a legally separate organization results in the government being financially accountable for the legally separate organization and, therefore, the government should report that organization as a component unit.

This Statement also requires that a component unit in which a government has a 100 percent equity interest account for its assets, deferred outflows of resources, liabilities, and deferred inflows of resources at acquisition value at the date the government acquired a 100 percent equity interest in the component unit. Transactions presented in statements of the component unit in that circumstance should include only transactions that occurred subsequent to the acquisition.

The requirements of this Statement are effective for periods beginning after December 15, 2018. The requirements should be applied retroactively, except for the provisions related to (1) reporting a majority equity interest in a component unit and (2) reporting a component unit if the government acquires a 100 percent equity interest. Those provisions should be applied on a prospective basis.

GOVERNMENTAL INDUSTRY UPDATES

SUPREME COURT LEVELS PLAYING FIELD FOR RETAILERS

On June 21, in a 5-4 decision, the Supreme Court overturned precedent in favor of state and local governments in a major tax case, *South Dakota v. Wayfair*. The court said governments can require remote retailers with no physical presence in their state to collect and remit sales taxes.

The ruling follows what local governments viewed as years of congressional inaction on discrepancies between the tax treatment of online retailers versus "Main Street," or brick-and-mortar businesses.

The case produced curious alliances, with Justice Anthony Kennedy writing the majority opinion and being joined by Justices Ruth Bader Ginsberg, Samuel Alito, Neil Gorsuch, and Clarence Thomas. Chief Justice John Roberts wrote for the minority and was joined by Justices Stephen Breyer, Sonia Sotomayor, and Elena Kagan.

GOVERNMENTAL INDUSTRY UPDATES (Continued)

What the Supreme Court Said

The majority said the requirement of physical presence for tax purposes established in *National Bellas Hess v. Illinois* (1967) and affirmed in *Quill v. North Dakota* (1992) was both “unsound and incorrect.” The majority said that in today’s growing e-commerce environment, the physical presence test was an unnecessarily strict threshold for determining whether a state or local government can require sales tax collection from a retailer.

In addition, while the physical presence test was meant to prevent discrimination between intrastate and interstate commerce, it effectively discriminated by creating a tax shelter for businesses that sell goods and services to the state’s consumers, but do not maintain a physical presence in the state.

There is one important caveat to the ruling, which is otherwise a significant win for local governments. The case has been remanded to South Dakota courts for further proceedings, meaning that South Dakota’s taxation law is still subject to other aspects of Commerce Clause review.

In particular, the South Dakota courts may consider whether the taxation scheme places undue burden on online retailers. The Government Finance Officers Association’s federal liaison center noted that the court emphasized that the question of undue burden on businesses has not yet been resolved.

Impact on Local Governments

Forty-five states impose a sales tax. Only Alaska, Delaware, Montana, New Hampshire, and Oregon do not. In addition, local sales taxes are collected in 38 states. Sales tax is the second-largest revenue source for counties nationwide, and uniform enforcement and collection is a top priority for county governments.

The ruling is expected to result in anywhere from \$8 billion to \$33.9 billion in additional annual sales tax revenue for state and local governments. The large variation is based on estimates from different survey groups. For instance, the Government Accounting Office estimates state and local governments lose \$8 billion to \$13.4 billion a year in uncollected taxes from online sales, while the International Council of Shopping Centers and the National Conference of State Legislatures estimated in 2015 that the difference in treatment of state and local governments cost \$26 billion.

Some deviation in potential receipts is expected in the near term because not all states have set a date when they will implement the Supreme Court ruling.

The National League of Cities suggests that, in the future, having a substantial economic presence in a state will likely be sufficient grounds for a state and local government to require a retailer to collect and remit sales taxes. It is important to remember that the case is not about imposing new taxes on retailers, but rather about treating businesses similarly, allowing state and local governments to collect billions in lost revenue each year.

Moving Forward

Some states have been working on laws similar to South Dakota’s, and more will take up the issue as a result of the *Wayfair* decision. Local governments can work with their state municipal leagues, county associations, and state legislatures to ensure that methods for collecting local sales taxes are included in any proposed legislation.

GOVERNMENTAL INDUSTRY UPDATES (Continued)

Moving Forward (Continued)

Twenty-four states have adopted the Streamlined Sales and Use Tax Agreement, which offers a model for how states can simplify and centralize their tax collection methods. More states are expected to adopt the agreement.

The agreement is a cooperative effort of 44 states, the District of Columbia, local governments, and the business community to simplify and make more uniform the sales and use tax collection and administration by retailers and states. The agreement minimizes costs and administrative burdens on retailers that collect sales tax and encourages “remote sellers” to collect tax in states that have adopted it.

Information on the agreement and which states have adopted it can be found at <http://www.streamlinedsalestax.org/>.

Conclusion

The recently decided *Wayfair* case has been remanded for further proceedings not inconsistent with the court’s opinion. While it is worthwhile for local governments to move forward with activities related to encouraging state or local action with respect to sales tax collection, tax and legal professionals will need time to digest the opinion and consider its application in different scenarios.

Also, to the extent states wish to adopt tax statutes like South Dakota’s, it will bear watching to see whether other applications of Commerce Clause review will invalidate all or some of South Dakota’s law.

It is still possible that Congress will take action addressing the issue of online taxation. Local governments should monitor congressional developments and be prepared to make their views known if legislation begins to move this fall.

STATE AND LOCAL PENSIONS IN CONTEXT: HISTORY AND CURRENT TRENDS

Addressing the budgetary effects of current and future pension obligations is high on the list of concerns for local government financial officers and elected officials. While retirement system costs remain a relatively small portion of state and local government budgets (on average 4 to 9 percent), more than 40 percent of cities reported a rise in costs associated with pensions in the last year.

A recent National League of Cities survey found that the cost of employee/retiree pensions ranks third – after infrastructure and public safety needs – as the most negative factor affecting city budgets.

In addition to the growing costs and fees associated with pension funds, local governments face demographic challenges in reaching or sustaining full funding because fewer active workers are available to provide contributions that support benefit payments to current retirees.

Currently, the U.S. averages 1.53 current state or local government workers to 1 retiree. However, there is a lot of variation, and some states – Nebraska, Texas, and Utah – have more than two active workers per retiree, while others have less than one worker per retiree (Alaska, Michigan, and Pennsylvania).

Local governments need to carefully evaluate their investment strategies to address these challenges.

GOVERNMENTAL INDUSTRY UPDATES (Continued)

Pension Composition and Investment History

Beginning in the 1970s, state and local pension funds began to take steps to advance-fund their pensions. Public pension plans started shifting funds away from low-risk, fixed-income investments to equities and alternative investments. According to the Urban Institute, pension plans receive most of their annual income from investments rather than contributions. In 2013, 71 percent of total pension plan revenue came from net investment earnings, 20 percent came from employer contributions, and 8 percent came from employee contributions.

Alternative investments include private equity, hedge funds, real estate, and commodities. These can be more difficult to value than stocks or bonds and generally carry higher fees. They can be used to diversify investment portfolios or achieve higher rates of return, but also come with higher levels of risk.

Many public plans exceeded their investment return targets in the 1990s, and by 2000, most public plans were nearly 100 percent funded. Unfortunately, the last decade of economic upheaval and stock market volatility reduced pension assets and rates of return. This led to higher pension costs for state and local budgets, and resulted in pension plans no longer being fully funded.

Alternative Investments and Pension Yields

State-sponsored pension plans, in which many local governments participate rather than maintain their own plans, use a wide range of investment strategies. A 2017 Pew Charitable Trusts survey of investment data for the 73-largest public funds found that use of alternative investments ranges from zero to more than 50 percent of fund portfolios, depending on the fund. Several public pension funds surveyed are interesting noteworthy for their investments and returns.

For example, the Washington Department of Retirement Systems (WDRS) is among the highest-performing public funds. WDRS, one of the earliest adopters of alternative investments, began investing in private equities in 1981. In 2014, the WDRS had 36.3 percent of total investments in alternative asset classes, including 22.3 percent in private equity, 12.4 percent in real estate, and 1.6 percent in other alternatives. Notably, it does not hold any hedge funds. Because of its holdings, WDRS's 10-year returns were among the highest in the data Pew surveyed, reaching 7.6 percent in 2015.

By comparison, the three funds with the weakest 10-year performance made some of the largest and most recent shifts to alternative investments. Additionally, their hedge fund allocations are significantly more than the hedge fund allocations for WDRS. An independent audit of the South Carolina Retirement System's (SCRS), one of the three funds with the weakest performance, suggests that rapid diversification into alternative investments with large hedge fund investment was overly challenging for a new, under-resourced program.

By way of further comparison, some plans, unlike WDRS or SCRS, have consistently achieved relatively high returns without a heavy reliance on alternatives. The two Oklahoma state-sponsored retirement systems in the Pew survey are robust examples of this approach. One of the plans has lower-than-average allocations to alternatives while the other holds no alternatives, yet both plans have performed better than the average fund performance of 6.6 percent over 10 years.

The Oklahoma Teachers Retirement System (OTRS) had a 10-year return of 8.3 percent in 2015 and holds only 17 percent of its assets in alternatives, well below the average of 25 percent. Diversifying within its equity portfolio, employing low-fee strategies, and cutting operating costs are key features of its overall strategy.

GOVERNMENTAL INDUSTRY UPDATES (Continued)

Alternative Investments and Pension Yields (Continued)

The Oklahoma Public Employees Retirement System (OPERS), on the other hand, holds no alternative investments. OPERS's investment principles are guided by long investment horizons and a focus on long-term results. The system incorporates diversification passive investment management, except in less-efficient markets where it implements a more active strategy.

Long-Term Fiscal Benefit

Local officials should understand the specific pension needs of their communities and how to evaluate the health of their individual plans. In addition, they should understand not only the investment vehicles they choose for plans they administer, but also the investment vehicles of their state plans and how their experience compares to other states. In this way they can make better-informed decisions and influence the path forward for their investments to meet the challenges pension plan funding poses to local budgets.

KENTUCKY TAKES NEW ROUTE TO WIDER BROADBAND ACCESS

Many Americans, especially those in poor or rural areas, do not have access to high-speed internet services—at a time when wireless connectivity is becoming an integral part of everyday life.

FCC Chairman Ajit Pai announced in January that he was seeking an additional \$500 million to be used to bring down the cost of deployment in high-cost rural areas and that he was seeking reforms in the high-cost program to promote efficiency while minimizing potential abuse. “We need more deployment in sparsely populated rural areas if we are going to extend deployment to all Americans,” Pai said.

Groups like the National League of Cities, National Association of Counties, and the National Association of Towns and Townships agree that both rural America and poor urban areas suffer from significant gaps in accessibility. These groups, in concert with the National Association of Telecommunications Officers and Advisors and others, have long advocated for more funding and better legislative solutions, whether at the FCC, in Congress or in various states.

The groups also lobby for the ability of local governments to provide broadband services, much as they do other utilities and infrastructure, such as water and sewer, electricity, roads, and bridges.

However, the legislatures in approximately 20 states have chosen to restrict or prohibit elected leaders from acting to improve coverage for their businesses and residents. Kentucky is not one of those states.

Kentucky Promotes Public-Private Partnership

The public-private partnership Kentucky has created may serve as a model for governments in other states to bring broadband to underserved communities, whether at the state or local level. KentuckyWired plans to bring high-speed access to the entire state, including its most underserved and geographically inaccessible areas.

Kentucky's abundant limestone and dolomite deposits make burying cable or fiber a challenge. The Appalachian Mountains also present obstacles for stringing wire over poles, making it financially infeasible for most private telecommunications companies to provide service.

GOVERNMENTAL INDUSTRY UPDATES (Continued)

Kentucky Promotes Public-Private Partnership (Continued)

While residents in some areas may be able to access social media or even stream videos, for much of the state—east Kentucky in particular—the broadband infrastructure can't support high-tech business ventures or educational needs that rely on high-speed internet capacity.

KentuckyWired's goal is to provide the “middle mile” of broadband infrastructure for all 120 counties, without becoming an internet service provider. KentuckyWired expects to give direct broadband access to public schools and universities, state agencies, and other public institutions, while leasing access to private interests. To date, the project has built out about 600 miles of fiber and acquired leases for 50,000 of the 59,000 poles it needs for attachment.

Progress has been slowed because of delays in obtaining the necessary approvals from local governments and telecommunications providers alike. The slow roll has caused Kentucky taxpayers to assume the added contractual costs related to the delays. However, supporters hope once negotiations for the final portions of the project are complete, KentuckyWired will showcase the state as a technological pioneer in the provision of low-cost broadband services.

KentuckyWired may have its problems and cost overruns, but its potential transformative value is enormous. If successful, it will be a model to address the problem local elected officials face in working with telecommunications providers, whose financial interests cannot directly support an infrastructure investment. A well-structured public-private partnership, whether local, regional, or statewide, may provide a solution.