STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

Arizona's Universities
Capital Project Financing

REPORT HIGHLIGHTS
PERFORMANCE AUDIT

Subject

University capital projects include new construction, renovation, or improvement of buildings, facilities, or infrastructure. Capital projects are considered major when they cost $2 million or more. Capital projects are typically funded through the use of revenue bonds or certificates of participation, although agreements with private or governmental parties provide an alternative method of acquiring facilities.

Our Conclusion

The universities generally follow good practices for issuing and managing debt. The universities also follow best practices for mitigating the risks associated with third-party financing. Limited funding has resulted in the universities' using some debt to address building renewal needs.

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Research goals and enrollment promote significant capital expenditures

State support for Arizona State University's (ASU), the University of Arizona's (UA), and Northern Arizona University's (NAU) research goals, enrollment growth, and other factors has fostered capital development. The universities have undertaken significant capital development in recent years. Between fiscal years 2005 and 2007, capital expenditures exceeded $1 billion. About $754 million of this was used for new academic and research facilities, infrastructure, and residence halls. Another $253 million was used for renovating and improving existing facilities.

New Research Facilities—The State has provided the universities with funding to support new research facilities. In 2003, the Legislature passed a law approving annual General Fund appropriations of $14.5 million to ASU, $14.3 million to UA, and $5.9 million to NAU to help pay for research-related capital projects. These monies are to pay annual lease payments through 2031 for lease-purchase projects entered into before July 1, 2006, and the universities are using these monies to pay for 13 capital projects.

Enrollment Growth and Other Factors—Total fall enrollment in the universities increased 18 percent between 1997 and 2006. ASU accounted for most of this, increasing from 49,243 to 63,278 students—a 29 percent increase. ASU projects enrollment to increase to about 90,000 students by 2022. To accommodate this increase, ASU has expanded its Polytechnic campus and opened a new campus in downtown Phoenix. The universities have also built new facilities to attract and retain students.

Arizona Biomedical Collaborative Building 1 (ASU/UA)

Source: UA's 2009–2011 Capital Improvement Plan.

Applied Research and Development (NAU)

Source: Courtesy of NAU. Photograph by Jerry Foreman.

Capital Development Process—To oversee the growth, the Arizona Board of Regents (Board) has a multi-phase capital development process that includes a 5-year strategic plan and a long-term master plan. The universities also prepare annual capital improvement plans that:

- Provide information about land, leases, and buildings.
- Report on the condition of facilities and the status of projects.
- Request funding for building renewal.

All projects or groups of related projects with an estimated cost of $2 million or more are included in a university's capital development plan.

After the Board approves a capital development plan, the universities must obtain additional approvals to complete the design process and to authorize the project.

The Board submits debt-financed projects for legislative review. The university can proceed with financing and construction following all required board approvals and legislative reviews.

Universities have several options to pay for capital projects

The universities have primarily relied on issuing their own public debt and partnering with third parties to finance capital projects. Other options such as cash, private donations, and grants are used less frequently.

Public debt financing—The universities use two kinds of public debt to finance capital projects:

- Revenue bonds are securities in which the universities pledge various revenues to pay the bond principal and interest over time.
- Certificates of participation (COPs) are securities in which the university promises to pay lease payments over time in exchange for occupancy in a building owned by an outside party that sells shares of the agreement to investors. The university takes ownership of the building upon the final lease payment.

Capital Project Debt
As of June 30, 2007

$ 869 million in revenue bonds
$ 935 million in COPs
$ 164.2 million in payments in FY 2008
$ 2.78 billion in payments remaining over life of debt

Debt issued in fiscal years 2003 through 2007 paid for 61 major ($2 million or more) and minor (under $2 million) projects. ASU financed 22 projects at 4 campuses, NAU financed 20 projects at 2 campuses, and UA financed 19 projects at 2 campuses.

Third-party partnership arrangements—In a typical third-party arrangement, the university enters into a ground lease with a third party that outlines each party's roles, rights, and controls. The third party constructs the facility on the university's land parcel, and the facility provides a mechanism to generate revenues required to cover the project's costs. The facility's revenues usually derive from student rent or other student fees.

In 2002 through 2007, ASU, UA, and NAU used third-party arrangements to support 18 capital projects. Thirteen of these projects involved a nonprofit corporation that can issue tax-exempt revenue bonds to raise money for the project.[1] For example, an NAU-affiliated nonprofit corporation issued bonds to pay for the Pine Ridge Village student housing facility, and the ground lease agreement requires NAU to make long-term lease payments to the nonprofit to repay the revenue bonds.

For the five other third-party arrangements initiated between 2002 and 2007, the third party has involved a local government and/or a for-profit business entity. For example, ASU has entered into an intergovernmental agreement with the City of Phoenix to create the ASU Downtown Phoenix Campus. ASU moved the College of Public Programs and the College of Nursing and Healthcare Innovations to this campus in fall 2006, and plans to move its Walter Cronkite School of Journalism and Mass Communication and KAET/Eight public broadcasting studios in fall 2008. The City of Phoenix is paying for both the land and the facility construction using voter-approved general obligation bonds, and ASU is paying for furniture, fixtures, and equipment. UA also partnered with the City of Phoenix and a private developer to open a new medical school in downtown Phoenix. Similarly, NAU partnered with the City of Flagstaff, a private corporation, and an NAU-affiliated nonprofit corporation to develop a new hotel and conference center in Flagstaff.

Walter Cronkite School of Journalism and Mass Communications (ASU)

Source: ASU Web site http:\\www.asu.edu/tour/tempe/bdb.html> accessed on April 18, 2008.

1 As of June 30, 2007, only 12 of the 13 projects had issued bonds; ASU had yet to issue revenue bonds for an ASU Polytechnic project.

Less benefit to third-party financing exists now than in the past—Some third-party financing is not as attractive as in the past. Prior to fiscal year 2004, the debt a university-affiliated nonprofit corporation incurred in building a capital project was not considered a university liability. However, changes in governmental accounting standards now require the universities to report these projects as part of their long-term liabilities.

Universities follow good debt management practices

ASU, UA, and NAU have good credit ratings and follow recommended practices for issuing and managing debt. Their debt ratings are in the "AA" or "A" grade, indicating that they are quality investments. As such, the universities can usually obtain lower interest rates and sell their bonds and COPs more easily.

Universities follow most recommended practices—These practices include:

- Adhering to debt limits—By statute, the universities' debt service may not exceed 8 percent of total expenditures and mandatory transfers. At the end of fiscal year 2007, ASU, UA, and NAU were at 3.5 percent, 4.5 percent, and 4.3 percent, respectively.
- Using a professional finance team—The universities have hired professional finance teams, and the Board must approve them.
- Grouping projects to save on issuance costs—The universities usually combine more than one capital project into one debt issuance.
- Using credit enhancements when appropriate—Enhancements such as bond insurance guarantee that the bond insurer will pay the debt obligation if the bond issuer fails to make scheduled payments.
- Using a mix of variable- and fixed-rate debt when appropriate—Although a fixed rate provides certainty, fixed-rate interest may be higher than variable-rate interest.
- Refinancing debt when appropriate—By issuing new debt, a university can take advantage of a reduction in interest rates. The universities reported having received an economic gain of several million dollars by refinancing.

The only debt management practice UA and NAU have not followed is having a written debt management policy. UA's policy is in draft form, and NAU needs to develop a policy or formal guidelines.

Recommendations

UA should:

- Finalize and implement its debt management policy.

NAU should:

- Develop and implement a debt management policy or formal guidelines.

Universities generally follow recommended practices for third-party projects

As with other financing, third-party projects carry some risk. Such projects can still affect a university's debt capacity even if they do not result in a university's taking on debt because rating agencies assess the likelihood that a university will take over a third-party project should it fail.

The universities generally follow recommended practices to protect against risks with third-party arrangements. Because such agreements are complex, the universities use experienced legal experts. The agreements include purchase option provisions, when appropriate, to avoid potential liabilities. They also verify the third party's qualifications and use a competitive request for proposals process.

In order to assess the need for and potential success of a project, the universities also conduct feasibility studies. For example, before NAU moved forward with its plans for a hotel and conference center, it contracted for a feasibility study. The study confirmed the need for the facility, that it was likely to achieve desired levels of occupancy, and that it had favorable financial projections.

Universities use debt for some building renewal needs

The universities are required to compute their building renewal needs and request a state appropriation through annual capital improvement plans. The universities compute their needs using a uniform funding formula approved by the Legislative Joint Committee on Capital Review (JCCR).

Because of competition for limited General Fund monies, the universities have rarely received 100 percent of the building renewal monies requested. Between fiscal years 1999 and 2008, the universities received about 14 percent, or $69 million, of the $502 million requested.

Because of limited building renewal appropriations, the universities have used other funding sources, including using bond or COP proceeds, for building renewal projects. Between fiscal years 2003 and 2007, the universities allocated $94.3 million in bond and COP debt to pay for building renewal projects. Despite the use of these monies, insufficient building renewal funding has contributed to a backlog of deferred maintenance. The Board defines deferred maintenance as building deficiencies where deterioration and/or safety concerns are evident and affect the proper functioning of the building. Typically, such deficiencies include heating, ventilation, and air conditioning components; roofs, flooring, walls, and ceilings; and electrical and plumbing systems. At the end of fiscal year 2007, the universities reported an estimated $419 million in outstanding deferred maintenance for academic and support facilities.

Cracked walls in NAU's Capital Assets Building

Source: Courtesy of NAU.

Although building renewal projects are prioritized, because funding is insufficient, some needs may not be immediately addressed and may result in further damage. For example, fire sprinklers might have mitigated some of the damage caused by the November 2007 fire in ASU's Memorial Union. However, an ASU official said a lack of funding delayed the installation of sprinklers in this building. In December 2007, a water pipe in NAU's Physical Sciences Building burst because of fatigue, causing flood damage on the first and second floors, displacing classes and faculty during final exam week.

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