STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

Water Infrastructure Finance Authority

REPORT HIGHLIGHTS
PERFORMANCE AUDIT AND SUNSET REVIEW

Our Conclusion

The Water Infrastructure Finance Authority (WIFA) was created in 1997 and provides financial assistance, through below-market interest rate loans, for the construction, rehabilitation, and improvement of clean water and drinking water facilities in Arizona. However, the interest rate determination process that WIFA uses includes a project's priority ranking compared to other, unrelated projects, which can lead to higher interest rates for some projects and, therefore, reduced cost savings for some borrowers. In addition, the process WIFA uses to determine interest rates is unique to 19 states surveyed by auditors. We recommend that WIFA revise its interest rate determination process so that rates are not dependent on unrelated projects, and test and evaluate it prior to implementation to ensure that it allows WIFA to continue operating without State General Fund appropriations.

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WIFA administers various water infrastructure financing programs

WIFA programs and responsibilities—WIFA's purpose is to provide financial assistance to build and improve clean water and drinking water facilities in Arizona. State statutes creating WIFA authorize it to issue bonds and administer federal grants through three programs:

- **Clean Water Fund—**provides low-interest loans for planning, construction, and upgrading publicly owned wastewater and water reclamation systems.
- **Drinking Water Fund—**provides low-interest loans to public and private drinking water systems such as water treatment plant upgrades and well replacement.
- **Technical Assistance Program—**provides grants to wastewater and drinking water systems in need of assistance to complete the planning or design phase of a system.

Project scoring and prioritization—WIFA scores projects based on three factors: local fiscal capacity, how the project addresses existing deficiencies, and proposed water or energy efficiency or environmental innovation. The total score is called the Priority Value and WIFA places an applicant with the highest Priority Value score at the top of the Project Priority List (PPL). After being placed on the PPL, applicants must obtain debt authorization and complete a Project Finance Application, which WIFA's Board of Directors must ultimately review and approve. WIFA does not pay money up front but reimburses borrowers' eligible project costs.

Project Funding—Funding for WIFA programs comes from three sources:

- **Federal grants—**WIFA receives annual grants from the U.S. Environmental Protection Agency. In 2012, WIFA received $25.6 million in federal grants.
- **Bond proceeds—**WIFA issues revenue bonds for project loans and to provide state matching funds. As of June 30, 2012, WIFA had outstanding bond debt of almost $1 billion. Its revenue bonds have a AAA rating, the highest possible rating.
- **Loan payments and fees—**The money paid by borrowers is used to fund new loans, provide the 20 percent state match required for federal grants, and retire outstanding bonds. In 2012, WIFA received $146.6 million in loan repayments.

Although WIFA provides low-interest loans, the process could reduce cost savings for some borrowers

WIFA provides below-market interest rate loans—To provide below-market interest rate loans, WIFA developed a subsidy rate table (see page 2) that discounts interest rates below the current municipal bond rate for governmental borrowers or prime rate for non-governmental borrowers. The discount is based on two main factors, specifically, (1) a project's Clean Water or Drinking Water PPL percentile, and (2) a project's local fiscal capacity. Projects with higher PPL percentile and higher Local Fiscal Capacity scores (i.e., worse fiscal capacity) receive better discounts. In contrast, projects with lower PPL percentile and lower Local Fiscal Capacity scores (i.e., better fiscal capacity) receive lesser discounts. During fiscal years 2010 through 2012, WIFA used this process to award below-market interest rate loans for all projects we examined.

Using the PPL to determine subsidy rates could reduce cost savings for some borrowers—Each project on a PPL affects the percentile of all other projects. Because a project's interest rate is dependent on its PPL percentile, a project's interest rate is inherently dependent on all other projects on the PPL. As such, WIFA's management of the PPLs, while appropriate for funding prioritization, can lead to inequitable rate determination. Simply adding projects to or removing projects from the PPL lists can affect a project's PPL percentile sufficiently to affect its subsidy rate and ultimately, its interest rate. Projects are added to the PPLs throughout the year as applications are received. Projects are removed at the end of the fiscal year in which the project is funded. Projects are also removed from the PPLs without funding from WIFA when they are funded from another source or discontinue the application. Each of these changes can potentially affect interest rates and borrowers' costs for unrelated projects.

WIFA's subsidy rate table, based on a project's Local Fiscal Capacity score and PPL percentile

Local Fiscal Capacity score	PPL percentile: Above 80	79 to 60	59 to 40	39 to 20	Below 20
100	70%	70%	70%	75%	75%
90	70%	70%	75%	75%	80%
80	75%	75%	75%	80%	80%
70	75%	75%	80%	80%	80%
60	80%	80%	80%	80%	80%
50	80%	80%	80%	80%	85%
40	80%	80%	80%	85%	85%
30	80%	85%	85%	85%	85%
20	85%	85%	85%	85%	90%
10	85%	85%	85%	90%	95%
0	90%	90%	90%	90%	95%

Projects that remain on the PPLs for an extended period of time can have a particularly lingering impact on the subsidy for all projects funded during that time. Of the 41 projects on the PPLs in 2011, 12 were still on the lists in 2013. Consequently, nearly 30 percent of the projects affected interest rate determinations for the other projects for more than 2 years.

WIFA also has programs to assist disadvantaged communities and very small drinking water systems. Both programs offer interest rates lower than those provided to borrowers that do not qualify. Although projects may qualify for special programs, they are scored and placed on the PPLs like all other projects. Consequently, projects that may qualify for special programs can affect the subsidy rate that non-qualifying borrowers receive.

Auditors identified one instance where projects funded in 2009 and 2010 had identical Local Fiscal Capacity and PPL scores but were awarded different subsidy rates due to WIFA's process of using the PPL to determine the subsidy rate. The first project was awarded a subsidy rate of 75 percent and the second was awarded a subsidy rate of 70 percent. As such, the first project received less of a discount than the second, resulting in higher interest and fee payments for the borrower. Over the life of the loan, auditors calculated that the first borrower will pay approximately $250,000, or 8 percent, more in interest and fees as a result of this difference.

Other states surveyed do not make a borrower's interest rate dependent on the other projects—Auditors surveyed the clean water and drinking water programs in 19 states and found that in none of them is a borrower's interest rate dependent on other projects. In most states, the interest rate was set by using a fixed discount from a municipal bond or bond issuance rate, sometimes considering the merits of the project. In others, the interest rate was set as a fixed rate by the governing board.

Recommendations

WIFA should:

- Set loan interest rates independent of other projects, using a fixed discount from the market rate.
- Consider additional discounts based on the merits of the project.
- Test and evaluate its revised process prior to implementation to ensure it allows WIFA to continue operating without State General Fund appropriations.

Water Infrastructure Finance Authority

A copy of the full report is available at:
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