A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Performance Audit and Sunset Review

Water Infrastructure Finance Authority

September • 2013
REPORT NO. 13-08

Debra K. Davenport
Auditor General

The **Auditor General** is appointed by the Joint Legislative Audit Committee, a bipartisan committee composed of five senators and five representatives. Her mission is to provide independent and impartial information and specific recommendations to improve the operations of state and local government entities. To this end, she provides financial audits and accounting services to the State and political subdivisions, investigates possible misuse of public monies, and conducts performance audits of school districts, state agencies, and the programs they administer.

The Joint Legislative Audit Committee

Senator **Chester Crandell,** Chair

Senator **Judy Burges**
Senator **Steve Gallardo**
Senator **Katie Hobbs**
Senator **Andy Biggs** (*ex officio*)

Representative **John Allen,** Vice Chair

Representative **Paul Boyer**
Representative **Andrea Dalessandro**
Representative **Martin Quezada**
Representative **Kelly Townsend**
Representative **Andy Tobin** (*ex officio*)

Audit Staff

Jay Zsorey, Financial Audit Director and Contact Person

Adam Tillard, Team Leader
Angela Fanzo
Michelle Hutson

Copies of the Auditor General's reports are free.
You may request them by contacting us at:

Office of the Auditor General
2910 N. 44th Street, Suite 410 • Phoenix, AZ 85018 • (602) 553-0333

Additionally, many of our reports can be found in electronic format at:
www.azauditor.gov

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

MELANIE M. CHESNEY
DEPUTY AUDITOR GENERAL

September 9, 2013

Members of the Arizona Legislature

The Honorable Janice K. Brewer, Governor

Mr. Henry R. Darwin, Chair
Water Infrastructure Finance Authority Board of Directors

Ms. Sandra L. Sutton, Executive Director
Water Infrastructure Finance Authority

Transmitted herewith is a report of the Auditor General, *A Performance Audit and Sunset Review of the Water Infrastructure Finance Authority* (WIFA). This report is in response to an October 26, 2010, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq. I am also transmitting within this report a copy of the report highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, WIFA agrees with all of the findings and plans to implement most of the recommendations. WIFA has identified a different method to address one of the recommendations.

My staff and I will be pleased to discuss or clarify items in the report.

Sincerely,

Debbie Davenport
Auditor General

Attachment

cc: Water Infrastructure Finance Authority Board of Directors

2910 NORTH 44th STREET • SUITE 410 • PHOENIX, ARIZONA 85018 • (602) 553-0333 • FAX (602) 553-0051

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

INTEGRITY • ACCOUNTABILITY • MAKING A DIFFERENCE

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.

2013

September • Report No. 13-08

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.

TABLE OF CONTENTS

continued

TABLE OF CONTENTS

Tables

Figures

concluded

INTRODUCTION

Scope and Objectives

The Office of the Auditor General has conducted a performance audit and sunset review of the Water Infrastructure Finance Authority (WIFA) pursuant to an October 26, 2010, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq.

This performance audit and sunset review addresses WIFA's process for ensuring borrowers receive below-market interest rate loans. The report also includes responses to the statutory sunset factors.

WIFA administers the State's Clean Water and Drinking Water State Revolving Fund programs

Programs and responsibilities

WIFA was established in 1997 as a separate legal entity of the State authorized to provide financial assistance for the construction, rehabilitation, and improvement of clean water and drinking water facilities within Arizona (see textbox for WIFA's mission). It administers two revolving funds initially established at the federal level—the Clean Water State Revolving Fund and the Drinking Water State Revolving Fund programs. Prior to WIFA, another agency, the Wastewater Management Authority, administered the clean water program. WIFA was created in response to federal legislation that created the drinking water program. The Legislature eliminated the Wastewater Management Authority and transferred its responsibilities to WIFA.

WIFA's Mission—To maintain and improve water quality in Arizona by providing financial assistance and technical assistance for basic water infrastructure.

Federal regulations require each state to designate an administrator for these revolving fund programs, but do not specify a particular type of agency or entity to act as the administrator. WIFA was established to administer these programs and has statutory authority to issue bonds and apply for, accept, and administer federal grants. The bonds issued by WIFA are solely its obligation and are not a legal debt of, or enforceable against, the State. WIFA issues bonds to provide monies to make loans for water infrastructure projects. Although some states have established similar infrastructure financing authorities, generally, states' environmental and natural resources or health agencies administer the revolving fund programs.

WIFA administers three main programs: the Clean Water State Revolving Fund program, the Drinking Water State Revolving Fund program, and the Technical Assistance program, as follows.

- **Clean Water State Revolving Fund program**—This program was established under federal Clean Water Act Amendments enacted in 1987 and provides low-interest rate loans to publicly owned wastewater and water reclamation systems for projects such as the expansion of a wastewater treatment plant's capacity. Publicly owned wastewater and water reclamation systems can apply for loans and use the proceeds to plan, engineer, construct, upgrade, and/or equip wastewater treatment and water reclamation facilities. For example, in fiscal year 2011, WIFA provided a $1.5 million loan to the City of Prescott for a sewer replacement project. During fiscal year 2012, WIFA approved two loan applications for financial assistance through the Clean Water State Revolving Fund program totaling $6.7 million.

- **Drinking Water State Revolving Fund program—**This program was established with the passage of the federal Safe Drinking Water Act Amendments enacted in 1996. It provides low-interest rate loans to publicly and privately owned drinking water systems for projects such as water treatment plant upgrades and well replacement. Publicly and privately owned drinking water systems can apply for loans and use the proceeds to plan, engineer, construct, upgrade, and/or equip drinking water systems. For example, in fiscal year 2012, WIFA provided a $332,000 loan to a privately owned water company in Mohave County for a new well. During fiscal year 2012, WIFA approved 14 loan applications for financial assistance through the Drinking Water State Revolving Fund program totaling $30.5 million.

- **Technical Assistance program—**This program provides grants to wastewater and drinking water systems with limited resources that are in need of assistance to complete the planning and/or design phase of a project. For example, technical assistance grants may be used to fund preliminary engineering reports, feasibility studies, and environmental assessments. Technical assistance grants are generally awarded at no more than 60 percent of the total costs for planning and design and are capped at $35,000 for each grant. However, WIFA provides 100 percent of the total cost for projects that qualify for the Green Project Reserve program. Funding for this program is provided through the Clean Water and Drinking Water State Revolving Fund programs. During fiscal year 2012, WIFA reviewed and approved 5 clean water technical assistance grant applications totaling $147,150 and 12 drinking water technical assistance grant applications totaling $349,799.

WIFA supplements its clean water and drinking water programs by administering two programs that focus on disadvantaged communities and very small drinking water systems. To be classified as disadvantaged, communities must either be designated as "colonia" by the federal government or meet specific scoring criteria established by WIFA (see page 3 for project scoring information).[1] The disadvantaged community designation applies to both the clean water and drinking water programs. Disadvantaged communities can receive more favorable loan terms at WIFA's discretion. Specifically, WIFA can reduce a disadvantaged community borrower's combined interest and fee rate to as low as 2.0 percent or extend the term of the loan beyond the standard 20-year term, to as long as 30 years. WIFA's very small drinking

[1] 42 USC §1479(f)(8) defines a colonia as a community that: (A) is in the State of Arizona, California, New Mexico, or Texas; (B) is in the area of the United States within 150 miles of the border between the United States and Mexico, except that the term does not include any standard metropolitan statistical area that has a population exceeding 1,000,000; (C) is determined to be a colonia on the basis of objective criteria, including lack of potable water supply, lack of adequate sewage systems, and lack of decent, safe, and sanitary housing; and (D) was in existence as a colonia before November 28, 1990.

water systems program applies to systems that serve less than 3,300 customers and have fewer than 1,000 connections. Applicants that qualify receive loans with a 1.0 percent interest rate.

Application process, prioritization, and project funding

WIFA receives applications on an ongoing basis for its Clean Water and Drinking Water State Revolving Fund programs loans through its Web-based application system. In accordance with statute, WIFA must "[d]etermine the order and priority of projects … based on the merits of the application." To meet this requirement, WIFA staff first review and score each application based on criteria consistent with the federal Clean Water and Safe Drinking Water Acts. Specifically:

- Local Fiscal Capacity, as measured by the following:
  - Median household income of the community to be served by the project compared to the State's median household income,
  - Proposed user fees compared to the median household income of the community to be served by the project, and
  - Outstanding and proposed debt of the community to be served by the project compared to the community's median household income;
- How the project addresses existing public health or compliance issues, such as correction of sewer overflow or excessive drinking water contaminants; and
- Portion of the project devoted to water or energy efficiency or environmental innovation.

For example, more points are awarded to projects that serve communities whose median household income is less than the state median household income; address a public health or compliance issue identified by the Arizona Department of Environmental Quality (ADEQ); or have a larger portion of the project devoted to water or energy efficiency or environmental innovation.

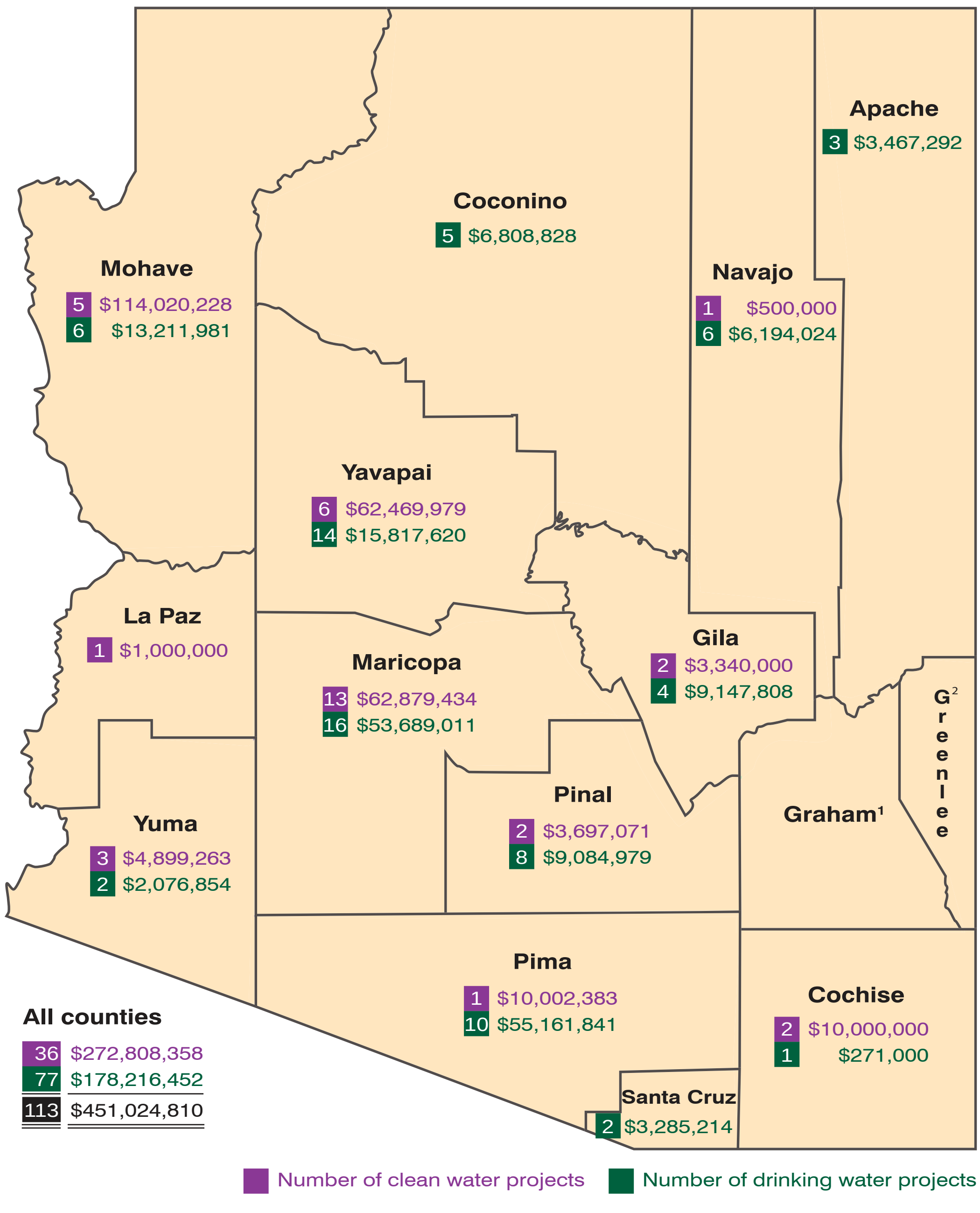
The total score awarded for each project is called the Priority Value and is used to compile separate clean water and drinking water Project Priority Lists (PPLs) (see Appendices B and C, pages b-1 and c-1, respectively, for the fiscal year 2013 clean water and drinking water PPLs). Each PPL specifies the relative priority order of projects to be funded. Projects with higher Priority Value scores are ranked higher on the PPL, indicating the increased importance placed on funding those projects. At the beginning of each fiscal year, WIFA prepares updated PPLs for both the drinking water and clean water programs. The PPLs are also updated throughout the year as new applications are received and approved or projects are canceled by the applicant.

Once on the Project Priority List, applicants must obtain debt authorization and complete a Project Finance Application.[1] WIFA staff review the application for completeness and propriety. Once approved by WIFA staff, Project Finance Applications are reviewed by the WIFA Board of Directors (Board). The Board must approve all applications. Following board approval, loan documents are drafted by WIFA and reviewed by the borrower. Once in agreement, WIFA and the borrower execute the loan (see Appendix A on page a-1 for more information regarding WIFA's loan application process).

WIFA provides year-round funding opportunities and approves millions of dollars in loans and technical assistance grants every year. The number of loans funded from the PPLs depends on the extent of available monies and the readiness of the projects to proceed. As shown in Figure 1 (see page 5), in fiscal years 2010 through 2012, WIFA approved 113 applications for drinking water and wastewater facilities resulting in loans of approximately $451 million. During this timeframe, all projects that were ready to proceed were funded. Loan monies are not disbursed to borrowers until they incur eligible project costs. Borrowers provide documentation supporting project expenses to WIFA staff for review. Once the expenses are approved by WIFA staff, loan monies are disbursed to reimburse project costs. This process continues throughout the project until all loan monies are disbursed. As shown in Table 2 (see page 9), WIFA disbursed $62.8 million in loan monies to borrowers during fiscal year 2012.

1 According to WIFA's administrative rule AAC R18-15-104, applicants obtain debt authorization by demonstrating that they are legally authorized to enter into long-term indebtedness, and are legally authorized to pledge a dedicated revenue source for repayment. Documentation supporting this determination is required by WIFA.

Figure 1: Number of clean water and drinking water projects and dollars awarded to public and private entities in each county
Fiscal years 2010 through 2012



1 Graham County did not receive clean water or drinking water program loans between fiscal years 2010 and 2012; however, in fiscal year 2008, two clean water projects totaling $3,195,000 and three drinking water projects totaling $7,723,380 were awarded.

2 Greenlee County did not receive clean water or drinking water program loans between fiscal years 2008 and 2012.

Source: Auditor General staff analysis of WIFA's loan portfolio for fiscal years 2010 through 2012.

Funding

WIFA does not receive any State General Fund appropriations. Funding for the Clean Water and Drinking Water State Revolving Fund programs is primarily received from the following sources:

- **Federal grants—**As the State's designated administrator for the two revolving fund programs, WIFA receives annual federal grants from the U.S. Environmental Protection Agency. Rather than receiving the federal grants in lump-sum amounts, WIFA submits requests for cash drawdowns as it reimburses wastewater and drinking water systems for water infrastructure project costs. For fiscal year 2012, WIFA received approximately $25.6 million in federal grant monies to provide financial assistance for water infrastructure projects. As shown in Table 1 (see page 8), WIFA received more than $2.6 million for the clean water program and almost $23.0 million for the drinking water program. In addition, WIFA is required to match 20 percent of the federal grant awards with nonfederal funds. WIFA uses bond proceeds or fees to meet this requirement.

- **Bond proceeds—**WIFA has statutory authority to issue revenue bonds to provide additional monies for water infrastructure project loans and to provide state matching funds. WIFA issued $138.7 million in revenue bonds in fiscal year 2011 and had outstanding bond debt of approximately $998 million as of June 30, 2012. As of January 2013, national credit rating agencies had awarded a AAA credit rating, the highest possible rating, to WIFA's revenue bonds. WIFA's high credit rating reduces its cost of borrowing when issuing bonds, which in turn allows WIFA to provide low-cost loans to local and rural communities and private water systems.

Revenue bond—A municipal bond issued to finance a project. These bonds are repaid from the revenues the project generates.

- **Borrower loan payments and fees—**These monies may be used to fund new loans, provide funding for the 20 percent state match of federal grants, or retire WIFA's outstanding bonds. Loan terms are usually 20 years. Borrower loan repayments are payable in semiannual, and in certain circumstances, monthly or quarterly, installments. Loan principal and interest payments made by borrowers are returned to the respective revolving fund programs. As shown in Table 2 on page 9, in fiscal year 2012, WIFA received approximately $146.6 million in loan repayments. This amount included approximately $21.8 million in interest (see Table 1, page 8). In addition, a majority of WIFA borrowers also pay servicing fees. As shown in Table 1, WIFA received approximately $16.2 million in loan fees from borrowers. WIFA may use these monies for any program purpose, including administrative costs.

As shown in Table 1 (see page 8), WIFA's total administrative expenditures were more than $2.2 million during fiscal year 2012. WIFA is authorized to use 4 percent of its federal grants for administrative purposes and does so. Approximately 67 percent of the total administrative expenditures were personnel costs. Total administrative expenditures decreased by 43 percent from fiscal years 2010 to 2012, primarily due to the expiration of the federal American Recovery and Reinvestment Act (ARRA) funding and a reduction in loan applications received.

Organization and staffing

WIFA is governed by a 12-member board of directors (Board). Seven of the board members are appointed by the Governor for 5-year staggered terms and represent municipalities, counties, sanitary districts, public water systems, and Native American tribes. The other 5 board members represent the following agencies: the Arizona Department of Environmental Quality, Arizona Commerce Authority, Arizona Department of Water Resources, Arizona Corporation Commission, and Office of the State Treasurer.

To assist in its duties, the Board is supported by a total of 19 authorized full-time equivalent (FTE) positions. As of June 14, 2013, WIFA had two vacancies. In addition to the executive director, WIFA's staffing is organized in the following divisions:

- **Administration (4 FTE)—**This division provides WIFA with human resources, payroll services, strategic planning, board and agency administration, and records management.

- **Financial Services (8 FTE)—**This division is responsible for managing the Clean Water State Revolving Fund, Drinking Water State Revolving Fund, and Technical Assistance grant programs. Responsibilities include review of project applications and ensuring appropriate placement of eligible projects on the PPLs.

- **Fiscal/Loan Servicing (6 FTE)—**This division manages WIFA's daily financial operations. Specifically, it is responsible for executing WIFA loan disbursements; collecting loan repayments; managing WIFA debt service, investments, and federal grants; and monitoring the state match monies.

Table 1: Schedule of revenues, expenditures, and changes in fund net assets for the Arizona Clean Water and Drinking Water State Revolving Fund programs
Fiscal years ended 2010 through 2012
(Unaudited)

	2010	2011	2012		
	Total	Total	Clean water	Drinking water	Total
Revenues:					
Program loan interest revenue[1]	$ 22,347,120	$ 23,123,041	$ 15,288,825	$ 6,532,914	$ 21,821,739
Debt management fees[2]	13,248,075	14,808,090	10,714,272	5,477,641	16,191,913
Investment earnings	6,067,134	6,587,730	5,515,706	1,663,793	7,179,499
Federal grants	74,779,238	32,871,941	2,636,311	22,988,381	25,624,692
Total revenues	116,441,567	77,390,802	34,155,114	36,662,729	70,817,843
Expenditures and transfers:					
Administrative expenditures—					
Personnel services and related benefits	1,348,308	1,276,177	800,450	686,896	1,487,346
Professional and outside services	197,385	179,173	72,891	66,226	139,117
Travel	27,748	32,708	15,337	15,326	30,663
Equipment	20,354	101,424	5,943	81,046	86,989
Other operating	207,116	264,555	98,184	109,514	207,698
Other program activities[3]	1,563,377	299,900	196,080	68,434	264,514
ARRA administrative transfers to ADOA[4]	404,286				
Small water systems contributed capital[5]	85,988				
Total WIFA administrative expenditures	3,854,562	2,153,937	1,188,885	1,027,442	2,216,327
Transfers to the ADEQ[6]	7,963,295	7,018,503	1,111,288	3,531,677	4,642,965
Linked expense[7]		2,491,384			
Total administrative expenditures	11,817,857	11,663,824	2,300,173	4,559,119	6,859,292
Technical assistance[8]	1,042,826	837,783	98,741	277,957	376,698
Program loan interest expense[9]	37,769,218	39,621,958	26,294,911	8,006,146	34,301,057
ARRA expense/forgivable principal expense	31,477,252	10,459,525	774,236	4,758,757	5,532,993
Depreciation				17,295	17,295
Total expenditures and transfers	82,107,153	62,583,090	29,468,061	17,619,274	47,087,335
Net change in fund balance	34,334,414	14,807,712	4,687,053	19,043,455	23,730,508
Fund balance, beginning of year	401,705,663	436,040,077	236,994,539	213,853,250	450,847,789
Fund balance, end of year	$436,040,077	$450,847,789	$241,681,592	$232,896,705	$474,578,297

1 Amounts are annual interest charged to loan recipients. Recipients are given a subsidy rate to reduce the cost of borrowing below the current market rate.

2 Amounts are annual administrative fees charged to most loan recipients that are available to defray WIFA's administrative expenses. Most loans have a 1.5 to 3.0 percent annual administrative fee.

3 Amounts are expenditures for surveys prepared by WIFA and certain investment expenses associated with WIFA's bonds.

4 According to WIFA, amounts are a portion of ARRA funds received that are due to the State. State ARRA administrative costs were used to fund program oversight through the Governor's Office and the ARRA programs tracking system.

5 According to WIFA, amounts are Small Water Systems cash balances transferred to the State Legislature.

6 Amounts are monies passed through to the ADEQ for its role in administering three drinking water programs and to fund the Staff Technical Assistance that is offered through the ADEQ's Capacity Development Program to assist small individual drinking water systems serving 10,000 or fewer people.

7 According to WIFA, amounts are program loan and interest adjustments.

8 Amounts are Planning and Design Assistance Grants awarded to eligible applicants.

9 Amounts are a combination of bond interest paid to WIFA bondholders and other costs associated with bond issuance.

Source: Auditor General staff analysis of WIFA's fiscal years 2010 through 2012 financial statements audited by an independent certified public accounting firm.

Table 2: Statement of cash flows for the Arizona Clean Water and Drinking Water State Revolving Fund programs Fiscal years ended 2010 through 2012 (Unaudited)

	2010	2011	2012		
	Total	Total	Clean water	Drinking water	Total
Cash flows from operating activities					
Receipt of program loans	$ 100,706,704	$ 134,445,168	$ 79,255,704	$ 67,358,797	$ 146,614,501
Loans made to borrowers	(244,250,993)	(143,418,520)	(40,089,335)	(22,757,784)	(62,847,119)
Receipt of debt management fees	12,844,486	14,025,322	10,911,336	5,822,016	16,733,352
Receipt (use) of loan reserves	75,687	133,266	362	195,508	195,870
Payment of administrative costs	(11,794,099)	(11,681,178)	(2,280,151)	(4,539,097)	(6,819,248)
Payment of technical assistance costs[1]	(1,042,826)	(837,783)	(98,741)	(277,957)	(376,698)
Payment of ARRA expense/forgivable principal expense[2]	(31,477,252)	(10,459,525)	(774,236)	(4,758,757)	(5,532,993)
Payment of program loan costs	(39,799,773)	(41,204,299)	(58,022,477)	(19,439,874)	(77,462,351)
Net cash provided (used) by operating activities	(214,738,066)	(58,997,549)	(11,097,538)	21,602,852	10,505,314
Cash flows from noncapital activities					
Principal paid on bonds	(73,370,000)	(80,119,998)	(190,965,467)	(69,654,533)	(260,620,000)
Receipts from new bond issue[3]	200,359,911	190,191,070	185,808,042	65,300,224	251,108,266
Receipt of administrative grants	4,840,688	5,103,782	385,688	3,971,252	4,356,940
Capital contributions—federal grants	69,938,550	27,768,159	2,250,623	19,017,129	21,267,752
Net cash provided (used) by noncapital activities	201,769,149	142,943,013	(2,521,114)	18,634,072	16,112,958
Cash flows from capital and related financing activities					
Purchasing of capital assets				(103,770)	(103,770)
Net cash provided (used) by capital and related financing activities				(103,770)	(103,770)
Cash flows from investing activities					
Purchase of investments	(8,138,345)	(10,095,758)	(189,263)	(231,067)	(420,330)
Interest received on investments	6,144,496	6,855,463	5,554,813	1,706,913	7,261,726
Net cash provided by investing activities	(1,993,849)	(3,240,295)	5,365,550	1,475,846	6,841,396
Net increase (decrease) in cash and cash equivalents	(14,962,766)	80,705,169	(8,253,102)	41,609,000	33,355,898
Cash and cash equivalents at beginning of year	85,989,140	71,026,374	103,393,334	48,338,209	151,731,543
Cash and cash equivalents at end of year	$ 71,026,374	$ 151,731,543	$ 95,140,232	$ 89,947,209	$ 185,087,441

1 Amounts are Planning and Design Assistance Grants awarded to eligible applicants.

2 Amounts are additional subsidization in the form of forgivable principal for those projects WIFA has identified as disadvantaged communities and critical projects.

3 According to WIFA, amounts reported consist of revenue bonds and revenue refunding bonds issued for fiscal years 2010 and 2011 and revenue refunding bonds issued for fiscal year 2012. Amounts also include costs of issuance, discounts, and bond premiums.

Source: Auditor General staff analysis of WIFA's fiscal year 2012 financial statements audited by an independent certified public accounting firm.

FINDING 1

WIFA provides below-market interest rate loans, but its process could reduce cost savings for some borrowers

Although the Water Infrastructure Finance Authority of Arizona (WIFA) has ensured its loans for clean water and drinking water projects are made at below-market interest rates, its process for doing so can result in borrowers receiving different subsidy rates even though they received the same evaluation scores on their applications. To meet state and federal requirements, WIFA has developed a subsidy rate table that it uses to discount the current municipal bond or prime rate when it grants water infrastructure loans. WIFA's process includes consideration of a project's priority ranking compared to other, unrelated projects. Under this approach, the sheer number of projects on the priority list can affect the loan subsidy rate—and consequently, the borrower's interest rate and the cost of repaying the loan. According to WIFA, its process for determining interest rates was put in place to capture the business environment at the time of funding. However, other states surveyed for this audit do not consider a project's priority ranking against other, unrelated projects as a factor when determining a borrower's interest rate. WIFA should revise its process so that interest 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.

WIFA meets requirement to provide below-market interest rate loans

Consistent with state and federal requirements, WIFA has provided below-market interest rate loans to Arizona communities and water systems for the purpose of making drinking water and clean water infrastructure improvements. WIFA's interest rate determination process considers a project's Local Fiscal Capacity score—an indicator of a community's economic status—and total project score ranking compared to other projects (see Introduction, pages 3 through 4 for more information on scoring). These factors are used to discount current market interest rates, enabling WIFA to meet statutory and regulatory requirements.

State and federal regulations require below-market interest rates—Arizona Revised Statutes §§49-1225(C) and 49-1245(C) grant WIFA the power to set interest rates for drinking water and clean water infrastructure loans, respectively. Each statute also requires that "the rate shall not exceed the prevailing [current] market rate for similar types of loans." Federal grants awarded to WIFA include a similar requirement—that WIFA provide funding "at below-market interest rates" to fund drinking water and clean water infrastructure loans.

WIFA's interest rate determination process meets requirements—WIFA has developed a subsidy or discount rate table that it uses to discount the current municipal bond or prime rate (see textbox for definitions). This process ensures that all loans are executed at a below-market rate, thus satisfying the state and federal requirements. Auditors examined a total of 30 projects funded during fiscal years 2010 through

> **Subsidy**—A benefit provided by the government to reduce a burden or encourage growth. WIFA uses a subsidy rate to discount the interest borrowers pay on loans.
>
> **Municipal bond rate**—The annual interest rate paid on a bond issued by state or local government. WIFA uses the Municipal Market Data Index determined by Thomson Reuters Corporation, a business data provider.
>
> **Prime rate**—The interest rate banks charge their most financially sound customers.

2012 and determined that WIFA met the state and federal requirements to provide below-market interest rates in each case.

However, while assisting auditors with other work, WIFA identified one instance during fiscal year 2009 in which the combined interest and fee rate calculation was inaccurate. According to WIFA, a staff member used the incorrect municipal bond rate, resulting in an interest rate that, although still below market, was higher than it should have been. Since the error was identified, WIFA has corrected the rate, recalculated the total interest and fee payments due to date, and credited the borrower the overpaid interest and fees of approximately $10,500. Auditors did not identify another error of this type in work performed during fiscal years 2010 through 2012.

WIFA considers multiple factors to determine interest rates—WIFA's process for setting interest rates relies on two main factors. The first is the project's ranking on WIFA's clean water and drinking water Project Priority Lists (PPLs)—prioritized lists of all projects actively seeking funding or previously funded during the fiscal year. The second is the project's Local Fiscal Capacity score. (See Introduction, pages 3 through 4, for further explanation of these factors.) These two factors are used to determine a subsidy rate, or discount, for each project. To determine the project's combined interest and fee rate for governmental applicants, the subsidy rate is applied to the current municipal bond rate. For nongovernmental entities, the subsidy rate is applied to the current prime rate plus two percentage points.[1] Specifically:

- **WIFA uses project scores to determine subsidy rate—**Table 3 on page 13 shows how a project's ranking on the PPL and its Local Fiscal Capacity score interrelate in establishing the project's subsidy rate, which can range from 70 percent to 95 percent. Although a subsidy rate of 70 percent may sound like a smaller subsidy than a rate of 95 percent, the opposite is true. For example, a 70 percent subsidy rate means that a governmental borrower will be paying only 70 percent of the current municipal bond rate, while a 95 percent subsidy rate means that a governmental borrower will be paying 95 percent of the current municipal bond rate. Second, a higher fiscal capacity score indicates that a community has a lower ability to pay for a project, and a lower score indicates that a community has a greater ability to pay for a project. Under WIFA's process, projects with higher priority (i.e., higher PPL percentile) and worse fiscal capacity (i.e., higher Local Fiscal Capacity score) fall in the upper left-hand corner of the figure and receive better subsidy rates (e.g., 70 percent). By contrast, projects with lower priority (i.e., lower PPL percentile) and better fiscal capacity (i.e., lower Local Fiscal Capacity score) fall in the lower right-hand corner of the figure and receive lesser subsidy rates (e.g., 95 percent).

[1] The prime rate is used to establish interest rates on short-term lending. Because WIFA's loans are usually for 20 years, WIFA adds 2 percentage points to the prime rate to more accurately reflect market rates.

Table 3: 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%

Source: WIFA Procedures II.1.1 and II.1.2, effective May 31, 2012.

For example, in fiscal year 2011, WIFA approved a clean water project loan for the City of Prescott. At the time of approval, the project's priority relative to all other clean water projects was in the 56th percentile, and the community had a Local Fiscal Capacity score of 40. This combination placed the project near the middle of the table, with a subsidy rate of 80 percent (see Table 3 above).

- **WIFA uses subsidy rate to calculate combined interest and fee rate**—The subsidy rate and a current market rate are used to calculate the combined interest and fee rate. Using Prescott again as the example, its subsidy rate of 80 percent was applied to the current municipal bond rate of 3.94 percent, resulting in an interest and fee rate of 3.15 percent (3.94 x .80 = 3.15). This calculation is generally done about 2 days prior to loan closing.

WIFA's rate determination process could reduce cost savings for some borrowers

Although WIFA has provided below-market interest rate loans, auditors determined that using the PPL as a factor in identifying subsidy rates led to the potential for inequitable rate determination. WIFA's management of projects on the PPL, while appropriate for funding prioritization, could increase some borrowers' interest rates and thereby reduce their cost savings. Specifically, (1) the manner in which WIFA adds or removes projects from the PPL, (2) leaving projects on the PPL for an extended period of time, and (3) including projects on the PPL that may qualify for special programs can affect a borrower's combined interest and fee rate. Auditors identified one example where projects with identical scores received different subsidy rates, resulting in reduced cost savings for one community.

Table 4: Example PPL showing potential effect on PPL percentile after adding projects

Example of PPL with 10 projects

Rank	Project name	PPL Percentile
1	Project A	90%
2	Project B	80
3	Project C	70
4	Project D	60
5	Project E	50
6	**Project F**	**40**
7	Project G	30
8	Project H	20
9	Project I	10
10	Project K	0

Example of same PPL after adding Project X and Project Y

Rank	Project name	PPL Percentile
1	Project X	92%
2	Project A	83
3	Project B	75
4	Project Y	67
5	Project C	58
6	Project D	50
7	Project E	42
8	**Project F**	**33**
9	Project G	25
10	Project H	17
11	Project I	8
12	Project K	0

Source: Auditor General staff-prepared example.

Adding or removing projects from the PPL—Because each project on a PPL affects the percentile of all other projects, any addition or removal of projects can affect interest rate determinations and potentially borrowers' costs. Projects can be added or removed from the PPL at any time during the year, a necessary aspect of funding prioritization. WIFA adds new projects to the PPL following review by WIFA staff and approval by the Board of Directors (Board). WIFA removes projects from the list for a variety of reasons, including at the end of the fiscal year in which a project is funded, when the applicant receives funding from a different source, or when the applicant decides not to continue with the project.

However, under WIFA's current approach, simply adding projects to the PPL can change a project's subsidy rate. Table 4 shows a PPL with 10 projects. Project F is in the 40th percentile. The subsidy rate for this project would be determined by using the "59 to 40" column of the Subsidy Rate Table (see Table 3 on page 13). However, if two projects were added to the PPL, the impact on Project F's percentile could be significant enough to change its subsidy rate. Table 4 shows the impact of two projects—Projects X and Y—being added to the example PPL with higher PPL scores than Project F. Notice that Project F's percentile falls from the 40th to the 33rd percentile although nothing related to Project F has changed. As a result, the subsidy rate for Project F would be determined by using the "39 to 20" column of the Subsidy Rate Table (see Table 3 on page 13), potentially decreasing the subsidy rate by 5 percent.

Likewise, removing two projects from a PPL can have a similar effect. Auditors examined the drinking water and clean water PPLs WIFA prepared at the beginning of fiscal year 2011, which identified 41 total projects (see Table 5 below). Of those 41 projects, 20 projects were removed from the PPLs at some point during fiscal years 2011 or 2012 without being funded. Projects remained on the PPLs for between 3 and 24 months of the time period examined prior to being removed. WIFA removed projects for a variety of reasons, including the applicant identifying an alternate funding source, being unable to obtain debt authorization, and canceling the project. Each of

Table 5: Projects from the initial fiscal year 2011 PPLs and outcomes As of June 30, 2012

	Total projects	Funded during fiscal year 2011	Funded during fiscal year 2012	Removed without funding	On fiscal year 2013 PPL
Drinking water[1]	27	2	3	10	10
Clean water	14	1	1	10	2
Total	41	3	4	20	12

[1] According to WIFA, two projects on the fiscal year 2011 drinking water PPL were later combined with another project. The combined project was included on the fiscal year 2013 Drinking Water PPL and included here as one project. As such, the number of drinking water projects funded, canceled, and still remaining on the fiscal year 2013 PPL does not agree to the total number of projects.

Source: Auditor General staff analysis of WIFA's clean water and drinking water PPLs for fiscal years 2011 through the initial PPLs for fiscal year 2013.

these projects, although never funded, had the potential to alter the interest rate awarded to the seven projects funded during that time even though they were unrelated.

Leaving projects on the PPL for an extended period of time—Again, because each project included on the PPL affects the PPL percentile of other projects, the length of time projects remain on the PPL, both funded and unfunded, can impact borrowers' savings. As previously mentioned, WIFA removes funded projects from the PPLs at the end of the fiscal year in which they are funded. A project funded on August 30 is removed from the PPL the following June 30, about 10 months later. A project funded May 30 is also removed on June 30, only 1 month later. As such, projects funded earlier in the fiscal year remain on the PPL longer and can have an extended impact on the PPL percentile for all other projects awaiting funding compared to those projects funded later in the fiscal year.

Unfunded projects can have a particularly lingering effect. Once a project application is received, reviewed by WIFA staff, and approved by the Board to be added to the PPL, it is placed in score rank on the PPL. After a project is placed on the PPL, the applicant must still obtain debt authorization and complete a project finance application. The project finance application is reviewed by WIFA staff to ensure the borrower is capable of managing the project and the loan. Following review and board approval of the project, loan documents are drawn up and the loan is executed (see Appendix A, page a-1, for more information on WIFA's loan process). This process can happen relatively quickly or take an extended period of time. In addition, projects may be modified depending on the borrower's need or WIFA's review, potentially increasing the length of time projects spend on the PPLs.

Auditors examined the drinking water and clean water PPLs that WIFA prepared at the beginning of fiscal year 2011, which identified 41 total projects (see Table 5 on page 14). Of those 41 projects, 12 projects were also on the PPLs that WIFA prepared for fiscal year 2013. Consequently, nearly 30 percent of the projects affected PPL percentiles for more than 2 years, and potentially the subsidy rates for other projects funded during that time.

Including projects on the PPL that may qualify for special programs—As discussed earlier, WIFA has programs to assist disadvantaged communities and very small drinking water systems (see Introduction, pages 2 through 3). Both programs offer loan terms more favorable than those awarded to projects that do not qualify. Although their combined interest and fee rate may be determined by an alternate method, WIFA includes projects that may qualify for these programs on the PPLs, potentially increasing interest rates and thereby reducing cost savings for borrowers who do not qualify for special programs.

Auditors examined the drinking water and clean water PPLs WIFA prepared at the beginning of fiscal year 2013, which identified 27 total projects—19 drinking water and 8 clean water projects. Of those 27 projects, 8 projects met the criteria to qualify as disadvantaged—5 drinking water and 3 clean water projects. In addition, WIFA indicated that 12 projects on the drinking water PPL met the criteria to qualify as very small drinking water systems; 5 projects qualified for both programs. In total, auditors identified 15 projects, or 56 percent, on the drinking water and clean water PPLs that met the criteria for special programs, yet still had the potential to affect the subsidy rates of unrelated projects on the PPLs.

WIFA's rate determination process led to inequitable treatment—The impact of WIFA's process is not just potential; it has affected subsidy rate determinations and borrowers' cost savings. Auditors identified one instance of two drinking water projects funded in fiscal years 2009 and 2010 that received identical Local Fiscal Capacity and PPL scores but were awarded different subsidy rates due to WIFA's rate determination process. 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 and thereby reduced cost savings. 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.

WIFA should modify its rate determination process to ensure equitable treatment among projects

WIFA should discount project interest rates independent of unrelated projects. According to WIFA, its process for determining the combined interest and fee rate was put in place to capture the business environment at the time of funding. However, none of the states auditors surveyed make a project's discounted interest rate dependent on a comparison to other projects.[1] WIFA's interest rate determinations would be more equitable if it modified its interest rate determination process so it does not consider unrelated projects. In addition, WIFA should make similar modifications to its disadvantaged community designation. Finally, WIFA should monitor interest and fee revenues received under the modified rate determination processes to ensure it remains self-sufficient.

Other states surveyed do not make borrower's interest rate dependent on other projects—In a survey of 19 state-run clean water and drinking water revolving fund programs, auditors determined that WIFA was unique in its comparison of applicants to other projects to determine interest rates. Although there was not a common practice across all 19 states, auditors determined that in none of the states is a borrower's interest rate dependent on other projects. Specifically:

[1] Auditors surveyed California, Colorado, Connecticut, Idaho, Indiana, Iowa, Kansas, Massachusetts, Minnesota, Nevada, New Jersey, New Mexico, New York, Oklahoma, Rhode Island, Texas, Utah, Virginia, and Wyoming.

- In 15 of 19 states, the interest rate was set by:
    - Using a fixed discount from a municipal bond or bond issuance rate;[1] or
    - Discounting a municipal bond rate based on the merits of the project or community.
- In 4 of 19 states, the interest rate was set as a fixed rate by the governing board.[2]
- In 1 of 19 states, the interest rate was set by the governing board (drinking water) or administering agency (clean water). For both types of projects, the rate could be reduced depending on the merits of the project.

For example, Rhode Island's Clean Water State Revolving Fund Program sets its interest rates as 67 percent of the most recent General Obligation Bond rate; Wyoming charges a fixed rate of 2.5 percent. In both cases, the interest rate is not dependent on unrelated projects.

WIFA should modify its interest rate determination process so it does not consider unrelated projects—Similar to other states, WIFA should use an interest rate determination process that does not consider unrelated projects. It should determine interest rates as a fixed discount from current market rates. In addition, WIFA can further discount interest rates based on the merits of each project. For example, projects that address existing deficiencies can receive additional discounts.

WIFA should modify disadvantaged community designation so it does not consider unrelated projects—WIFA also uses the PPL ranking when identifying disadvantaged communities—communities that are at or above the 50th percentile on the PPLs may be designated as disadvantaged. In order to treat these communities equitably, WIFA should modify its Disadvantaged Community designation to eliminate consideration of unrelated projects.

WIFA should monitor interest and fee revenues generated under modified rate determination process to ensure it remains self-sufficient— As discussed earlier, WIFA does not receive any State General Fund appropriations for the Clean Water and Drinking Water State Revolving Fund programs; instead, it relies on federal grants, bond proceeds, and borrower loan payments and fees (see Introduction, pages 6 through 7 for additional information about funding). The revised process should be tested and evaluated prior to implementation, to ensure that it allows WIFA to continue operating without State General Fund appropriations. Following implementation, WIFA should continue to monitor borrower loan payments and fees generated by its modified rate determination process to ensure that it continues to operate without State General Fund appropriations.

[1,2] The State of Connecticut uses a fixed rate for clean water projects and a discounted municipal bond rate for drinking water projects.

Recommendations:

1.1 To ensure equitable treatment among projects when setting loan interest rates, WIFA should develop an interest rate determination process, defined in its rules, that calculates the combined interest and fee rate independent of other projects. It should be determined as a fixed discount from the current Municipal Market Data Index or prime rate.

1.2 WIFA could further subsidize interest rates depending on the merits of the project. For instance, lower rates can be awarded for projects that:

   a. Serve communities whose median household income is lower than the state median household income;

   b. Specifically address deficiencies identified by the Arizona Department of Environmental Quality;

   c. Contain energy-efficient or environmentally innovative aspects; and

   d. Assist smaller communities.

1.3 WIFA should modify its Disadvantaged Community designation to eliminate consideration of unrelated projects.

1.4 The revised process should be tested and evaluated prior to implementation to ensure that it allows WIFA to continue operating without State General Fund appropriations. Following implementation, WIFA should continue to monitor the interest and fee revenues received under the new interest rate determination process to ensure it remains self-sufficient.

SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2954, the Legislature should consider the following factors in determining whether the Water Infrastructure Finance Authority (WIFA) should be continued or terminated.

Auditors' analysis of WIFA's performance related to these factors found that it should update two areas of its information technology policies and procedures (see Sunset Factor 2, pages 20 through 22), and more fully comply with the State's open meeting law (see Sunset Factor 5, page 24).

Sunset factor analysis

1. **The objective and purpose in establishing WIFA and the extent to which the objective and purpose are met by private enterprises in other states.**

The Legislature established WIFA in 1997. WIFA is a separate legal entity of the State, authorized to provide financial assistance related to the construction, rehabilitation, and improvement of drinking water, wastewater, wastewater reclamation, and other water quality facility projects. WIFA's mission is to maintain and improve water quality in Arizona by providing financial assistance and technical assistance for basic water infrastructure. In support of its mission, WIFA provides financial assistance to Arizona's communities through three main programs. WIFA is able to provide financial assistance through these programs by applying for and accepting federal grant monies; issuing revenue bonds; and utilizing borrower principal, interest, and fee revenue generated from project loan repayments. The three programs are as follows:

- **Clean Water State Revolving Fund program**—As Arizona's designated administrator of this federal program, WIFA uses the federal grant monies it receives, loan principal, interest, and fees, and bond proceeds solely to provide below-market interest rate loans to political subdivisions and Indian tribes.[1] Monies awarded to eligible projects are used to plan, design, construct, acquire, restore, or rebuild wastewater treatment facilities.

- **Drinking Water State Revolving Fund program**—As Arizona's designated administrator of this federal program, federal grant monies received by WIFA, loan principal, interest, and fees, and bond proceeds are used solely to provide below-market interest rate loans to publicly and privately owned community drinking water systems and nonprofit, noncommunity drinking water systems.[2] Monies awarded to eligible projects are used to plan, design, construct, acquire, restore, or rebuild drinking water facilities. A portion of the grant monies WIFA receives also provide for set-aside funds, which are passed through to the Arizona Department of Environmental Quality to administer three drinking water programs;

1 A.R.S. §49-1201(10) defines a political subdivision as "a county, city, town, or special taxing district authorized by law to construct wastewater treatment facilities, drinking water facilities or nonpoint source projects."

2 The U.S. Environmental Protection Agency defines a community water system as "a water system which supplies drinking water to 25 or more of the same people year-round in their residences" and a noncommunity water system as "a water system which supplies water to 25 or more of the same people at least 6 months per year in places other than their residences, e.g., schools, factories, office buildings, hospitals."

specifically, the Wellhead Protection program, the Public Water System Supervision program, and the Capacity Development program.[1]

- **Technical Assistance program—**WIFA offers Planning and Design Assistance grants to assist eligible wastewater and drinking water systems to prepare for project construction. Funding for this program is provided through the two revolving fund programs. The purpose of this program is to help prepare water and wastewater facilities for future infrastructure project construction. Through this program, WIFA provides grant funding of no more than 60 percent of the total costs for planning and design workup to a maximum award of $35,000.

Auditors surveyed eight western states and did not identify any states that met the objective and purpose of WIFA through private enterprises.[2]

2. The extent to which WIFA has met its statutory objective and purpose and the efficiency with which it has operated.

WIFA has generally met its statutory objective and purpose to provide at or below-market financial assistance related to the construction, rehabilitation, and improvement of drinking water, wastewater, wastewater reclamation, and other water quality facility projects. Some examples of where WIFA is efficiently meetings its objective and purpose include:

- **Improved efficiencies in scoring, ranking, and prioritizing project applications—**WIFA implemented a database system in 2007 to track and store all financial and managerial activity regarding project loans and grants in order to increase its loan and grant-tracking efficiency. In addition, in 2008, WIFA developed and implemented a standardized Internet-based application system to replace paper applications and create additional efficiencies in the project scoring and ranking process. The Internet-based application system is programmed with WIFA's scoring criteria and automatically scores and ranks each project for inclusion on the Project Priority Lists, which are prioritized lists of all clean water and drinking water projects seeking funding, thereby reducing the chance of scoring errors. Both the Internet-based application system and the project documentation database system are linked in order to transfer appropriate project data from the application system to the documentation database.

- **Provides at or below-market financial assistance to all eligible applicants—**WIFA accepts applications for financial assistance from water systems throughout the State and offers all approved borrowers at or below-market interest rate loans for 100 percent of eligible project costs.

[1] Set-aside funds are defined as federal grant monies received that are allotted for purposes other than providing at or below-market interest rate loans and grants.

[2] Auditors surveyed eight western states' water infrastructure entities, specifically, California, Colorado, Idaho, Nevada, New Mexico, Texas, Utah, and Wyoming.

WIFA provides a 5 to 30 percent discount on the tax-exempt AAA municipal bond rate for governmental entities and the prevailing prime rate plus 2 percent for nongovernmental entities.[1] The percentage of the discount is based on a variety of factors specific to the project and community it serves, as well as a project's placement on the Project Priority Lists. Auditors examined a total of 30 projects funded during fiscal years 2010 through 2012 and determined that WIFA met the state and federal requirements to provide below-market interest rates in each case. WIFA has also developed programs to assist disadvantaged communities and very small drinking water systems.

However, the audit also identified the following areas for improvement:

- **WIFA should modify its interest rate determination process to ensure equitable treatment among projects—**Although WIFA's process for determining interest rates complies with state and federal requirements, auditors identified the potential for inequitable interest rate determination, which may reduce cost savings for some borrowers. WIFA determines a project's discounted interest rate using project-specific factors and by the ranking of a project compared to other, unrelated projects. Auditors identified one instance where WIFA's interest rate determination process resulted in reduced cost savings for one borrower. Additionally, in a survey of 19 states, auditors determined that WIFA was unique in its ranking of projects as a factor in determining interest rates.[2]

  Similar to other states, WIFA should revise its interest rate determination process so that interest rates are not dependent on a project's ranking on the priority list. The revised process should be tested and evaluated prior to implementation to ensure that it allows WIFA to continue operating without State General Fund appropriations. For additional information, see Finding 1, pages 11 through 18.

- **WIFA should update two areas of its Information Technology (IT) policies and procedures—**Although WIFA's IT procedures appear to be well-managed in practice, it lacks documented policies and procedures for governing access to its computer systems. In addition, although WIFA has documented policies and procedures governing changes to its computer systems, those policies and procedures have not been reviewed and approved by appropriate personnel. These deficiencies increase the risk that IT procedures could be performed inconsistently, especially if WIFA staff change. Auditors did not identify a significant threat to WIFA's computer systems; however, to ensure a properly managed and monitored IT system, WIFA should (1) document, review, and approve policies and procedures

1 The prime rate is used to establish interest rates on short-term lending. Because WIFA's loans are usually for 20 years, WIFA adds 2 percent to the prime rate to more accurately reflect market rates for long-term loans.

2 Auditors surveyed California, Colorado, Connecticut, Idaho, Indiana, Iowa, Kansas, Massachusetts, Minnesota, Nevada, New Jersey, New Mexico, New York, Oklahoma, Rhode Island, Texas, Utah, Virginia, and Wyoming.

governing access to its computer systems, and (2) review and approve policies and procedures governing changes to its computer systems.

3. **The extent to which WIFA serves the entire State rather than specific interests.**

WIFA is responsible for providing at or below-market interest rate loans and grants to local and rural communities and Indian tribes for drinking water, wastewater, wastewater reclamation, and other water quality facility infrastructure projects. WIFA demonstrates a commitment to serving and informing the entire State through the composition of the Board of Directors and participation in various organizations and conferences. To accomplish this, A.R.S. §49-1202 requires that WIFA be governed by a 12-member Board of Directors. Further, A.R.S. §49-1202 also requires the Governor to appoint 7 board members representing large and small communities, sanitation districts, public water systems, and Indian tribes. The remaining 5 board members set forth in statute represent state agencies.

WIFA's loan and grant programs are available to applicants across the State. The audit found that counties, cities, and towns throughout the State have applied and been approved for financial assistance through the Clean Water and Drinking Water State Revolving Fund programs (see Figure 1, page 5).

In addition, WIFA provides the public with information through other means to ensure that it serves all Arizona citizens. Specifically:

- **Conferences—**WIFA participates in conferences throughout the State held by organizations such as the Rural Water Association, the Arizona Water Association, and the Government Finance Officers Association of Arizona by handing out pamphlets and presenting information on how WIFA provides below-market interest rate loans, technical assistance grants, and principal forgiveness for eligible applicants.[1]

- **Partnership with the Arizona Department of Environmental Quality—**WIFA maintains a high level of coordination with the Arizona Department of Environmental Quality by meeting on a quarterly basis to discuss and share information regarding ways to better serve Arizona's rural communities.

- **Partnership with the Rural Water Infrastructure Committee (RWIC) and Annual Funding Forum—**WIFA partners with the RWIC and is responsible for providing administrative support and leadership. The RWIC's mission is to serve as a "One Stop" funding source and technical assistance resource for Arizona's rural communities. The RWIC seeks to create a sustainable organization of funders and technical assistance providers who partner to

[1] WIFA provides forgivable principal projects identified as critical and as part of its Disadvantaged Community program. In fiscal year 2012, WIFA forgave $5.5 million in principal (see Table 2, page 9).

continue to meet the needs of the various water and wastewater systems throughout Arizona. The RWIC is composed of representatives from the following federal and state funding agencies and technical assistance providers: the Water Infrastructure Finance Authority, the Arizona Commerce Authority, the U.S. Department of Agriculture Rural Development, the Rural Community Assistance Corporation, the Border Environmental Cooperation Commission, the North American Development Bank, the Rural Water Association of Arizona, the Arizona Water Association, the Inter Tribal Council of Arizona Tribal Water Systems, and the U.S. Department of the Interior/Bureau of Reclamation. Each year, an annual funding forum is held that allows each member of the RWIC to provide a brief overview to the public of the financial assistance available to rural communities. The forum also allows the public to meet with members of the RWIC to address any questions or concerns.

- **Small Community Water Infrastructure Exchange Quarterly Teleconference—**WIFA participates in the Small Community Water Infrastructure Exchange, a network of public and nonprofit water funding officials. The Exchange holds quarterly teleconferences to allow participants to discuss and gather ideas regarding ways to assist small and/or rural communities with their water infrastructure needs.

- **Monthly Multi-Agency Tribal Infrastructure Collaborative Meeting—**The Multi-Agency Tribal Infrastructure Collaborative (MATIC) is a group of representatives from various funding agencies that was created to increase awareness and promote coordinated delivery of infrastructure programs and services to tribal communities. WIFA staff participate in the monthly meetings, and also have presented and met with tribal representatives at MATIC's Tribal Resources Forum.

- **Partnership with the Arizona Councils of Governments—**Arizona Councils of Governments are regional councils that serve citizen and local government needs that cross city, town, and county boundaries. WIFA presents funding opportunities at the regional council meetings and is able to speak directly with individual city and town representatives who are interested in potential funding.

- **Planning and Design Assistance Grant Program—**WIFA provides financial assistance to help prepare water and wastewater facilities for future infrastructure project construction. Awards are typically made to facilities with limited resources that need assistance in completing the planning and design phase of an infrastructure project. For instance, grant monies may be used to cover the costs of feasibility studies, district formation, capital improvement plans, preliminary engineering reports, and environmental assessments. Grants are generally awarded at no more than 60 percent of the total costs for planning and design and are capped at $35,000 for each grant. However, WIFA provides 100 percent of the total cost for projects that qualify for the Green Project Reserve program. Although funding is not limited to certain communities, the Planning and Design Assistance Grant Program is primarily targeted toward smaller and/or rural communities.

4. **The extent to which rules adopted by WIFA are consistent with the legislative mandate.**

   General Counsel for the Auditor General has analyzed WIFA's rulemaking statutes and believes that WIFA has adopted rules consistent with the legislative mandate.

5. **The extent to which WIFA has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public.**

   The audit found that WIFA informs the public of proposed rules through Notices of Proposed Rulemaking filed with the Secretary of State's Office and published in the Arizona Administrative Register. For example, WIFA filed a Notice of Proposed Rulemaking in May 2010 and held a public meeting in June 2010 to obtain public comment and input regarding its most recent rules revisions. The final updated rules were posted on WIFA's Web site and published in the Arizona Administrative Register in November 2010.

   The audit also found that WIFA generally complied with the State's open meeting law for its August 2012 board meeting. Auditors found that written board meeting minutes were available for the public within 3 working days as required by A.R.S. §38-431.01(D). Auditors observed that WIFA posted notice of the August 2012 board meeting on its Web site and in the Arizona Department of Environmental Quality lobby more than 24 hours before the meeting; however, auditors found that in August 2012 the WIFA Web site did not state where all physical and electronic public meeting notices would be posted as required by A.R.S. §38-431.02(A)(1)(a). WIFA updated the Web site to include a statement in September 2012.

   In addition, WIFA uses its Web site to inform the public. For example, its Web site includes Financial Assistance Intended Use Plans and Project Priority Lists, Technical Assistance Planning and Design Assistance Grant Awards, and Annual Reports. In addition, its Web site includes an overview of each program offered, the loan application process, governmental and nongovernmental contract packets, a link to the E-Application System login, and its statutes and rules.

6. **The extent to which WIFA has been able to investigate and resolve complaints that are within its jurisdiction.**

   WIFA is not a regulatory agency and does not have authority to investigate and resolve complaints. According to WIFA, it has never received a complaint.

7. **The extent to which the Attorney General or any other applicable entity of state government has the authority to prosecute actions under the enabling legislation.**

   WIFA's enabling legislation provides the Attorney General authority to assist WIFA with certain aspects of its operations. Specifically, A.R.S. §§49-1226, 49-1246, and 49-1276 give the Attorney General's Office the authority to assist WIFA in enforcing financial assistance agreement provisions and collecting delinquent loan payments as necessary.

8. **The extent to which WIFA has addressed deficiencies in its enabling statutes that prevent it from fulfilling its statutory mandate.**

   According to WIFA, it has not identified any deficiencies in its enabling statutes that prevent it from fulfilling its statutory mandate. However, statutory changes affecting the agency were enacted in calendar years 2007 and 2009:

   - Laws 2007, Ch. 226, §11, amended A.R.S. Title 49, Ch. 8, by adding article 3, which established the Water Supply Development Revolving Fund to be administered by WIFA pursuant to A.R.S. §49-1271 et seq. When funded, the Water Supply Development Revolving Fund provides loans to water providers for water supply development, refinances debt obligations of water providers, and provides financial assistance to water providers to purchase insurance for local bond obligations. However, since its establishment, this fund has received no legislative appropriations.

   - Laws 2009, Ch. 113, §10, amended A.R.S. §49-1202(B)(7-9) to increase the population size of counties that are represented by three Governor-appointed members of the Board of Directors to be more in line with new population estimates.

9. **The extent to which changes are necessary in the laws of WIFA to adequately comply with the factors in the sunset law.**

   The audit did not identify any needed changes to WIFA's statutes.

10. **The extent to which the termination of WIFA would significantly affect the public's health, safety, or welfare.**

    Terminating WIFA would significantly harm the public's health, safety, and welfare since WIFA provides below-market financial assistance to local and rural communities, private water systems, and Indian tribes for planning, designing, constructing, acquiring, restoring, or rebuilding drinking water, wastewater, wastewater reclamation, and other water quality facility infrastructure projects to help ensure clean and safe water for the public. WIFA has been awarded a AAA credit rating by national credit rating agencies, which in turn reduces WIFA's cost of borrowing, allowing WIFA to offer below-market financial assistance to eligible applicants. Without transferring its functions to another agency, low-cost financial assistance may not be readily available for those Arizona communities and water systems seeking financial assistance.

WIFA's functions could be transferred to another agency since federal regulations require that the State designate an administrator for the Clean Water and Drinking Water State Revolving Funds.[1] However, provisions outlined in A.R.S. §41-3014.06 specify that the Legislature cannot terminate WIFA if it has a contractual obligation to the United States or any United States agency or any outstanding debts, obligations, or guarantees. WIFA currently has a written agreement with the U.S. Environmental Protection Agency (EPA) for the administration of the Clean Water State Revolving Fund program and the Drinking Water State Revolving Fund program. Additionally, WIFA has approximately $998 million in outstanding bond debt as of June 30, 2012.[2] If the Legislature terminated WIFA, certain provisions would have to be made to transfer the operating agreement with the EPA to another state agency and pay or retire WIFA's bond debt.

11. **The extent to which the level of regulation exercised by WIFA compares to other states and is appropriate and whether less or more stringent levels of regulation would be appropriate.**

    WIFA is not a regulatory agency; therefore, this factor does not apply.

12. **The extent to which WIFA has used private contractors in the performance of its duties as compared to other states and how more effective use of private contractors could be accomplished.**

    Like some of the eight western states auditors surveyed, WIFA uses private contractors for a variety of functions.[3] Specifically:

    - **Bond and financial services—**Like WIFA, four of the states surveyed contract for some form of bond or financial services. The State of Colorado issues bonds to help fund projects; its contracted services include bond and arbitrage advisors. In two states, the contracted services were limited to financial statement audits. WIFA contracts for these services as well as general financial advising, including municipal bond rates used to determine interest rates charged to applicants.

    - **Information technology services—**Two of eight states surveyed reported that they contract for information technology services. Like Arizona, both

[1] 40 CFR §35.3110(c)(d) and 40 CFR §35.3510(b)

[2] WIFA Audited Financial Statements for the Year Ended June 30, 2012.

[3] Auditors surveyed eight western states' water infrastructure entities, specifically, California, Colorado, Idaho, Nevada, New Mexico, Texas, Utah, and Wyoming.

California and New Mexico contract with Northbridge Computing Services for support for the Loan and Grants Tracking System, a project documentation database system used to track the financial and managerial activity regarding project loans and grants.

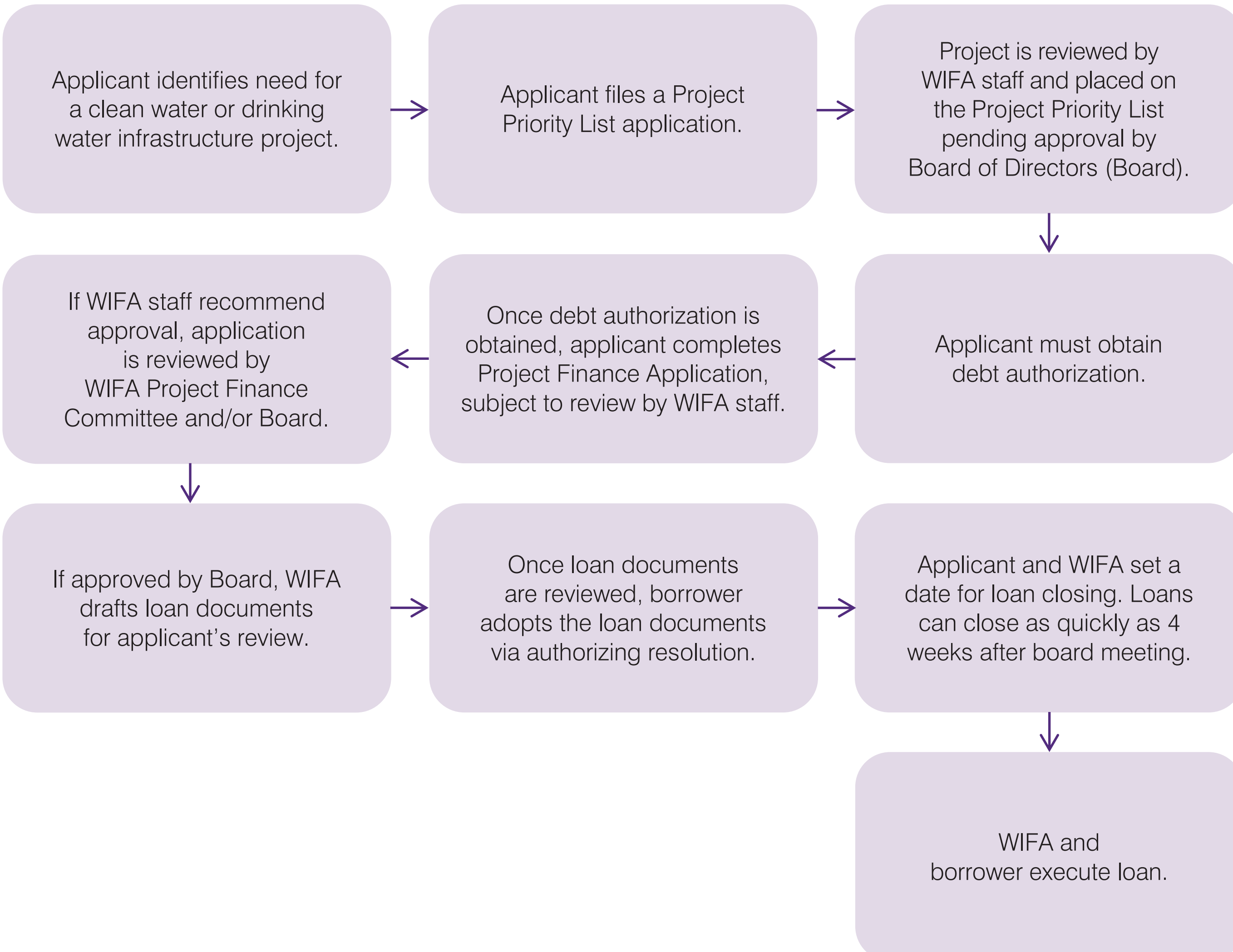
- **Marketing services—**Two of the eight states surveyed reported that they contract for marketing services directed at informing their state about the opportunities available through the clean water and drinking water state revolving funds. WIFA contracts out for a similar function. In fiscal year 2012, WIFA used a contractor to develop a presentation and marketing brochures WIFA staff use when making presentations at various locations around Arizona. (See response to Sunset Factor 3, pages 21 through 23, for more information regarding presentations.)

- **Technical assistance for borrowers—**Similar to WIFA, five of the eight states reported that they use private contractors for technical assistance for borrowers. The assistance includes a variety of activities, such as completing needs surveys or assisting with the development or monitoring of water infrastructure projects. WIFA also contracts for similar assistance. For example, WIFA uses contractors to complete an annual rate survey that provides information to both borrowers and WIFA about the rates charged for drinking water and wastewater services in Arizona, information used in completing and reviewing project applications. In addition, WIFA contracts for a needs survey required by the U.S. Environmental Protection Agency. Every 4 years, WIFA is required to determine drinking water and wastewater infrastructure needs going forward. In Texas, the needs survey is contracted out to the Texas Commission on Environmental Quality, paid for with federal grant funding.

The audit did not identify any additional areas where WIFA should consider using private contractors.

APPENDIX A WIFA loan process

Figure 2: Summary of WIFA's loan application and approval process



Source: Auditor General staff summary of the WIFA loan application process.

APPENDIX B

Clean Water Revolving Fund Project Priority List

Table 6: Clean Water Revolving Fund Project Priority List (PPL) Fiscal year 2013

PPL rank[1]	Applicant	Population	County	Project name	Project number	Amount requested	Subsidy rate[2]
1	Pinewood Sanitary District[3]	6,000	Coconino	Expansion of sewer line	002 2013	$2,500,000	80%
2	Ash Fork Sanitary District[3]	650	Yavapai	Centralized wastewater collection/treatment system	004 2013	5,500,000	80
3	Town of Springerville[3]	1,900	Apache	Sewer system rehabilitation	003 2013	600,000	80
4	Town of Gila Bend	1,980	Maricopa	Wastewater treatment plant	007 2013	4,609,500	80
5	Town of Buckeye	25,000	Maricopa	Reclaimed water system improvements	006 2013	4,500,000	80
6	Big Park Domestic Wastewater Improvement District	2,500	Yavapai	Big Park Domestic Wastewater Improvement District, 2012	005 2013	5,000,000	85
7	Town of Buckeye	25,000	Maricopa	Industrial park lift station	008 2013	1,400,000	80
8	Town of Buckeye	25,000	Maricopa	Apache Road sewer line extensions	009 2013	600,000	80

1 PPL rank represents the order in which projects are prioritized and is based on total priority value score. See Introduction, pages 3 through 4, for more information on priority value score.

2 The subsidy rate is the discount rate determined by WIFA to reduce borrowers' interest rate. See Finding 1, pages 11 through 18, for detailed information on WIFA's use of the subsidy rate.

3 Designated as disadvantaged communities. See Introduction, pages 2 through 3, for more information on disadvantaged communities.

Source: Auditor General staff summary of the Water Infrastructure Finance Authority: SFY 2013 Clean Water Intended Use Plan.

APPENDIX C

Drinking Water Revolving Fund Project Priority List

Table 7: Drinking Water Revolving Fund Project Priority List (PPL) Fiscal year 2013

PPL rank[1]	Applicant	Population	County	Project name	Project number	Amount requested	Subsidy rate[2]
1	Cienega Water Company[3]	140	La Paz	Fluoride treatment and system upgrades	007 2013	$ 50,000	80%
2	Sulger Water Company #2[3]	50	Cochise	Well, tank and disinfection system improvements	022 2013	56,000	80
3	Sunland Water Company[3]	170	Pinal	New well and blending plan for arsenic compliance	008 2013	125,000	80
4	Clear Springs Utility Company[3]	1,180	Cochise	Clear Springs utility consolidation and upgrades	009 2013	511,000	75
5	Rim Trail Domestic Water Improvement District[3]	25	Gila	Rim Trail surface and groundwater sustainability upgrade	004 2013	250,000	80
6	Sabrosa Water Company	100	Maricopa	Arsenic treatment and zorrillo well drilling	021 2013	149,252	80
7	East Slope Water Company	2,877	Cochise	System improvements	010 2013	3,000,000	85
8	Litchfield Park Service Company	39,000	Maricopa	Airline reservoir solar project	017 2013	1,170,000	85
9	Litchfield Park Service Company	39,000	Maricopa	LPSCO recharge wells	018 2013	1,755,000	85
10	Town of Payson	15,500	Gila	Payson Cragin project phase II	006 2013	6,250,000	80
11	Town of Clarkdale	4,097	Yavapai	Twin 5s water main replacement	002 2013	1,800,000	80
12	Livco Water Company	850	Apache	Refurbish exterior of water tank	019 2013	30,000	80
13	Town of Springerville	1,900	Apache	Water system improvements	016 2013	1,100,000	80
14	Sonoita Valley Water Company	327	Santa Cruz	System consolidation	013 2013	228,000	85
15	Town of Clarkdale	4,026	Yavapai	Water System Security Improvements	003 2013	68,000	80
16	Sandario Water Company	1,000	Pima	Capital Improvements (Storage, Pipe Replacement)	014 2013	780,000	85
17	Payson Water Company, Inc	1,148	Gila	Mesa del Caballo supplemental water supply project	005 2013	1,150,000	85
18	Southland Utilities Company, Inc.	1,958	Cochise	System improvements	020 2013	1,045,941	85
19	Town of Buckeye	25,000	Maricopa	Sundance to historic town water connection	001 2013	5,500,000	85

1 PPL rank represents the order in which projects are prioritized and is based on total priority value score. See Introduction, pages 3 through 4, for more information on priority value score.

2 The subsidy rate is the discount rate determined by WIFA to reduce borrowers' interest rate. See Finding 1, pages 11 through 18, for detailed information on WIFA's use of the subsidy rate.

3 Designated as disadvantaged communities. See Introduction, pages 2 through 3, for more information on disadvantaged communities.

Source: Auditor General staff summary of the Water Infrastructure Finance Authority: SFY 2013 Drinking Water Intended Use Plan.

APPENDIX D

This appendix provides information on the methods auditors used to meet the audit objectives.

This performance audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The Auditor General and staff express appreciation to the Water Infrastructure Finance Authority (WIFA) Board of Directors, Executive Director, and staff members for their cooperation and assistance throughout the audit.

Methodology

Auditors used various methods to study the issues addressed in this report. Auditors attended a board meeting, interviewed WIFA officials and staff, and reviewed documents, including policies and procedures and organizational charts. Auditors also reviewed federal laws and regulations, federal grant awards, state statutes, and various reports completed by WIFA. Additionally, auditors reviewed Web sites and spoke with officials in eight other states to identify common practices for administering programs like WIFA's.[1]

Auditors also used the following specific methods to address the audit's objectives:

- To determine the propriety of WIFA's loan portfolio, auditors selected a sample of 30 projects, tracing and agreeing information from the borrowers' applications and signed loan documents to WIFA's Loan and Grants Tracking System. In addition, auditors performed an in-depth analysis of four of those projects by rescoring each project's Project Priority List (PPL) score and recalculating the resulting subsidy and combined interest and fee rate.

- To determine the length of time projects were on the PPL, auditors identified all projects included on the initial fiscal year 2011 clean water and drinking water PPLs. Those projects were tracked on the subsequent PPLs through the beginning of fiscal year 2013. Auditors confirmed results with WIFA staff to ensure the accuracy of auditors' conclusions.

- To identify projects that qualified for special programs, auditors examined the clean water and drinking water PPLs included in the fiscal year 2013 Intended Use Plan and obtained designations from WIFA staff.

- To identify similar projects that received different subsidy rates, auditors obtained a download of projects approved during fiscal years 2009 through 2012 and examined the respective Local Fiscal Capacity and PPL scores, the primary determinants of a project's subsidy rate. For projects that received identical Local Fiscal Capacity and PPL scores, auditors compared the respective subsidy rates to determine if any of those projects received different subsidies. Borrowers that were designated as disadvantaged communities and very small drinking water systems were excluded from the analysis.

[1] Auditors interviewed officials in California, Colorado, Idaho, Nevada, New Mexico, Texas, Utah, and Wyoming.

- To determine the potential increase in interest and fee payments, as discussed on page 16, auditors used WIFA's spreadsheets and amortization tables that tracked the loan award and subsequent payment schedule. The total expected interest and fee payments were calculated using the actual subsidy rate and resulting combined interest and fee rate, then recalculated using the revised subsidy rate and resulting combined interest and fee rate.

- To compare WIFA's method for determining interest rates charged on loans for the clean water and drinking water programs to methods used in other states, auditors interviewed officials from 19 states, specifically inquiring about interest rate determination.

- To identify the number of clean water and drinking water projects and dollars awarded to public and private entities by county, auditors worked with WIFA staff to classify each loan awarded during fiscal years 2010 through 2012 by county.

- To assess the effectiveness of WIFA's information technology (IT) practices, auditors researched applicable IT industry standards and recognized best practices; interviewed staff responsible for WIFA's IT practices; and reviewed documentation detailing the responsibility of WIFA personnel, including policies and procedures related to network security, database management, and individual employee computer use.

- Auditors also used some additional methods to obtain information used throughout the report, including the Introduction and Sunset Factors. Specifically, auditors observed the June 20, 2012, board meeting; reviewed the board meeting notices and agendas; reviewed board meeting minutes for meetings from fiscal years 2009 through 2012; and reviewed various policies and procedures establishing WIFA's administration of its programs. Additionally, auditors gathered and analyzed information from WIFA reports, its Web site, and federal grant awards.

- Auditors' work on internal controls included a review of policies and procedures of the project application process through the execution of loans through the processing of loan payments. Additional work was performed on the interest rate determination process. Auditors' conclusions on internal controls are reported in Finding 1 of the report.

AGENCY RESPONSE

JANICE K. BREWER
Governor

SANDRA L. SUTTON
Executive Director

Water Infrastructure Finance Authority of Arizona
Arizona's water and wastewater funding source
1110 W. Washington Street, Suite 290, Phoenix, Arizona 85007 | azwifa.gov | (602) 364-1310

August 27, 2013

Deborah Davenport
Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Ms. Davenport:

Below please find the Water Infrastructure Finance Authority (WIFA) of Arizona's response to the revised preliminary report draft of the performance audit and sunset review.

Agency Response to Performance Audit Finding

Finding 1: *"WIFA provides below-market interest rate loans, but its process could reduce cost savings for some borrowers."*

> **Recommendation 1.1:** *"To ensure equitable treatment among projects when setting loan interest rates, WIFA should develop an interest rate determination process, defined in its rules, that calculates the combined interest and fee rate independent of other projects. It should be determined as a fixed discount from the current Municipal Market Data Index or prime rate."*
>
> **Response:** The finding of the Auditor General is agreed to and a different method of dealing with the finding will be implemented. This recommendation, along with Recommendation 1.2, would require WIFA to move from its current one-step automated process to a two-step process. To establish a process that sets the combined interest and fee rate independent of other projects, WIFA will assign the subsidy (discount) based solely on a project's local fiscal capacity and total project points. This will eliminate the comparison of unrelated projects, thereby addressing the intent of the Auditor General recommendation. This approach will also address Recommendation 1.2. WIFA will implement the new process at the start of state fiscal year 2015.

Recommendation 1.2: *"WIFA could further subsidize interest rates depending on the merits of the project. For instance, lower rates can be awarded for projects that:*

a. Serve communities whose median household income is lower than the state median household income;
b. Specifically address deficiencies identified by the Arizona Department of Environmental Quality;
c. Contain energy-efficient or environmentally innovative aspects; and
d. Assist smaller communities."

Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented. WIFA's current scoring methodology does subsidize interest rates based on the merits of a project. When WIFA implements its new method for scoring projects as described in Response 1.1 above, communities will receive the subsidization independent of other projects as recommended. WIFA will implement the new process at the start of state fiscal year 2015.

Recommendation 1.3: *"WIFA should modify its Disadvantaged Community designation to eliminate consideration of unrelated projects."*

Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented. WIFA will modify its Disadvantaged Community Designation policy to assign the designation based solely on a project's local fiscal capacity points, eliminating the consideration of unrelated projects. WIFA will implement the new process at the start of state fiscal year 2015.

Recommendation 1.4: *"The revised process should be tested and evaluated prior to implementation to ensure that it allows WIFA to continue operating without State General Fund appropriations. Following implementation, WIFA should continue to monitor the interest and fee revenues received under the new interest rate determination process to ensure it remains self-sufficient."*

Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented. WIFA will test and evaluate the revised process prior to implementation. Implementation is planned for the start of state fiscal year 2015.

Agency Response to Sunset Factor Analysis Areas for Improvement:

Area for Improvement 1: *"WIFA should update two areas of IT policies and procedures for governing access to its computer systems."*

Response: The recommendation of the Auditor General is agreed to and the audit recommendation will be implemented. The WIFA Board of Directors has approved a policy that governs staff access to WIFA computer systems. Documentation of procedures is in process and will be completed by December 31, 2013.

Area for Improvement 2: *The WIFA website did not state where all physical and electronic public meeting notices would be posted as required by A.R.S. § 38-431.02(A)(1)(a).*

Response: The recommendation of the Auditor General is agreed to and the audit recommendation will be implemented. As noted in the revised preliminary report draft, WIFA updated its website to include the statement in September 2012.

The WIFA Board of Directors and staff appreciate the opportunity to respond to the audit findings and recommendations. Thank you for your consideration of WIFA's important role in Arizona.

Sincerely,

Sandra L. Sutton
Executive Director

cc: Water Infrastructure Finance Authority Board of Directors

Performance Audit Division reports issued within the last 24 months

11-07 Department of Corrections—Oversight of Security Operations
11-08 Department of Corrections—Sunset Factors
11-09 Arizona Department of Veterans' Services—Veterans' Donations and Military Family Relief Funds
11-10 Arizona Department of Veterans' Services and Arizona Veterans' Service Advisory Commission—Sunset Factors
11-11 Arizona Board of Regents—Tuition Setting for Arizona Universities
11-12 Arizona Board of Regents—Sunset Factors
11-13 Department of Fire, Building and Life Safety
11-14 Arizona Game and Fish Commission Heritage Fund
12-01 Arizona Health Care Cost Containment System—Coordination of Benefits
12-02 Arizona Health Care Cost Containment System—Medicaid Eligibility Determination
12-03 Arizona Board of Behavioral Health Examiners
12-04 Arizona State Parks Board
12-05 Arizona State Schools for the Deaf and the Blind
12-06 Arizona Health Care Cost Containment System—Medicaid Fraud and Abuse Prevention, Detection, Investigation, and Recovery Processes
12-07 Arizona Health Care Cost Containment System—Sunset Factors
13-01 Department of Environmental Quality—Compliance Management
13-02 Arizona Board of Appraisal
13-03 Arizona State Board of Physical Therapy
13-04 Registrar of Contractors
13-05 Arizona Department of Financial Institutions
13-06 Department of Environmental Quality—Underground Storage Tanks Financial Responsibility
13-07 Arizona State Board of Pharmacy

Future Performance Audit Division reports

Arizona State Board of Cosmetology