



A REPORT  
TO THE  
ARIZONA LEGISLATURE

Performance Audit Division

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Performance Audit

# Water Infrastructure Finance Authority

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APRIL • 2003  
REPORT NO. 03 – 03



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**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.

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DEBRA K. DAVENPORT, CPA  
AUDITOR GENERAL

STATE OF ARIZONA  
OFFICE OF THE  
**AUDITOR GENERAL**

WILLIAM THOMSON  
DEPUTY AUDITOR GENERAL

April 24, 2003

Members of the Arizona Legislature

The Honorable Janet Napolitano, Governor

Mr. Greg Swartz, Executive Director  
Water Infrastructure Finance Authority of Arizona

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Water Infrastructure Finance Authority. This report is in response to a May 14, 2002, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the Sunset review set forth in A.R.S. §41-2951 et seq. I am also transmitting with this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Water Infrastructure Finance Authority agrees with the findings and plans to implement all of the recommendations.

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

This report will be released to the public on April 25, 2003.

Sincerely,

Debbie Davenport  
Auditor General

Enclosure

# PROGRAM FACT SHEET

## Water Infrastructure Finance Authority

### Services:

The Water Infrastructure Finance Authority (WIFA) finances drinking water and wastewater infrastructure projects for communities throughout Arizona. WIFA administers three main programs:

- **Clean Water Revolving Fund program**—Provides low-interest rate loans for the planning, engineering, constructing, upgrading, and/or equipping of publicly owned wastewater and water reclamation projects. For disadvantaged communities designated by WIFA, it may also provide hardship grants instead of loans.
- **Drinking Water Revolving Fund program**—Provides low-interest rate loans for the planning, engineering, constructing, upgrading, and/or equipping of public and private drinking water system facilities.
- **Technical Assistance Program**—Assists eligible wastewater and drinking water systems serving populations of 10,000 or fewer to prepare for project construction through pre-design and design grants.

### Mission:

“To maintain and improve water quality in Arizona by providing financial assistance and technical assistance for basic water infrastructure.”

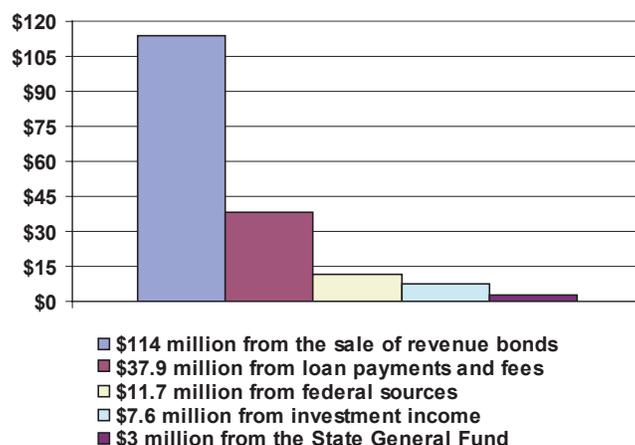
### Personnel:

A 12-member board of directors governs WIFA:

- Seven board members are appointed by the Governor and represent Native American tribes, municipalities, counties, sanitary districts, and public water systems. They serve 5-year staggered terms.
- Five board members represent state agencies. The Director of the Arizona Department of Environmental

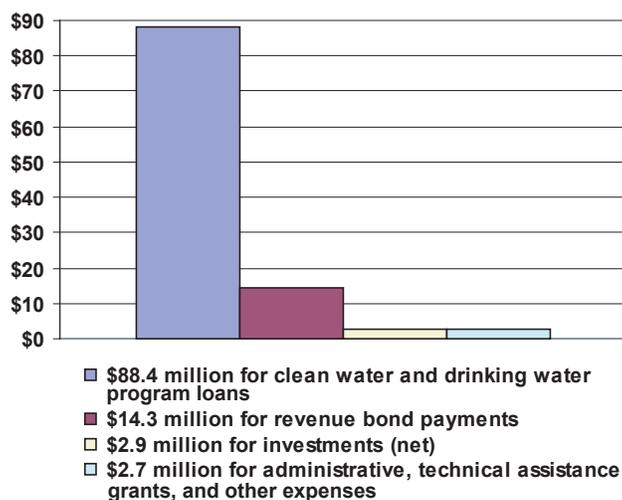
### WIFA funding sources:

**\$174.2 million (fiscal year 2002 actual)**



### WIFA funding uses:

**\$108.3 million (fiscal year 2002 actual)**



Quality serves as the board chairman. The other four state agencies represented on the board are the Arizona Corporation Commission, Department of Commerce, Department of Water Resources, and the Office of Treasurer.

As of January 2003, WIFA had 12 staff, including an executive director, controller, and finance director.

### Facilities and Equipment:

WIFA performs its duties in Phoenix at 1110 West Washington Street in the building being lease-purchased by the State. Its equipment includes typical office equipment such as furniture and computer equipment. WIFA also owns one vehicle.

### Program Goals (Fiscal Year 2003):

1. Award WIFA's resources in accordance with the needs of Arizona's citizens.
2. Maintain the fiscal integrity of WIFA's funds and assure continuous enhancement for future generations.
3. Facilitate access to and effectively deliver financial and technical assistance.
4. Coordinate with other funding sources, technical resources, and regulatory authorities.
5. Assume leadership role in water infrastructure finance.
6. Efficiently administer WIFA.
7. Facilitate and encourage board-of-director involvement in WIFA.

### Adequacy of performance measures:

The Water Infrastructure Finance Authority has established appropriate performance measures. For example, WIFA has established measures focusing on whether the wastewater and drinking water systems with the most need receive financial assistance, maintaining the revolving funds for the future, and facilitating communities' and systems' access to financial and technical assistance.

# SUMMARY

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The Office of the Auditor General has conducted a performance audit and Sunset review of the Water Infrastructure Finance Authority (WIFA) pursuant to a May 14, 2002, resolution of the Joint Legislative Audit Committee. The audit was conducted as part of the Sunset review set forth in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

WIFA finances projects related to building or improving drinking water, wastewater, or other water quality facilities. Through two revolving fund programs, WIFA provides low-interest rate loans to communities throughout Arizona. The Clean Water Revolving Fund program assists publicly owned wastewater systems, while the Drinking Water Revolving Fund program assists public and private drinking water systems. WIFA also provides grants from these two funds through the Technical Assistance Program. These grants assist eligible wastewater and drinking water systems serving populations of 10,000 or fewer with the pre-design and design of projects.

Funding for the two revolving fund programs comes from a combination of federal grants, revenue bond proceeds, loan repayments, and some State General Fund monies. For the 2003 funding cycle, WIFA has received 52 drinking water applications requesting over \$100 million in WIFA assistance and 51 clean water applications requesting nearly \$149 million in WIFA assistance as of December 18, 2002.<sup>1</sup> WIFA has also received 38 applications for its Technical Assistance Program. For the 2002 funding cycle, WIFA approved loans totaling more than \$114 million.

## Processes for reviewing and scoring applications need improvement (see pages 11 through 16)

WIFA has developed processes for prioritizing water infrastructure project applications, but could benefit from additional review steps in its processes to help ensure all eligible projects are accurately scored and the project interest rates appropriately determined. WIFA's processes are consistent with federal requirements and if correctly applied, can help ensure that projects are consistently and properly evaluated.

<sup>1</sup> The 2003 Drinking Water Revolving Fund and Clean Water Revolving Fund programs' funding cycle is calendar year 2003. While WIFA has an application deadline of October 1 prior to the funding cycle year, it will accept and review applications throughout the funding cycle.

Auditors reviewed WIFA's scoring data sheets for the 2002 and 2003 funding cycles and did not note any errors in the 2002 funding cycles scoring sheets, but found errors and omissions in the 2003 funding cycle scoring data sheets that resulted in more than 90 percent of the projects initially being inaccurately scored. Inaccurate scores have two potential effects. They can result in projects being placed too high or too low on the priority list and can also result in projects being charged an interest rate that is higher or lower than it should have been. Although WIFA corrected these errors and omissions after auditors pointed them out and before the Board approved the final priority list and funded any projects, the presence of so many errors signals a need to take steps so that similar errors are minimized in the future. Therefore, WIFA should develop additional procedures to help staff make accurate calculations and institute more reviews of completed work.

## Other pertinent information (see pages 17 through 24)

In response to legislative staff inquiries, auditors developed information on two national issues affecting Arizona's water systems—the federal formula for allocating monies from the Clean Water State Revolving Fund and the new federal arsenic standard. This report also contains information on concerns raised by WIFA's external auditor regarding WIFA's accounting and financial reporting management controls.

- **Federal Clean Water Allocation Formula**—The federal Clean Water State Revolving Fund, which provides monies to local water systems and communities for water and wastewater infrastructure projects, is funded through annual grants provided by the federal government. The federal Clean Water Act determines individual state funding levels. However, the current formula does not accurately reflect some states' needs, including Arizona's, and relative to other states of similar size and need, Arizona is receiving less money. As a result, WIFA has relied more heavily on other sources of funding, such as bonds, to meet Arizona's clean water infrastructure needs. If the formula were based on states' current needs, similar to the federal drinking water allocation formula, Arizona would receive a significant increase in its clean water allocation. According to WIFA's 2002 Wastewater, Water Reclamation and Storm Water Infrastructure Needs Survey, Arizona's federal clean water allocation could increase from approximately \$9 million a year to \$45 million annually. During the 107th Congressional Session (2002), congressional delegates introduced legislation to allocate clean water appropriations based on states' current needs, but the legislation was defeated. These efforts will continue.
- **New Federal Arsenic Standard**—In 2001, the U.S. Environmental Protection Agency established a new standard for arsenic in drinking water to reduce the health risks associated with arsenic. According to the Arizona Department of Environmental Quality (ADEQ), this new standard will potentially affect hundreds

of water systems in Arizona that are not in compliance, and bringing them into compliance will cost an estimated \$565 million to \$987 million. Compliance will be particularly burdensome for small water systems (those serving fewer than 10,000 people), because these systems may be unable to increase water rates sufficiently to cover compliance costs. According to the ADEQ, 287 of the 320 affected water systems in the State are small water systems, and it will cost these 287 systems an estimated total of \$142 million to comply. As a result, ADEQ has developed an Arsenic Master Plan to help the affected small water systems identify treatment options and cost estimates associated with compliance. ADEQ and WIFA plan to coordinate their efforts to help ensure that Arizona's drinking water systems comply with the new arsenic standard and are provided with adequate funding options.

- **WIFA's Financial Reporting and Internal Controls**—During the fiscal year 2001 and 2002 financial audits, WIFA's external auditors identified opportunities for WIFA to strengthen its internal controls over its accounting and financial reporting systems. Additionally, WIFA was unable to meet its statutory and Department of Administration deadlines for submitting its final fiscal year 2002 audited financial statements. While WIFA's executive director has acknowledged the need to improve WIFA's internal controls, and WIFA has hired additional staff and is in the process of implementing a new automated accounting system, WIFA's external auditors made additional recommendations for improvement.

## Sunset Factors (see pages 25 through 31)

As part of the Sunset review process, this audit makes the following additional recommendations:

- WIFA should renew its Clean Water Revolving Fund program agreement with the U.S. Environmental Protection Agency.
- WIFA should ensure that its board meeting minutes provide a detailed description of any disclosed conflict of interest and establish a special file for retaining board meeting minutes that disclose conflicts of interest.
- WIFA should file the required statement with the Secretary of State indicating where it will post public meeting notices.



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# INTRODUCTION & BACKGROUND

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The Office of the Auditor General has conducted a performance audit and Sunset review of the Water Infrastructure Finance Authority (WIFA) pursuant to a May 14, 2002, resolution of the Joint Legislative Audit Committee. The audit was conducted as part of the Sunset review set forth in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

## WIFA history and purpose

The Legislature established WIFA in 1997 as a separate legal entity of the State, authorized to provide financial assistance for projects related to the construction or improvement of drinking water, wastewater, or other water-quality facility projects. Prior to WIFA, the Wastewater Management Authority provided financial assistance for wastewater infrastructure projects to Arizona's communities. However, in response to federal legislation that created the Drinking Water State Revolving Fund program to assist states in their efforts to provide safe drinking water, the Legislature eliminated the Wastewater Management Authority and created WIFA.

In addition to being established as a separate legal entity of the State, WIFA is statutorily authorized to have a judicially noticed seal; to sue and be sued; to acquire, hold, and dispose of property; and to hire attorneys and consultants. Additionally, WIFA has statutory authority to issue bonds, which according to statute, are its own obligations and not those of the State.

Federal laws require each state to designate an administrator for the Clean Water State Revolving Fund and Drinking Water State Revolving Fund programs, but do not specify a particular type of agency or entity. While some states have established infrastructure financing authorities like Arizona has, generally, states' environmental and natural resources agencies administer the programs. Additionally, in some other states, water resources boards or health departments serve as the administrator.

WIFA finances wastewater and drinking water infrastructure.

## WIFA programs

WIFA administers three main programs:

- **Clean Water Revolving Fund program**—Congress created the Clean Water State Revolving Fund in 1987 as part of the federal Clean Water Act. This program provides financial assistance to publicly owned wastewater and water reclamation systems through low-interest loans for projects such as expansion of a wastewater treatment plant's capacity and septic system upgrades. Publicly owned wastewater and water reclamation systems can apply for loans to plan, engineer, construct, rehabilitate, upgrade, and/or equip wastewater treatment or water reclamation facilities. For example, in 2002, WIFA provided a \$6.5 million loan to the Town of Florence for a new wastewater treatment plant. For disadvantaged communities designated by WIFA, it may also provide hardship grants instead of loans.
- **Drinking Water Revolving Fund program**—This program is newer than the Clean Water Revolving Fund program, having been created by Congress in 1996 as part of the federal Safe Drinking Water Act. It provides low-interest loans for projects such as water storage facility improvement and rehabilitation of wells. Publicly and privately held drinking water systems can apply for loans to plan, engineer, construct, rehabilitate, upgrade, and/or equip drinking water facilities. For example, in 2002, WIFA provided a \$10 million loan to the City of Yuma for four projects, including the design and construction of additional water transmission-line capacity. Projects may also use fund monies to prevent pollutants from reaching sources of drinking water.
- **Technical Assistance Program**—The Technical Assistance Program assists eligible wastewater and drinking water systems to prepare for project construction. The program provides pre-design and design grants to eligible systems serving populations of 10,000 or fewer people and offers loans to all eligible systems. This program also funds policy projects, such as residential rate surveys and the State's Arsenic Master Plan, that benefit drinking water and wastewater systems state-wide. Funding for this program comes from the two revolving fund programs.

## Project activity

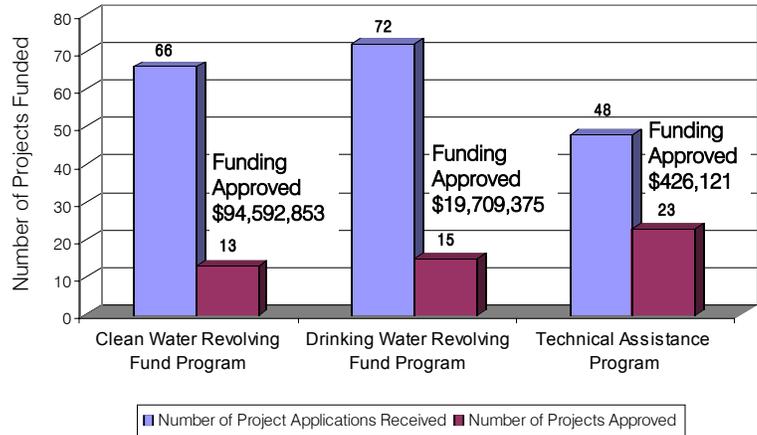
Since 2001, WIFA has received over 100 applications annually requesting financial assistance for water infrastructure projects. WIFA reviews and prioritizes each application received based on the problem addressed by the project, project benefits, and the community's economic and financial conditions. For the 2003 funding cycle,

Since 2001, WIFA has received over 100 assistance applications each year.

WIFA has received 52 drinking water applications requesting over \$100 million and 51 clean water applications requesting nearly \$149 million as of December 18, 2002.<sup>1</sup> WIFA has also received 38 applications for its Technical Assistance Program.

The number of projects to be funded from the priority list depends on the extent of available funding and the readiness of the project to proceed. For funded projects, WIFA disburses the loan monies throughout construction as the communities and water systems incur project costs. As illustrated in Figure 1, WIFA approved loans totaling more than \$114 million for 28 projects during the 2002 funding cycle. Further, it provided just over \$426,000 in technical assistance grants for 23 projects. For those projects that do not receive loans because the projects are not ready to proceed, the communities and water systems can reapply for assistance in the next funding cycle. Additionally, communities and water systems can seek funding from other sources, including the U.S. Department of Agriculture—Rural Utilities Service, and the North American Free Trade Agreement’s (NAFTA) Border Environment Cooperation Commission.

**Figure 1** Number of Project Applications Received and Approved, and Funding Provided To Approved Projects Funding Cycle 2002<sup>1</sup>



<sup>1</sup> The 2002 funding cycle for the Clean Water Revolving Fund and the Drinking Water Revolving Fund programs is the calendar year. The 2002 funding cycle for the Technical Assistance Program began on July 1, 2001, and ended on June 30, 2002.

Source: Auditor General staff analysis of WIFA’s Funding Cycle 2002 Drinking Water Revolving Fund Priority List revised in February 2002, WIFA’s Funding Cycle 2002 Clean Water Revolving Fund Priority List revised in February 2002, the *Technical Assistance Intended Use Plan Funding Cycle 2002*, and other data provided by the Water Infrastructure Finance Authority.

Since 1989, WIFA and its predecessor, the Wastewater Management Authority, have either loaned or granted hundreds of millions of dollars to communities and water systems for projects. According to the U.S. Environmental Protection Agency (EPA), as of June 30, 2002, WIFA and its predecessor had issued 131 loans financing nearly \$479 million in water infrastructure. Nearly three-quarters of these loans and approximately 32 percent of the funding (\$154.4 million) assisted small communities and water systems.<sup>2</sup> Within EPA’s Region 9, Arizona leads in the number of drinking water loans issued and the amount of assistance provided, while for clean water, it falls second to California.<sup>1</sup> Further, according to the EPA, compared to other states,

Nearly \$479 million in water infrastructure projects have been financed.

<sup>1</sup> The 2003 calendar year is the Drinking Water Revolving Fund and Clean Water Revolving Fund programs’ funding cycle. While WIFA has an application deadline of October 1 prior to the funding cycle year, it will accept and review applications throughout the funding cycle.

<sup>2</sup> Small communities and water systems are those serving populations of 10,000 or fewer for drinking water assistance and 9,999 or fewer for clean water assistance.

Arizona maximizes the amount of financial assistance it provides for drinking water projects.

## Organization and staffing

WIFA is governed by a 12-member board of directors. Seven of the board members are appointed by the Governor and represent Native American tribes, municipalities, counties, sanitary districts, and public water systems. They serve 5-year staggered terms. The other five board members represent state agencies. The Director of the Arizona Department of Environmental Quality (ADEQ) serves as the board chairman. The other four state agencies with representation on WIFA's Board are the Arizona Corporation Commission, Department of Commerce, Department of Water Resources, and Office of Treasurer. WIFA has 12 staff, including an executive director, controller, and finance director. The staff review community and water system applications for financial assistance, finalize project loans, and distribute loan monies.

## WIFA budget

Funding for WIFA's two revolving fund programs come from a variety of sources, including federal grants, state matching monies, revenue bonds, and borrower loan payments and fees.

- **Federal grants**—The EPA provides WIFA with yearly federal grants for its Clean Water Revolving Fund and Drinking Water Revolving Fund programs, but not in lump-sum amounts. Instead, WIFA submits funding requests as it pays for water infrastructure project costs. Any portion of the yearly allocated grant amount that is not requested by WIFA is held by the EPA. According to WIFA management, under WIFA's predecessor, Arizona did not draw down its full clean water allocation annually due to limited loan activity. This resulted in a large balance of federal grant monies remaining with the EPA. Between 1991 and 1996, Arizona accumulated a balance with the EPA of nearly \$28 million in clean water fund monies. Since 1996, WIFA has taken steps to reduce this balance. For example, in 2001, WIFA was allocated approximately \$9 million in federal grants for the Clean Water Revolving Fund program, but received over \$18 million. According to the EPA, since the inception of the two fund programs, Arizona has been allocated more than \$180 million in federal grants for these two programs.
- **State matching of federal grants**—Arizona must provide state funding at a level of at least 20 percent of the federal grants. WIFA may generate this matching amount through State General Fund appropriations, revenue bond proceeds, fees assessed by WIFA on its loans, or a combination of the three. As illustrated

Federal grants help fund infrastructure projects.

<sup>1</sup> EPA Region 9 includes Arizona, California, Hawaii, and Nevada. According to the EPA, WIFA's Drinking Water Revolving Fund program closed 74 loans totaling \$158.9 million between July 1, 1996, and June 30, 2002.

in Table 1 (see page 6), WIFA received approximately \$3 million from the State General Fund, which was used toward its state match in fiscal year 2002. Prior to fiscal year 1998, WIFA funded the state match entirely through revenue bond proceeds and loan fees.

- **Revenue bonds for project financial assistance**—In addition to using bond proceeds for state matching, WIFA issues revenue bonds to fund water infrastructure projects that have received loan approval from WIFA's board of directors. As illustrated in Table 1 (see page 6), WIFA issued \$110 million in bonds in fiscal year 2002 and had an outstanding bond debt of approximately \$241.9 million as of June 30, 2002. As part of its bond issuance requirements, WIFA must maintain a reserve for the bonds it issues. The reserves are held in guaranteed investment contracts administered by WIFA's trustee, US Bank. As of September 2002, WIFA had approximately \$24 million invested in these contracts for bond debt service reserves. The interest generated on the guaranteed investment contracts is either used to pay bond holders or reverts back to the revolving fund programs where it can be used for additional loans.
- **Borrower loan payments and fees**—Loan principal and interest payments made by communities are returned to the revolving fund programs and these monies generally become available for new loans or are used to retire bond debt. As illustrated in Table 1 (see page 6), in fiscal year 2002, WIFA received over \$35.6 million in loan payments, including approximately \$8.4 million in interest. A majority of WIFA's borrowers also pay loan fees. WIFA has separate loan fee rates for government and nongovernment entities, which typically range from 1.5 percent to 3 percent of the loan amount. In fiscal year 2002, WIFA generated over \$1.9 million in loan fees and had over \$8 million in unspent loan fee monies as of October 2002. WIFA may use these monies for any purpose, including operations or funding the state match.

The monies that WIFA spends may be categorized into four areas—loans and grants, payments to bond holders, operations, and ADEQ water quality program administration. Loans and grants reflect the financial assistance WIFA provides to wastewater and drinking water systems for infrastructure improvements. As shown in Table 1 (see page 6), in fiscal year 2002, WIFA disbursed \$88.4 million for project loans and had approximately \$277.4 million in outstanding loans receivable as of June 30, 2002. For those projects financed through revenue bonds, WIFA makes payments to the bond holders. For fiscal year 2002, WIFA's administrative expenses were approximately \$1 million. Federal law allows states to use up to 4 percent of their federal grant allocation to administer the revolving fund programs. States can retain the unused portion of the 4 percent to use for administrative expenses in future years or for program loans. WIFA funded its administrative expenses through this 4 percent mechanism.

WIFA had over \$241 million in outstanding bond debt as of June 30, 2002.

**Guaranteed Investment Contracts** are signed with financial institutions guaranteeing certain interest rates. Anything above that rate becomes profit for the financial institution.

WIFA has over \$277 million in outstanding loans receivable.

**Table 1**      **Schedule of Cash Flows for the Arizona Clean Water and Drinking Water Revolving Funds<sup>1</sup>**  
**Year Ended June 30, 2002**  
**(Unaudited)**

	<b>Clean Water</b>	<b>Drinking Water</b>	<b>Total</b>
<b>Cash flows from operating activities:</b>			
Federal grants received	\$ 7,124,564	\$ 2,973,717	\$ 10,098,281
State General Fund appropriations received	1,443,200	1,551,900	2,995,100
<b>Program loans:<sup>2</sup></b>			
Principal payments collected	22,584,674	4,630,399	27,215,073
Interest payments collected	6,688,305	1,743,020	8,431,325
Loan fees collected <sup>3</sup>	898,056	1,024,387	1,922,443
Loan reserves collected	8,906	280,772	289,678
Loans made	(59,666,912)	(28,757,501)	(88,424,413)
Technical assistance grants and other expenses paid	(143,413)	(179,824)	(323,237)
Financial assistance expenses paid	(677,847)		(677,847)
Federal administrative grants received	269,831	1,358,803	1,628,634
Administrative expenses paid for ADEQ set-aside <sup>4</sup>		(625,486)	(625,486)
Other administrative expenses paid	(498,630)	(547,227)	(1,045,857)
Cash transfers (to) or from other funds	<u>(14,050,196)</u>	<u>14,050,196</u>	<u></u>
Net cash used for operating activities	<u>(36,019,462)</u>	<u>(2,496,844)</u>	<u>(38,516,306)</u>
<b>Cash flows from noncapital financing activities:<sup>5</sup></b>			
Proceeds from sale of revenue bonds	58,158,154	55,877,441	114,035,595
Principal paid on revenue bond maturities	(5,270,270)	(464,730)	(5,735,000)
Interest paid on revenue bonds	<u>(7,368,609)</u>	<u>(1,188,384)</u>	<u>(8,556,993)</u>
Net cash provided by noncapital financing activities	<u>45,519,275</u>	<u>54,224,327</u>	<u>99,743,602</u>
<b>Cash flows from investing activities:</b>			
Interest received on investments	5,461,384	2,142,716	7,604,100
Net change in investments purchased and matured or sold	<u>681,426</u>	<u>(3,567,565)</u>	<u>(2,886,139)</u>
Net cash provided by (used for) investing activities	<u>6,142,810</u>	<u>(1,424,849)</u>	<u>4,717,961</u>
Net increase in cash and cash equivalents	15,642,623	50,302,634	65,945,257
Cash and cash equivalents, beginning of year	<u>45,359,956</u>	<u>3,415,896</u>	<u>48,775,852</u>
Cash and cash equivalents, end of year	<u>\$61,002,579</u>	<u>\$53,718,530</u>	<u>\$114,721,109</u>

<sup>1</sup> The Authority also maintains a Hardship Grant Fund; however, this Fund is not presented because it was insignificant in comparison to the Clean Water and Drinking Water Revolving Funds.

<sup>2</sup> Amounts relate to loans made to local governments and others in Arizona to finance various projects. As of June 30, 2002, the Authority's outstanding loans receivable was \$277.4 million.

<sup>3</sup> Amounts are annual administrative fees charged to loan recipients that are available to defray the Authority's administrative expenses.

<sup>4</sup> Amounts are monies passed through to the Arizona Department of Environmental Quality (ADEQ) for its role in administering three drinking water programs.

<sup>5</sup> Amounts are the proceeds from the \$110 million revenue bonds issued in October 2001 and the principal and interest paid on the Authority's revenue bonds. As of June 2002, the Authority's bonds payable was \$241.9 million.

Source: Auditor General staff analysis of the Water Infrastructure Finance Authority's audited *Financial Statements* for the year ended June 30, 2002. The statements were audited by an independent certified public accountant.

Finally, as illustrated in Table 1 (see page 6), during fiscal year 2002, WIFA passed-through approximately \$625,000 in federal monies to ADEQ to administer three drinking water programs. Each state can designate up to 25 percent of its federal Drinking Water State Revolving Fund grant to establish and implement programs that place an emphasis on preventing water contamination and encouraging better system operations.<sup>1</sup> ADEQ receives monies through WIFA from the federal Drinking Water State Revolving Fund to administer three programs—Wellhead Protection, Capacity Development, and Public Water System Supervision (PWSS). For the PWSS program, the Act requires Arizona to provide a dollar-for-dollar match for expenditures made under this program. This match is provided by ADEQ through State General Fund monies.

## Audit scope and methodology

This audit focused on WIFA's processes for prioritizing and funding water infrastructure projects, the federal clean water allocation formula, the new federal arsenic requirements, and WIFA's accounting and financial reporting management controls. This performance audit and Sunset review includes one finding and associated recommendations:

- While WIFA has developed specific processes for approving projects, WIFA needs additional review steps in its processes to help ensure that all eligible projects are accurately scored and prioritized, and that the project interest rates are appropriately determined.

In addition, this report contains other pertinent information in three areas:

- The federal formula used to allocate Clean Water State Revolving Fund program monies and how the formula affects Arizona's funding.
- The new federal arsenic standard for drinking water and its impact on Arizona drinking water systems.
- Issues regarding WIFA's financial reporting and accounting internal controls.

Finally, within the Sunset Factors (see pages 25 through 31), the report recommends that WIFA should renew its Clean Water Revolving Fund agreement with the EPA, properly disclose board member conflicts of interest, retain these disclosures in a

### ADEQ Drinking Water Programs

- **Wellhead Protection**—Wellhead protection is a voluntary program designed to help water systems enact protection programs to ensure their water systems remain contaminant free.
- **Capacity Development**—When the Safe Drinking Water Act was reauthorized in 1996, Congress required all new public water systems to demonstrate technical, managerial, and financial capability before they could be allowed to operate. ADEQ assesses new systems' compliance with these requirements and works with new and existing systems to meet them.
- **Public Water System Supervision (PWSS)**—PWSS includes several programs for implementation and enforcement of the Safe Drinking Water Act. Examples include operator certification programs and monitoring water systems' compliance with drinking water standards.

<sup>1</sup> The Safe Drinking Water Act allows Arizona to spend up to 15 percent collectively for the Wellhead Protection and Capacity Development programs, and up to 10 percent of its federal grant for the Public Water System Supervision program.

special file, and file the required statement with the Secretary of State indicating where public meeting notices will be posted.

Auditors used a number of methods to study the issues addressed in this report. They attended three WIFA board meetings; interviewed the WIFA board chairperson, WIFA staff, and an official with the EPA's Region 9 office; and reviewed statutes, rules, policies and procedures, and WIFA board meeting minutes from January 2000 through October 2002. To perform more specific audit steps, they used the following methods:

- To evaluate WIFA's processes for reviewing, scoring, prioritizing, and funding water infrastructure projects, auditors reviewed the federal Clean Water and Safe Drinking Water acts and relevant portions of the Code of Federal Regulations. Auditors also reviewed funding cycle 2002 and 2003 scoring data sheets, which included 143 and 103 projects, respectively; observed WIFA staff score three clean water and three drinking water priority list applications for the 2003 funding cycle; and reviewed the scoring of the 103 projects' interest rate subsidies for funding cycle 2003. In addition, auditors reviewed 2002 funding cycle loan information for the Clean Water Revolving Fund and Drinking Water Revolving Fund programs. Finally, auditors attended the public hearing held in November 2002 for the Clean Water Revolving Fund and Drinking Water Revolving Fund programs' intended use plans, and observed WIFA staff conduct an on-site visit for a project financed by WIFA.
- To develop information on the federal clean water allocation formula and its effect on Arizona's funding, auditors reviewed sections of the Clean Water Act, fact sheets, and reports issued by the EPA, including the most recent needs surveys for the Clean Water State Revolving Fund and Drinking Water State Revolving Fund programs—the *1996 Clean Water Needs Survey* and the *2001 Drinking Water Needs Survey*, as well as the *2002 Clean Water and Drinking Water Infrastructure Gap Analysis*. Auditors also reviewed the *2002 Wastewater, Water Reclamation and Storm Water Infrastructure Needs Survey Clean Water Needs Survey* prepared by WIFA staff. In addition, auditors reviewed two bills and a proposed amendment considered by the 107th Congress to revise the federal clean water allocation formula, interviewed an environmental protection specialist from EPA's Washington, D.C. office, and interviewed a staff member from the office of one Arizona senator.
- To assess the impact of the federal arsenic standard on Arizona's drinking water systems, auditors reviewed the federal arsenic rule published in the January 22, 2001, edition of the *Federal Register*, interviewed a water quality official from the Arizona Department of Environmental Quality (ADEQ), and reviewed ADEQ's draft Arsenic Master Plan, as well as arsenic fact sheets issued by the EPA. Auditors also reviewed summaries of several health studies on arsenic in drink-

ing water conducted by the National Academy of Sciences (NAS), including *Arsenic in Drinking Water* (1999) and *Arsenic in Drinking Water: 2001 Update*.

- To develop information on WIFA's financial reporting and accounting management controls, auditors reviewed the annual financial statements prepared by WIFA's external auditors for fiscal years 2001 and 2002, and the management letters from the fiscal year 2001 and 2002 financial audits, and interviewed a Department of Administration official.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Water Infrastructure Finance Authority board members, executive director, and staff for their cooperation and assistance throughout the audit.



# FINDING 1

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## Processes for reviewing and scoring applications need improvement

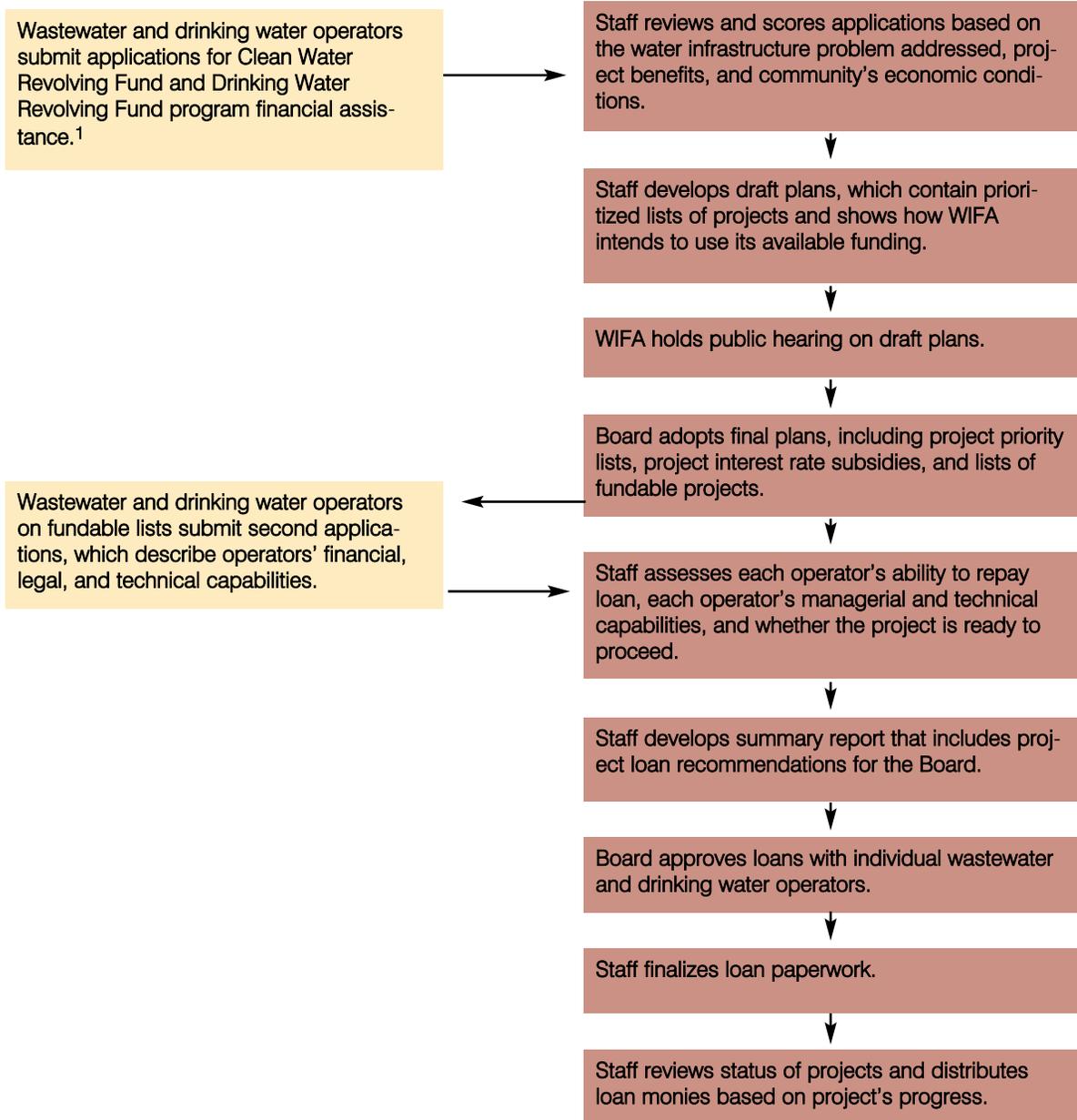
Although WIFA has developed processes for prioritizing, funding, and overseeing water infrastructure projects, it could benefit from additional review steps in its processes to help ensure that all projects are accurately scored and the project interest rates appropriately determined. WIFA's processes are consistent with federal requirements and, if correctly applied, can help ensure that projects are evaluated consistently and properly. However, when auditors examined WIFA's evaluation of 2003 funding cycle applications using these processes, they found that most projects initially received incorrect scores. Auditors also reviewed the 2002 funding cycle scores and did not find any problems. While WIFA corrected these 2003 funding cycle scores after auditors brought them to its attention and before funding any projects, these mistakes could have affected both the priority order established for funding the projects and the interest rates that applicants would pay for the loans. By adding steps to its review of project applications, WIFA can address these problems.

## Processes are consistent with federal requirements

WIFA has procedures in place for prioritizing and funding water infrastructure projects, and for reviewing projects that are ready to be funded to ensure that required reserves are present and that adequate technical expertise is in place. These processes are consistent with federal requirements.

**Procedures for prioritizing projects**—Federal laws require states to annually develop and submit “intended use plans” that detail how the states plan to use their available funding to finance drinking water and wastewater infrastructure projects through their Drinking Water State Revolving Fund and Clean Water State Revolving Fund programs. As illustrated in Figure 2 (see page 12), WIFA employs

Figure 2 Project Application and Loan Process  
As of February 2003



<sup>1</sup> Wastewater and drinking water operators include communities, sanitary districts, private drinking water companies, and Native American tribes.

Source: Auditor General staff analysis and summary of Water Infrastructure Finance Authority (WIFA) administrative rules, policies, and interviews with WIFA staff.

several steps in its processes to review project applications and approve loans. WIFA's information in its intended use plans and its other steps to deal with these requirements include the following:

- **Project priority list**—Federal regulations require states to establish processes for prioritizing all project applications received from wastewater and drinking water systems. The prioritized list of projects must then be included in the intended use plan. WIFA has established in administrative rule a priority process that encompasses the federal requirements, and awards points based on the type of existing water infrastructure problem, project benefits, and the community's economic and financial conditions. Once it scores all project applications, WIFA generates a list that ranks all applicants in priority order starting with the project that received the most points overall. For the 2003 funding cycle, WIFA received and prioritized 103 drinking water and clean water applications requesting over \$249 million in WIFA assistance.
- **List of fundable projects**—Federal regulations require states to identify which projects they anticipate funding during the year. WIFA develops a list of fundable projects that reflects a subset of the priority list and is based on WIFA estimates of available funding. WIFA also takes steps to determine if the projects on its list are ready to proceed. In deciding this, WIFA determines whether the applicant has received debt authorization, completed the project design, received plan and specification approvals generally from the Arizona Department of Environmental Quality, and solicited project bids. For the 2003 cycle, WIFA anticipates funding 29 drinking water and clean water projects totaling over \$92 million.
- **Interest rate subsidies**—Federal laws require states to provide loans to communities at or below market interest rates. WIFA complies with this requirement by setting the interest rate on every project in its intended use plan at 70 to 100 percent of the tax-exempt rate for governmental entities or, for nongovernmental entities, at the prime rate. The extent of the interest rate subsidy is based on a project's position on the priority list and the community's financial and economic conditions, which are scored as part of the prioritization process. Although the interest rate subsidy is included in the intended use plan, the actual interest rate is not determined until just before the loan is finalized.
- **Public comment**—Federal regulations require states to provide the public with the opportunity to comment on the intended use plans during their develop-

2003 project applications have requested over \$249 million in assistance.

WIFA provides loans at or below market interest rates.

### Interest Rate Calculation Example

Before WIFA finalizes a loan, it determines the current interest rate and then calculates the project's interest rate based on the project's position on the priority list and the community's financial and economic condition. For example, on January 15, 2003, the tax-exempt rate was 4.77 percent. Instead of paying 4.77 percent interest on its loan, a public entity with the maximum interest rate subsidy would pay 70 percent of the rate, or approximately 3.3 percent.

ment. WIFA meets this requirement by holding a public hearing on the plans before WIFA's Board adopts them.

**Additional project reviews required prior to funding**—Federal regulations require states to ensure that systems have a dedicated revenue source to repay loans. Further, the Safe Drinking Water Act also requires that systems have the technical, managerial, and financial capability to reliably deliver safe drinking water. To comply, WIFA has established a process to review the technical, managerial, financial, and legal capacities of all projects that are ready to be funded. During this review, WIFA considers, for example, the revenue sources the system will use to repay the loan and the management and technical expertise of system staff. This review results in recommendations to WIFA's Board about whether, or under what conditions, WIFA should enter into a loan agreement with the system. For example, if a community had not yet hired a project manager to oversee construction, the Board would condition the loan approval on the community hiring a project manager. If a community or water system is unable to meet the conditions required by WIFA, it would not receive funding, but can reapply in the next funding cycle.

WIFA also uses document reviews and on-site visits to monitor project progress during construction. WIFA requires all borrowers to submit project status reports with their requests for loan funds. A borrower does not receive the loan proceeds from WIFA in one lump sum at the beginning of the project, but rather over the course of the project's construction as construction milestones are met and costs are incurred. In addition to document reviews, WIFA staff with an engineering background typically will conduct at least two site visits to assess project construction against project expenditures.

## WIFA needs to ensure scoring accuracy

While these processes are consistent with federal requirements, WIFA needs to do more to ensure the accuracy with which they are carried out. Auditors reviewed WIFA's scoring data sheets for both the 2002 and 2003 funding cycles and while no errors were identified in the 2002 funding cycle scoring data sheets, auditors found several errors and omissions in the 2003 funding cycle scoring data sheets that resulted in more than 90 percent of the projects initially being inaccurately scored. Because such errors could affect WIFA's lending capacity and the communities that receive WIFA loans, WIFA should incorporate management reviews into its processes and develop policies and procedures to improve the reliability of its scoring data sheets.

**WIFA initially inaccurately scored majority of projects**—Auditors' review of WIFA's 2003 funding cycle scoring data sheets for the two revolving fund programs found errors in 96 of the 103 (93 percent) projects' initial scores. While similar errors

were not identified by auditors in their review of the 2002 funding cycle scoring data sheets, the 2003 errors resulted from inaccurate calculations, skipped steps, and missing data. For example, due to a missing formula on the scoring data sheets, Clean Water Revolving Fund program applicants did not receive any points for project cost effectiveness, which is scored based on the project's costs per household connected to the system. According to Administrative Rule R18-15-205(A)(3)(d), WIFA should award up to 20 points for a project's cost effectiveness out of the 100 total points available for a community's financial and economic conditions. Additionally, due to an inaccurate calculation, applicants received more points than were possible for the communities' financial and economic conditions. As a result, applicants' scores were inflated.

WIFA corrected these errors and omissions after auditors brought them to WIFA's attention and before the Board approved the final priority list and funded any projects. However, the presence of so many errors on the data scoring sheets is a signal that steps are needed to minimize similar errors in the future. Such errors can have the following consequences:

- **Accuracy of interest rates affected**—Because a project's score helps determine a project's interest rate subsidy, inaccurate scoring initially resulted in interest rates that were set too low in some cases, and too high in others. Auditors determined that if the mistakes had not been caught, the overstated interest rate subsidies for nine projects could have decreased WIFA's available loan monies in the future by more than \$2.2 million. Further, the understated interest rate subsidies could have cost the 12 affected communities more than \$835,000 in additional interest.<sup>1</sup> The following examples illustrate the potential effect of inaccurate interest rate subsidies.
  - ◆ The interest rate subsidy miscalculation on a \$20 million water treatment plant project for a Maricopa County community would have resulted in WIFA over-subsidizing the project. Over the course of the loan, WIFA would have failed to collect more than \$1.2 million in interest that the community should have paid. Since it would not have been collected, this money would be unavailable to fund other communities' projects in the future.
  - ◆ For a community in Cochise County, the interest rate subsidy miscalculation for its \$11 million sewer rehabilitation loan would have resulted in WIFA under-subsidizing the project. Over the course of the loan, the community would have overpaid nearly \$341,000 in interest.
- **Priority order may be incorrect**—The scoring errors also caused some projects to be incorrectly prioritized on the draft priority list. Although some projects were mis-prioritized by one or two positions, one project improved its position on the priority list by 11 positions after the errors were corrected. Currently, scoring inaccuracies are not a significant concern because WIFA is able to fund projects

Scoring errors can affect project interest rates and ranking.

<sup>1</sup> The projects included in these dollar estimates are those that WIFA anticipates funding during 2003 as reported in the 2003 Drinking Water Revolving Fund and Clean Water Revolving Fund programs' intended use plans.

that are ready to proceed, regardless of their position on the final priority list. However, future potential increased demand on these funds, resulting from such things as the need for state drinking water systems to comply with the new arsenic standard (see Other Pertinent Information, pages 20 through 22), could result in WIFA relying more on a project's priority scoring information to allocate project funding.

**WIFA needs to improve project scoring reliability**—Two main steps are needed to improve the reliability of scores. First, where needed, WIFA needs to adopt procedures that staff can use to help ensure the accuracy of information. For example, to improve the accuracy of scoring data sheet information, WIFA could develop a procedure that would guide WIFA staff through the process as they review formulas and enter information into the scoring data sheets. Second, WIFA should develop a policy requiring management review of the scoring data sheet information and formulas for accuracy before the draft intended use plans are distributed for public comment and before final WIFA board approval. Such reviews can help discover and correct inadvertent errors within the scoring data sheets.

## Recommendations

1. WIFA should develop and implement policies and procedures that WIFA staff can use when reviewing formulas and entering information into the scoring data sheets to help ensure their accuracy and completeness, and to help in reducing errors.
2. WIFA should develop and implement a policy incorporating management review of its scoring data sheets and formulas prior to the draft intended use plans' distribution for public comment and Board approval to help ensure the accuracy of the information used to allocate funding.

# OTHER PERTINENT INFORMATION

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In response to legislative staff inquiries, auditors developed information on two national issues affecting Arizona's water systems: the federal formula used to allocate Clean Water State Revolving Fund monies to the states, and the impact of the new federal arsenic standard on drinking water systems. Auditors also followed up on concerns raised by WIFA's external auditor about weaknesses in WIFA's financial reporting and accounting management controls.

## Federal clean water allocation formula

The federal Clean Water State Revolving Fund, which provides monies to local water systems and communities for water and wastewater infrastructure projects, is funded through annual grants provided by the federal government. Individual state funding levels are determined by the federal Clean Water Act of 1987. However, the current funding levels do not meet some states' needs, including Arizona's. As such, WIFA has had to rely more heavily on alternative sources of funding, such as bonds, to assist in meeting Arizona's clean water infrastructure needs. A formula based on states' current needs would allow Arizona to receive a significant increase in its annual clean water allocation.

**Formula does not reflect Arizona's current needs**—The federal Clean Water State Revolving Fund, which is described more fully in the Introduction and Background of this report, distributes an average of \$1.35 billion per year to fund clean water infrastructure projects throughout the country. Arizona's allocation, 0.68 percent of the total, ranks 37th in the country. This allocation has provided Arizona with approximately \$9 million per year in clean water grants for federal fiscal years 2000 through 2002. Arizona's allocation percentage, which has remained essentially unchanged for years, is based on a formula that is derived in part from 25-year-old population data and needs surveys.

Under this formula, Arizona's clean water allocation falls short of meeting the State's water infrastructure needs. According to an analysis of EPA data in a 2002 report by the Northeast-Midwest Institute, Arizona is one of 14 states that have clean water infrastructure needs that exceed their annual federal allotments.<sup>1</sup> The EPA defines

Arizona is one of several states where needs exceed allocation.

clean-water “needs” as the estimated 20-year costs for constructing publicly owned wastewater transportation and treatment facilities or other funding activities specified in the Clean Water Act. Arizona’s projected 20-year clean-water needs have increased substantially over the past 10 years, rising from \$975 million in 1990 to \$6.3 billion in 2000.<sup>2</sup> These changes and use of the current allocation methodology have resulted in a disparity between states’ clean-water needs and their annual allocations. For example, recent estimates indicate that Arizona and Maryland have similar populations, and Maryland has less documented clean-water needs than Arizona.<sup>3</sup> However, under the current allocation formula, Maryland receives approximately \$32 million a year in federal monies, or more than three times Arizona’s allocation of approximately \$9 million.

## Revolving Fund Allocations

**Clean Water Allocations**—Allocation percentages included in the Clean Water Act serve as the basis for allocating clean water monies to the states. These percentages are based in part on population and needs survey data from the 1970s and 1980s. Clean-water needs, as determined by more recent EPA surveys, are not used as the basis for allocating clean water monies. The 1996 *Clean Water Needs Survey* is the EPA’s most recently published clean-water needs survey.

**Drinking Water Allocations**—Allocations from the Drinking Water State Revolving Fund are based on the most recent *Drinking Water Infrastructure Needs Survey*. States receive funding based on their share of the total 20-year drinking-water needs estimate. The EPA’s most recent *Drinking Water Needs Survey* was conducted in 1999 and published in February 2001.

Arizona’s diminished capacity to meet its needs through the federal Clean Water State Revolving Fund allocation has required WIFA to rely more heavily on issuing revenue bonds. Specifically, WIFA has had to periodically issue revenue bonds to fund loans to address the State’s clean-water needs, and these bonds need to be repaid with interest. However, regardless of increases in federal clean water funding, WIFA’s Executive Director indicates WIFA will continue to issue revenue bonds to facilitate the construction of water infrastructure projects.

**New formula could result in increased federal funding**—Unlike the federal Clean Water State Revolving Fund, allocations from the federal Drinking Water State Revolving Fund are based on the most recent Drinking Water Infrastructure Needs Survey. This fund, also described in the Introduction and Background of this report, assists states with drinking water projects rather than wastewater treatment projects. Should Congress change the clean water formula to a needs-based formula similar to the drinking water formula, Arizona would receive an increase in its clean water federal funding. For example,

Arizona’s drinking-water needs allocation is based on its share of the total 20-year drinking-water-needs estimate for all states, as reported in the *Drinking Water Needs Survey* published in 2001. Based on the reported needs, Arizona currently receives

- <sup>1</sup> The Northeast-Midwest Institute, *The Clean Water State Revolving Fund: A Primer*, March 2002. The Northeast-Midwest Institute is a private, nonprofit, and nonpartisan research organization that conducts research and analysis, and provides evaluations of key federal programs.
- <sup>2</sup> The \$975 million estimate is based on Arizona’s documented 20-year needs as reported in the EPA’s 1990 *Clean Water Needs Survey*. The \$6.3 billion 20-year needs estimate was submitted by WIFA to the EPA for inclusion in the 2000 *Clean Water Needs Survey*.
- <sup>3</sup> Estimates based on the documented needs reported in the EPA’s 1996 *Clean Water Needs Survey*. Population comparisons are based on the 2000 Census.

1.13 percent of the total annual drinking water congressional appropriation, which resulted in a grant of approximately \$9.1 million in federal fiscal year 2002.

Allocating clean water monies based on a current needs-based approach could significantly increase the amount of federal clean water money for Arizona. According to WIFA's *2002 Wastewater, Water Reclamation and Storm Water Infrastructure Needs Survey*, Arizona's clean water allocation could increase from approximately \$9 million to \$45 million annually if the formula were based on the EPA's most recent *Clean Water Needs Survey*. Increased federal funding would require a larger contribution from the State to meet the 20 percent state matching requirement. As a result, WIFA would need to provide \$9 million in state-matching funds annually, which represents a \$7.2 million increase in matching funds. However, the State General Fund would not have to provide these monies; rather, WIFA could use bond proceeds to cover this increased state-matching requirement.

**State and federal efforts to change the formula**—In the past several years, there have been various attempts at both the state and federal levels to change the federal clean water allocation formula. In April 1998, the Arizona Legislature submitted a concurrent memorial to the President and the Congress of the United States urging them to update the clean water allocation formula to ensure that Arizona receives funding consistent with its needs. More recently, during the 107th Congressional Session, congressional delegates introduced legislation in the Senate (S.1961—Water Investment Act of 2002) and in the House of Representatives (H.R. 3930—Water Quality Financing Act of 2002) that would require the EPA to allocate clean water appropriations based on the most recent *Clean Water Needs Survey*, similar to the method used for the Drinking Water Revolving Fund program. However, the proposed bills were defeated during the session. Similar legislation proposed by Arizona's delegates has also failed. Nevertheless, according to a legislative assistant for one Arizona senator, the senator plans to continue his efforts to change the clean water allocation formula to one based on current needs.

Needs-based allocation could significantly increase clean-water federal monies.

## New arsenic standard

In 2001, the EPA established a new standard for arsenic in drinking water to reduce the health risks associated with arsenic. According to the Arizona Department of

Environmental Quality (ADEQ), this new standard will potentially affect hundreds of water systems in Arizona that are not in compliance and will cost an estimated \$565 million to \$987 million to comply. As a result, ADEQ has developed an Arsenic Master Plan to help affected small water systems identify treatment options and cost estimates associated with compliance. ADEQ and WIFA plan to coordinate their efforts to ensure that Arizona's drinking water systems comply with the new arsenic standard and provide these systems with adequate funding options.

### Adverse Health Effects of Arsenic in Drinking Water

The contamination of arsenic in drinking water can result from either natural or human activities. Arsenic occurs naturally in soil, water, plants, and animals. Agricultural applications, mining, and smelting also contribute to arsenic releases in the environment. According to the Arizona Department of Environmental Quality, most of the arsenic in Arizona's drinking water is naturally occurring.

Studies have linked long-term exposure to arsenic in drinking water to cancer of the bladder, lungs, skin, liver, and prostate. The table below shows the estimated long-term increased cancer risks associated with arsenic levels in drinking water.

Arsenic Level in Drinking Water (in parts per billion, or ppb)	Approximate Total Cancer Risk
5 ppb	1.5 in 1,000
10 ppb	3 in 1,000
20 ppb	6 in 1,000

Source: The National Research Council, *Arsenic in Drinking Water: 2001 Update*.

EPA adopts a more stringent arsenic standard—In January 2001, the EPA reduced the acceptable level of arsenic in drinking water from 50 parts per billion (ppb) to 10 ppb. Congress had directed the EPA to establish a new arsenic standard as part of the 1996 amendments to the federal Safe Drinking

Water Act.<sup>1</sup> To determine an appropriate stan-

dard, the EPA worked with the National Research Council (NRC) to study the health risks associated with exposure to low levels of arsenic in drinking water.<sup>2</sup> In a 1999 report, the NRC concluded that the 50 ppb standard did not achieve the EPA's goal of protecting public health. The EPA set the new standard at 10 ppb to protect consumers against the effects of long-term, chronic exposure to arsenic in drinking water. Impacted water systems have until 2006 to bring their drinking water systems into compliance with the new arsenic rule.

Several thousand water systems across the country serving millions of people will need to take action to lower the arsenic levels in their drinking water. According to the EPA, approximately 4,100 of the nation's 74,000 water systems will need to lower the current levels of arsenic in their drinking water. Of those affected systems, 97 percent serve fewer than 10,000 people. These small water systems typically rely on wells for

Arsenic requirement changed from 50 to 10 parts per billion (ppb).

<sup>1</sup> Congressional Research Service. *Arsenic in Drinking Water: Recent Regulatory Development and Issues*. August 23, 2001.

<sup>2</sup> The National Research Council is part of the National Academies, which also includes the National Academy of Sciences (NAS). The NRC and NAS are private nonprofit institutions that provide science technology and health policy advice under a congressional charter.

drinking water, which tend to have higher levels of arsenic. The EPA estimates that the new arsenic standard will affect 12.7 million people nationwide and will cost water systems an estimated \$181 million per year for 20 years to address. Compared to the other states, Western states have more water systems with arsenic levels greater than 10 ppb. According to ADEQ, Arizona is one of several Western states, including Nevada and New Mexico, that face significant compliance issues related to the new arsenic standard.

**Arizona's costs to comply will be significant**—The new arsenic standard will apply to an estimated 1,100 of Arizona's more than 1,600 water systems, but only an estimated 320 of these systems will have to take action to lower their levels. Additionally, according to the EPA's 1999 *Drinking Water Infrastructure Needs Survey*, Arizona estimates it will cost between \$565 and \$987 million for water systems to comply with the new standard.<sup>1</sup> Larger water systems may have more available options to pay for the costs of compliance. For example, the City of Scottsdale instituted a 5 percent water-rate hike for its users and bonding to cover the estimated \$64 million in costs to comply with the new arsenic standard. However, the new arsenic rule will be particularly burdensome for small water systems because these systems may be unable to increase water rates sufficiently to cover their arsenic compliance costs. According to ADEQ, 287 out of the 320 affected water systems in the State are small water systems, and it will cost these 287 systems an estimated total of \$142 million to comply with the standard.

Arizona compliance costs could reach nearly \$1 billion.

**Master plan identifies treatment options**—To begin addressing these new requirements, ADEQ formed a stakeholder group in 2002. The group, consisting of representatives from ADEQ, municipalities, and the scientific community, was formed to develop an Arizona Arsenic Master Plan (master plan). The master plan was funded through a \$50,000 grant from WIFA and identifies appropriate arsenic treatment options, corresponding costs, and potential funding sources for affected water systems serving fewer than 10,000 persons. Although the master plan focuses on small groundwater systems, ADEQ believes that the report will also provide useful information for larger systems. The master plan identifies two basic categories of options for affected water systems:

- **"Nontreatment" Options**—Nontreatment options consist of blending treated water, consolidating water sources, or replacing existing water sources with new sources. According to the master plan, nontreatment options tend to be more economical, and easier to implement and manage than the treatment options described below.
- **Treatment Options**—Water systems that cannot use nontreatment options may choose treatment options that either filter or absorb arsenic. According to the master plan, treatment options include reverse osmosis, which filters arsenic; or activated alumina, a treatment method that absorbs arsenic. The EPA classifies some of these treatment technologies as the best-available technologies, which

<sup>1</sup> Arizona's arsenic estimate reported in the separate state estimates section of the EPA's 1999 *Drinking Water Infrastructure Needs Survey* published in February 2001.

Water systems will have several funding options available.

ADEQ highly recommends using. According to the master plan, treatment options have the tendency to be more expensive to implement and more complicated to manage than nontreatment options.

Although the estimated costs associated with the new arsenic standard are substantial, Congress has not provided additional funding to the states to assist with compliance costs. Therefore, small water systems will be turning to one of several available funding sources. The federal Safe Drinking Water Act allows states to use federal Drinking Water State Revolving Fund monies to fund some costs of compliance. As a result, WIFA will provide loans and grants through its Drinking Water Revolving Fund program to cover some of the arsenic compliance costs incurred by Arizona's water systems. According to WIFA's Executive Director, while only a few water systems have applied for financial assistance as of December 2002, he anticipates that more water systems will submit applications for arsenic compliance funding as the 2006 deadline approaches. In addition to WIFA, water systems can apply for financial assistance from several other sources, including the U.S. Department of Agriculture—Rural Utilities Service, and the North American Free Trade Agreement's (NAFTA) Border Environment Cooperation Commission.

**WIFA and ADEQ will coordinate efforts**—WIFA and ADEQ plan to coordinate efforts to address funding and compliance issues associated with the new arsenic standard. Specifically, WIFA will serve as the primary source for prioritizing water system projects and funding arsenic treatment projects through its Drinking Water Revolving Fund programs. WIFA will also assist ADEQ with identifying funding options for water systems in Arizona as part of the Arsenic Master Plan.

### Selected ADEQ Conditions for Extensions To the New Arsenic Rule

- The extension will not result in an unreasonable risk to public health.
- Necessary capital improvements cannot be completed before January 2006.
- The water system does not have a reasonably available alternative source of water that can be used to achieve compliance with the arsenic standard.
- The water system is unable to comply with the arsenic standard because of compelling factors, which may include economic factors.

Source: Arizona Department of Environmental Quality Arsenic Master Plan.

ADEQ plans to continue its efforts to ensure water systems are in compliance with the new arsenic standard. Specifically, administrative rules require water systems to periodically test the arsenic levels in their drinking water and report the results of those arsenic tests to ADEQ. Also, according to ADEQ's Safe Drinking Water Manager, ADEQ plans to monitor arsenic compliance through the Public Water System Supervision program and provide technical assistance regarding arsenic compliance to water systems.

ADEQ will also be responsible for granting extensions to the 2006 arsenic standard deadline to eligible water systems. In order to qualify for an arsenic standard extension, a water system must demonstrate that various conditions exist that prevent it from complying by the compliance date.

## Concerns about WIFA internal controls

During the fiscal year 2001 and 2002 financial audits, WIFA's external auditors identified opportunities for WIFA to strengthen its internal controls over its accounting and financial reporting systems. Additionally, WIFA did not meet the statutory deadlines for submitting its final fiscal year 2002 audited financial statements. In response to these issues, the Auditor General has scheduled a review of WIFA's internal financial controls in 2003.

**Internal control weaknesses identified**—While conducting fiscal year 2001 and 2002 financial audits, WIFA's external auditors noted weaknesses in WIFA's accounting and financial reporting systems. Specifically, for the fiscal year 2002 audit, WIFA's external auditors reported that daily and monthly accounting procedures were not consistently followed and accounting procedures were not performed in a timely manner. Additionally, the external auditors reported that accounting entries lacked sufficient information to reconcile and to fully explain account balances in both the fiscal year 2001 and 2002 financial audits. The external auditors detailed the internal control concerns, along with recommendations for improvement, in separate letters to WIFA management.

External auditors identified several internal control weaknesses.

An effective internal control system is necessary to help ensure the reliability of an entity's financial reporting, to ensure compliance with laws and regulations, and to help protect against fraud or error. Further, internal controls need to be monitored to ensure that staff follow policies and procedures for the accounting and reporting of financial information. WIFA's executive director has acknowledged the need to improve WIFA's internal controls and increase his level of involvement in the accounting and financial reporting process. Additionally, WIFA has hired staff to assist in accounting for WIFA's fiscal activities and is in the process of implementing a new automated accounting system to improve the effectiveness of its internal controls and plans to implement this system by August 2003.

**WIFA missed statutory financial reporting deadlines**—Although statute requires WIFA to submit audited financial statements within specified deadlines, WIFA was unable to meet these deadlines for its final fiscal year 2002 statements. Specifically, A.R.S. §49-1204 requires WIFA to submit its audited financial statements to the Auditor General immediately after 120 days from the end of the fiscal year. Additionally, A.R.S. §35-131(H) requires applicable state entities to submit financial statements in accordance with Department of Administration (DOA) policies and procedures. Specifically, the Department required WIFA to submit its final fiscal year 2002 financial statements by December 2, 2002. WIFA missed both of these reporting dates. According to WIFA's executive director, ongoing issues related to the absence of key personnel and WIFA's outdated financial reporting structure, coupled with management's attempts to implement a new automated accounting system, caused WIFA to miss these deadlines for submitting its final financial statements.

State statute requires WIFA to submit its financial statements within a specified time-frame because DOA must include this information in required state and federal financial reports. In response to WIFA's missed deadline, DOA officials met with WIFA to establish a new deadline for the submission of WIFA's audited financial statements. DOA required WIFA to submit its financial statements by February 24, 2003, and WIFA met this deadline.

**The Auditor General will conduct a review**—In response to these various issues, the Auditor General's financial audit division has scheduled a review of WIFA's internal controls in 2003. The review will assess the effectiveness of WIFA's internal accounting and financial reporting controls as well as the adequacy of management oversight, and will include an assessment of WIFA's management directives, accounting policies and procedures, and monitoring activities.

# SUNSET FACTORS

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In accordance with A.R.S. §41-2954, the Legislature should consider the following 12 factors in determining whether the Water Infrastructure Finance Authority (WIFA) should be continued or terminated.

## 1. The objective and purpose of establishing WIFA.

The Legislature established WIFA in 1997. WIFA serves as a separate legal entity of the State, authorized to provide financial assistance for projects related to the construction or improvement of drinking water, wastewater, or other water quality facility projects. WIFA's mission is as follows:

"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:

- **Clean Water Revolving Fund program**—As the State's designated administrator of this program, WIFA receives federal grant monies to provide low-interest rate loans to publicly held wastewater facility projects. Monies may be used to plan, engineer, construct, upgrade, and/or equip wastewater treatment of water reclamation facilities.
- **Drinking Water Revolving Fund program**—As the State's designated administrator of this program, WIFA receives federal grant monies to provide low-interest rate loans to public and private drinking water systems. Funds may be used to plan, engineer, construct, upgrade, and/or equip drinking water facilities. WIFA passes-through some of these federal monies to the Arizona Department of Environmental Quality to separately administer three drinking water programs (see page 7).
- **Technical Assistance Program**—Through this program, WIFA provides pre-design and design grants and loans for eligible wastewater and drinking

water systems. Eligible grant recipients must serve populations of 10,000 or fewer. Funding for these grants is provided through the two revolving fund programs.

**2. The effectiveness with which WIFA has met its objective and purpose and the efficiency with which it has operated.**

WIFA has effectively met its overall objective and purpose. Since 1989, WIFA and its predecessor have provided approximately \$479 million in water infrastructure loans to communities and water systems throughout Arizona. In addition to administering and distributing federal grants, WIFA periodically issues revenue bonds to fund loans. WIFA has approximately \$241.9 million in outstanding bond debt as of June 30, 2002. In 2001, national credit rating agencies awarded a AAA rating, the highest possible rating, to WIFA's revenue bonds. High credit ratings allow WIFA to sell its bonds at lower interest rates, which in turn help WIFA to provide low-cost financial assistance to communities. Additionally, WIFA's standardized application process complies with federal requirements for prioritizing and funding wastewater and drinking water projects and assists in the consistent review of these projects.

Although WIFA has developed a standard application review process, it has not formally established an appropriate level of review to ensure the accuracy of the scoring data sheets it uses to score and prioritize water infrastructure projects. As a result, WIFA initially inaccurately scored more than 90 percent of the project applications it received for the 2003 funding cycle, which could have affected WIFA's lending capacity and the communities that receive its loans. Similar errors were not identified by auditors in their review of the 2002 funding cycle scoring data sheets. To improve its process for determining the level of assistance to provide to communities, WIFA should establish additional policies and procedures to help ensure that it uses accurate information when prioritizing these projects and determining the subsidized financial assistance they will receive (see Finding 1, pages 11 through 16).

Finally, WIFA must have written agreements with the EPA to administer the Clean Water Revolving Fund and Drinking Water Revolving Fund programs. While WIFA has a current agreement with the EPA for the Drinking Water Revolving Fund, its agreement to administer the Clean Water Revolving Fund has expired. According to an EPA official, the agreement is reactivated with each grant awarded; however, an updated written agreement is needed. Therefore, WIFA should update and renew its Clean Water Revolving Fund agreement with the EPA.

WIFA should renew its Clean Water Revolving Fund agreement with the EPA.

### 3. The extent to which WIFA has operated within the public interest.

WIFA has operated in the public interest by providing below-market loans and grants to local communities, private water systems, and Native American tribes for critical drinking water and wastewater infrastructure projects. Since its inception, WIFA has funded numerous projects designed to improve the quality of Arizona's drinking water and wastewater infrastructure. Specifically, during the 2002 funding cycle, WIFA provided approximately \$94.6 million in clean water financial assistance, approximately \$19.7 million in drinking water financial assistance, and approximately \$426,000 in technical assistance grants.

To ensure that WIFA serves the public's interest, WIFA is governed by a 12-member board of directors (Board). The Board comprises representatives from several state agencies, large and small communities, sanitation districts, and Native American tribes. Pursuant to A.R.S. §49-1202, WIFA board members cannot have a direct or indirect personal financial interest in any clean water or drinking water project financed by WIFA.

However, WIFA does not follow state guidelines regarding conflict-of-interest disclosures for its board members. Conflicts potentially arise, for example, when the Board votes on projects for systems that serve the board members or their relatives. The Attorney General advises in the *Arizona Agency Handbook* that "any public officer or employee who has a conflict of interest in any agency decision or in the award of a contract must disclose that interest in the agency's special conflict-of-interest file. A.R.S. §38-503(A), (B)." Additionally, A.R.S. §38-509 requires public agencies to maintain a special file for documents related to conflict-of-interest disclosures. According to WIFA's executive director, board meeting minutes serve as public notice when board members refrain from voting due to conflicts of interest. A review of board meeting minutes for 2001 and 2002 found four instances where board members had refrained from voting. However, if meeting minutes are used, A.R.S. §38-502(3) requires they provide a description of the conflict. WIFA's board meeting minutes do not provide that description, nor does WIFA maintain a special file for conflict disclosure documents as required by statute. Therefore, WIFA should ensure that its meeting minutes provide a detailed description of any disclosed conflict and establish a special file for retaining board meeting minutes that disclose conflicts of interest.

Further, external reviews of WIFA's financial systems have identified opportunities for WIFA to strengthen its internal controls. Specifically, WIFA's external auditors noted that daily and monthly accounting procedures were not consistently followed, accounting procedures were not performed in a timely manner, and that accounting entries lacked sufficient information. Additionally, WIFA was unable to meet the statutory deadlines for submitting its final fiscal year 2002 audited financial statements. In response to these issues, the Auditor General

WIFA should follow state guidelines for conflict of interest disclosures.

has scheduled a review of WIFA's financial accounting and reporting internal controls in 2003 (see Other Pertinent Information, pages 23 through 24).

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

At the request of the Office of the Auditor General, the Governor's Regulatory Review Council (GRRC) reviewed WIFA's rules and determined that WIFA has established all rules that are specifically required by statute or necessary to limit or define its function. Additionally, WIFA submitted its 5-year rule review report to GRRC on December 31, 2002, as required by statute.

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

WIFA reports that it has encouraged public input in drafting its proposed rules. For example, WIFA held a public meeting in September 2001 to obtain public comment and input regarding its most recent rule revisions. WIFA indicated that it follows the guidelines established by the GRRC regarding public hearings for proposed rules and will continue to follow this process for rule revisions proposed in its 5-year rule review report.

To further facilitate public input into its activities, WIFA provides stakeholders with draft versions of its annual intended use plans, which detail project priority lists and proposed uses of funds for the clean water, drinking water, and technical assistance programs. WIFA also holds public hearings for its draft intended-use plans to solicit and incorporate public comments. In fact, WIFA held a public meeting in November 2002 to solicit public comment on its 2003 funding cycle intended use plans for the Clean Water Revolving Fund and Drinking Water Revolving Fund programs. Additionally, WIFA holds periodic workshops and training sessions to help communities navigate the application and funding process.

WIFA reports that it has complied with the State's open meeting laws by posting public meeting notices at least 24 hours in advance at the required locations and making agendas available to the public. However, WIFA has not filed the required statement with the Secretary of State indicating where meeting notices will be posted, but should do so.

WIFA should file the required statement on where meeting notices will be posted.

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

WIFA does not have the authority to investigate and resolve complaints.

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

A.R.S. §49-1226 and A.R.S. §49-1246 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 which prevent it from fulfilling its statutory mandate.**

Several changes have been made to WIFA statutes in recent years, some of which have enhanced WIFA's ability to fulfill its statutory mandate. For example:

- Laws 1998, Chapter 72 provides WIFA with greater flexibility in structuring, issuing, and managing revenue bonds. This legislation gave WIFA the ability to restructure its bond debt in 1999, which resulted in WIFA receiving a AAA bond rating (the highest possible rating) from national credit rating agencies.
- Laws 2001, Chapter 250 grants authority to WIFA to intercept a municipality's state-shared revenues in the event of a default on a WIFA loan by the borrower (intercept authority). State-shared revenues are monies that the State collects and then disburses to Arizona communities according to various statutory requirements and formulas.
- Laws 2001, Chapter 250 also authorizes WIFA to provide planning and design loans to local governments prior to local debt authorization to facilitate project development and public input.

In future legislative sessions, WIFA plans to request action on two matters. First, it plans to request a change in statute regarding its intercept authority for state-shared revenues. Currently, both WIFA and the Greater Arizona Development Authority (GADA) have authority to intercept such revenues in the event that borrowers default.<sup>1</sup> While statute does specify that GADA and WIFA should enter into an inter-creditor agreement if a borrower defaults and owes money to both authorities, WIFA reports that it will continue its efforts to statutorily enhance its intercept coordination with GADA. Second, WIFA plans to propose legislation to

<sup>1</sup> The Greater Arizona Development Authority provides financial assistance to counties, cities, towns, special districts, and Native American tribes for constructing or improving infrastructure such as parks, public safety buildings, and telecommunications services.

expand its hardship grants program to both drinking water and wastewater projects. The hardship grants program provides financial assistance to designated disadvantaged communities for wastewater infrastructure projects.

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

Audit work did not identify any needed changes to WIFA's statutes.

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

Terminating WIFA could harm the public's health, safety, and welfare since WIFA provides valuable, low-cost financial assistance to Arizona's communities for drinking water and wastewater infrastructure improvement projects. If WIFA were terminated and its functions not transferred to another entity, this low-cost financial assistance might not be available to Arizona's communities and water systems, which could result in the public paying more for drinking water and wastewater infrastructure improvement projects. Additionally, some communities may be unable to finance projects on their own and the public could suffer from the potential decline in water quality.

If the State were to terminate WIFA, it would have to address certain statutory provisions. Specifically, federal laws require each state to designate an administrator for the Clean Water and Drinking Water State Revolving Funds, but do not specify a particular type of agency or entity. Therefore, the Legislature could designate another state entity to assume WIFA's responsibilities if WIFA were terminated.

However, provisions outlined in A.R.S. §41-3004.19 specify that the Legislature cannot terminate WIFA if it has a contractual obligation with any federal agency or outstanding debts. WIFA currently has a written agreement with the EPA for the administration of the Drinking Water Revolving Fund program, but needs to renew its agreement to administer the Clean Water Revolving Fund program. Additionally, WIFA has approximately \$241.9 million in outstanding bond debt as of June 30, 2002. If the Legislature terminated WIFA, certain provisions would have to be made to transfer the operating agreement with the EPA to another state entity and pay or retire WIFA's bond debt.

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

This factor does not apply since WIFA does not have regulatory authority.

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

According to A.R.S. §49-1203(B)(10), WIFA can contract for the services of outside advisors, attorneys, consultants, and aides to assist it in performing its duties. As a result, WIFA reports that it relies on private contractors in all phases of project conception, development, and financing. The following are examples of services provided by some of WIFA's private contractors:

- **Financial advisors**—WIFA contracts with financial advisors to assist with the preparation, management, and coordination of its bond issues. This assistance includes making recommendations for investing bond proceeds and structuring debt and repayment schedules.
- **Private attorneys**—WIFA also contracts with a private attorney firm to assist with the preparation of the official bond statements and provide legal advice regarding the language in WIFA's loan agreements. To issue and market bonds, WIFA must use specialized attorneys that have developed the necessary expertise to provide an objective legal opinion concerning the issuance and sale of the bonds, including the sources of payment and security for the bond issue.<sup>1</sup>
- **Trustee**—WIFA contracts with a trustee, US Bank, to administer its approximately \$78 million in guaranteed investment contracts, which are contracts signed with financial institutions guaranteeing a specified rate of return on investments. As part of its bond issuance requirements, WIFA must maintain a reserve for the bonds it issues, and these reserves are held in the guaranteed investment contracts.
- **External auditors**—WIFA contracts with a public accounting firm to perform an annual financial audit of its funds as required by A.R.S. §49-1204(A).
- **Technical Assistance Providers**—WIFA and its borrowers contract with engineering and financial firms to review, plan, and design WIFA-funded financial and technical assistance projects.

This audit did not identify any further uses for private contractors.

<sup>1</sup> "Selection of Bond Counsel." Michigan Department of Treasury. 4 Feb. 2003. <[http://www.michigan.gov/treasury/0,1607,7-121-1752\\_2235\\_2238-5898--,00.html](http://www.michigan.gov/treasury/0,1607,7-121-1752_2235_2238-5898--,00.html)>.



# AGENCY RESPONSE



Water Infrastructure Finance Authority of Arizona  
*Janet Napolitano, Governor*

April 21, 2003

Debra K. Davenport, Auditor General  
Office of the Auditor General  
2910 N. 44th Street, Suite 410  
Phoenix, Arizona 85018

Ms. Davenport:

On behalf of the Board of Directors of the Water Infrastructure Finance Authority of Arizona (WIFA), I am pleased to submit the attached response to the Office of the Auditor General's WIFA Performance Audit Report. I am particularly pleased that the revised Performance Audit Report incorporated many of the conclusions from our April 4, 2003 meeting and incorporated many concerns within WIFA's April 8, 2003 correspondence.

I believe the tone of the Report is constructive, productive, and objective and will serve WIFA well as we continue to automate our internal financial management systems. We look forward to demonstrating our progress during follow-up reviews.

Sincerely,

Greg Swartz, Executive Director  
Water Infrastructure Finance Authority

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*Arizona's Water  
and Wastewater  
Funding Source*



cc: Dale Chapman, Melanie Chesney, Andrea Leder, Bill Thomson, Jessica Tucker

**Water Infrastructure Finance Authority of Arizona  
Response to Performance Audit Report**



**Submitted to the Auditor General**

**April 21, 2003**

## **Water Infrastructure Finance Authority of Arizona Response to Performance Audit Report**

### **Introduction**

The Performance Audit Report (henceforth, the “Report”) by the Office of Auditor General (OAG) includes three substantive components – ***Audit Findings, Other Pertinent Information, and Sunset Factors***. The Water Infrastructure Finance Authority (WIFA) will respond to OAG recommendations and issues by report component below.

### **WIFA’s Response to Audit Findings**

The OAG identified and addressed one audit finding relating to the accuracy of priority scores within WIFA’s 2003 Funding Cycle project priority lists. The OAG recommended that WIFA implement policies and procedures to ensure accuracy of scores used to generate project priority lists.

It is essential and factual to note that scoring errors noted in the OAG Report concerned draft scores on draft priority lists for the 2003 Funding Cycle. WIFA’s Board of Directors adopts final priority lists following public and comment. Subsequently, WIFA’s Board of Directors considers and awards funding only after an applicant submits a detailed Project Finance Application and after staff complete a due diligence report on the applicant. In effect, there are multiple reviews and opportunities to correct omissions and errors prior to a Board action on a loan request.

Given the distinction between draft priority lists, final priority lists, and Board actions to award funding, WIFA contends that it is unlikely that draft scoring errors can translate into incorrect interest rates and subsidies within loan agreements. Regardless of the low probability of compounded errors, WIFA believes enhancing procedures to reduce errors will increase confidence in the process and outcome. Accordingly, ***the finding of the Auditor General is agreed to and the audit recommendation will be implemented*** as outlined below.

To enhance procedures for scoring projects on the draft priority list, WIFA will:

1. Clarify procedures to ensure consistent scoring. Implementation Deadline: September 30, 2003
2. As part of WIFA’s ongoing automation effort, automate priority list scoring process with business rules governing scoring separate from application data input. Implementation Timeline: November 30, 2003
3. Require staff to certify priority list scores. Implementation Timeline: November, 2003.
4. Require Project Priority Committee (subset of Board members) approval of draft priority lists prior to public review and comment. Implementation Deadline: November 30, 2003

### **WIFA’s Response to Other Pertinent Information**

Within the Other Pertinent Information component of the Report, the OAG reported on three issues:

- Federal Clean Water (Revolving Fund) Allocation Formula
- New Arsenic Standard
- Concerns about WIFA Internal Controls

WIFA will separately respond to each of the three issues as detailed below.

### Federal Clean Water (Revolving Fund) Allocation Formula

WIFA will continue to coordinate with the Governor's Office and the Congressional Delegation to encourage Congress to adopt a needs-based formula to allocate CWRP funding.

### New Arsenic Standard

WIFA was pleased to assist the Arizona Department of Environmental Quality in generating the Arsenic Master Plan and looks forward to the challenge of providing financial assistance to those water systems affected by the new arsenic standard.

### Concerns about WIFA Internal Controls

In accordance with state statute, WIFA must secure the services of an external auditor and generate annual audited financial statements. The OAG noted concerns about WIFA's Internal Controls based on statements from external auditors associated with the 2001 and 2002 audits.

It is essential and factual to note that WIFA's accounting system simply summarizes transactions initiated and occurring within accounting systems managed by the State of Arizona and WIFA's Trustee. Presently, WIFA has no authority to independently withdraw, deposit, or transfer funds outside of the State of Arizona and Trustee accounting systems. Furthermore, all withdraws, deposits, and transfers must conform to Federal, State, and WIFA Master Indenture requirements.

WIFA maintains a redundant "shadow" accounting system, including a general ledger, to summarize transactions controlled elsewhere, to categorize the data in a manner consistent with accounting standards, to compute net worth, and to facilitate reporting of the data. In effect, given the parameters under which WIFA operates, the possibility of fraud or deceit is very remote.

WIFA agrees it must continue to improve its internal financial controls through automation, retaining skilled, experienced, and motivated staff, and by adopting relevant policies and procedures. However, the concerns about internal controls and ability to meet reporting deadlines must be viewed within the context of the unique challenges facing WIFA's FY 2002 Audit.

Simply put, it is reasonable to view the FY 2002 Audit as an anomaly. More specifically, during the July 1 through December 31, 2002 period, the following concurrent events impacted WIFA :

- WIFA's Move to New Office Space
- Absence of Key WIFA Fiscal Personnel
- Implementation of a New General Ledger Accounting Structure
- New WIFA Controller (*In response to the FY 2001 Audit, WIFA's Board authorized the creation of a new Controller position in April, 2002 and management filled the position in July, 2002.*)
- New WIFA Environmental Manager and Environmental Coordinator (*Staff responsible for technical and environmental issues occupied their positions for less than six months with no prior priority list experience.*)
- 5 Year Rule Review (*WIFA analyzed its rules and made recommendations for improvements to comply with a December 31, 2002 deadline from the Governor's Regulatory Review Council.*)
- FY 2002 Financial Audit
- Sunset/Performance Audit
- Arbitrage Audit
- Ongoing Automation Efforts
- Change in Trustee

Simply put, during the period July through December, 2002, WIFA was overwhelmed and targeted

resources as best it could under unique circumstances. The unfortunate consequence – concerns about internal controls and ability to meet reporting deadlines – was the direct result of this overwhelming workload and reliance on new staff to perform unfamiliar tasks.

Given the above circumstances, WIFA’s Executive Director delayed the final audited financial statements to ensure financial accuracy, compliance with GASB 34, and to meet the higher standard resulting from WIFA’s financial statements becoming material, for the first time due to increasing fund balances, within the State’s Comprehensive Annual Financial Report.

Looking to the future, the need for comprehensive and integrated financial software applications constitutes the greatest challenge to improve WIFA’s internal controls and reporting capability. Accordingly, WIFA continues to design, implement, and deploy software applications to automate day-to-day fiscal and program functions.

Since July, 2002 until present, the Authority implemented the following fiscal software applications:

- Fixed Asset Management,
- Interim Loan Servicing (*interim until comprehensively integrated with all fiscal applications*),
- Federal Capital Contributions, and
- Grant Management

WIFA will implement the following critical and integrated fiscal applications by July 1, 2003:

- Deposits,
- Withdraws,
- Transfers,
- Investment Management,
- Debt Management,
- State Match Management,
- Accounting Structure (*governs and automates transactions within and between accounts*), and
- General Ledger (*vast majority of data reported within general ledger will be entered as transactions within other fiscal applications; direct general ledger entries will be limited to non-cash transactions and end of year adjustments such as bond cost amortizations*).

In conclusion, WIFA continues to make dramatic progress to implement customized fiscal software applications that interface within WIFA as well as with the State and Trustee accounting systems.

### **WIFA’s Response to Sunset Factors**

In accordance with A.R.S. 41-2954, OAG reviewed<sup>12</sup> “Sunset Factors” and noted three issues:

- WIFA should renew its CWRP Operating Agreement with EPA.
- WIFA must enhance procedures for disclosing Board members conflicts of interest.
- WIFA must file required public meeting notice statement with the Secretary of State.

For each of the above, ***the finding of the Auditor General is agreed to and audit recommendation will be implemented*** (renew CWRP Operating Agreement) or has been implemented (disclose conflicts of interest and public meeting notice statement).

## Performance Audit Division reports issued within the last 12 months

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<b>02-01</b>	Arizona Works	<b>02-11</b>	Department of Health Services—Health Start Program
<b>02-02</b>	Arizona State Lottery Commission	<b>02-12</b>	HB2003 Children’s Behavioral Health Services Monies
<b>02-03</b>	Department of Economic Security—Kinship Foster Care and Kinship Care Pilot Program	<b>02-13</b>	Department of Health Services—Office of Long Term Care
<b>02-04</b>	State Parks Board—Heritage Fund	<b>03-01</b>	Government Information Technology Agency—State-wide Technology Contracting Issues
<b>02-05</b>	Arizona Health Care Cost Containment System—Member Services Division	<b>03-02</b>	Registrar of Contractors
<b>02-06</b>	Arizona Health Care Cost Containment System—Rate Setting Processes		
<b>02-07</b>	Arizona Health Care Cost Containment System—Medical Services Contracting		
<b>02-08</b>	Arizona Health Care Cost Containment System—Quality of Care		
<b>02-09</b>	Arizona Health Care Cost Containment System—Sunset Factors		
<b>02-10</b>	Department of Economic Security—Division of Children, Youth and Families, Child Protective Services		

## Future Performance Audit Division reports

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Department of Commerce

State Board of Funeral Directors and Embalmers

Electric Deregulation