

REPORT HIGHLIGHTS PERFORMANCE AUDIT

Subject

The Legislature established the Water Infrastructure Finance Authority (WIFA) in 1997 to provide financial assistance for projects related to the construction or improvement of drinking water, wastewater, or other water quality facilities.

Our Conclusion

WIFA has developed processes for prioritizing projects, but additional review steps could help to ensure that eligible projects are accurately scored and the project interest rates appropriately determined. This report also discusses how the outdated federal formula used to allocate Clean Water State Revolving Fund monies fails to recognize Arizona's needs, and the significant costs the State faces to comply with the new federal arsenic drinking water standards.



2003

WIFA Funds Water Facility Projects

WIFA administers three main programs designed to improve public drinking water systems and wastewater treatment systems.

WIFA Programs

- **Clean Water Revolving Fund program**—provides low-interest loans to plan, engineer, construct, rehabilitate, upgrade, and/or equip public wastewater and water reclamation systems, such as wastewater treatment plants.
- **Drinking Water Revolving Fund program**—provides low-interest loans to plan, engineer, construct, rehabilitate, upgrade, and/or equip public and privately held drinking water systems.
- **Technical Assistance Program**—assists eligible wastewater and drinking water systems to design facilities and prepare for construction.

WIFA plays a particularly important role in assisting smaller communities. Since 1989, WIFA and its predecessor issued 131 loans and grants, providing an estimated \$479 million to Arizona communities and water systems. Three-fourths of these loans and 32 percent of this money (\$154.4 million) assisted small communities and water systems serving 10,000 or fewer people for drinking-water assistance and 9,999 or fewer people for clean-water assistance.

WIFA uses several sources to provide project funding:

- **Federal grants**—Arizona is allocated federal grant monies annually to help



City of Peoria's Greenway Water Treatment Plant

pay for water infrastructure projects. As WIFA pays for these water infrastructure costs, it requests these grant monies from the U.S. Environmental Protection Agency (EPA).

- **State General Fund**—Arizona must match at least 20 percent of the federal grants. In the past few years, the State has used General Fund monies to provide the match. For example, in fiscal year 2002, WIFA received approximately \$3 million from the State General Fund, which it used toward the match. Before 1998, revenue bonds and loan fees provided the match.
- **Revenue bonds**—WIFA issues revenue bonds to fund projects approved by its board. WIFA last issued bonds in fiscal year 2002, totaling \$110 million. These bonds have the highest rating, AAA, which permitted WIFA to sell them at lower interest rates to benefit Arizona water systems. WIFA had about \$242 million in bonds outstanding as of June 30, 2002.
- **Loan payments and fees**—Borrowing communities make principal and interest payments that are returned to WIFA's revolving fund programs and used for retiring debt and new loans. In fiscal year 2002, WIFA collected more than \$35.6 million in loan payments, including interest.

WIFA Needs To Better Ensure Accuracy of Project Review and Scoring Processes

Each calendar year, WIFA accepts loan applications from communities and water systems for funding for water infrastructure projects from the two revolving funds.

Prioritization and monitoring procedures comply with federal requirements—In compliance with federal regulations, WIFA establishes a project priority list by scoring the applications based on:

- The existing water infrastructure problem
- Project benefits
- The community's economic condition

Federal regulations then require WIFA to develop a list of fundable projects. WIFA bases its list on whether the project is ready to proceed and the amount of funds available. If a project is not ready to proceed and therefore not eligible for funding, communities and water systems can reapply for assistance in the next funding cycle.

Federal law also requires WIFA to provide loans at or below market interest rates. WIFA sets the interest rate just prior to finalizing the loan. It charges from 70 percent to 100 percent of the tax-exempt rate for governmental entities, and the prime rate for nongovernmental entities.

Before finalizing the loan, federal regulations require WIFA to ensure that each system has a dedicated revenue source to repay the loan. WIFA also requires that each system have the management, technical, and financial capability to operate.

Ninety-three percent of initial application scores had errors—Our review found scoring errors in 96 of the 103 projects that WIFA initially scored for the 2003 funding cycle. Inaccurate calculations, skipped steps, and missing data resulted in these errors. While WIFA corrected these errors before the Board approved the final priority list and funded any projects, the errors could have resulted in WIFA inaccurately determining the interest rate subsidies.

- The interest rate subsidy miscalculation on a \$20 million project in a Maricopa County community would have caused WIFA to set the interest rate too low for the project loan. As a result, the community would have underpaid \$1.2 million in interest to WIFA over the loan term.
- For a Cochise County community, the interest rate subsidy miscalculation would have caused WIFA to set the interest rate too high for the project loan. As a result, the community would have overpaid more than \$341,000 in interest to WIFA over the loan term.

The initial scoring errors also led to incorrectly prioritized projects. After the corrections, one project moved up 11 positions on the draft priority list.

WIFA could improve scoring reliability by developing a procedure to guide staff as they review formulas and enter information into the scoring data sheets. In addition, WIFA would benefit from a policy requiring management to review formulas and scoring data sheets.

For the 2003 funding cycle:

- WIFA received 103 applications requesting over \$249 million in assistance.
- WIFA anticipates funding 29 projects totaling over \$92 million.

Recommendations

WIFA should:

- Develop policies and procedures to ensure scoring data sheets' accuracy and completeness.
- Develop a policy requiring management to review scoring data sheets and formulas prior to the draft priority lists' distribution for public comment and Board approval.

Other Pertinent Information

Our report also contains other pertinent information regarding Arizona's allocation of federal clean water funds; the cost impacts to Arizona of new arsenic standards; and concerns about WIFA's financial controls.

Arizona's Federal Clean Water Allocation Falls Short of Needs

The EPA distributes about \$1.35 billion annually to fund clean water infrastructure projects throughout the country. Arizona is one of 14 states whose infrastructure needs exceed their federal allotment, and it currently ranks 37th in clean water grant monies allocated at a total of \$9 million per year. This is in part because the formula for the allocation is derived from 25-year old population data and needs surveys.

Maryland, which has a similar population and less documented clean-water needs, receives more than three times Arizona's \$9 million at \$32 million a year.

According to EPA and WIFA data, Arizona's projected 20-year clean water needs have increased substantially over the last 10 years, from \$975 million in 1990 to \$6.3 billion in 2000..

This means that WIFA has had to rely more heavily on issuing revenue bonds, which require repayment with interest, for funding clean water projects.

The drinking water allocation is need-based—In contrast to the clean water formula, federal drinking water grants are based on recent needs. Arizona's allocation is based on its share of the total 20-year drinking-water needs estimate for all states published in a 1999 survey. Based on the reported needs, Arizona was allo-

cated a \$9.1 million federal grant in fiscal year 2002.

If the clean water allocation were based on recent reported needs as is the drinking water allocation, Arizona's clean water allocation could go from \$9 million to \$45 million a year, according to a WIFA 2002 needs survey. The State would have to increase its matching funds by \$7.2 million (\$9 million total), but could issue revenue bonds rather than rely on the General Fund to do this.

A change in the clean water formula requires congressional action. Although congressional delegates tried to make this change in 2002, the proposed legislation was defeated. One Arizona senator plans to continue his efforts to move toward a needs-based clean water allocation formula.

New Arsenic Standard Could Cost State Almost \$1 Billion

In January 2001, the EPA reduced the acceptable level of arsenic in drinking water systems to 10 parts per billion (ppb) from 50 ppb, pursuant to amendments to the Safe Drinking Water Act passed by Congress. Impacted water systems have until 2006 to bring their systems into compliance.

About 6 percent of the nation's water systems will need to lower their current levels of arsenic to comply with the new standard. However, Western states' systems—particularly those in Arizona, New Mexico, and Nevada—will face significant compliance problems.

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*.

Larger systems have more options available to pay for compliance costs. For example, the City of

Scottsdale recently instituted a 5 percent rate hike and plans to issue bonds to pay the estimated \$64 million to comply. However, passing the significant compliance costs for small systems on to their users could be particularly burdensome.

The federal Safe Drinking Water Act authorizes states to use the federal Drinking Water State Revolving Fund monies to

help fund arsenic compliance costs. In addition, the Arizona Department of Environmental Quality may grant extensions beyond the 2006 deadline to qualifying water systems.

Concerns about WIFA Internal Controls

WIFA receives an annual financial audit from independent external auditors. During the fiscal year 2001 and 2002 audits, WIFA's external auditors noted weaknesses in WIFA's internal controls over its accounting and financial reporting systems. While WIFA has taken some steps to address these weaknesses, including hiring staff and developing a new automated accounting system, WIFA's external auditors made additional recommendations for improvement.

In addition, WIFA was unable to meet its statutory deadlines for submitting its final fiscal year 2002 audited financial statements. This delayed the State in issuing its financial reports. According to WIFA's executive director, an outdated financial reporting system and attempts to implement an automated accounting system resulted in the delay.

In response to these issues, the Auditor General has scheduled a review of WIFA's internal and management controls in 2003.

Impact of the Change in the Arsenic Standard

Nationwide estimates:

- 12.7 million people affected
- 4,100 (5.5 percent) of the nation's 74,000 water systems affected
- Costs to comply—\$181 million annually for 20 years

Arizona estimates:

- 320 (20 percent) of Arizona's more than 1,600 systems affected
- Costs to comply—between \$565 million and \$987 million
- 90 percent of affected systems (287) are small with fewer than 10,000 customers

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