



UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

111886
~~13216~~

COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

IN REPLY
REFER TO:

B-197590

MARCH 25, 1980

The Honorable Cecil D. Andrus
Secretary of the Interior

ASC 0053



111886

Dear Mr. Secretary:

Subject: [Selected Water Sales Contracts] (CED-80-69)

During our review of the adequacy of western water supplies to support energy and mineral development, we identified several large and important Federal reservoirs in the Upper Colorado and Upper Missouri Basins which have water for sale. We briefly analyzed industrial water marketing practices at those reservoirs. As a result of that analysis, we identified several issues that warrant your attention.

We found that the Water and Power Resources Service (formerly the Bureau of Reclamation) had, on occasion, not charged enough for water to (1) recover total reimbursable project costs, (2) account for the increased market value of water, and (3) account for the increased availability of water for sale. In each case Federal costs could have been recovered more quickly if appropriate prices had been charged. Since we limited our analysis to contracts identified in the energy and mineral review, we do not know how prevalent the issues discussed in this report may be. Nevertheless, we believe each issue involves important water marketing practices that should be examined carefully and corrected where possible.

We believe that the examples in this report demonstrate the need for additional monitoring of water marketing policies to assure adequate water prices, project repayment, and regional and project consistency. None of our recommendations involve new legislation or even new Interior policies; we are simply recommending that additional attention be given to appropriate marketing practices.

009216

(080370)

Generally, Resources Service project authorizations require that project users reimburse the U.S. Treasury for costs associated with certain uses such as irrigation, municipal and industrial water, or power. Most of the other project costs are classified as nonreimbursable and are financed from the U.S. Treasury. In addition, if irrigators do not repay their share of project costs, Federal power users must pay a larger share of total project costs.

The time period for repayment is generally set for a maximum of 40 or 50 years. The authorization acts do not have a minimum repayment period; the Resources Service can reduce the repayment period at its own discretion.

INTERMEDIARIES PROFIT, BUT RESOURCES SERVICE DOES NOT RECOVER FULL COSTS FROM WATER USERS

The Resources Service permitted the State of Wyoming to resell Federal project water--and make a large profit--while not charging the State even enough to recover all reimbursable project costs. Wyoming can buy water from the Resources Service at low prices and sell to consumers at high market prices, realizing a profit of several million dollars per year. However, since the Resources Service charges Wyoming prices too low to pay for the reimbursable cost of the project, either the taxpayer or power users must pay more for their shares to make up the difference.

In the mid-1960s the Resources Service completed Fontenelle Dam and Reservoir (Seedskaadee Project) on the Upper Green River in Wyoming. Although the reservoir was originally designed primarily to provide irrigation water, the marginal value of irrigation water resulted in a reallocation to municipal and industrial use. On the other hand, the reservoir's strategic location for future energy and mineral development and the limited availability of alternative sources of water have greatly increased the water's market value for municipal and industrial use.

In 1962 the Resources Service sold to the State of Wyoming 60,000 acre-feet of reservoir capacity under a 40-year contract for \$43,000 per year. In turn, Wyoming

sold the 60,000 acre-feet for \$340,000 per year. The contract contains no provision to limit or share Wyoming's profit.

In 1974, the Resources Service sold another 60,000 acre-feet of Fontenelle Storage. In addition, the contract provided the State with 65,000 acre-feet of direct flow rights from the Green River. The contract price was about \$0.5 million per year. Wyoming offered the 125,000 acre-feet of water for sale at \$25 to \$40 per acre-foot, depending on the quantity purchased. Wyoming has requests for all of the water. When all water is sold, Wyoming's revenue will be between \$3.25 million and \$5 million per year and its cost about \$0.5 million per year; consequently, Wyoming's profit could be \$4.5 million per year (less minor administrative expenses).

Recognizing to some extent the income the State will generate from the first sale, the Resources Service included an agreement that limits (only temporarily) Wyoming's profit on the second sale:

"For those contracts which are executed between the State and a third party and which provide revenues to the State in excess of that required to be paid to the United States, as specified herein, the State agrees that 50 percent of such excess revenues will be returned to the United States and will be applied to the unpaid balance of the repayment obligation, including interest,
* * * Any such revenues so applied will accelerate the repayment of the State's obligation."

While reducing the payment period has merit, it does not increase long-term revenue to the Federal Government; it simply speeds up the repayment period. When the contract price is repaid, all of Wyoming's annual revenue will be profit.

Although Wyoming's opportunity to profit from Fontenelle water sales is substantial, the Resources Service's revenue from the two contracts is not sufficient to recover all reimbursable project costs. Fontenelle still has about 65,000 acre-feet of storage which no one has offered to buy. If this water remains unsold, the Federal Government will

never fully recover its costs of this project from users. Instead, either the power user (if the water is allocated to irrigation) or the taxpayer (if the water is allocated to nonreimbursable use) will have to pay the cost of the remaining storage.

Based on an Interior Solicitor's opinion, the Resources Service appears to have had authority to charge Wyoming for the total reimbursable project costs. In 1974 the Assistant Solicitor for Water wrote:

"In my opinion, the Secretary has the discretion to fix water rates per M&I [municipal and industrial] uses at levels exceeding the amounts to return the costs presently charged to such uses, * * * so long as there is a reasonable basis for such exercising discretion and he does not act arbitrarily or capriciously."

And the Assistant Solicitor continued:

"In the absence of an express statutory requirement or a clear expression of intent in the legislative histories, it cannot reasonably be inferred that Congress would have intended to perpetuate rates which, because of changed circumstances years after the feasibility studies were completed, are not only presently unrealistic, but counter-productive from the point of view of encouraging water conservation."

FAILURE TO CONFIRM ALTERNATIVE COST
OF WATER RESULTED IN THOUSANDS OF
DOLLARS IN LOST REVENUE

Because the Resources Service failed to determine the appropriate price for industrial water sales in Wyoming, several thousand dollars of revenue was lost and much more may be lost in the future. Instead of charging the current market price, the Resources Service sold water to an energy company at reduced rates. However, since the water was sold under short-term contracts, additional revenue could be returned to the Treasury if appropriate prices are used in succeeding contracts.

The Resources Service issued three separate 500-acre-foot water contracts for North Platte River water to an energy company between January 1978 and March 1979. The energy company used the water to generate electric power in a steam powerplant and paid \$25 per acre-foot for the water.

Resources Service officials said the city of Cheyenne, Wyoming, had sold water to the energy company for \$25 an acre-foot. Since Resources Service policy requires that alternative sources of water be considered in setting municipal and industrial water prices, the \$25 price seemed consistent with Resources Service policy.

However, at the time of all three Resources Service contracts, Cheyenne had contracted with the utility for a price of \$30 per acre-foot, not \$25. Beginning in 1977, Cheyenne raised its price of water from \$25 to \$30. The \$25 amount was only valid in 1975 and 1976, before the Resources Service contracts. Resources Service officials said they were not aware that Cheyenne had raised its price to the utility company.

In addition, the water from the Resources Service contract was worth more than water from the Cheyenne contract. While Resources Service water was available at the location where the utility company would use it, the Cheyenne water had to be sent downstream. The State Engineer ruled that 15 percent of the Cheyenne water was lost during conveyance to the utility company. Consequently, the energy company could use only 85 percent of the water it purchased from Cheyenne. This means that the Resources Service contract could deliver 15 percent more water per acre-foot sold than could the city of Cheyenne.

If the price of water from the three Resources Service contracts had been calculated to include the higher price charge by Cheyenne, and the difference in the value of the water, revenue to the Government would have increased \$12,000 for the three contracts. Since the energy company had already paid the higher price to the city of Cheyenne, it is likely that the energy company would not have objected to paying the same price to the Resources Service.

The three contracts involving North Platte River water resulted in a \$12,000 decrease in Federal revenue; similar underpricing may cause larger decreases on future contracts.

For example, the energy company with the three Resources Service contracts and the city of Casper, Wyoming, have requested new water contracts. If the same water prices are charged for the two proposed contracts, over \$80,000 per year will be lost. Similar losses may occur on other proposed contracts.

WHILE RESOURCES SERVICE RECEIVES NO
REVENUE FROM RETURN FLOWS, AN INTERMEDIARY
BENEFITED FROM THEIR SALE

Although the Resources Service typically claims return-flow waters (water that can be reused after first being applied to cropland and percolated back into the water system) derived from its projects, the Fryingpan-Arkansas Project return-flow rights were given, without charge, to the Southeastern Colorado Water Conservancy District. The district, in turn, sold project return flows to farmers and municipalities. Because the district does not pay for return flows, part of the project cost was shifted to others, such as power users. However, since the contract will soon be renegotiated for final payment, the Resources Service has another opportunity to recover an appropriate value for the return flows.

A contract between the Resources Service and the Southeastern Colorado Water Conservancy District was executed January 21, 1965. We were told that the initial draft of the contract reserved return flows for the United States. However, the executed contract reserved return flows for the district. The apparent basis for this contract provision is a regional solicitor's November 12, 1964, memorandum which states:

"The expectation that return flows resulting from the project will benefit project water users is one of the benefits considered in the development of the project. The project plan does not carry any intent of extracting revenues from such water even if possible."

Reasons cited by Resources Service officials for not charging the district for return flows included:

--Such charges were excluded from the contract.

--The district has the right to return flows and this right was probably given to the district during contract negotiations.

- Sales of return flows were not part of the contract because no one knew they could be sold.
- The Federal Government could not charge for return flows because it did not know how to define or measure them.
- They did not realize that the district was charging or could charge anyone for return flows.

Regardless of the merit of each reason, return flows are a substantial benefit of the Fryingpan-Arkansas Project and the district profits from their sale.

After the State Engineer ruled that 40 percent of the irrigation water returns to the river system, the district began (in 1972) selling return flows for the limited amount of available water, and it plans to continue selling them. When the project is completed, much more water will be available. Based upon 40 percent of initial diversions, approximately 27,680 acre-feet of return flows will be made available for second sale. Without considering the potential for further resale (return flows on return flows), the district could generate revenue of \$149,472 per year at the current repayment rate of \$5.40 an acre-foot.

However, the return flows could be worth much more than \$5.40 per acre-foot. For example, on January 17, 1978, the district sold 650 acre-feet of return flows for \$10.30 an acre-foot. The district has made several similar sales.

While the Resources Service did not charge for return flows, it recognized their value and the revenue they would provide beneficiaries. If return flows do increase project revenue, they increase the irrigators' ability to repay project costs. Some of the additional revenue should be applied to repaying project costs.

In addition, the Resources Service may have another opportunity to recover revenue from sales of return flows. Because project costs exceed original estimates, the current water service contract will be renegotiated for final payment. When that renegotiation occurs, the Resources Service can recover a higher proportion of project costs from irrigators by recognizing the sales of return flows as an additional source of project revenue.

CONCLUSIONS

In each of the three contracts discussed in this letter, we found that the Resources Service had charged water rates that were too low to guarantee expeditious Federal cost recovery. Unfortunately, when water intermediaries or users do not pay an appropriate share of Federal project costs, others must make up the difference. In fact, part of the cost may never be repaid to the Federal Government. Since the water consumers had already paid higher prices than the Resources Service charged, higher Federal rates would probably have had little, if any, impact on them.

In our opinion, these three contracts do not protect the interest of the Federal Government because they do not provide for timely repayment of project costs. The Resources Service has the obligation to at least consider the implications of its pricing policies on repayment and, therefore, on the taxpayer. Based on Interior's Assistant Solicitor's opinion, the Resources Service appears to have ample authority to base the sales price of municipal and industrial water on the local market price of that water as established by comparison with other water sales or the subsequent resale of the Federal project water. Low water rates simply do not appear justified.

RECOMMENDATIONS

We recommend that the Secretary of the Interior require the Commissioner, Water and Power Resources Service, to:

- Set water prices at an amount that will at least recover all reimbursable costs when additional contracts for Fontenelle water are issued.
- Include in the Fryingpan-Arkansas contract a requirement that some revenue from the sale of return flows be repaid to the U.S. Treasury.
- Use prices that recognize the current value of water when new North Platte River municipal and industrial water contracts are issued.

- - - -

The Assistant Commissioner for Planning and Operations, Resources Service, and other officials at headquarters and regional offices, stated that the above data and factual information was correct. Service officials in offices responsible for administering the three contracts concurred that higher prices were probably warranted by the circumstances of each case--when considered under current Service marketing practices.

Headquarters officials questioned, however, whether the first recommendation (Fontenelle) was justifiable and equitable to prospective contracting entities. They also said they were unsure about the legality of the second recommendation under the existing Fryingpan-Arkansas contract. They added that the third recommendation (North Platte) had already been implemented.

We believe that requiring future Fontenelle Reservoir contractors to repay all remaining reimbursable costs is both justifiable and equitable. Since the current contractor has the right of refusal to all remaining water, that same entity is the most likely future contractor for all remaining water. Requiring increased recovery of project costs is justified by (1) the law mandating repayment of all reimbursable costs, (2) Interior's legal opinion suggesting accelerated repayment through higher municipal and industrial water rates, and (3) the large profit accruing to the contractor.

The question of equity is misplaced. Since the U.S. taxpayer must absorb those costs that project users or beneficiaries do not, the taxpayers are the ones inequitably treated. It appears far more equitable that water users or beneficiaries absorb project costs than those whose benefits from the project are few. In effect, the existing pricing policy has provided the contractor (i.e., State of Wyoming) with a form of revenue sharing but without specific congressional authorization.

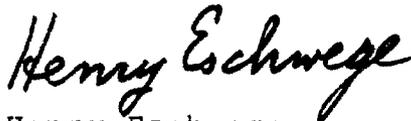
If the Service is unsure about the entitlement to revenues from return flows, a request for a legal opinion from the Interior Solicitor seems warranted. Since initial work on contract renegotiation will begin later this year, results of the Solicitor's opinion would be helpful in preparing for renegotiation.

While the Resources Service receives no revenue from return flows, the contractor profits from their sale. Consequently, even with a negative opinion from the Solicitor, the issue of return flows should be reintroduced during any contract renegotiation initiated by the contractor. This is so because a significant source of income (the sale of return flow rights) was excluded in determining repayment ability.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs no later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to appropriate House and Senate committees and to the Director, Office of Management and Budget. We will also make copies available to interested organizations as appropriate and to others upon request.

Sincerely yours,



Henry Eschwege
Director