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Deconstructing the Colorado River: Part II

In Part I, *WS* reviewed the emerging economic and environmental pressures on the Colorado River (*WS January 1994*). From an economics perspective, the long-term market value of Colorado River water for consumptive uses must increase. This rising value of water will intensify the stakes of parties in the emerging changes in the law and policy governing the Colorado River. The culmination of Reclamation's three-year effort to draft regulations for administering entitlements in the Lower Colorado River Basin is the critical next step.

On May 6, Reclamation released "informational copies" of the third version of its draft regulations and a draft notice of proposed rulemaking anticipated to be published this June in the *Federal Register*. In this article, *WS* analyzes how the draft regulations address the key issues on use of Colorado River water, which are:

- off reservation leasing Indian reserved water rights;
- interstate leasing;
- amount of water eligible for transfer;
- the Regional Director's discretion during approvals;
- banking Colorado River water;
- the use of conservation plans to increase the transparency and accountability of formal decision-making by entitlement holders;
- administration of the reasonable use standard;
- the imposition of fees to pay the costs of reimbursable services provided by Reclamation.

In general, adoption of Reclamation's draft regulations would broaden the potential market for water transactions and expand the use of economic principles in regulatory decision-making. Despite *WS*'s award of "high marks" to this draft, there remain troubling ambiguities and omissions that, if remedied, could further the use of market forces and economic principles in resolving the pressures on the Colorado River.

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"Deconstructing the Colorado River" is the second article in a two-part series on the allocation of Colorado River water. It reviews the May 6 release of Reclamation's draft "Regulations for Administering Entitlements to Colorado River Water in the Lower Colorado River Basin." The regulations would broaden the scope of potential markets for water transactions and expand the use of economic principles in regulatory decision-making.

"The 1993 Annual Bond Market Review" reports on the $4.99 billion in new money and the $7.76 billion in refinancings in 1993 for water projects in the western states.

"Finance Update" reviews the results from the 156 issues that raised $1.69 billion in the first quarter of 1994 and examines eighteen proposed finance bills.

"Legislative Update" describes the 100 state bills tracked by *WS* this year.

"Litigation Update" examines a ninth federal circuit opinion concerning the allocation of water from the federal Central Valley Project in California. The court held that neither federal law nor contracts required Reclamation to satisfy the needs of San Luis contractors in preference to the holders of downstream water rights.

BACKGROUND

For almost three years, Reclamation has been drafting regulations for the Lower Colorado River Basin. In May 1991, Reclamation released for outside comment draft regulations for "Administrating Entitlements to Colorado River in the Lower Colorado River Basin." It received numerous comments (for *WS*'s views on the 1991 draft, see "Rules of the River," *WS October 1991*). In December 1992, Reclamation released an updated version of the draft regulations to reflect the comments received on the 1991 draft.

For the past year, western water interests have speculated on the status of the draft regulations. The May 6 release should alleviate the mounting apprehension in the west created by the long delay in drafting. The draft regulations are now under final review by the Department of Interior and will be soon submitted to the Office of Management and Budget (OMB) prior to publication in the *Federal Register*. Once the regulations pass OMB review, there will be many opportunities for public discussion and review. After publication, Reclamation plans to hold a series of public meetings in the Colorado River Basin states during the formal 90-day comment period. These meet-

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ings will identify any changes in the regulations needed to achieve consensus for the adoption of the final regulations.

LEASING INDIAN WATER RIGHTS

The proposed regulations let tribes engage in two types of water transactions allowing water available under Indian Reserved Water Rights to be used off the reservation: (1) direct leasing and (2) banking of water and subsequent leasing. Both types of transactions would involve water conserved by "extraordinary" conservation measures or land fallowing. The Department of Interior recognizes that "off-reservation use of Indian entitlement water presents complex legal issues which have not been completely resolved in judicial decisions." In the draft notice of proposed rulemaking (NOPR), Interior describes the basis for its "preliminary legal conclusions" and invites public comment.

WS anticipates a broad and potentially contentious debate over two major issues. Are reserved rights marketable for use off the reservation? Must marketed water have a previous history of use?

The first question has been at the center of numerous legal disputes over Indian water rights. Non-Indians generally argue that the reserved rights doctrine requires water be used only on the reservation. After all, they argue, water rights were reserved for the purpose of the reservation which, in the case of the relevant tribes in the Lower Basin, the U.S. Supreme Court held was agricultural. Indians generally argue that marketing water off the reservation maximizes the economic value of their reserved rights and, as such, may be viewed as consistent with the economic development of the reservation. In the draft NOPR, Interior advances an interpretation of previous supplemental decrees in *Arizona* v. *California* and federal statutes in favor of tribes.

The second question involves one of the major differences between state water law and the reserved rights doctrine. Non-Indians must put a right to beneficial use *before* that right is perfected. Non-use can result in loss of right. Under the reserved rights doctrine, Indians are not required to put water to beneficial use before their right is perfected. Nor can they lose their right by non-use. In the draft NOPR, Interior recognizes this distinction. But, Interior's legal discussion does not explain why the draft regulations limit off-the-reservation marketing to conserved water with a history of use. Instead, the draft regulations reflect the general position of non-Indians, although Interior invites comment on "deferral agreements," which would allow the marketing of water without a recent record of beneficial use (see below).

The stakes of the debate are substantial. The U.S. Supreme Court awarded five Lower Basin tribes reserved rights with annual diversions of up to 917,552 af for the irrigation of 138,563 net acres. Between 1987 to 1992, total annual diversions averaged 773,160 af, or 84.3 percent of maximum annual diversion rights. Most of the diversions represent leasing by non-Indians for on-the-reservation irrigation. Adoption of the proposed draft regulations, therefore, may release a significant block of water into markets in the Lower Basin, even if Indian marketing is limited to water with a record of historical use.

INTERSTATE LEASING

For the first time, the draft regulations allow interstate leasing of water. The draft states, "the leasing of water by the entitlement holder shall be viewed and accounted as a beneficial consumptive use of Colorado River water in the state in which the entitlement is held for the period of the lease." Suppose, for example, Las Vegas leased water from an Arizona agricultural district. The water used by Las Vegas would be credited as beneficial consumptive use of the district's entitlement and, therefore, charged against the State of Arizona's 2.8 million af entitlement for Colorado River water. As with previous versions of the draft regulations, the permanent transfer of entitlements across state lines would not be allowed.

Interstate leasing is generally subject to the same regulations as intrastate leasing (see next section). The term of a lease cannot exceed 50 years. "A lease may be renewed, for a period not to exceed 50 years for each renewal, subject to approval by the Regional Director, if the water associated with the entitlement is not expected to be needed for beneficial consumptive use within the lessor's state during the term of the renewal of the lease and after the public is given an opportunity to comment on the proposed renewal."

Unfortunately, the draft regulations do not specify the criteria that would be used to assess whether leased water would be "needed" within the lessor's State. *WS* can imagine the following situation. At the time of lease renewal, another water user in the lessor's State steps forward with a professed need for the water, but offers price terms and other forms of consideration less valuable to the lessor than the terms offered by the original lessee. Economic considerations would dictate renewal of the interstate lease. What would Reclamation do? If Reclamation plans to rely on market forces, it should say so. If not, why not?

This ambiguity about lease renewals may be significant. Recall two forces at work in the Lower Basin: (1) escalating municipal and industrial demands call for a reallocation of water from agricultural to urban uses, and (2) municipalities need long-term, reliable water supplies. The time horizon for prudent planning exceeds 50 years. By not clearly specifying the "rules of the road," the draft regulations may sacrifice potential economic gains created by interstate leasing.

APPROVAL CRITERIA

The draft regulations contemplate five types of water

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transactions:

- *Assignment*: "the permanent conveyance of an entitlement from an entitlement holder to another person for the same purposes as, and at the same locations";
- *Exchange*: "the exchange of Colorado River water for an agreed-upon amount of other Colorado River water or non-Colorado River water";
- *Lease*: "the temporary conveyance of use of an entitlement";
- *Transfer*: "permanent change in the place of use of all or part of an entitlement";
- *Water Banking and Marketing of Banked Water*: storage of conserved water for later use or marketing.

This section discusses the provisions concerning leases and transfers, which are similar to those for assignments and exchanges. The next section discusses banking transactions. Transfers are permitted only within the State where the entitlement is located. As already discussed, intrastate and interstate leasing are allowed.

The amount of water eligible for inclusion in transfers or leases would be limited to historical reasonable and beneficial consumptive use for the previous five years, or other appropriate period as determined by the Regional Director. For transfers, the approved amount would be the average use during the period. For leases, the approved amount is the water made available through conservation practices or "temporarily discontinued use" such as land fallowing. In addition, the Regional Director would also consider "relevant information concerning the lessor's historical water use pattern, terms of the lease, and the nature of the entitlement to be used for the lease." The availability of water from a transaction must be confirmed by the "Verification Committee," described below. For transfers or leasing involving land fallowing, the Regional Director would require contractual commitments providing for the permanent management of idled lands for purposes including, but not limited to, vegetative management, dust abatement, erosion control, and fire protection. Such commitments may include "direct management by the parties to the (allowed transaction) at their expense, with oversight by the Regional Director," or "establishment of a non-revocable interest-bearing account which will provide sufficient annual revenues for management of idled lands."

The transactions must be approved by the Regional Director. In reviewing a transfer request, "the Regional Director shall consider", among other relevant factors,

(i) potential impacts on other entitlement holders;
(ii) relevant law which may facilitate, constrain, or prohibit such transfers;
(iii) applicable Departmental, Reclamation, or other Federa regulations, policies, or guidelines in effect at the time of the review;
(iv) comments from interested parties, particularly parties which may be affected by the proposed action.

Comparable factors are listed for approval of leases. In addition, the Regional Director will consider:

- applicable provisions of water service contracts;
- potential economic impacts on the area of origin;
- effect on return flows or other water management matter which may affect the overall operation of the system.

It is noteworthy that the draft NOPR *implies* that the principles and criteria for water marketing issued by the Bush Administration may be the policy of the Clinton Administration (for background on the principles and criteria, see "Interior's Policy of Voluntary Water Transactions," *WS January 1991*). If so, Interior should state it explicitly. Otherwise, speculation in the west will continue about which "Departmental, Reclamation, or other Federal regulations, policies, or guidelines in effect at the time of the review" are applicable.

Transfers or leases also "will not be approved unless the party or parties to the (transaction) commit in writing to mitigate or compensate for third-party impacts of such (transactions)," for transfers, "as required by the Regional Director," or for leases, "to the satisfaction of the Regional Director." While the purpose of the slightly different language for transfers and leases is unclear, the general approach represents a significant improvement over the 1991 draft regulations, which had required compensation or mitigation to the "satisfaction of the affected parties."

Criteria for the Regional Director's decisions are left unspecified. According to Reclamation's 1989 Criteria, third parties are identified as those entities who may have some identifiable interest in the transaction, and would have legal standing in an adjudication process in an appropriate state forum. Would the Regional Director take into account, or even defer to, any judgments by politically-accountable local officials that any third party impacts are acceptably mitigated? By not specifying the criteria for judgment, the draft regulations do not end speculation about Reclamation's actual policy toward water transactions.

The draft regulations also create a new four-person Verification Committee as part of the approval process. For lease or banking transactions involving non-Indian water, the committee shall have one representative from each Lower Division State and one representative from Reclamation designated by the Regional Director. For transactions involving Indian water, the committee shall consist of one representative from the Bureau of Indian Affairs (BIA), appointed by the Area Director of the Phoenix Area BIA office, two representatives chosen by the tribes with rights in the Lower Basin, and one Reclamation representative appointed by the Regional Director. "A majority vote of the committee members shall be sufficient to approve the amount of water conserved by a proposed conservation action or expected to be made available as a result of temporarily discontinued use of water within an entitlement holder's

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service area." The intent is to assure that transactions involve "identifiable, quantifiable, and verifiable" water savings. "If a proposal is rejected by the committee, the proposal may be resubmitted to the committee in modified form for review and approval." The draft regulations do not indicate whether proponents of the transaction can appeal the decision of the committee, even in the case of a deadlocked 2-2 vote.

Finally, while not part of the draft regulations, the draft NOPR solicits comments on the viability and legality of deferral agreements for transactions involving Indian or non-Indian entitlements. The draft NOPR defines a deferral agreement as a "transaction where an entitlement holder would agree to limit its water use for a period of time so as to ensure increased water deliveries to junior entitlement holders. . . . The deferring entity's agreement not to use a fixed portion of its entitlement would have to be for a set period of years and would be subject to verification by the (Interior) Secretary." The draft NOPR comments that such agreements "may not benefit from the beneficial use characterizations provided for in the proposed regulations for both direct leasing and banking-marketing transactions." Under a deferral agreement, that is, Indians and non-Indians alike could include water in transactions that lacked a recent history of beneficial use.

BANKING

The draft regulations also include Reclamation's long-awaited banking provisions. Any user of Colorado River water may bank water conserved by extraordinary conservation measures or land fallowing. In deciding how much water may be banked, the Regional Director will exercise discretion guided generally by the factors governing the amount of water that may be transferred or leased. As with a leasing transaction, the Verification Committee must find (by majority vote) the water savings identifiable, quantifiable, and verifiable. For purposes of decree accounting, Reclamation will show the conserved water "used" in the year that the water is conserved. The entitlement holder will then have a "deposit" of banked water in Lake Mead. The water can only be used or subsequently marketed by the depositor. A fee would be assessed to recover reimbursable costs.

The amount of water placed into the bank will be more than the amount available for subsequent use. First, evaporation losses will be charged reflecting the evaporation rate of Lake Mead as estimated by the U.S. Geological Survey. Second, banked water is assumed to sit "on top" of Lake Mead. Therefore, when water is spilled for purposes of flood control, banked water is assumed to be released before "system water" — stored water for delivery under existing contractual entitlements. The draft regulations specify a "first in-last out" rule in determining whose banked water is spilled. That is, the first party to put water into the bank is the last to lose their deposit due to flood control releases.

As a practical matter, the opportunity to bank water in Lake Mead may represent, at best, only a short-term storage opportunity. For example, assume that annual evaporation loss equals 5 percent and flood control releases occur, on average, every twelve years. For each acre foot deposited, a banker may expect to have 0.87 af available if banked water is stored for one year, 0.50 af available after five years, .25 af available after ten years, and 0.06 af available after twenty years. While the proposed banking regulations provide another dimension of flexibility in the allocation of Colorado River water, Reclamation should not anticipate that parties would engage in significant and costly conservation programs and bank the water in Lake Mead for subsequent long-term use or marketing programs to be developed at a later date.

Other specific banking guidelines would be subsequently established by the Regional Director. For banked water from all entitlement holders other than Indians, this would be done in consultation with the agency of each state authorized to represent the state in Colorado River matters. Guidelines for Indian entitlement holders would be subsequently established by the Regional Director in consultation with BIA and affected Indian tribes.

CONSERVATION PLANS

The draft regulations include new and significant provisions concerning conservation plans. The "Criteria for Water Conservation Plans" (attached to the draft) describes the data and analysis needed for consultations with entitlement holders concerning the development and implementation of conservation plans required by federal law. This 25-page appendix warrants study by all entitlement holders.

The Criteria identifies "commonly applicable" and "potentially applicable" practices. Commonly applicable practices are expected to be implemented by all non-tribal entitlement holders in all adequate conservation plans. These practices include water measurement and accounting, incentive pricing and billing, a designated person responsible for preparation of water conservation plans, and information/education and assistance programs. Potentially applicable practices are also expected to be implemented, "unless the non-tribal entitlement holder demonstrates that the practice does not make sense for the entitlement holder to implement, or unless otherwise provided by law." For agricultural uses, the appendix lists 13 practices, including water transfers, on-farm program incentives, and land retirement. For municipal and industrial users, the appendix lists 8 practices, including audit/incentive programs, wastewater management/recycling, and drought/water shortage contingency plans.

The entitlement holder's water conservation plan must document the basis, rationale, and details for excluding any

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potentially applicable practice. "Such documentation shall address, as appropriate, applicability, cost-effectiveness, and any cost-beneficial, financial, environmental, or legal constraints." In addition, the conservation plan must review past plans (listing practices and projected results and assessing implementation success), discuss water management problems, opportunities, and goals, and include schedules for actions, budgets, and projected results. When plans are reviewed later, entitlement holders should anticipate being held accountable for deviations between projected and actual results.

The Criteria specify the following procedure for the adoption of plans. The entitlement holder's governing body must first approve a draft plan or update. Reclamation would then evaluate the submission based on the Criteria and any other applicable planning consideration, including federal environmental law. Reclamation would notify the entitlement holder whether the plan meets the criteria. The entitlement holder's governing body, after making appropriate changes, would then adopt the plan in final form. Reclamation would then publish a "Notice of Draft Decision" in the *Federal Register* and allow at least a 45-day public comment period. Reclamation would issue a final determination of adequacy within 30 days after the close of the public comment period.

The draft regulations are devised to increase the transparency and accountability of decision-making by the governing board of entitlement holders. If the regulations are adopted, preparation of conservation plans would not be a pro forma exercise. As a "commonly applicable practice," water pricing would be subjected to especially close scrutiny. Concerning the "potentially applicable practices," decisions not to implement must be defended by extensive analysis. The Criteria provide a significant role for economic considerations. But the draft regulations do not explicitly state that entitlement holders would not be required to undertake uneconomic actions.

REASONABLE USE STANDARD

As in earlier versions, the draft regulations would limit entitlement holders to the amount of water reasonably required for their uses and purposes. This requirement would not apply to Indians. For non-Federal entitlement holders, the Regional Director "will give due consideration to relevant State law in making determinations of unreasonable use." In making such determinations for agricultural uses, the Regional Director will consider at least 14 enumerated factors. For domestic uses, the Regional Director will consider 8 enumerated factors. Absent from the lists of factors is whether the practices are economic given the circumstances of the entitlement holder.

WS anticipates the following scenario. An agricultural entitlement holder can change water use and/or land use practices and conserve water. The cost of the changes are greater than the value of water in its service area. Of course, the change in practices would be economic if the saved water were valued at prices reflecting municipal and industrial uses. Is it unreasonable for the agricultural user not to change water use or land use practices if it has not received a bid from a bona fide buyer? The draft regulations provide no guidance on how Reclamation would answer this question.

FEES

The draft regulations lists the fees the Regional Director would impose to fund the cost of administering water entitlements and "other purposes consistent with the regulations." A general user fee would be assessed consisting of two charges: (1) a flat accounting charge uniform for each entity, district, of municipality with an entitlement, and (2) a charge to fund the cost of operation, management, and water master functions (net of the accounting charge) assessed in proportion to water right or net diversion on a per acre-foot basis. The fee would reflect the costs of traditionally reimbursable functions, "exclusive of costs associated with traditionally nonreimbursable functions or reimbursable costs recovered from other sources." The general fee would be established after consultation with entitlement holders. Other fees would be imposed for deviations of diversions from the Master Schedule, the wheeling of non-Colorado River water, enforcement actions, and the provision of services associated with the specific entitlements not conferred to all entitlement holders or assessed under the general user fee (such as banking).

CONCLUSION

While the content of the regulations may change further before publication in the *Federal Register*, the May 6 version reflects the growing importance of economic principles in shaping western water law and policy. They also represent a potentially significant implementation of the Clinton Administration's general policy of "reinventing government" — more emphasis on market forces than on extensive regulation to allocate resources, decentralization of decision-making in the federal bureaucracy, and imposition of user fees to pay for the provision of services.

The full effect of this policy shift, of course, will depend on three factors: (1) the specific form of the final regulations adopted after the final internal review before publication, (2) the changes made in response to public comments; and (3) the actual implementation of the regulations as the Regional Director and the Secretary of Interior exercise their discretion in actual decision-making. Concerning the first two factors, western water interests should link proposed changes in the draft regulations to the administration's general policy of reinventing government. Concerning the last factor, "time will tell." □