

## **Fennemore Craig Comments on CAP Staff ADD Water Proposal Dec. 7, 2010**

**We represent four masterplanned community developers** (DMB Associates, El Dorado Holdings, Sunbelt Holdings, Robson Communities) with projects in all three Counties and Active Management Areas that make up the CAP service area. Projects are located within CAGR Member Lands and Member Service areas as well as in the service and planning areas of CAP subcontractors who are not in CAGR.

Our overriding common goal is an orderly, predictable and cost effective structure for securing and sharing future water supplies. We also believe that it is important to preserve the ability of smaller municipal providers, including private water companies, to participate in the ADD Water process.

**We have been participating in this process since its inception** and have appreciated the opportunity to do so. We remain optimistic that this process will succeed.

**We are appreciative of the staff's efforts** to develop a strawman proposal. A strawman is particularly important in this instance as the next logical step building on the Summary of Emerging Consensus (SEC). While the SEC remains a valuable summary of consensus reached to date, the consensus reached thus far is on very general points. We need to dig into the details as the staff has done.

**Regarding those details**, there are a number of points in the staff proposal that we support. In the interests of time, we will limit our remarks to major issues and we should also note that our remarks are preliminary as we hope to benefit from the input of other stakeholders in understanding the implications of the program proposed here. That said, we have the following observations and concerns:

**Phased approach** – Our major concerns are with the phased approach and the approach to CAGR, which we will discuss in a few minutes.

**Types of ADD Water Supplies** – We support the choice to include Colorado River water (Priorities 1-4), imported groundwater and (perhaps more conceptually given the obstacles to development), brackish groundwater supplies. Given their likely availability and cost, it makes sense to focus on these supplies in lieu of ocean desalination. We appreciate the strawman's assumption that if these supplies are inadequate, ocean desalination will be revisited.

**ADD Water Supply Portfolio** – We are strongly supportive of the single portfolio concepts enunciated in the strawman proposal. The size of the overall pool provides valuable risk sharing among users. We are supportive of utilizing a mix of permanent and non-permanent supplies. We believe that focusing solely on permanent supplies will make ADD Water inordinately expensive, and places useful supplies off limits. We

believe that the large pool that will be developed mitigates the risk of relying on non-permanent supplies.

**Eligibility to contract** – we are in general agreement about the eligible participants. We do believe, that if the phased approach is retained, the lack of existing financial resources for many municipal providers and landowners means that there will need to be partnering with outside investors in order to have a seat at the table.

**Classes of ADD Water Contracts** – we are generally supportive of the approach taken by staff here but would note that not all long term contracts are equal and that contracts with greater flexibility in delivery terms – for example, contractors such as CAGR D who only need ADD Water for replenishment purposes, with attendant annual and year-to-year flexibility - should receive some price break over higher priority, direct delivery contractors.

**Flexible Arrangements for ADD Water Contracts** – we are generally supportive of the approach taken here, but note that having paid essentially the full cost of water, contractors are entitled to substantial flexibility in reassigning those contractual rights over time so as to recover their costs, should they not ultimately need the water contracted for.

### **Back to the Phased Approach:**

We understand that the phased approach is driven by the need for certainty by contractors as to exactly what they are paying for and how much they are paying. In fact, we dare say that the pressure for a phased approach originates from many stakeholders concerns about the existing CAGR D enrollment process, where there is no limit on enrollment or volume of water supplies ultimately acquired, and potentially leaving “early enrollers” at risk of paying the high costs for acquiring water supplies for later enrollers.

For certain ADD Water contractors, a phased approach may be the best option and if CAGR D can participate in that phased option, perhaps this can be made to work. What does not work for us is shifting to a phased approach while simultaneously abandoning the existing CAGR D structure.

The phased approach itself is problematic for a number of reasons:

- The door is open for only limited periods – essentially a single auction once every five years. This will force providers and developers to enter the bidding process before they actually need water, thereby artificially increasing the demand and increasing the cost.
- While CAP can plan to initiate the next phase in five years, there is the potential for phases to be delayed, with resulting complexities.
- Securing exactly 50,000 acre-feet at once is going to be a significant challenge and is going to result in market distortions.

- It would seem to make more sense to have an open door, relying on the fact that the cost of ADD Water will keep contractors away until the water is actually needed. A continuous, open door approach would also take advantage of the fact that the need to contract for ADD water will almost certainly precede the need for delivery of ADD Water by years.
  - o Let's take a typical prospective CAGR member who signs up for ADD Water as the price of enrollment. An enrollee would seek membership at the same time it seeks to demonstrate an assured supply, which is at least two years before a subdivision is recorded, and it will be three years after that before the first drop of water needs to be replenished and then perhaps another two years before the subdivision is built out. The larger the project, the more extended the timeframe. In other words, you can expect at least a five to ten year window before all of the water contracted for will actually need to be delivered.
  - o The strawman proposal really does not take into account this reality and instead assumes that the full 50,000 acre-feet will need to be in place and deliverable every five years.
  - o The strawman proposal also places an inordinate amount of pressure on CAP to acquire supplies in large tranches. A more gradual approach would allow CAP to take advantage of market conditions, moving quickly to tie up supplies as they become available.

**Market Based Allocation Method** - We applaud the creativity of this approach (particularly the impressive PowerPoint presentation) and believe that it actually responds to one of our stated concerns – that the cheap water gets bought up first, by those with the most resources, leaving the most expensive water for those with the least resources. So we are not ready to discount this approach altogether. But we do believe that the market clearing price of one auction is likely to be the floor for the next auction (at least that would be the message to sellers). So this approach could inadvertently increase costs. We also note that the potential panic buying that a once-in-every-five-years auction would encourage, could also have the effect of driving up the price.

**Finances** – We understand the concerns raised by CAP subcontractors over use of CAP ad valorem taxes, but also note that landowners in the three county area that lack access to the CAP system or who do not hold CAP subcontracts have an interest in how that tax is spent for the benefit of the three counties as a whole. Use of ad valorem taxes recognizes the community-wide value of ADD Water. ADD Water benefits all land in the three-county area by increasing the overall water supplies and allowing land to continue developing in an orderly fashion, and preventing the negative “we’re out of water” headlines. Given the limited costs associated with ADD water pre-launch, this seems to us to be a reasonable use of CAP funds, particularly given the lengths to which CAP staff has gone to put in place safeguards to protect CAP subcontractors and the existing financial viability of the CAP system.

**Water Supply Acquisition Costs** – This is the toughest nut to crack as whoever is in charge of acquiring water rights is assuming a significant responsibility and all

stakeholders acknowledge that the costs of ADD Water means that there will be no free rides. As discussed above, we think the approach of locking up options and then auctioning those off will result in increased costs and uncertainty about the availability of supplies in off auction years.

**Capital Costs for Improvement to CAP Canal Capacity** – this seems to be one of the easier nuts to crack. We support staff’s approach.

**OM&R Costs** – skip this. We have not fully evaluated this part of staff’s proposal.

### **CAGR D and the ADD Water Program**

We have major concerns with this portion of the staff proposal, particularly as to the Post-ADD CAGR D obligations. We have to admit that this phrase from staff’s PowerPoint caught us off guard: “Continuing the present CAGR D program poses unacceptable financial/legal risk to CAWCD.”

CAGR D has an existing fee system that works. Yes, fees are going up and we recently supported a proposal from staff to significantly raise fees and rates. We also supported legislation last year to expand the authority of CAGR D to bond and to include a membership fee so that all Member Lands and Member Service Areas will pay something. Several years ago, we also supported the creation of an activation fee, paid at the time of public report (i.e., when lots are about to be sold) that would be paid by developers for both member lands and member service areas. In short, we have supported measures to ensure the long term financial integrity of the system and will continue to do so.

CAGR D’s staff’s most recent projections indicate they are on-target in acquiring replenishment water sufficient to meet replenishment obligations as of 2015. What concerns people about CAGR D is the long-term replenishment number of some 227,000 acre-feet. In 2004, CAGR D staff projected that this demand would occur in 2035; with the current recession, this date has likely been pushed out even further. Again, CAGR D staff projections indicate no reason why CAGR D cannot meet its current Plan of Operation and acquire sufficient water supplies to meet its replenishment obligations thirty to forty years from now.

The staff proposal essentially abandons this system, in one fell swoop. If adopted in this form, the proposal will create substantial uncertainties about the ability to secure access to ADD Water and will also create inequities between lands that are enrolled now and lands to be enrolled in the future.

Abandoning the existing “open door” enrollment process will create unwarranted fears about the availability of water for Arizona’s future, which can be avoided by working with CAP to address what it sees as unacceptable financial and legal risks within the context of the existing system. It is very important to us to maintain a predictable and orderly process where the timing and location of development is not driven by water. We

think that maintaining “open door” enrollment, with some reasonable adjustments to fees and timing of payment, is important for the development community, for private water companies and for smaller cities and towns.

Finally, a brief word on the Plan of Operation. Whatever exact form the ADD Water program takes, it must be supportive of the current Plan of Operation and it must increase the likelihood of approval of the next Plan of Operation. We would appreciate further detail from CAP staff as to how the CAGR Plan of Operation ‘fits’ into their proposal.

**Just Water** - We are supportive of the concepts outlined in the staff proposal. Working in a cooperative manner with interests outside the three county area to put into place a structure that assists them with resolving their water supply needs is a laudable goal and one that will help pave the way for legislation to implement ADD Water.

### **Conclusion**

We again thank you for the efforts in producing this strawman and believe that it creates a context for further discussions on the shape of ADD Water. The success of ADD Water is essential to Arizona’s water future and we look forward to working with CAP staff and stakeholders to reach that goal.