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MEMORANDUM

To: Director, Policy and External Affairs  
Attention: W-1500  
Director, Operations  
Attention: W-6000  
Director, Program Analysis Office  
Attention: D-5000  
Regional Director, PN, MP, LC, UC, GP  
Attention: PN-1000, PN-3300, MP-100, MP-440, LC-1000, LC-4450,  
UC-100, UC-446, GP-1000, GP-2100

From: Eluid L. Martinez  
Commissioner **SGD ELUID L. MARTINEZ**

Subject: Policy for Pricing Water Converting from Irrigation to Municipal and Industrial Service

The issue of recovering capital costs associated with water converting from irrigation to municipal and industrial (M&I) use was the subject of an August 1992 Audit Report (Audit) by the Office of Inspector General (OIG) entitled "Repayment of Municipal and Industrial Water Supply Investment Costs." This report criticized the Bureau of Reclamation (Reclamation) for not recovering sufficient revenues on water converted from irrigation to M&I use. Reclamation did not concur with two of the recommendations included in that report whereupon the matter was remanded to the Office of Policy, Management, and Budget (PMB) for resolution. Reclamation worked with PMB to develop a policy which would be acceptable to all parties concerned. In the context of resolving this Audit, Reclamation prepared the policy for pricing water converting from irrigation to M&I use set forth below. The OIG concurred with this policy.

Where M&I is an authorized project purpose, general authority for the Secretary to sell water at a rate other than that charged for irrigation is provided in section 9 of the Reclamation Project Act of 1939 (The Act of August 4, 1939, ch. 418, 53 Stat. 1187). Section 9(c)(2) grants the Secretary authority to enter into water service contracts for a period not to exceed 40 years at "such rates as in the Secretary's judgment will produce revenues sufficient to cover an appropriate share of annual operation and maintenance costs" and "such fixed charges as the Secretary deems proper." Although interest is not specifically mentioned in section 9(c)(2), a

legal determination has been made that it is one of the items which properly can be included within the classification of "fixed charges." Where M&I is not an authorized purpose, the Act of February 25, 1920 (Sale of Water for Miscellaneous Purposes), provides the Secretary with authority, under certain conditions, to supply water for miscellaneous purposes, such as for M&I usage.

The Secretary's authority was supplemented by passage of the Water Supply Act of 1958 (Act of July 3, 1958, 72 Stat. 297). This Act provides that the Federal Government should participate and cooperate with the States and local interests in developing domestic, municipal, and industrial water supplies in connection with the construction, maintenance, and operation of Federal navigation, flood control, irrigation, or multiple-purpose projects. The interest rate established in section 301(b) of the Act is used in 9(c)(2) contracts to determine current and future interest charges attributable to M&I capital investment, unless a different rate is specified by the Congress for the project in the authorizing legislation. For fiscal year 1998, the interest rate under the 1958 Act is 8.874 percent. Under these laws, and court and Solicitor's Office opinions, it also is clear that the Secretary has authority to set M&I rates above those required to cover capital and operation and maintenance (O&M) costs.

In many instances, the final price agreed to between Reclamation and the prospective purchaser will be a negotiated price. However, at a minimum, the price should leave the Federal Government no worse off financially than if the transfer had not occurred. Water use for M&I purposes should fetch a higher price than that for irrigation purposes. The rate adopted should reflect a portion of the cost incurred by the Federal Government in appropriating project construction funds as well as interest payable from the project sponsors on their outstanding repayment obligation. While this policy does not seek to recover past subsidies to that block of transferred water during the time that it served the irrigation purpose, it does encourage the Federal Government to negotiate rates above the irrigation rate.

Consistent with the above, the preferred base (floor) negotiation rate will be an M&I rate established in existing Reclamation water service contracts found within the local area, provided that the rate reasonably reflects the existing market price. In the event that such contracts have not been executed, then a local market M&I rate will be used, assuming that one can be determined. The use of either a contract or local market rate serves as a good indicator of the price buyers and sellers are willing to pay to participate in water conversion activities. However, if neither of these rates are available, then the current cost method, or other cost-based methods, should be utilized to establish the baseline M&I rate for contract negotiation purposes. Regardless of the rate established, the contract would contain a provision providing for a review of the rate at 5-year intervals. Where applicable, all three rates (contract rate, cost-based rate, market rate) should be determined for use in justifying the established negotiated contract M&I rate.

An exact "formula" for pricing converted water cannot be provided because of the differing situations of many conversions. However, in establishing a rate, Reclamation will develop

sufficient information to determine the explicit relationship between its proposed rate, the market rate (if such a rate can be determined), and various cost-based rates. A discussion concerning the rationale for selecting a particular rate will become part of the Reclamation's official records concerning the transaction. It should be noted that it is not Reclamation's intent to seek to extract all of the potential gains associated with a given conversion.

Over the long term, Reclamation's goal should be to use market information to assist in establishing water prices. To do this, Reclamation is initiating the preparation of wholesale water demand studies and the compilation of existing wholesale rates for municipalities for each of the particular markets it services. In the interim, in situations where there is no established price, Reclamation will determine a price using the procedures described above.

**Repayment and disposition of revenues** - This policy is applicable to permanent and temporary conversions of water. Revenues will be treated in accordance with applicable Reclamation law and policy.

Any capital obligation that is to bear interest will be at the current rate as determined by using the formula set forth in the Water Supply Act of 1958 or as required by other applicable law. This policy applies to the recovery of capital costs. O&M costs are to be treated separately.

**Documentation** - All pricing decisions for conversions are required to have a documentary record describing how the rate was developed and provide information on the rates that would have resulted if alternative methods were used, e.g. market-based or cost-based, to compute the rate. At a minimum, for each proposed conversion, Reclamation will examine the water market in the area and document and analyze the extent to which market transactions provide guidance for pricing conversions. The Commissioner will report to the Assistant Secretary - Water and Science on the individual quantity and prices of the conversions that occurred during the year.

**Payout** - As was noted earlier, the Secretary has ample authority to contract and set prices for supplying water for M&I purposes. The fact that an irrigation contractor pays out its share of the costs attributable to the irrigation function does not affect this authority.

If a water user entity has fully repaid its reimbursable cost obligation to the United States, an existing M&I market water rate for the area would still be used to establish a base M&I rate for the conversion contract. If no rate exists, then the current cost approach can be used. This amount would then serve as the basis for estimating an interim base M&I water rate. The amount repaid by the entity does not enter into the calculation of the rate. Also, the contract would carry a 5-year contract review provision which would provide that if a market rate was to be established during the existing contract timeframe, then it would be used as the base M&I rate in subsequent contract amendments or renewals.

This policy is effective immediately and applies to all proposed conversions that have not been reduced to contract, unless an exception is approved by the Commissioner in writing. All proposed conversions should be incorporated into existing contracting procedures, including the preparation and approval of a basis of negotiation.

Additional background information and guidance including examples of the current cost method will be provided in the near future. If there are questions regarding this policy and its implementation, please contact Larry Schluntz at 303-236-1061, extension 287 or Jim Handlon at 202-208-3759 or via the LAN. Please incorporate this memorandum in sections II and IV of the looseleaf book "Policy Instructions for Repayment, Water Service, and Other Contracts" sent to you by memorandum of February 26, 1980.

bc: W-1000, D-5000, W-5000, D-5200 (Simons)

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