COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-198376

May 21, 1984

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FOR 30 DAYS

The Honorable George Miller
House of Representatives

Dear Mr. Miller:

This is in response to your letter of October 27, 1983, concerning the repayment of Operation and Maintenance (O&M) expenses and capital costs under water service contracts with water districts served by the Bureau of Reclamation's Central Valley Project (CVP), California. The Director of our Resources, Community, and Economic Development Division has already responded to your request for information about repayment for three of these districts in GAO/RCED-84-122, dated March 16, 1984.

As is our usual practice, on November 29, 1983, we requested comments on this matter from the Secretary of the Interior. By letter dated March 28, 1984, the Deputy Assistant Secretary for Water and Science responded on the Secretary's behalf. Pertinent portions of the Deputy Assistant Secretary's response will be referred to in our analysis of the issues.

Your first question concerns water service contracts under which the water rates charged a district may not be increased and, therefore, the district is not required to pay the full amount of current O&M charges. Your question is whether there is legal authority for not paying the full amount of O&M charges in view of the O&M repayment requirements of the Reclamation Project Act of 1939.

You next refer to the practice of reducing the reimbursement of capital charges in order to increase the O&M proportion of the total payment established by contract. The amount of unpaid capital (construction) costs is added to the remaining costs which ultimately are to be repaid to the Government. You indicate that some districts may not currently be repaying any of the capital cost obligation. It appears to you that this practice of deferring capital costs would extend repayment periods beyond the 40-50 years authorized by Reclamation law. You wish to know, if, absent specific authorization, the Bureau has legal authority to allow an extended capital repayment period.

Lastly, you note that in some districts O&M costs have exceeded the total contract water rate even after exhausting the capital component of the rate. You wish to know if there is a provision of Reclamation law or policy under which the unpaid O&M costs may be recovered, either through a supplemental contract or by adding the costs onto the end of the repayment period.

In our opinion, for the reasons stated below, rates specified in water service contracts which now are insufficient to cover all current O&M charges may not be increased prior to the end of the term, unless otherwise contractually authorized. The deferral of capital repayment because of the practice of assigning an increased share or all of the water charges to O&M is proper provided that as a result the term of any one contract does not exceed 40 years. Capital repayment must be completed during the useful life of the project. It is proper to recover previously unpaid O&M costs by adding them to current O&M charges upon renewal of a water service contract, or as authorized by the terms of the contract.

Background

Under section 9(d) of the Reclamation Project Act of 1939, 43 U.S.C. § 485h(d) (1976), the repayment by a water user organization of the construction cost of a reclamation project that is allocated to irrigation must be made within 40 years in addition to a development period of not more than 10 years. Under section 9(e) of the Act, 43 U.S.C. § 485h(e), the Secretary, in lieu of a section 9(d) contract, may elect to enter into a contract to furnish water for irrigation purposes to a water user organization. Section 9(e) further provides that--

> Each such contract shall be for such period, not to exceed forty years, and at such rates as in the Secretary's judgment will produce revenues at least sufficient to cover an appropriate share of the annual operation and maintenance cost and an appropriate share of such fixed charges as the Secretary deems proper, due consideration being given to that part of the cost of construction of works connected with water supply and allocated to irrigation; and shall require payment of said rates each year in advance of delivery of water for said year. . . .

Section 1 of the Act of July 2, 1956, ch. 492, 43 U.S.C. § 485h-1 (1976), deals with the administration of contracts under section 9 of the Reclamation Project Act of 1939. This section as codified provides that the Secretary shall--

> (1) include in any long-term contract hereafter entered into under said subsection (e) of section 485h of this title provision, if the other contracting party so requests, for renewal thereof under stated terms and conditions mutually agreeable to the parties. Such terms and conditions shall provide for an increase or decrease in the charges set forth in the contract to reflect, among other things, increases or decreases in construction, operation, and maintenance costs and improvement or deterioration in the party's repayment capacity. . . .
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> . . . .
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> (3) credit each year to every party which has entered into or which shall enter into a long-term contract pursuant to said subsection (e) of section 485h of this title so much of the amount paid by said party . . . as is in excess of the share of the operation and maintenance costs of the project which the Secretary finds is properly chargeable to that party. . . .
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> . . . .
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> (6) include a reasonable construction component in the rates set out in any long-term contract hereafter entered into under said subsection (e) of section 485h of this title prior to amortization of that part of the cost of constructing the project which is assigned to be repaid by the contracting party.

We have reviewed the current water service contracts of the Arvin-Edson, Panoche and San Luis water districts of the CVP. Each contract recites that it is pursuant to Federal Reclamation Laws, and that renewals of each individual contract "may be made for successive periods not to exceed 40 years each." All contracts have a fixed per acre-foot charge by the United States for agricultural water furnished to the districts. In addition, the Panoche and San Luis contracts provide for a rate redetermination in 1996 and, if necessary, every 5th year thereafter in accordance with the agricultural water rate policy of the Project for that facility. These contracts are in effect through December 31, 2008. The Arvin-Edson contract extends through February 28, 1995. The Arvin-Edson contract, signed in 1968, is for 32 years, replacing a 1962 contract. The 1974 Panoche contract superseded a 1955 agreement and has a duration of 34 years. The San Luis contract, signed in 1974, will also expire after 34 years. It replaced a contract signed in 1959.

Analysis

Under section 9(e) of the Reclamation Project Act of 1939, the Secretary has the option of entering into a water service contract in lieu of a 40-year construction cost repayment contract under section 9(d). Under section 9(e), the maximum contract period is 40 years. Although under a construction cost repayment contract the capital cost assigned to a district must be repaid in the contract period, there is no similar requirement for water service contracts. Section 9(e) gives the Secretary the authority to choose a more flexible means of contracting with districts than is available under construction cost repayment contracts. Water service contracts are particularly appropriate when a number of districts participate in an undertaking such as the CVP which involves multiple facilities constructed over a long time period. In the case of the CVP, the final repayment obligation of a particular district may not be known for many years after the district begins to receive project water.

A section 9(e) contract also differs from a section 9(d) construction cost repayment contract in that it includes O&M charges as well as an increment for construction costs. The water charge will be:

> [A]t least sufficient to cover an appropriate share of the annual operation and maintenance cost and an appropriate share of such fixed charges as the Secretary deems proper . . . .

The legislative history of the Reclamation Project Act of 1939 sheds little light on section 9(e). However, the major thrust of the 1939 Act was to relieve the inflexibility of repayment contracts then in use (H.R. Rep. No. 995, 76th Cong., 1st Sess. 1, 2 (1939)). In a 1948 opinion (Sol. Op. M-35047, 60 I.D. 180), the Interior Solicitor, after review of the legislative history of the Act, concluded that the Secretary had the discretionary power to extend the repayment of construction costs of supply facilities allocated to irrigation beyond a 40-year period, under water service contracts.

The Act of July 2, 1956, ch. 492, 70 Stat. 483, responded to problems which arose in the administration of section 9 contracts. A major concern of water user organizations was that the Government might not renew water service contracts at their expiration. While not amending section 9(e), section 1(1) of the Act (43 U.S.C. § 485h-1(1)) provides for renewal of water service contracts together with modification of contract rates to reflect changed circumstances, including increased O&M and construction costs. Also, under subsection (3) (43 U.S.C. § 485h-1(3)), the amount in excess of the O&M costs the Secretary finds to be properly chargeable to the water user organization is to be credited every year to repayment of construction costs. The Act also provides that at a district's request, the section 9(e) water service contract may be converted to a 9(d) contract for the repayment of construction charges, whenever repayment can be completed within 40 years (subsection (2)).

In supporting H.R. 101, which was later enacted, the Acting Secretary of the Interior advocated the inclusion of a provision specifically requiring that a reasonable construction component be included in all long-term contracts entered into under section 9(e). According to him:

> [T]o permit execution of long-term contracts which do not provide for collection of a share of construction costs would be a major departure from the basic reclamation policy that irrigation costs are to be reimbursable. It would appear that H.R. 101 is not intended to fix into the law any new principle in this respect. It is impossible, of course, to write a figure into the law that will be usable in all circumstances, but even a general provision will be helpful as a guide both to this Department and to water users.

S. Rep. No. 2241, 84th Cong., 2d Sess. 6 (1956). Consequently, section 1(6) of the Act (43 U.S.C. § 485h-1(6)), requires the Secretary to "include a reasonable construction component in the rates set out in any long-term contract."

Subsequently, the Assistant Director of the Bureau of the Budget (later the Office of Management and Budget), wrote to the Secretary of the Interior in response to the Acting Secretary's letter. The Assistant Director stated that:

> [T]he 9(e) type of water service contract should not be used as a means of avoiding

> repayment of the construction investment within a specified period of years . . . the bill should require the Secretary to set water rates which would repay the irrigation investment . . . over a period of not more than 50 years, exclusive of any development period.

Senate Report, pages 7 & 8. While the Bureau of the Budget report was included in the Senate Report, no action was taken on its recommendation.

In 1948, hearings were held by the Subcommittee on Irrigation and Reclamation of the Committee on Public Lands of the House of Representatives on a predecessor bill dealing with the administration of the Reclamation Project Act. In a report dated January 10, 1948, the Secretary described the differences between 9(d) and 9(e) contracts:

> The incidental burden of the contract upon the water users concerned is much lighter than the burden borne by water users whose organization has entered into a 9(d) contract, since, under section 9(e), the water rate fixed need not be calculated on the basis of returning costs, allocated to irrigation and assigned for repayment by water users, within a 40-year period.

Hearings on H.R. 3194, 80th Cong., 2d Sess. 11 (1948).

In testimony following submission of the letter, the Assistant Chief, Counsel, of the Bureau of Reclamation explained that increased costs are chargeable to irrigators under a 9(e) contract notwithstanding the longer repayment period. If there are rapidly increased costs, because of the elasticity provided under these contracts, the period during which construction costs would be returned to the Government would be expanded. The maximum time limit for repayment of all construction costs would be the useful life of the project. (Hearings, p. 17.)

Your first question deals with section 9(e) water service contracts under the terms of which the rates may not be increased because of increased O&M charges. In this regard the Deputy Assistant Secretary states that--

> At the time each Central Valley Project (CVP) contract was executed, the Secretary anticipated that the specified rates would be at

> least sufficient to cover the contractor's appropriate share of the annual operation and maintenance (O&M) costs of the CVP. Thus, we believe that the specific requirement of 43 U.S.C. § 485(h)(e) has been met.

The Reclamation Project Act only requires the Secretary to establish a rate which at the time it is established is judged to be sufficient to cover an appropriate share of O&M and capital repayment charges. It does not mandate an increase in the water rates set by the contract prior to renewal or other contractually authorized readjustment time in order to reflect added costs. Accordingly, section 9(e) of the Act is not violated because the contract water rates no longer are sufficient to recover the initially assigned share of O&M charges. Compare U.S. v. Coachella Valley County Water District, 111 F. Supp. 172, 180 (1953), which upheld a section 9(d) contract which covered estimated but not actual construction costs. As discussed below, O&M costs unrecouped under current contract payment schedules will be recovered when the service contracts are renewed.

Your second question refers to Interior's practice of reducing reimbursement for capital charges so that increased O&M charges may be repaid from the water rates fixed by section 9(e) contracts. Consequently, repayment periods for capital costs have been extended. According to the Deputy Assistant Secretary:

> All CVP O&M costs have been recovered on a cumulative basis. The situation caused by the fixed-rate contracts has resulted in a reduction in the cumulative revenues available for repayment of capital investment. . . . We do intend to recover all capitalized costs in a businesslike manner, consistent with existing law, when opportunities are available to do so (e.g., when a contract comes up for renewal). That cost recovery will be accomplished in accordance with the Secretary's ability to establish water service rates under section 9 of the Reclamation Project Act of 1939.

Our review indicates that the basic reason that section 9(e) water service contracts were authorized in the Reclamation Project Act was to provide an alternative to the rigid repayment contracts under which the capital repayment assigned to a district is required to be completed within the contract term. There is no similar requirement for section 9(e) contracts which instead provide for a water service charge, which, when established includes, "at least an appropriate share of the annual operation and maintenance cost and an appropriate share of such fixed charges as the Secretary deems proper." No particular water service contract may be for longer than 40 years. However, inherent in the concept of this type of contract is its renewability, which was confirmed in section 1(1) of the Act of July 2, 1956. Upon renewal of a section 9(e) contract, the Secretary is specifically required to provide for alteration of water charges based on changes in operation and maintenance costs, as well as construction costs.

Renewal provides the opportunity to increase water rates to reflect increased O&M costs, and to reestablish an appropriate capital repayment element in the new rate. At that time the Secretary must also determine the appropriate length of time for the renewal contract (not to exceed 40 years). There is no express limit on the number of renewals or the total amount of time necessary for repayment of capital costs. However, as indicated by the Assistant Chief, Counsel, of the Bureau of Reclamation in his testimony, this should occur within the useful life of the project.

The CVP consists of a number of units and many individual works and different sources of water supply. Water service contracts were adopted as particularly appropriate in this circumstance. Interior has considered that the CVP as a whole will not be completed until the last work has been finished. In this context, the Deputy Assistant Secretary informed us as follows:

> The Bureau of Reclamation has tentatively computed the proportionate share of CVP capital costs to be repaid by each CVP water service contractor. The Bureau intends to recover the entire capital costs of the CVP within a 50-year period as contemplated under Federal reclamation law. This will be accomplished through amendments and renewals of existing contracts, and repayment assistance from CVP power and miscellaneous revenues.

In answer to your second question, in our view, the Secretary may increase the portion of water payments credited to O&M charges with the result that capital repayment will be delayed. Although no one contract may exceed 40 years duration, renewals are authorized. Since capital repayment must only be completed within the useful life of the project, rather than within the 40 year initial contract term, Interior's policy of completing recovery of all assigned capital costs within 50 years of the completion of the total CVP is unobjectionable.

Your last question deals with the failure to repay all current O&M costs even when all contract water charges are applied to these costs. In response to our inquiry, the Deputy Assistant Secretary for Water and Science indicated, as discussed above, that consistent with existing law all capitalized O&M costs would be recovered by means of the water rates established when opportunities arise to increase these contractual rates.

Section 5 of the Reclamation Extension Act of 1914, 38 Stat. 686, 687-8, codified as 43 U.S.C. § 492 (1976), provides as follows:

> In addition to the construction charge, every . . . landowner under or upon a reclamation project shall also pay, whenever water service is available for the irrigation of his land, an operation and maintenance charge . . . . If the total amount of operation and maintenance charges and penalties collected for any one irrigation season on any project shall exceed the cost of operation and maintenance of the project during that irrigation season, the balance shall be applied to a reduction of the charge on the project for the next irrigation season, and <u>any deficit incurred may likewise be added to the charge for the next irrigation season</u>. (Emphasis added.)

Under section 9(e) of the Reclamation Project Act, the Secretary may establish rates which are at least sufficient to cover an appropriate share of the annual operation and maintenance cost, "as the Secretary deems proper." The language of this provision is expansive enough to include past or capitalized annual O&M costs which remain unpaid and which are to be collected under section 5 of the Reclamation Extension Act. While normally only current annual O&M costs are included in the water rates, the inclusion of a water rate component for past, unpaid annual O&M charges is not precluded. Further, although the rate is fixed for the duration of a water service contract, or until a contractually specified readjustment date, flexibility is achieved not only through a lengthening of the period of payment but also by a change in rates upon renewal or periodic readjustment. We conclude, therefore, that the Secretary has the authority to recover unpaid annual O&M charges by increasing water rates upon contract renewal or at the next readjustment date specified in the contract.

The current water service contracts of the Panoche and San Luis water districts provide for a rate determination in 1996 and every 5th year thereafter. The Arvin-Edson contract in effect through February 1995 does not provide for rate redetermination before renewal. The fixed per acre-foot charges for water specified in these contracts may be changed to increase repayment of construction charges as well as current and past unpaid O&M charges, but not until 1996 for the Panoche and San Luis water districts and 1995 for the Arvin-Edson Water Storage District. However, in the event that a district chooses to amend its contract under the Reclamation Reform Act of 1982, the price of water may be increased at that time and annually thereafter to cover all operation and maintenance charges.

We trust that we have been responsive to your inquiry. Unless you notify us otherwise, this report will be available for distribution after 30 days.

Sincerely yours,

for Milton J. Socolar

Comptroller General
of the United States