

**SURFACE WATER CONVEYANCING (SALE AND LEASE)
MUNICIPALITY/DEVELOPER PERSPECTIVE**

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NOTE: The views expressed in this paper are those of the author alone.

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Author of "Evolution of a Water Rights Adjudication Settlement," State Bar of Texas,
Environmental Law Journal, Vol. 19, No. 3, Winter 1989 (Part 1); Vol. 20, No. 1,
Summer 1989 (Part 2).
Author of "The Trans-Texas Water Program; Coordinating Competing Demands and
Limited Supplies," Fourth Annual Conference on Texas Water Law, November 4-5, 1994.
Author of "Managing Water Rights During Drought Conditions: The Water User's
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Co-Author of "Interbasin Transfers-A Problem Resolved? Basin of Origin Protection,"
Texas Water Law Institute, October 23-24, 1997.
Author of "Groundwater (Background and Recent Cases)," Texas Water Law Institute,
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Author of "Current Issues in Texas Water Law: Interbasin Transfers of Surface Water After
Senate Bill 1," CLE International - Texas Water Law, May 4-5, 2000
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SURFACE WATER CONVEYANCING (SALE & LEASE) MUNICIPALITY/DEVELOPER PERSPECTIVE

I. INTRODUCTION

The purpose of this article is to highlight contractual terms and conditions that are generally negotiated and included in surface water conveyancing. Regardless of whether the transaction is a sale of a surface water right or merely a lease, there are certain contractual terms that should be included in every transaction. This article will attempt to focus on these contractual terms from the perspective of a municipality/developer. To further sharpen the focus of this article, I am assuming the municipality/developer is seeking to acquire surface water for subsequent use by its customers. As luck would have it, my esteemed colleague, Ed McCarthy, and I recently successfully completed such a transaction between a landowner and a river authority for the long-term lease of the landowner's surface water rights for use by the river authority.

II. IS AN OPTION AGREEMENT NECESSARY?

One of the first questions that needs to be addressed is whether the nature of the proposed transaction makes it necessary or desirable to have the parties first negotiate and enter into an option agreement regarding the sale of the water right or lease of the surface water. Generally speaking, if the parties have essentially agreed upon the sale or lease terms and no additional authorization or amendment of the underlying water rights is needed, an option agreement is not necessary. More times than not, however, the parties need a period of time to finalize the negotiations and the transaction will require one party or other to file an application with the Texas Commission on Environmental Quality (TCEQ) to either obtain additional authorization or to amend existing authorization or both. This takes time and an option agreement provides both sides benefits during this period. The seller or lessor generally receives option money and the purchaser or lessee "locks up" the water until the negotiations and regulatory processes are complete. In the recent transaction completed by Mr. McCarthy and me, our clients did in fact enter into an Option Agreement. Discussed below are the terms/conditions that were included in the Option Agreement.

A. Grant of Option

As with most options, the optionor specifically grants to the optionee the right and option to enter into the particular transaction being contemplated. In our transaction, the landowner granted the river authority the

right and option to enter into the lease agreement that was attached as an exhibit to the option agreement. In this particular transaction, the parties decided to negotiate the lease terms contemporaneously with the option agreement terms so that the option period was essentially to allow time for the regulating process to run its course and not for the parties to negotiate the actual conveyance agreement.

B. Option

The option agreement needs to address the term of the option. The term of the option can be whatever the parties deem to be an appropriate period of time, generally ranging anywhere from six (6) months to two (2) years. The parties generally will include language that allows the term to be extended by agreement of the parties.

C. Consideration

Obviously, the parties will negotiate and reach an agreement on the amount of consideration (\$) the optionee will pay the optionor. The main issue here is whether or not the option consideration is separate from the consideration to be paid under the sale or lease agreement. If the option is exercised, will the option consideration be counted as a credit towards the consideration paid under the sale or lease agreement?

D. Optionor's Obligations

The optionor's obligations are usually related to securing the various permits, amendments, or additional regulatory authorizations that may be required to allow the optionor to sell or lease the water and to allow the optionee to be able to make use of the water for the duration, purpose and location that the optionee desires. Parties will generally negotiate a time-line for the optionor to accomplish such obligations. The optionor's costs are usually borne by the optionor, but this too is negotiable. In the recent transaction that Mr. McCarthy and I completed, my client, the optionee river authority, wanted the right to identify additional amendments that might be necessary to provide additional authorizations to allow the optionee to make the maximum beneficial use of the water. The cost associated with obtaining these additional amendments was the obligation of my client and the parties negotiated terms wherein a budget was agreed upon to reimburse the optionor for its legal and engineering costs to support my client's efforts.

An additional optionor obligation may involve securing written waivers from intervening water right holders whose rights are located between the point of diversion of the optionor and the point of diversion desired by the

optionee. From my client's perspective, the purpose of such a waiver is to eliminate or reduce possible objections to any required TCEQ amendments. This obligation can be included as a mandatory requirement meaning my client the optionee could terminate the transaction if the optionor is unsuccessful in securing the waivers. In the transaction that Mr. McCarthy and I recently completed, the optionor was only required to use his best efforts to secure the waivers.

E. Notice of Optionee's Exercise of Option

The option agreement should include language setting forth the process of what the optionee is to do in order to exercise the option. Specific steps or events are recommended so that there will be no question as to when the optionee exercises the option. These may include the payment of additional money to the optionor, executing the conveyance documents and/or providing notice to the optionor. Of course, the optionee's exercise of the option must occur within the timeframe specified in the option agreement. In the recent transaction that Mr. McCarthy and I completed, the optionee can exercise the option by executing and delivering to the optionor duplicate originals of the lease agreement that the parties had negotiated and attached as an exhibit to the option agreement. The optionor then has thirty (30) days to execute the lease agreement and return it to the optionee. Upon receipt of the fully executed lease agreement by the optionee, the lease agreement becomes effective.

F. Early Termination of Option

From the municipality/developer perspective, you want the right to terminate the option at any time, with or without cause, by simply giving a 7- to 10-day written notice to the optionor. If, for example, necessary regulatory approvals are not timely being obtained or circumstances change such that the supply of water subject to being purchased or leased is no longer needed or economical for use by the municipality/developer, the municipality/developer wants the right to terminate the deal. This early termination right, however, creates an issue for the municipality/developer. Will the municipality/developer be able to obtain a full or partial refund of the consideration paid to the optionor for the option? The issue should be negotiable.

G. Assignment

From the municipality/developer perspective, you want the ability to assign your option rights to a third party without obtaining the consent of the optionor. An option for water can be a valuable right and the municipality/developer wants the flexibility to "market"

such right. The issue relating to assignment is generally not the right to assignment, but rather will prior consent of the other non-assigning party be required. As with other issues, this too is negotiable.

H. Right of First Refusal

Landowners, more times than not, want to preserve their right to sell their water rights to a third party subject of course to whatever option or conveyancing agreement they may have with the municipality/developer. If the municipality/developer only has an option to lease the water, it may prove useful to include a right of first refusal for the municipality/developer in the option agreement. In the transaction Mr. McCarthy and I recently completed, the optionor did grant my client a right of first refusal. As was the case of the option agreement itself, the terms relating to the right of first refusal were also subject to negotiation by the parties. For example, how long will the first right of refusal be effective? What events trigger the optionor's requirement to notify the optionee of a proposed third-party sale? What steps does the optionee need to take in order to successfully exercise the first right of refusal? And what happens if the optionee fails to properly or timely exercise the first right of refusal? From the municipality/developer perspective, you want the rights associated with the rights of first refusal to be as broad as possible and the exercise of such right to be as simple as possible. All of these questions/issues are subject to negotiation.

I. "Boilerplate" Provisions

There are a number of "boilerplate" provisions that are included in surface water conveyances that are of a benefit to a municipality/developer.

1. Governing Law

Agreements should always be governed by the laws of the State of Texas.

2. Venue

From the municipality/developer perspective venue should be in the county where the municipality/ developer will use the water. If the landowner is located in another county, undoubtedly the parties will need to negotiate and arrive at some agreement with respect to venue. Should litigation arise, venue may be critical to one's success.

3. Severability

If one or more of the provisions contained in the option agreement shall for any reason be held invalid, illegal or unenforceable in any respect, the municipality/developer does not want its option agreement

to also be declared invalid, illegal or unenforceable. The inclusion of this type of severability language is essential.

4. Modification

From the municipality/developer perspective, you do not want the landowner to be able to modify the option agreement, unless such a modification is agreed to by both sides in writing.

5. No Third-Party Beneficiary

A municipality/developer will not want to be subjected to any third-party claims by entering into the option agreement. Language stating that the parties are entering into the option agreement solely for the benefit of themselves and that the option agreement shall not be construed in any way to confer any right, privilege, or benefit to any third-party is recommended.

6. Waiver

Such language generally provides that any waiver by the municipality/developer with respect to default by the landowner in connection with the option agreement shall not be deemed a waiver with respect to any subsequent default. As a practical matter, the parties routinely agree that the waiver provision applies equally to both sides.

7. Notices

To help ensure that parties timely receive any required notices under the option agreement, the notice should be required to be in writing, mailed by certified mail, return receipt requested, and shall be effective on the date actually received. If a party wants to change a mailing address, that party should be required to give the other party at least ten (10) days written notice of such address change.

8. Entire Agreement

Language should be included that states the option agreement constitutes the entire agreement and supercedes all prior agreements, both written and oral, between the landowner and the municipality/developer with respect to the subject matter of the option agreement. This type of language protects both sides in the transaction.

III. THE SALE/LEASE AGREEMENT

For the purpose of this paper, I will focus on the terms generally found in a lease agreement. Many of the terms found in a lease agreement are also found in sales of surface water rights.

A. Primary Term

Depending upon your client's specific water needs,

the term of the lease agreement will vary from short-term (1-10 years) to long-term (11-50 years). Generally, a municipality/developer will be seeking to secure the right to the water for a term that will be long-term in nature while the landowner will be somewhat reluctant to lease his water for long periods of time. The length of the primary term is very dependent upon the facts of the particular transaction so will be the subject of some negotiation.

B. Termination

How much prior written notice to the landowner is necessary and when does the termination notice go into effect are two issues to be negotiated. From the municipality/developer perspective, the ability to terminate the lease with the least amount of notice to the landowner and the least amount of financial impact to the municipality/developer is the goal.

In the recent transaction completed by Mr. McCarthy and me, my client agreed to give the landowner at least twelve (12) months prior written notice. However, the termination date will not take effect until December 31 of the calendar year that is at least thirty-six (36) months after the date the landowner receives my client's written termination notice. Once the lease is terminated, then all prospective obligations by both parties also terminate, but both parties remain liable for any obligation or liability incurred by that party that arose prior to the date that the lease is terminated.

C. Rent

Rent is probably the most negotiated term of any surface water conveyance. Regardless of whether the conveyance is by sale or lease, the landowner almost always has an inflated expectation of the value of his water to be sold or leased. Many factors can have an impact on the value of the water to be conveyed. From the municipality/developer perspective, one critical question is how dependable is the water supply during a repeat of the drought of record. In order to rely upon the water, the municipality/developer must be assured that such water will be available and dependable during such a drought. If it is not dependable during a drought, then the value of such water supply to a municipality/developer is greatly diminished since most customers of these entities are of the type that cannot go without water during a drought. The more reliable the water is during a drought, the higher the purchase price or rent that a municipality/developer can expect to pay. Related questions that a municipality/developer should inquire about to help determine the value of the water include

whether the water to be leased or sold has any conditions as to when, how, and where the water may be used by the municipality/developer. The more conditions or limitations, the less the value of the water supply to the municipality/developer. Obviously, the lower the value of the water supply to the municipality/developer, the lower the purchase price or rent that the municipality/ developer will be willing to pay a landowner. An additional issue that needs to be decided is whether or not the payment of rent will be on a take-or-pay basis. In other words, is rent payable regardless of whether the municipality/developer actually diverts and beneficially uses any part or all of the leased water.

Language in a lease agreement should include the standard language one would see about whether the rent is paid, annually, quarterly, or monthly and what are the ramifications of not paying rent on time.

Another area of concern to the municipality/ developer is rent adjustments that may or may not be made during the course of the lease term. This is especially true if the lease is a long-term lease. It is important to restrict any such adjustments so that over time the rent paid for the water is still economical as compared to other sources of water that may become available to the municipality/developer. Typically, the rent adjustments will be tied to some type of uniform index that has a history of reliability. An example is the consumer price index. It is important to the municipality/developer to be able to anticipate what the rent will be in years to come so that adequate budgets and revenues can be generated to pay the rent.

In addition to deciding what type of adjustment to the rent is acceptable, it is important to decide when such adjustments can be made. In other words, what period of time must pass before a rent adjustment can be made. There is no standard “window” but many leases have a five (5) year window, which means that after the passage of such time the landowner will have the opportunity to raise the rent. If, for example, the consumer price index (CPI) was used, then every five (5) years based upon the CPI at that time the rent could be raised accordingly.

Rent increases can become somewhat complicated as evidenced in the lease agreement recently completed by Mr. McCarthy and me. In that deal, the landowner may increase the rent every January 1st throughout the term of the lease agreement. Any rent increases in an affected calendar year shall be the greater of the following:

(1) the same percentage increase, if any, in the rate my client charges for raw water available from a particular reservoir under my client’s water rights as such rate increase was implemented by my client during the previous calendar year, provided that at no time shall any increase pursuant to this section result to a rent in excess of seventy percent (70%) of my client’s then-current rate until such time as my client’s rate is increased to \$167 per acre-foot per year. When my client’s rate is increased to \$167 per acre-foot per year, the rent shall be increased to an amount equal to my client’s rate less \$50.00, and all future increases in my client’s rate shall result in an equal increase in the rent such that the rent shall always be equal to my client’s rate less \$50,00; or

(2) fifty percent (50%) of any dollar amount, if any, that my client charges for the leased water (exclusive of the actual cost of service charges within that particular operation for debt service, and operations and maintenance related to the diversion, treatment and/or delivery of such water) above the rent per acre foot paid by my client to the landowner. For example, if my client pays the landowner \$50.00 per acre foot rent for the leased water, and my client assesses an amount, whether as a premium or surcharge, to my client’s customer by charging \$55.00 per acre foot (exclusive of the actual cost of service charges within that particular operation for debt service, and operations and maintenance related to the diversion, treatment and/or delivery of such water), then my client shall promptly pay to the landowner fifty percent (50%) of the \$5.00 in excess of the \$50.00 per acre foot rent paid. Beginning in the calendar year following the twentieth anniversary of the effective date of the lease agreement, my client shall pay the landowner, in addition to the rent, one hundred percent (100%) of any amount in excess, if any, of the rent my client charges its customers for the leased water; or

(3) an amount equal to the dollar amount, if any, my client charges its in-district customers for “run-of-river” surface water (exclusive of the actual cost of service charges within that particular operation for debt service, and operations and maintenance related to the diversion, treatment, and/or delivery of such water) above the amount my client paid the landowner as rent during the prior calendar year. For example, if my client is paying the landowner rent in the amount of \$50.00 per acre foot, and my client begins charging any of its in-district customers for “run-of-river” water in the amount of \$45.00 per acre foot (exclusive of the actual cost of service charges within that particular operation for debt service, and operations and maintenance related to the

diversion, treatment and/or delivery of such water), then my client continues to pay the landowner the \$50.00 per acre foot rent; however, if my client is charging any of its in-district customers more than \$50.00 per acre foot, *e.g.*, \$55.00 per acre foot, then in such event my client shall be obligated to pay the landowner rent in an amount equal to the greatest amount my client is charging any of its in-district customers per acre foot, *e.g.*, \$55.00 per acre foot.

Notwithstanding anything to the contrary in above language, during the term of the lease agreement, the rent due and payable to the landowner by my client in any subsequent calendar year shall never be reduced below the rent paid to the landowner during the immediately preceding calendar year.

D. Events of Default

As with any lease agreement, the lessor will undoubtedly want the agreement to define what actions or lack thereof by the lessee constitute a material breach of the lease agreement.

One obvious event of default is failure to timely pay the rent. From a municipality/developer perspective, before the lessor can find the lessee in material breach, the lessor needs to first notice the lessee, in writing, of the alleged event of default. The lessee will want to have language in the lease agreement giving the lessee sufficient time in which to cure any material breach after receiving the written notice of default from the lessor.

E. Lessor's (Landowner's) Remedies

In water lease agreements, the landowner typically wants language that allows the landowner, after notice and opportunity to cure a material breach, to terminate the lease. As the user of the water, the municipality/developer will seek language to either not allow termination as an option to the landowner or language that makes it as difficult as possible for the landowner to terminate the lease agreement.

F. Right of First Refusal

As was discussed above relating to terms in an option agreement, the municipality/developer may wish to have a right of first refusal. It may be that after years of paying rent for the water, it becomes more feasible for the municipality/developer to purchase the water right from the landowner. The municipality/developer needs to protect itself against the landowner selling such water right to a third-party. The terms of a right of first refusal in the option agreement are essentially the same for a lease agreement.

G. Representations/Warranties Regarding Water

To the extent that it is possible, the municipality/developer would like to have representations/warranties regarding the quantity or quality of the water that may be available for diversion and use under the lease agreement. Landowner's are very reluctant to do so and usually lease water "as is." In sales of water rights, however, the purchaser should require representations and warranties from the landowner with regard to his ownership rights.

H. Avoidance of Cancellation

An issue that arises in the lease of water is what happens if the underlying water right of the landowner is cancelled. Under current Texas water law, the underlying water right is subject to cancellation if water under the right has not been beneficially used for a ten (10) year period.¹ To avoid this type of negative consequence from happening, language should be added to the lease to require the lessee to use its best efforts to divert and use the amount of water subject to the lease during a single calendar year at least one (1) year out of every (10) years throughout the term of the lease and any extension of the lease agreement. Language should be developed identifying which party, lessor or lessee or both has the obligation to protect the water right from cancellation.

I. Taxes, Fees and Assessments

Depending upon which river basin the landowner's water right is located, there may be some obligations upon the landowner to pay certain state regulatory fees. For example, there may be a requirement to pay "Watermaster Fees" assessed by the TCEQ. A sale of the landowner's water right will transfer that obligation to the purchaser but should the obligation to pay such fees also be transferred in the lease situation? From the municipality/developer perspective, the payment of regulatory fees should remain with the owner of the water right which in the lease situation still is the landowner. The municipality/developer, after negotiating a reasonable rent, does not want to incur "add-on" costs. A lease agreement should address the issue so that when the fee becomes due, there is no dispute between the parties as to whose obligation it is to pay.

J. Assignment and Transfer

From the municipality/developer perspective, the

¹See Texas Water Code § 11.171 *et seq.*

ability to assign the lease agreement to a third-party without first obtaining the consent of the landowner is preferred. The landowner generally desires the same right. What type of prior consent will be needed to assign a parties' rights under the lease agreement is generally negotiated.

K. "Boilerplate" Provisions

The "boilerplate" provisions discussed above in Section II.I regarding option agreements should also be included in lease agreements.

IV. CONCLUSION

Having a dependable long-term water supply is of the utmost importance to municipalities/developers. However, prior to purchasing a water right or leasing water, the municipality/developer must be assured that the water will be available when and where it is needed and at a reasonable cost. Once obtained, the municipality/developer must be assured that its rights to the water supply are protected. Most terms in option agreements and sale or lease agreements are subject to negotiation and should be carefully structured to ensure the municipality/developer a dependable long-term water supply at a reasonable cost.