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JOHN E. THORSON*

Water Marketing in Big Sky Country: An Interim Assessment

ABSTRACT

Water marketing has received the most attention and is most active in the Southwest. Yet, in the Northern Rockies, Montana is experimenting with methods to improve the transferability and marketability of water. The 1985 Montana Legislature enacted major legislation that provides the framework for the marketing of water by private water users, the state, and Indian tribes. Water marketing pursuant to the legislation has been hampered by a depressed regional economy and legal uncertainties. In this review of water marketing in the "Big Sky" state, Montana lawyer John Thorson provides an assessment of the difficulties of modifying the West's water law and institutions.

INTRODUCTION

Water marketing has three dimensions in Big Sky Montana. The first emphasizes the allocation of water on a subregional or regional basis. The second involves water allocation on a local basis—that is, within water basins or sub-basins. The third dimension concerns the marketing of reserved Indian water rights.

In the realm of regional marketing, the state has established reasonably consistent and innovative public policies to guide water sales transactions. The problem: no buyers. At the local level, where there are modest but growing opportunities for water sales, public policies are immature—if not in disarray. Concerning the marketing of Indian water rights, the state and one of its reservations have entered into a historic agreement; but the authority of the Indian tribes under federal law to market their water is still in question.

This paper examines Montana's water marketing policies at each of these three levels. The context in which these policies developed is explained. The important features of Montana's water marketing system are reviewed. The paper concludes discussing the major shortcomings that have developed in each of these marketing areas.

*Mr. Thorson is a member of the law firm of Doney & Thorson, Helena, Montana, where he specializes in water law. He received his bachelor's degree from the University of New Mexico and his law degree from the University of California, Berkeley, where he was note and comment editor of the *California Law Review*. He is a member of the California, Montana, and New Mexico bars.

I. ADVENT OF WATER MARKETING IN MONTANA

The fear of water marketing was, ironically, the basis for Montana accepting marketing as an important means for protecting the state's water resources. During the energy boom of the 1970's and early 1980's, Montanans worried that portions of their state would become Owens Valleys[1] to massive coal plants and thirsty new cities. One symbol embodied these fears of devastation and ruin: coal slurry pipelines. A ban on coal slurry pipelines using water was enacted in 1979.[2] The state also had a ban on the exportation of water out-of-state.[3]

By 1985, Montana decisionmakers began to appreciate three facts that ultimately led them to acquiesce in, if not embrace water marketing: (1) many water marketing opportunities already existed under law; (2) water marketing might increase the state's ability to profit from, as well as control and condition large water uses; and (3) water marketing as a concession to a tribe was useful in negotiating Indian water rights.

An examination of existing opportunities for the purchase of water led decisionmakers to understand that water marketing was not the radical notion it seemed to be. As indicated in Table 1, which was prepared for the legislature at the time, water could be purchased from numerous sellers: federal and state agencies, private parties, and possibly Indian tribes.

Legislators were also influenced by the "market participant" concept that had been developed somewhat obliquely by the United States Supreme Court. Under a line of cases, the Court has allowed states, when they act as "market participants," to discriminate in the purchase and sale of goods in a fashion that would otherwise violate the dormant interstate commerce clause. The theory was used by the Supreme Court to uphold a Maryland law which discriminated against out-of-state scrap dealers. Justice Powell wrote: "Nothing in the purposes animating the Commerce Clause prohibits a State, in the absence of congressional action, from participating in the market and exercising the right to favor its own citizens over others."[4] In *Reeves v. Stake*,[5] the Court upheld a South Dakota statute that authorized a state-owned cement plan to sell only to state residents. In 1984, the Court, while striking down an Alaskan statute requiring instate first processing of state-owned timber, seemed

1. With the construction of a pipeline, Owens Valley, California, fell victim to Los Angeles' thirst for water. The incident is dramatically portrayed in the popular movie "Chinatown." For excellent summaries of this history, see W. KAHRL, WATER AND POWER (1982) and M. REISNER, CADILLAC DESERT (1986).

2. 1979 Mont. Laws 552, § 2, *repealed by* 1985 Mont. Laws 573, § 24.

3. 1921 Mont. Laws 220, § 1, *repealed by* 1985 Mont. Laws 573, § 23.

4. Hughes v. Alexander Scrap Corp., 426 U.S. 794, 810 (1976).

5. 447 U.S. 429 (1980).

TABLE 1
Possibilities for Water Sales in Montana
(As of 1984)

INTERESTED PARTY	WHO SELLS?	CONSIDERATION PAID TO WHOM?	STATE JURISDICTION?
Approaches federal government for industrial water from			
Fort Peck Reservoir[a]	Option to state	Equally to state & federal government if sold by state	Whether state sells or not
Yellowtail, Tiber, Canyon Ferry[b]	Same	Same	Same
Other reservoirs (Hungry Horse, (Clark Canyon, Gibson)	Federal government	To federal government	Probable[c]
Approaches federal government for water for other purposes	Federal government	To federal government	Probable[c]
Approaches state for water from state reservoirs (for any beneficial use)	State government	To state	Yes
Approaches private party for water for any beneficial use	Private party	To private party	Change of use review[d]
Appropriates water in own name for any beneficial use; perhaps later transfer of use (including to an out-of-state location)	No sale; simply application for permit	None paid	Public interest criteria[e]; perhaps change of use[f] or MFSA[g]
Indian tribe	Tribe[h]	Tribe	Probable jurisdiction over off-reservation movement or use of water (if otherwise lawful)

Notes:

a Under Memorandum of Agreement between the State of Montana and the U.S. Bureau of Reclamation (1976).
b Under proposed Memorandum of Agreement between the State of Montana and the U.S. Bureau of Reclamation (1984 draft).
c So long as state conditions do not defeat the primary purpose of the federal project. United States v. California (New Mellones Dam), 694 F.2d 1171 (9th Cir. 1982).
d Mont. Code Ann. § 85-2-402 (1983).
e Mont. Code Ann. § 85-2-311 (1983).
f Mont. Code Ann. § 85-2-402 (1983).
g Major Facility Siting Act, Mont. Code Ann. § 75-20-101 to -1205 (1983).
h Tribal marketing is probably subject to federal approval. 25 U.S.C. §§ 407, 415 (1982).

to indicate that Alaska could choose the purchasers with whom it would deal so long as the state did not attempt to restrict the post-purchase behavior of the buyers.[6]

6. South-Central Timber Dev., Inc. v. Wunnicke, 467 U.S. 82 (1984).

Thus, if the state were to market water, it might be able to condition water use in a way not available to it in its regulatory capacity. Also, payments to the state could be extracted for large water uses.[7]

At the same time the legislature was considering water marketing issues in its 1985 session, the Montana Reserved Water Rights Compact Commission[8] and the Sioux and Assiniboine Tribes of the Fort Peck Reservation were completing a compact quantifying the tribes' reserved water rights. Authorization for the tribes to market their water became an important discussion point in the last stages of the negotiations.

II. THE WATER MARKETING SYSTEM CREATED BY THE 1985 LEGISLATURE

The 1985 Montana Legislature was the most active legislature on water issues since the original Water Use Act was passed in 1973. The legislature took actions which affected water marketing at the local and regional levels and established a precedent for water marketing by Indian tribes.

A. Local Marketing

The fewest changes made in water marketing law were in local marketing, as Montana law already provided for the transfer and severance of water rights through the administrative system.[9] The legislature did, however, adopt increasingly stringent public interest criteria to govern new appropriations and transfers of or changes in existing rights.[10]

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7. For excellent discussions of the "market participant" concept, see N.M. WATER RESOURCES RESEARCH INST., STATE APPROPRIATION OF UNAPPROPRIATED GROUNDWATER: A STRATEGY FOR INSURING NEW MEXICO A WATER FUTURE (1986); Rodgers, *The Limits of State Activity in the Interstate Water Market*, 21 LAND & WATER L. REV 357 (1986).

8. The Commission represents the state in reserved water negotiations with Indian tribes and the federal government. *See* MONT. CODE ANN. § 2-15-212 (1987).

9. *Id.* § 85-2-403.

10. The legislation, H.B. 680, 49th Leg. (codified at MONT. CODE ANN. § 85-2-311 (1983)) creates three levels of public interest criteria and a special set of "out-of-state" conservation criteria for evaluating permit applications, change of appropriation applications, and reservation of water applications.

When applying for new water permits, potential appropriators now have to satisfy either "Level 1" or "Level 2" criteria, regardless of whether the water will be used in or out-of-state. "Level 1" public interest criteria roughly parallel preexisting law. These criteria apply to appropriations of less than 4000 ac-ft/yr and 5.5 cfs and require only the traditional examination of the potential effect of a new water use on other appropriators in a basin (*e.g.*, whether there will be adverse effect on prior appropriators, whether the diversion will be properly constructed, whether the proposed use is beneficial).

"Level 2" public interest criteria, applying to diversions in excess of 4000 ac-ft/yr and 5.5 cfs, restate temporary criteria added in 1983. By permanently adopting these criteria, the legislature has made clear that large diversions will be carefully evaluated on the basis of a broader, state-wide public interest.

Drafters of the legislation (H.B. 680) were concerned that potential appropriators would seek to

B. Regional Marketing

In the area of subregional or regional marketing, the legislature was much more ambitious. It established a limited state water-leasing program that involved a maximum of 50,000 acre-feet (ac-ft) of impounded water.[11] A lease from the state is now required to obtain water in any amount for transport outside any one of five specified river basins or for uses of water in excess of 4000 acre-feet/year (ac-ft/yr) and 5.5 cubic feet per second (cfs).[12] Lesser amounts of water can also be leased.

As water is leased, it is appropriated in the name of the state, and a certificate is issued to the state department of natural resources and conservation.[13] If lease applications exceed 50,000 ac-ft/yr of water, the department must return to the legislature for additional leasing authority.[14] Leases are limited to 50 years but can be renewed for up to an additional 50 years.[15] Leases must be approved by the board of natural resources and conservation.[16]

The source of water for the leasing program is impounded water from any reservoir within Montana.[17] Water cannot be leased from a reservoir in a basin for which a pending or final decree under the statewide general stream adjudication program has not been issued.[18] This restriction does

avoid the public interest criteria and the new state water leasing program (see next section on Regional Marketing) by acquiring existing rights and securing a change in type of use, place of use, or place of diversion from the department. H.B. 680 prevents this by incorporating the "Level 1" and "Level 2" standards in a substantially revised "change in appropriation rights" section. A specialized requirement ("Level 3") is set forth for change applications that would result in water in excess of 4000 ac-ft/yr and 5.5 cfs being consumed: these change applications must be approved by the legislature. For the same reasons, certain of the public interest criteria have been added to the water reservations procedures. While it has not been used for this purpose, it is arguable that the reservation of water system allows water to be reserved for existing as well as future beneficial uses. Again, the drafters were concerned that potential water users would attempt to avoid the leasing program and the public interest criteria by applying for water under this provision.

The legislature also provided additional public interest criteria to provide an especially careful review of applications to move water out-of-state. These conservation criteria were designed to provide the state with constitutionally permissible means to regulate and review out-of-state movement of water. They stem from the opportunity left by the U.S. Supreme Court in Sporhase v. Nebraska *ex rel.* Douglas, 458 U.S. 941 (1982), for states to prefer their own citizens for water if necessary for "health and safety" purposes. In fashioning these water conservation criteria, Montana has attempted to rely upon and learn from New Mexico's recent experiences in the City of El Paso v. Reynolds litigation, 563 F. Supp. 379 (D.N.M. 1983); 597 F. Supp. 694 (D.N.M. 1984). The Montana drafters believe that their revisions of the New Mexico scheme, coupled with Montana's overall pattern of public interest criteria, results in a constitutionally defensible limitation on the exportation of water from the state.

11. MONT. CODE ANN. § 85-2-141 (1987).
12. *Id.* § 85-2-301.
13. *Id.*
14. *Id.* § 85-2-141(4).
15. *Id.* § 85-2-141(5).
16. *Id.* § 85-2-141(1).
17. *Id.* § 85-2-141(3).
18. *Id.* § 85-2-141(3)(a).

not apply to federal reservoirs for which the state has a water purchase and revenue sharing agreement with the U.S. Bureau of Reclamation.[19]

Water is leased through bilateral negotiations.On receipt of an application to lease water, the department evaluates the proposal with reference to statutory public interest criteria.[20] The department can require that 25 percent of the capacity of a proposed project be set aside for municipal and rural purposes (upon payment by the municipal or rural government of the costs of the tie-in).[21] All other terms and conditions are determined through negotiations.[22]

The legislature was concerned about the impacts of water marketing on agriculture. For this reason, the legislation gives specific authority to the department to use differential pricing, and the explicit legislative intent is that agriculture leasing is to be preferred.[23] The proceeds of the leasing program go to the state general fund.

C. Tribal Marketing

Ratification of the Fort Peck-Montana Compact[24] by the Montana Legislature in the spring of 1985 represented the largest Indian water rights settlement in history.[25] The tribes are given the annual right to divert from the Missouri River, the tributaries that flow through or are adjacent to the reservation, and groundwater the lesser of: (1) 1,050,472 ac-ft/yr of water, or (2) the amount of water necessary to supply a consumptive use of 525,236 ac-ft/yr.

Under the Compact, water can be transferred to non-Indians, either on- or off-reservation, but the transfer can only be of the right to use the water—the tribes may not permanently alienate the water awarded under the Compact. The tribes are guaranteed the right to transfer up to 50,000 ac-ft/yr for off-reservation consumptive uses. This amount can be increased in the event the state increases its own marketing authority. The Compact asks Congress to specifically ratify tribal authority to market water.

III. ASSESSMENT OF PROBLEMS AND PROSPECTS

The jury is still out on the effectiveness of Montana's water policy.

19. *Id.* § 85-2-141(3)(b) & (c).
20. *Id.* § 85-2-311..
21. *Id.* § 85-2-141(8).
22. *Id.*
23. Statement of Intent, H.B. 680, 49th Leg., 1985 Mont. Laws 573.
24. MONT. CODE ANN. § 85-20-201 (1987).
25. The Compact was approved by the Secretary of the Interior and the U.S. Attorney General. It was not submitted to Congress for ratification.

The following are some comments on the status of the marketing program in each of the three areas.

A. Regional Marketing

The reasons for Montana's regional water marketing program are explicit. Foremost, it provides the opportunity for the state, through application of the market participation theory, to condition the interstate movement of water so as to protect environmental values and other state policies. The water marketing program also ensures that the state receives fair consideration for the use of large amounts of water. Through a leasing program, the legislature has provided a means for the state to condition leases on the basis of public interest criteria and periodically review the uses of the leased water.

Thus, Montana has an adequate superstructure in place to respond to large-scale pressures on the state's water resources—those brought about by energy development or proposals for interstate transfers. Other elements of this water protection strategy include the reservation of waters on major rivers for instream flows and future uses, public interest criteria governing new appropriations and changes in water rights, water planning, and the public trust doctrine.

Problems remain, however, which threaten the effectiveness of this regional marketing and protection strategy. The state water marketing program limits leases from reservoirs, the larger ones of which are federal. Presently, federal reclamation law limits the marketing of water supplied by federal reclamation projects by limiting the amount of "profit" that can be earned by the transferor. A recent decision by the U.S. Supreme Court in *ETSI Pipeline Project v. Missouri*,[26] concerning the authority of the Bureau of Reclamation to approve the sale of water from the Oahe Reservoir in North Dakota to the ETSI coal slurry pipeline consortium, eliminates the ability of the Bureau to market surplus water from mainstem dams in the Missouri River basin. As the federal water agencies revise their water marketing policies, they may make inroads in the ability of the states either to profit from or protect the water of the state. If the Corps or Bureau actively seek to market their surplus water, they will be either competitors or price-establishing wholesalers for states.

Large hydro-generation rights on the Clark Fork River system in the western part of Montana will preclude any large state water leasing proposals. On the eastern side of the state, the absence of an interstate apportionment on the Missouri River system also constrains water marketing. Without a decree or compact, any large-scale marketing proposal will no doubt be greeted with objections from lower basin states.

26. 108 S. Ct. 805 (1988).

B. Local Marketing

It is at the local level that water marketing faces its greatest difficulties. Montana has yet to adopt a comprehensive and explicit policy for basin or sub-basin water marketing. The 1985 legislature, by establishing public interest permit and transfer criteria, attempted to fuse the broader public interest and the marketplace. Yet, numerous barriers still prevent the expeditious transfer of water to more efficient and higher value uses. While water rights can be transferred and severed from the land, such transactions must be approved by the department of natural resources and conservation in its application of public interest criteria.[27] While the state's water marketing program nominally promotes greater water use efficiency by emphasizing the economic value of water, many other features of the state's water policy, such as an ambitious water development program, undermine water use efficiency.

The lack of physical plumbing in the state also restrains local water marketing. During the 1977 California drought, that state's elaborate system of canals allowed water to be moved virtually anywhere in the state. Montana, a state nearly two-thirds the size of California, does not begin to have that type of plumbing system. Thus, it remains difficult to move water to places of demand.

The most significant barrier to local water marketing, however, is the lack of water rights quantification. Montana is attempting to complete a statewide water adjudication process; but even when completed (hopefully in the 1990's), most individual rights will not be quantified as to their consumptive amount. Thus, every water transfer proceeding will end up requantifying the amount that can be transferred without harm to other appropriators. Some basin wide procedure must be devised to calculate these consumptive shares.

Other uncertainties detract from the title of many water rights. The public trust doctrine,[28] not yet applied to appropriated water in Montana, has reminded the state of its obligation, as steward of the water resource, to prevent harmful water uses. The waste and reasonable use provisions of law will be more frequently enforced.

All these uncertainties increase the transaction costs of obtaining water

27. MONT. CODE ANN. § 85-2-402 (1987).

28. The public trust doctrine, having its origins in Roman and Anglo-Saxon law, holds that the sovereign has a fiduciary obligation in the management of important public resources. The landmark American case is Illinois Central Railroad v. Illinois, 146 U.S. 387 (1892). The doctrine has been increasingly applied to require state protection of public and environmental values when water is used by private appropriators. *See* National Audubon Soc'y v. Superior Court, 33 Cal.3d 419, 658 P.2d 709, 189 Cal. Rptr. 346, *cert. denied*, 464 U.S. 977 (1983); Montana Coalition for Stream Access v. Curran, 210 Mont. 38, 682 P.2d 163 (1984); Montana Coalition for Stream Access v. Hildreth, 211 Mont. 29, 684 P.2d 1088 (1984).

rights transfers. Many transfer approvals become *de novo* proceedings on these issues. For instance, the author represents a party seeking to purchase and transfer a modest irrigation water right in a partially adjudicated basin. Seven parties filed objections, and a two-day hearing took place almost one year after the initial application. The hearing examiner's decision was issued six months later, and we now await final arguments before the department. Two irrigation seasons have already passed, and we still do not know if this water rights transfer will be approved.

Like many other western states, Montana fails to provide any incentive for greater water efficiency. Title to salvage rights is uncertain, and the state should consider legislation allowing the salvager to expand acreage or to sell his salvaged water.

To better understand the fundamental questions that are raised in selling water rights in Montana, let me analogize to the sale of a car. I advertise to sell my classic 1957 Oldsmobile 98. While the first browsers are impressed with its apparent immaculate appearance, soon they ask hard questions. "I understand that you don't really own this car, that it is just on loan from the state?" "I heard that this isn't really an original 1957 but a clever replica manufactured about 1977." Or, "I've heard that this is really a taxi cab owned by the taxi company, available for everyone to use." Or, "I've heard that this car must be made available at any time, and for free, to members of the wilderness club." "How do I know it will run? I understand that you haven't used the car for ten years."

An even less friendly group arrives. Some neighbors are astonished that I would even consider selling the car—as they claim to own the wheels and transmission. An agent for the federal government claims that, since the car has been driven most often on interstate highways, that the Department of Transportation actually owns it. A lawyer serves me papers alleging that I had wrongfully converted the car from the rightful owners—a nearby Indian tribe. The marketability of my Olds 98 has dramatically diminished. Potential buyers have left by the back door.

C. Tribal Water Marketing

Execution of the Montana-Fort Peck Compact[29] is a historic benchmark in the development of western water law. It marks the first time that a tribe and a state have been able to quantify the Indian reserved right without federal dollars and a minimum of federal participation. The water marketing provisions of that Compact will be the model for other compacts in Montana and probably throughout the West.

29. *See supra* note 24.

Yet, ambiguity over the water marketing provisions of the agreement will remain until Congress affirms that tribes can at least lease and transfer their reserved water rights on- or off-reservation. The Fort Peck Compact calls upon Congress to approve legislation specifically recognizing the ability of the tribes to market their water;[30] but although four years have passed, legislation has not been introduced.

IV. CONCLUSION

Convincing and well-developed theories have been propounded in support of greater water efficiency and water marketing in the West. Many states are adopting legislation and regulations to promote this emphasis. Clever brokers and lawyers have been able to make water marketing work in spite of restrictive and cumbersome rules.

Yet, the experiences in Montana indicate that a large gulf exists between theory and practice. Western water allocation institutions are changing, but they are complex and sometimes rigid. A greater emphasis on economic efficiency and value in the allocation must be harmonized with other public policies, such as the emphasis on public rights, which move in an entirely different direction. Harmony will be achieved, if at all, only after policymakers rethink the purposes of their water management systems and practitioners understand those purposes and accept the means to achieve them.

30. *Id.*