Agriculture’s CAP Experience: Sustainability for Whom?

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AGRICULTURE'S CAP EXPERIENCE:
SUSTAINABILITY FOR WHOM?

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Sustainable Use of the West's Water
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Back to the Future II: Economic Discovery in Federally-Supported Irrigation Districts*

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*An earlier version of this paper was published as Working Paper #85, Department of Agricultural and Resource Economics, College of Agriculture, The University of Arizona, Tucson, September, 1994. This manuscript was written as a tribute to Jim Barr, Maurice Kelso, David Pingry and Robert Young, but especially to Bill Martin, who successfully applied economic analysis for over two decades to a controversial public policy debate. The fact that their analysis was correct, but largely ignored by public officials, should serve as a valuable lesson to lay people, economists, federal and local water administrators, and politicians interested in reforming water allocation practices and institutions in the West.
"... the Project would bring in water farmers in pump areas could not afford to buy and farmers in irrigation districts do not particularly need."

Young and Martin, 1967, p. 17

"I see CAP agriculture attempting to shift as much of its CAP water allocation and associated debt as is legally and economically possible to other CAP water users, i.e. M&I and Native Americans. Without these changes in CAP contracts, a majority of the CAP districts, and a significant portion of the growers, will declare bankruptcy and surrender their economic fate to the bankruptcy courts."

Wilson, 1992, p. 54

I. INTRODUCTION

Water allocation in the West has become a local policy issue. Special interests historically left out of public policy decisions concerning federal water - Native Americans, environmental groups, and urban populations - have reasserted their political right to influence the management of federally-allocated water. These new political alliances are challenging the traditional water interests in the West - agriculture and mining - as they pursue institutional change which favors a broader public interest and insures sustainable water resources.¹

The U.S. Bureau of Reclamation (BOR) has been, and is today, a key player in the evolution of water development and management in the West. Established by the National Reclamation Act of 1902, the BOR evolved into the dominant builder of dams, flood control projects, and electric power generating stations. Since the arid West required water for economic growth, Western political interests used the BOR "to redistribute income and wealth from the nation's taxpayers to the Western region via Federal projects" (Gardner 1992). The economic viability of many Western metropolitan areas - and a large percentage of commercial agriculture - is dependent on BOR-supported projects.

Some of the earliest water development in the West was self-financed by agricultural, municipal and mining interests. The willingness of the direct beneficiaries to fund infrastructure improvements implicitly indicated that these projects were economically beneficial. As water project implementation was relinquished to the federal government during the early part of this century and accelerated under BOR sponsorship, the projects on the margin became increasingly less economically viable. To justify the agricultural portions of these public investments, the BOR instituted a number of formal and informal policies such as low estimates of project costs, zero interest loans for agriculture, extended repayment periods, the ability-to-pay rule, postage-stamp pricing, and using power revenues to repay irrigation costs (Rucker and Fishback 1983; McCool 1987; Gardner 1992). These, as well as other policies, masked the true costs of these projects, creating an unsustainable financial obligation that could only be met through federal largess.
For several decades now, the BOR has experienced the transition pains of evolving from a public works organization to a water resources management agency (Beard 1993). Yet the burden of past and existing policies plague this transitional process. Getting water prices "right" will be an ongoing challenge for the BOR and other water management agencies. For until economic criteria are granted equal status with engineering and political interests, the pursuit of the management mantle will be elusive.2 The ongoing political economy surrounding the Central Arizona Project (CAP) illustrates the pains of this evolutionary process.

II. The Central Arizona Project and Non-Indian Agriculture

Historical Overview

The notice of substantial completion of the Central Arizona Project (CAP) in 1993 represented the realization of a 70-year long quest for many agricultural, community and political leaders of Arizona. Federal debt repayment of approximately $2.1 billion pursuant to the master repayment contract between the federal government and the Central Arizona Water Conservation District (CAWCD) has begun. Construction of this water delivery system to transport Colorado River water through a 335-mile aqueduct to farms and cities in Maricopa, Pinal and Pima counties required the ongoing financial and technical support of the the BOR for most of these 70 years.

The road towards the realization of the CAP dream began in 1919 with the formation of the League of the Southwest, an organization of the Colorado River Basin States having the expressed purpose of promoting the development of the river (Johnson 1977). In 1923, all the basin states, except Arizona, approved the Colorado River Compact. The Compact evolved into the Boulder Canyon Project Act (1928) which allocated 2.8 million acre-feet annually to Arizona. During the 1930s both Boulder (now Hoover) and Parker Dams on the lower Colorado River were completed by the BOR.

In 1941 Arizona Senator Carl Hayden asked the BOR to study all the realistic proposals for transporting Colorado River water to central Arizona. To complement this political effort, the Arizona State Legislature finally ratified the Colorado River Compact in 1944 and the State began to enlist the support of other basin states for the CAP. That same year the BOR recommended building the CAP and began engineering studies. Two years later, the Central Arizona Project Association (CAPA) was established as a lobbying entity solely for the purpose of insuring that the CAP dream would become a reality.

The 1950s were a decade of litigation. CAP authorization bills repeatedly failed to pass Congress due to ongoing water rights disputes between Arizona and California. So in 1952 Arizona filed an interstate legal suit against California to adjudicate its rights to the use of Colorado River water. In 1963 the U.S. Supreme Court decreed that Arizona had a right to 2.8 million acre-
feet (Arizona v. California, 373 U.S. 546). That same year CAPA opened an office in Washington, D.C. to assist the Arizona congressional delegation in securing authorization and appropriation legislation from Congress. After some deft political maneuvering by Senator Hayden, Representative Morris Udall, and other political leaders, Congress authorized the CAP as part of the Colorado River Basin Project Act (Public Law 90-357) in 1968.

Obtaining and maintaining federal funding for the CAP proved to be as politically challenging as the authorization process. By 1970, some federal funding was authorized to begin CAP pre-construction planning. Construction finally began on the Havasu Pumping Plant in 1973 but the enthusiasm generated by the construction start-up event soon waned. In 1977 the CAP was placed on the Carter Administration's "hit list" of federal water projects. Not only did current appropriated funds have to be justified, but the feasibility of the entire project was restudied by the Department of Interior, the Office of Management and Budget, the Council on Environmental Quality, and the Corps of Engineers. To combat this threat to the future of the CAP, the CAPA mobilized 17 chambers of commerce, and 104 water companies, irrigation districts and public utilities to send petitions and supporting resolutions to Congress. This community-wide effort was successful; several months later President Carter approved continued funding for the CAP contingent upon groundwater management legislation being passed and implemented by the State of Arizona.3

In 1980, Interior Secretary Cecil Andrus announced that Indian reservations in Arizona would have priority right to 309,828 acre-feet of CAP water, followed by 640,000 acre-feet for municipal and industrial (M&I) users, with the balance of the 1.5 million acre-feet going to non-Indian agriculture. Harquahala Valley Irrigation District, Tonopah Irrigation District and the City of Phoenix took delivery of CAP water in 1985, followed by the irrigation districts in Pinal County in 1987. Some households in Tucson, at the end of the 335-mile aqueduct, began drinking CAP water in November 1992.4

Back to the Future: A Tribute

We can go back to past economic analyses for insights on the future of the CAP and CAP-based agriculture. Early analyses, one prior to the signing of the Colorado River Basin Act, challenged the water ethic in Arizona which argued for increased supplies to support a growing economy (Young and Martin 1967; Kelso, Martin and Mack 1973). The CAP, it was argued by these authors, would deliver water to the farmer at higher prices than pumped groundwater. If the grower was forced to buy CAP water, this substantial increase in costs would drive many agricultural producers out of business or reduce their income. All projections pointed to CAP water being more expensive than groundwater for years to come; contrary to the arguments of some project proponents a crossover in groundwater and CAP water price levels would not occur.
And even if there was a crossover well into the next century, the water price would be so high that profitable agricultural production would be impossible. The real problem according to these modern day prophets was the misallocation of existing water supplies. As noted then, "Water scarcity, even growing scarcity, is far less costly to the Arizona economy than is popularly supposed; whatever costliness the scarcity does impose, amelioration is far more a matter of reforming man-made institutional inefficiencies in water administration and management than in reforming its nature-made physical scarcities." (Kelso, Martin and Mack 1973 p. 244). Urban growth, long an objective of Arizona politicians, could occur as municipalities urbanized farmland and obtained groundwater pumping rights or as agricultural water was transferred or sold to higher value uses.

In the year the CAP was placed on President Carter's "hit list" of federal water projects and funding was discontinued, Barr and Pingry (1977a,b) released reports which analyzed the complex cost structure of the CAP. They argued "that insufficient effort has gone toward providing a realistic assessment of the CAP's potential impacts throughout the course of its development, making the average citizen's stance on the project a matter of faith rather than reasoned judgment" (Barr and Pingry 1977b, p. 15). Using an investment analysis approach, the authors focused on the subsidies and costs of the project under different scenarios or experiments. They concluded that Project costs would be significantly higher than originally predicted. Repayment for the main canal would be close to $2.3 billion, not $1.2 billion, the variable costs of CAP water would be twice those of pumped groundwater, power revenues would be necessary to subsidize water delivery, and that postage stamp pricing of CAP water would increase the OM&R costs of the system. They pointed out that the M&I users and the taxpayers in the three-county service area eventually would pay the majority of the costs incurred to supply irrigation water to agriculture. The authors suggested that a reappraisal of the CAP should look closely at the opportunity costs of continuing CAP funding.

However, funding for the CAP was renewed in 1977 and agricultural irrigation districts began planning their CAP water distribution systems. These investments in irrigation infrastructure surpassed $100 million in the larger districts. Bush and Martin (1986) analyzed these investment decisions by projecting variable and fixed costs for representative farms in eight irrigation districts, with and without CAP water, over a 50-year planning horizon. They concluded that most irrigation districts would be worse off with the CAP than without it. Bush and Martin pointed out that the price of electrical energy, not the price of surface water, was the key factor in the survival of central Arizona agriculture.

Nevertheless, nine districts contracted for CAP water and built distribution systems with BOR and Central Arizona Water Conservation District (CAWCD) encouragement and support. These decisions downplayed all earlier economic analyses. Martin (1988) argued that growers,
through their districts and lawyers, were playing a water development game. As soon as the physical infrastructure was in place and the costs of the CAP had to be paid, past experiences had shown that the costs of water for non-Indian agriculture were negotiable within the existing institutional environment.\(^5\) Ironically, Martin predicted that these negotiations by non-Indian agricultural interests would use the same economic analyses which questioned the economic feasibility of the project for over two decades.

### III. BACK TO THE FUTURE II: ECONOMIC REALITY

#### Economic Discovery at the Irrigation District Level

It became clear in the late 1980s that economically sustainable water prices were unavailable to irrigation districts contracting for CAP water. Short-run projections by the CAWCD produced future CAP water prices of $60-80 per acre-foot, approximately two times the economic value of the water in agricultural production. Anticipating these looming economic pressures and at the request of the U.S. Water Conservation Laboratory (USDA-ARS) in Phoenix, the Board of Directors of the Maricopa-Stanfield Irrigation and Drainage District (MSIDD) agreed to participate in the Interagency Management Improvement Program (IMIP) in 1990.\(^6\) Originally designed for improving water management in developing countries, the implementation of the IMIP methodology in the MSIDD was the initial use of this technology transfer tool in the U.S. (Lowdermilk, et al. 1983; Clyma and Lowdermilk 1988). The overall goal of the IMIP was to improve the economic profitability and sustainability of irrigated agriculture in the MSIDD.

The IMIP brought together stakeholders in a proactive, non-confrontational manner to design and implement programs to improve water management.\(^7\) Phase I in the MSIDD was a diagnostic analysis, an effort to identify and evaluate areas of high and low performance on farms and in district operations (Dedrick, et al. 1992). Management planning activities (Phase II) followed, with support and regulatory agency personnel working with growers to reach a shared understanding of the status of irrigated agriculture and designing new policies and programs directed at improving irrigation water management. Phase III, completed in January, 1994, monitored and supported the initial implementation of the Phase II programs (e.g. improved on-farm water measurement, greater reliance on automated water delivery, negotiated water cost reductions). Growers and irrigation district personnel played a critical role throughout all phases of the IMIP.

Ex post evaluation of the IMIP concluded that an interorganizational and interdisciplinary approach to improving water management in federally-supported irrigation districts holds promise (LeClair, Bautista and Rish 1994). During the IMIP, growers had become more sensitive to water measurement issues, developed a better working relationship with MSIDD and other agency staff,
and gained a broader perspective on agricultural issues. MSIDD management and staff improved their understanding of grower issues, becoming more sensitive to the high degree of variability within and between farming operations. In addition, communication between the MSIDD and its growers improved through policy and program changes. An increased understanding of how agency programs were designed and implemented also was a favorable outcome. Finally, the support agencies themselves gained a new perspective on how their programs did or did not impact on irrigated agriculture, either favorably or unfavorably. The IMIP also led to greater interagency coordination. On the downside the IMIP could be improved by (1) even more grower involvement, (2) a sustained commitment from all participating agencies, (3) operating at a lower opportunity cost to personnel from participating agencies and (4) generating more educational opportunities for growers and agency personnel based on the IMIP.8

Yet throughout the IMIP it became increasingly clear that irrigated agriculture in the MSIDD was not economically sustainable under current prices and policies, even with increased technical efficiency. Plans to deliver CAP water to the MSIDD were fundamentally flawed from the beginning because they incorrectly modeled on-farm economic decision making, ignored principles of financial risk, and overestimated the ability of the MSIDD to control water policy decisions at the state, regional and national level.

Farm Level. The IMIP diagnostic analysis revealed deteriorating farm-level economic conditions in the MSIDD. Upland and American-Pima cotton yields since 1987 had trended downward, with wide year-to-year variation. Analysts attributed this unfavorable trend to poor soil fertility conditions due to an evolving cotton monoculture, poor growing weather, and damaging pest infestations (e.g. boll weevil, pink bollworm, whitefly).9 Real cotton prices had trended downward for the last 20 years. When combined with rising real costs for inputs, particularly CAP water, MSIDD growers found themselves in a difficult cost-price squeeze where their only survival strategies were cost-saving actions through better management practices and financial/legal restructuring.

Until 1986 agricultural lenders had made loan decisions based on repayment capacity and the market value of the grower's assets, particularly land. With land values appreciating rapidly in central Arizona due to urban development and speculative market pressures, lenders were assured that even bad loans could be repaid by selling the collateral. However, "paper equity" financing produced loan portfolios that could not be sustained on the value of agricultural production alone. With external macroeconomic pressures (e.g. recession, increased regulation, interstate banking) in the mid-1980s, lenders began to modify their lending practices, particularly with borrowers in CAP irrigation districts due to the economic factors discussed above. First, repayment capacity became the dominant criterion for loan approval. Secondly, most lenders began to require at least a 25% margin on their loans. But most importantly, a risk grading system for loans was followed
more deliberately where the rating attached to the loan reflected its riskiness to the lender. Loans
which did not receive a "passing grade" required that the lender establish a reserve for the loan.
These reserves represented bank capital upon which no return was earned, thereby raising the cost
to the lender of loaning money to businesses experiencing financial difficulties. Loan officers
became wary of lending to customers with marginal cash flow projections, low collateral values, a
restricted loan, or were out of margin on an existing loan, or who had experienced recent
carryovers. Partially as a result of this stricter lending environment, farmed acreage in the MSIDD
declined by over 20,000 acres from 1988-1991.

**District Level.** In conjunctive-use irrigation districts, where the district manages both
ground and surface water resources, growers are dependent on the economic success of their
neighbors. The MSIDD, a conjunctive-use district, must sell water to justify its existence and
survive as an operating entity. But the water must be sold at a price which covers the cost of water
and the cost of irrigation district services. Reductions in planted acreage due to the inability of
growers to obtain financing, or worse yet growers declaring bankruptcy, threatens the economic
viability of the irrigation district. For example, let \( Q^* = \frac{TFC}{P-AVC} \) where \( Q^* \) is the acre-feet of
water which needs to be sold to generate sufficient revenues to cover district-level variable and
fixed financial obligations, TFC represents the costs which are fixed and not subject to the amount
of water delivered, \( P \) is the district water price, and AVC represents expenses which vary with the
volume of water sold. Reasonable approximations for the MSIDD are $5.5 million in annual fixed
costs, a water price of $40/acre-foot and average variable costs of $20/acre-foot. In this scenario
the MSIDD needs to sell 275,000 acre-feet to break even. Assuming that 4.5 acre-feet per acre are
applied to MSIDD farms, 61,000 acres would have to be farmed to cover district financial
obligations. Planted acreage in the district was approximately 50,000 acres in 1994. This acreage
pattern is not financially sustainable. Assuming farmed acreage remains unchanged, economic
survival is dependent on the district taking action to lower its water costs, its fixed financial
obligations, or both.

Prior to 1994, the MSIDD had attempted to maintain water at affordable prices through two
programs: conjunctive management of groundwater and CAP water, and participation in the
indirect recharge program. A "low" average price for water was possible by blending well and
surface water. Electrical power to operate deep water wells was purchased from Electrical District
No. 3 which had long-term, low-cost hydroelectric power contracts with the Arizona Power
Authority and the Western Area Power Administration. During the period of 1990-93
approximately 60% of the irrigation water for MSIDD growers was pumped at a variable cost of
$20/acre-foot. Under the Arizona Department of Water Resources' indirect recharge program in
1992 and 1993, the MSIDD agreed to not pump as much groundwater in exchange for
groundwater pumping credits which were then "exchanged" with the CAWCD for a substantially
lower price on a portion of MSIDD's CAP water allocation. CAWCD would utilize these credits sometime in the future due to a drought along the Colorado River system and/or canal outages.

As with many BOR-supported projects an important portion of the cost of water is treated as a fixed cost and paid by ad valorem taxes, generally property taxes (Miller 1993). In the case of the MSIDD, the cost of constructing the distribution systems from the main CAP canal to and within the boundaries of the irrigation district was $110 million, 80% funded interest free by the federal government, and 20% financed through the sale of private, interest-bearing bonds. To meet debt payments, each acre in the MSIDD with a grandfathered water right is assessed a tax: approximately $85 per acre. This tax figure was adjusted downward through 1993 by lease payments (i.e. well credits) from the MSIDD to the grower based on the appraised value of the grower's wells in 1989 which were turned over to MSIDD's management control. These well credits ranged from $20 - $69 per acre. As a result, the growers with low well credits had relatively high tax payments which were treated as cash expenses in their financial projections prepared for their lender. Although CAP irrigation water was priced at $40/acre-foot, the actual cost of CAP water was $50-55/acre-foot if the grower planted 75% of his grandfathered acreage. To insure a "safety net" acreage level in 1992 and 1993, the MSIDD Board of Directors used financial reserves to pay the tax assessments for all its active growers. In 1994 the tax assessment was reduced to approximately $40 to reflect the actual cost of the district's debt service obligations. Well lease payments now are handled as a separate financial transaction between the district and the well owner.

Through the IMIP process, MSIDD management and BOR staff discovered that farming was not sustainable with the relatively high and increasing cost of CAP water. Making water delivery more technically efficient, although important, did not confront two looming economic realities. First, current acreage levels and tax payments would not support district-wide debt payments for more than three additional years. Both public and private debt obligations needed restructuring. Secondly, growers, district personnel, and agency staff realized that the future of the MSIDD was jeopardized under current contractual obligations. The federally-mandated "take-or-pay" provision required the district to either buy its full allocation of CAP water or pay $22.50/acre-foot (a charge for operation, maintenance and replacement (OM&R)) for the portion of the allocation not delivered to the district. MSIDD management recognized that the enforcement of take-or-pay in 1994 would force the district into default and Chapter 9 bankruptcy.

Economic Discovery System Wide

The original federally-supported feasibility studies envisioned that the majority (60-80%) of the imported Colorado River water allocated to Arizona would be used in non-Indian agriculture during the initial three decades of the project. As the urban population of central Arizona grew and
as the Indian reservations were able to use their CAP allocations, the amount of project water available to non-Indian agriculture would decline due to its lower priority right. This scenario did not unfold. Non-Indian agricultural sales of CAP water peaked at 502,000 acre feet in 1989; then declined precipitously to 260,000 acre feet in 1991 due to relatively high CAP water pricing. Sales to agriculture have averaged 340,000 acre-feet over the last three years with the implementation of price incentive programs (i.e., indirect recharge, pool pricing). These sales figures are less than half of the anticipated sales figures to non-Indian agriculture during the project's feasibility design phase.

Why? Owners of only 50% of the potentially irrigable acreage in central Arizona voted to accept CAP water. Not surprisingly, the first and foremost reason was cost. Many districts have access to lower cost water, either by other surface supplies (i.e. the Salt, Verde and Gila River federally-supported irrigation projects), effluent, or low cost groundwater due to preferential electric power contracts and/or shallow pumping lifts. Secondly, the owners of agricultural land recognized that CAP water would fall within the scope of the Reclamation Reform Act of 1982 (RRA). Under the RRA, lands with non-resident alien owners or with 26 or more owners would not be eligible to receive CAP water at favorable prices. Also, the 960-acre limitation under the RRA discouraged many landowners, particularly in Maricopa County, from contracting for CAP water. The irrigation districts that did contract for CAP water found themselves under the economic pressures forecasted by economists two decades before. The findings of the IMIP can be extended to the other eight CAP districts as well. Low cotton yields, declining real cotton prices, rising water costs, and financial constraints led to an uncertain economic future.

Feasibility studies for constructing distribution systems in irrigation districts were conducted by the BOR and private engineering firms during the late 1970s and early 1980s. These reports provided the basis for federal 9(d) loan approval and the issuance of private securities by the districts used to build their distribution systems. Estimates of the "ability to pay" for CAP water ranged from $65 to $85 per acre-foot in nominal terms. Although the present analysis has the benefit of hindsight, the non-price assumptions and methodology used in these earlier analyses were fundamentally flawed in four areas: acreage farmed, high-value crops, groundwater usage, and treatment of uncertainty (Wilson 1992).

Acreage Farmed. The feasibility studies generally assumed that all the CAP-eligible acreage in the district would be farmed every year for 50 years. This assumption was based on historical transitions made in California irrigation districts. Revenue from every acre would be available to pay for water and the acreage assessment. Yet due to government setaside programs, the lack of financing, the Groundwater Management Act of 1980, as well as other factors, all the acreage in these districts was not farmed over the last two decades. Approximately 50% of the
acreage in the CAP districts was farmed in 1992-1994. And as noted in the IMIP analysis, decreased cropped acreage places a greater financial burden on each producing acre.

**High-Value Crops.** The selection of a representative cropping pattern is an important step in the development of a representative farm budget. The crop mix determines expected gross revenues and operating costs. If these representative farm acreages are aggregated to reflect district-level acreage, care must be taken to insure the aggregate acreage figure is reasonable. Certain crops can be used as proxies for all specialty crops but the aggregate figures should reflect conservative conditions.

The feasibility studies for the largest CAP districts, MSIDD and Central Arizona Irrigation and Drainage District (CAIDD), did not follow these guidelines. In the MSIDD it was assumed that the representative farm (700 gross acres) harvested 70 acres of fall lettuce each year for 50 years. With 133 representative farms in the MSIDD, the study assumed that there were 9,310 acres of lettuce planted each year in the MSIDD. To compound matters, a similar assumption was made in the CAIDD feasibility study thereby producing over 18,000 acres of lettuce in these two districts on an annual basis. Between 1978-1981 only an average of 2,600 acres of fall and spring lettuce were planted in all of Pinal County (Arizona Agricultural Statistics Service 1990).

**Groundwater Usage.** By selecting the "ability to pay" methodology rather than "project generated payment capacity", the BOR and engineering firms created a secondary role for groundwater and farm-level decision making in their feasibility studies. The ability-to-pay procedure does not recognize the decision-making process of the grower or the conjunctive-use district when substitute water resources are available at lower prices. Project generated payment capacity would have calculated the additional income produced by the existence of the CAP which would be available to retire the new debt associated with the investment. Estimates of net farm income with and without the project over a 30-50 year planning horizon would have been generated. Explicit assumptions would have been made on future costs of ground water relative to CAP water, the cost of financing the district distribution systems, and the discounted rate of return on the projects.

Secondly, the ability-to-pay procedure does not recognize marginal decision making. It is an accounting, or worse yet, a political criterion. Rational farmers equate the marginal value, not the average, with the cost of the additional acre-foot of water. The marginal willingness to pay is less than the ability to pay. As a result, the BOR estimates overstated the willingness of growers to purchase CAP water on the margin. Finally, BOR analysts and others wrongly assumed that improved cotton prices and yields would increase dramatically the amount of CAP water sold, *ceteris paribus*. Again, rational business people will use their lowest cost resource first (i.e. groundwater) irrespective of what happens to commodity prices. Lower cost groundwater will be pumped up to the preferential power supply limitation. Then the next highest cost source of water
will be purchased. Therefore, as long as groundwater is relatively less expensive the underutilization of CAP water in the non-Indian agricultural sector will continue.

Uncertainty. There is no record of any sensitivity analysis being carried out in the district feasibility studies. Acreage planted, crop mix, yields and relative prices were assumed to be constant over the repayment period. Yet variability inherent in agricultural production is a well-established fact which demands consideration in any economic feasibility study (Reutlinger 1970). For example, Wilson (1992) demonstrated that with a 5% decline in gross revenues, a central Arizona grower's ability to pay for irrigation water dropped to $28 per acre-foot in the realistic representative farm model. This value was $8 less than CAWCD's energy cost in 1992 for delivering an acre-foot of CAP water to a district. A 10% decline in gross revenues produced an ability to pay of $19 per acre-foot. Simple sensitivity analysis using realistic farm models and scenarios would have demonstrated the tenuous economic future of CAP-dependent irrigation districts.

IV. The Work Out: Negotiations and Beyond

The CAP is designed as a multiple-purpose public works program providing irrigation water delivery, M&I water delivery, electric power generation, fish and wildlife habitats, recreation facilities, and flood control. Funds for repaying the nearly $2.1 billion debt associated with the main canal are generated by the sale of water, the sale of power from the Navajo Generating Station in northern Arizona, a four mill surcharge on power sold in Arizona from Hoover Dam, and a $0.10 per $100 assessed value ad valorem property tax within the CAWCD's service area. By the Spring 1992, the water resource and political leaders of Arizona finally recognized publicly that the permanent underutilization of CAP water was a reality. Fundamental to this realization were the economic interdependencies inherent in the CAP, often unappreciated by policy makers, were documented in the IMIP.

First, water sales to non-Indian agriculture could not be sustained unless the price of CAP water was competitive with groundwater. Without an indirect recharge-like program or a price subsidy, and the elimination of the take-or-pay provisions, sales of agricultural irrigation water were projected to decline within several years to a few thousand acre-feet. Lower water sales would create financial difficulties for the CAWCD assuming that power sales continued to generate a small, uncertain profit margin and that the ad valorem tax remained unchanged. Yet formal water sales projections developed by CAWCD in 1989 had included an 80% increase in revenue between FY92 and FY93 and an additional increase of 68% the following year. Projected water sale revenues were to increase from $32.1 million to $97.4 million over these two years. These projections were unrealistic in 1989 and not attained in the early 1990s. Furthermore, these overly
optimistic sales projections raised questions concerning the ability of the CAWCD to retire its debt, without drawing down its financial reserves or raising ad valorem taxes.

Secondly, M&I users of CAP water became concerned about the viability of CAP agriculture, particularly cities like Tucson who had committed to full dependence on CAP water by the end of the decade. This economic interdependency arises from the existence of CAWCD's fixed OM&R costs estimated at $30 million per year. M&I users realized that if non-Indian agriculture ceased to buy CAP water and was relieved of its take-or-pay provision, then M&I users would carry most of the OM&R burden. These fixed OM&R charges spread over 200,000 acre-feet of demand would drive the effective price of water to municipalities far beyond $150 per acre-foot within a year. Consequent water rate shock would be politically unacceptable to city councils throughout central Arizona.

A third interdependency is the interest obligation on the federal debt for the main canal. Under the master repayment contract between the U.S. Government and the CAWCD, no interest is paid on the federal loan for that portion of the system serving agriculture. The outstanding balance of the portion of the canal investment dedicated to serving M&I users is charged a 3.342% interest rate over the life of the repayment period. As agriculture is delivered less and less water, the share of cost bearing interest increases for the CAWCD. If the CAP were to become an M&I project, the annual interest payments alone to the federal government could surpass $50 million. The interest savings to the M & I sector for selling 200,000 acre feet to non-Indian agriculture is $10 million annually (Arizona Department of Water Resource 1993).

Arizona Governor Fife Symington formed two task forces, one in the summer of 1992 and a second in January of 1993, to study the underutilization issue and propose a work out plan (Brophy 1994). Yet as these task forces labored and negotiated in the public limelight, individual district management was encouraged to take unilateral actions to preserve the economic integrity of their districts and their growers. First, Harquahala Irrigation District, the first district to accept CAP water, sold its rights to CAP water to the federal government for nearly $29 million in December 1992. This water was used in the settlement of a longstanding legal claim of the Fort McDowell Indian Community. Near Chapter 9 bankruptcy for two consecutive years, Harquahala was able to free itself of its federal and private debt (Table 1).

In late 1993 the Hohokam Irrigation and Drainage District transferred its rights to CAP water (approximately 28,000 acre-feet per year) to the Arizona Municipal Water Users' Association, a private, non-profit corporation acting on the behalf of Chandler, Glendale, Mesa, Phoenix, Scottsdale and Tempe. In exchange the Association assumed virtually all the outstanding federal and private debt ($31 million) Hohokam had incurred in constructing its distribution system. In January 1994 New Magma Irrigation and Drainage District filed for municipal bankruptcy in Federal District Court. The District had faithfully met its private bond payments but
was in significant arrears with its federal debt. Chapter 9 bankruptcy enables the District to protect its $26 million investment in the distribution system, to continue receiving CAP water, to restructure both its federal and private debt, and to maintain control over its day-to-day operations. The New Magma bankruptcy represents the first Chapter 9 filing by a federally-supported irrigation district in the nation. In August 1994, Central Arizona Irrigation and Drainage District also declared bankruptcy. Concurrent with the New Magma and Central Arizona actions, the MSIDD retained an investment banking firm to investigate ways its federal and private debt could be restructured. In 1995, MSIDD initiated preliminary legal discussions with the State of Arizona and its private bondholders in anticipation of its inability to make its 1995-96 bond payments.

In light of the interdependencies between non-Indian agriculture and the other users of CAP water, the Governor's task forces and the CAWCD recognized that the only means to retain agriculture in the system was to reduce the price of CAP water to irrigation districts (Central Arizona Project Advisory Committee 1993). Yet the take-or-pay provisions of current subcontracts and debt repayments for the distribution systems would still burden the districts and growers. After extended negotiations, eight irrigation districts agreed to waive their long-term rights (i.e. subcontracts) to CAP water, substituting short-term, subsidized leases instead. These lease contracts do not contain take-or-pay provisions. Pool 1 ($17/af), Pool 2 ($27/af) and Pool 3 ($41/af) were made available through lease arrangements with 200,000 acre-feet available in both Pools 1 and 2 and all remaining agricultural water in Pool 3. Prices were to increase by $1/af until 1999. All of the Pool 1 allocation and most of Pool 2 were leased in 1994. A recommendation that the CAWCD assume the district-level debt associated with the distribution systems was rejected by the M&I users and the CAWCD.

With agricultural demand for CAP water running at less than one-half of federal expectations, the CAWCD has attempted to sell surplus Navajo power at a profit through the Western Systems Power Pool. Yet by selling power on the short-term market, CAWCD cannot guarantee that the price received will cover the costs of producing the energy. The Governor's Task Forces and the CAWCD recognized that profitable energy sales were necessary to support the debt service associated with the CAP. The Salt River Project (SRP) has made an offer to purchase the surplus Navajo capacity for $21.75 million annually. CAWCD would pay SRP for energy generated at a price that would cover the production and transmission costs. Under the proposed agreement CAWCD's Hoover and New Waddell capacity and energy would be integrated with SRP's system. SRP then can contract or use this capacity and energy at favorable long-term rates. In essence, the SRP offer enables the CAWCD to use low-cost Hoover energy to pump CAP water while holding higher-cost resources in reserve if needed; a strategy not unlike the decisions made at the grower and irrigation district level with regard to another resource, water.
V. Summary: Getting Water Prices Right

As the BOR and the CAWCD negotiate the "final" repayment obligations of the State of Arizona, all current economic evidence validates the prophetic analysis of Kelso, Martin and Young who questioned the economic wisdom of investing in the CAP for non-Indian agriculture. Districts with low cost groundwater and surface water supplies did not contract for CAP water. Districts with relatively higher cost groundwater supplies contracted for water but were unable to afford the water. M&I users now subsidize non-Indian agriculture to keep farmers in the project which lowers interest payments and increases the utilization of Arizona's Colorado River allotment. As predicted by Barr and Pingry, the sale of surplus electric power has become a critical source of funds for project repayment. Even M&I users have discovered that CAP water is significantly more expensive than alternative sources of water.

To be successful at transforming themselves from public works agencies to water resource management agencies, the BOR, irrigation districts and other water management entities should learn several painful yet valuable lessons from the CAP experience. First, management tools like the IMEP are valuable means for gaining an in-depth understanding of irrigated agriculture at the farm and district levels, something many government agency employees did not understand prior to 1991. The IMIP produced a shared understanding of the strengths and weaknesses within the MSIDD, proposed mechanisms and programs for alleviating problems, and guided the implementation of needed changes in farm, district and agency activities. Intelligent management of water resources requires an integrated approach, similar to the IMIP methodology.

Until the late 1980s, state and federal personnel publicly maintained the economic viability of CAP agriculture in the face of overwhelming evidence to the contrary. Political rhetoric had dominated economic analysis for over two decades. A flawed understanding of rational economic decisions led to apparent CAWCD, ADWR, and BOR surprise when CAP water sales to farmers fell dramatically in 1991. Yet through the IMIP, key agency personnel were able to inform and educate their colleagues concerning the pending economic crisis in CAP agriculture. Growers and irrigation districts indeed had made the rational economic choices predicted by Martin and others.

Clearly from the evidence outlined above, demand for CAP water has been grossly overstated for many years. Emphasis has been placed on supply, that is, building the main aqueduct, distribution systems, and water treatment plants. Yet agricultural, M&I and Native American water demand is not well understood. Legal allotments or entitlements have driven cash flow projections rather than sound estimates of effective demand. Price elasticity of demand remains an underutilized analytical tool in the water management community. Water managers must invest in more effective demand studies and market research if they intend to successfully manage Western water resources.
Finally, the Western water community should triple their efforts to explore the net benefits of relying on markets for getting prices right (Saliba and Bush 1987; Wahl 1989; Colby 1993). The recommendations from the Governor's Central Arizona Project Advisory Committee recognize the potential of water markets for allocating CAP water efficiently in central Arizona and beyond. While the CAWCD now has control over the CAP agricultural pool thereby facilitating market development, there still is suspicion of and political resistance to the market mechanism. Arizona has leaned heavily over the years on "command and control" policies for water allocation and management. Ironically, translating the recognition that markets are capable management tools into concrete action also was championed a quarter of a century ago: "... it is important that Arizona water policy include legislative provisions to insure that water supplies are freely transferable between uses when economic factors so dictate" (Young and Martin 1967, p. 18). Oh that we would learn from our economic history!

ENDNOTES

1. The Central Valley Project Improvement Act (Public Law 102-575 1992 HR 429) is an initial attempt to strike a balance between traditional economic interests and emerging environmental concerns. Fish and wildlife interests are granted equal status with other uses (e.g. irrigation). Limited market transactions are encouraged in the Act by shifting control of 20% of the water from water districts to individuals. Higher value uses for water may be sought without the constraint of local water interests.

2. One example of the low status of economic analysis in water management is the book by Johnston and Robertson (1991) which devotes two percent of its pages to economic issues involving the management of irrigation districts.

3. This federal condition for future fiscal support for the CAP produced the 1980 Arizona Groundwater Management Act. This legislation established the Arizona Department of Water Resources (ADWR), the four active management areas, the three irrigation non-expansion areas, and the current planning process involving water resources on a state-wide basis.

4. The Tucson City Council in the fall of 1993 voted to discontinue the delivery of potable CAP water to Tucson households due to widespread complaints concerning poor water quality. The decision to renew deliveries to households may be several years away.

5. The idea of the willingness to play the water development game was put forward by Martin, Ingram and Laney (1982). The Salt River Project in Arizona, the first Bureau of Reclamation-funded irrigation project, is a revealing case study of negotiations with the Bureau (Smith 1986).

6. The MSIDD was formed in 1962 in anticipation of the arrival of CAP water. Located 30 miles south of Phoenix, the district's boundaries encompass approximately 87,000 acres of farmable land. Upland and American-Pima cotton, and durum wheat are the major crops. The MSIDD is a conjunctive use district, blending ground water from district-controlled wells with CAP water and delivering water to "farm gate" turnouts. Low-cost hydroelectricity is purchased from Electrical District No. 3. CAP water deliveries began in 1987, with the entire district on line in 1989. MSIDD staff (40 employees) manage 225 miles of canals, delivering water to 50 individual customers at 15 ft³/s. Approximately 50% of the irrigated land is
sloping furrows, 25% level and low-gradient furrows, and 25% level basins. The predominant soils range from sandy loams to clay loams.

7. The principal supporting agencies in the IMIP were the USDA-ARS U.S. Water Conservation Laboratory (Lead Agency), USDA-Soil Conservation Service, U.S. Department of Interior-Bureau of Reclamation, Arizona Department of Water Resources, Arizona Department of Environmental Quality, Arizona Department of Agriculture, and The University of Arizona College of Agriculture.

8. The IMIP continues under the oversight of an Interim Coordinating Group lead by a grower. Other members include the MSIDD manager and representatives from the Irrigation Management Service, Soil Conservation Service, Arizona Department of Water Resources, Central Arizona Water Conservation District, and the U.S. Bureau of Reclamation.

9. Although crop rotation (e.g. cotton, alfalfa and small grain) was practiced historically in the district, due to recent financial stress growers have followed a near cotton monoculture. Over the period of 1989-1991, cotton represented 96% of the planted acreage in MSIDD (Dedrick, et al. 1992).

10. A representative feasibility study is Bookman-Edmonston Engineering, 1982. Engineering Report in Support of Application for Federal Loan Under Public Law 130 for Construction of a Irrigation Distribution System (Central Arizona Irrigation and Drainage District), Phoenix, Arizona. A twin report was done for the Maricopa-Stanfield Irrigation and Drainage District. All other districts had similar feasibility reports written to support private bond financing.

11. It has been assumed that the federal government would pay the water costs for water delivered, and the OM&R costs for the water allocated, to the Native American communities. This assumption currently is being negotiated in Bureau of Reclamation and CAWCD discussions.

12. These overly optimistic projections can be found in documents such as the Contract Revenue Bonds, Series B 1991 ($110,671,353.90) for the Central Arizona Water Conservation District, August 13, 1991, pp. C31-C32. A copy is available from the author.

13. A comprehensive discussion of the evolving CAP work out process can be found in Glennon (1995). Special emphasis is given to the events surrounding the CAP over the last three years.

REFERENCES


Table 1. Current Status of CAP Irrigation District Subcontractors

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1A conjunctive use (CU) district controls, and allocates virtually all water resources within its boundaries, i.e. pumped groundwater, and surface water. Grower controlled (GC) districts deliver only CAP water to growers on demand and the growers control their individual groundwater wells.