

# American Water Intelligence

Market-Leading Analysis of the American Water Industry

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## ABOUT AWI

### A new magazine for America's water business

#### Filling a niche not covered by others

News and analysis for all those to whom money matters in the water sector.

### Tracking treatment plants across the US

#### Find opportunities for your business

116 water, wastewater, desal, reuse and public-private projects currently tracked. P22

## WATER IN INDUSTRY

### Footsteps to the shale

#### Frack water draws in the US Filter crowd

But what are the strategies that are most likely to succeed? P10

## ANALYSIS

### Regionalization

Will consolidation be forced on the US utility sector by the rising cost of environmental compliance? It may already be starting to happen. P12

### Petersen profile

The public-private partnership sector has evolved out of the necessities and compromises of contract law. Lawyer Eric Petersen is one of the key people shaping the industry. P14

## WATER FINANCE

### Assessing the alternatives

#### Rate hikes, leases, infra-banks or bust?

Across the US from Cape Coral, FL, to San Jose, CA, communities are struggling with rising costs and falling revenues. P3

### German meter dreams

#### Elster prepares for New York IPO

Advanced metering has not caught on in the water sector as quickly as it has in gas and electricity. Will Elster change the game? P6

## TRACKER UPDATES

**Port Townsend WTP, WA:** Designers' statements of qualification due by October 7

**Huntington Beach SWRO, CA:** Coastal Development Permit approved

**WB Cater AWT Project, Santa Barbara, CA:** Construction tender due in November

## COMMENT

### Debra Coy

Don Correll was seemingly forced out of American Water because of frustrations about lagging returns. What should investors expect from the biggest investor-owned utility? P16

### Clay Landry

'All hat and no cattle' is the best way of describing many of the water pipeline projects which are trying to cash in on the rising value of water rights in the US. P20

# THE WET WATER MARKET



Clay Landry, head of water rights consultancy West Water Research, shares his thoughts on the water rights market

## The case for water rights

### Why should investors be considering water rights investment right now?

The American water industry presents investors with a wide range of opportunities in water utilities, consumer products, water treatment and equipment, and water resources. The most dynamic of these sub-sectors is the water resources market.

The water resources sector is commonly defined by water rights trading. This relatively new sector is poised for growth through the development of upstream assets by constructing pipelines, reservoirs, groundwater and effluent recharge facilities, and by creating mitigation credits.

Historically, investors have shied away from water rights investments because of:

- The lack of a clearly developed market.
- Challenges in understanding and valuing assets.
- Perceptions of water rights being a risky investment class.

The industry has suffered from a number of high-profile failures, including Enron's Azurix, Yale University's Baca Ranch water rights debacle, and the now Western Water Company's bankruptcy and delisting, among others.

Yet more than ever before, we are seeing investor dollars flow into the water resources sector despite its complexity and fragmentation. The objective of this column in the coming months will be to bring clarity and color to this often overlooked sector of the water industry. To kick off this first column, we highlight several investor-backed projects that exemplify the current trends and challenges.

## Pipeline development

### Portability unlocks the value in water rights – does that make pipelines a good investment?

Colorado's Front Range, Texas and Nevada are hot spots for private pipeline projects. Investors in these areas acquire low-priced upstream assets (water rights) and add value by developing infrastructure to deliver the water to municipal customers.

Explosive growth in Colorado has prompted a number of investor-backed pipeline projects that plan to deliver water to Front Range cities. One of the more ambitious, proposed by the Million Resource Conservation Group (MRCG), would pull 250,000 acre-feet (AF) from Wyoming's Green River to the Front Range through a 500-mile pipeline at an estimated cost of \$3 billion. The company's challenge is to find patient capital to fund the lengthy permitting phase while stomaching the regulatory risk that the project could be denied.

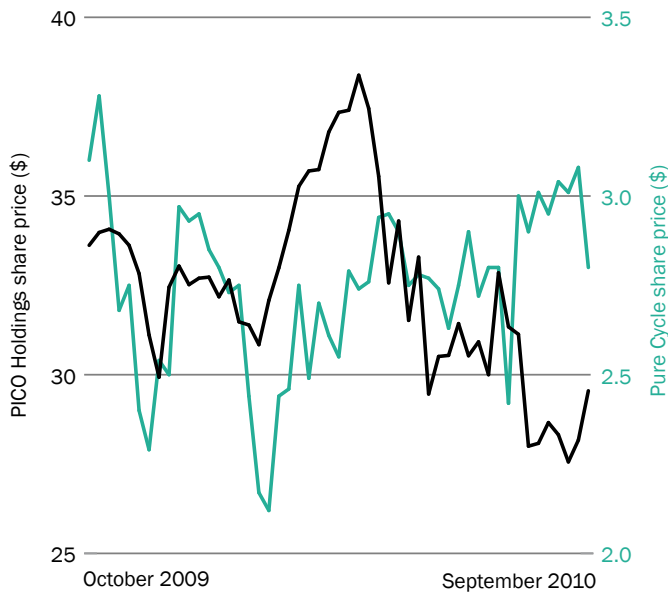
Pure Cycle Corporation (NASDAQ: PCYO) is planning a conveyance project that delivers Arkansas River water to Denver-area buyers. However, this seems to be a long-term play for the company. Pure Cycle estimates the cost of developing the water and pipeline to be in excess of \$500 million, but has postponed the project.

The old saying "all hat and no cattle" is appropriate for two high-profile Texas pipeline projects. T. Boone Pickens' Mesa Water plans to develop and deliver 200,000 AF of groundwater in the Texas Panhandle to cities hundreds of miles away. The estimated project cost is \$1.5 billion for the well field, pipeline, water and easements. However, Mesa Water has struggled to find customers.

Similarly, Southwest Texas Water Resources L.P. proposes to pump 40,000 AF of groundwater from Uvalde County and pipe it 67 miles to fast-growing Bexar County where the San Antonio Water System is located. The privately financed project is estimated to cost \$250 million, but local politics have wreaked havoc on the project.

Vidler Water Company, a subsidiary of PICO Holdings (NASDAQ: PICO), recently completed its 35-mile pipeline capable of delivering 8,000 acre-feet of groundwater from the Fish Springs Ranch to the northern edge of Reno, Nev. The company placed a hefty bet on Reno's booming real estate market when it started the project in 2000. Reno area water rights prices reached some of the highest levels in the United States, but after peaking at \$40,000 per acre-foot in 2005-2006, water rights prices in the region plunged as Reno became Ground Zero for the country's real estate woes. As a result of the bearish regional water rights market, Vidler has sold fewer than 50 AF of water and recouped little of its \$101.1 million investment.

## PIPE DREAMERS: PICO AND PURE CYCLE



mental, use. The company is selling the instream water rights in small quantities to mitigate the need for new groundwater rights for housing. Suncadia bought the irrigation rights at approximately \$1,300/AF and has sold over 30 AF of mitigation credits for nearly \$40,000/AF.

## Water rights trading

**Specialist investors have been buying into the market, but how can they ride the housing market downturn?**

Nearly every water resource play starts with some type of water right. Whether it is a complex aquifer storage-and-recovery project or a capital-intensive pipeline, all require some type of entitlement to water. A handful of investors have elected to focus almost exclusively on water rights and leave the development risk of pipelines and reservoirs to others. Aqua Capital Management L.P., based in Omaha, Neb., is one of the more active groups that have been buying water rights for private equity investors since 2006. The company has been assembling assets primarily in markets with active trading and low transaction costs. New York-based Water Asset Management dipped its toe into the water rights market in 2007 with a highly publicized acquisition of 2,724 AF of effluent credits valued at over \$70 million. Water Asset Management was the successful bidder at a water rights auction held by Prescott Valley, Ariz. Despite the slow housing market, the fund has managed to sell a significant portion of the credits to two large real estate development projects. WAM expects the balance of the effluent credits to be absorbed by small developers and landowners.

With investment in water rights and development expanding throughout the western United States, only one question remains: What is the next big water resources play?

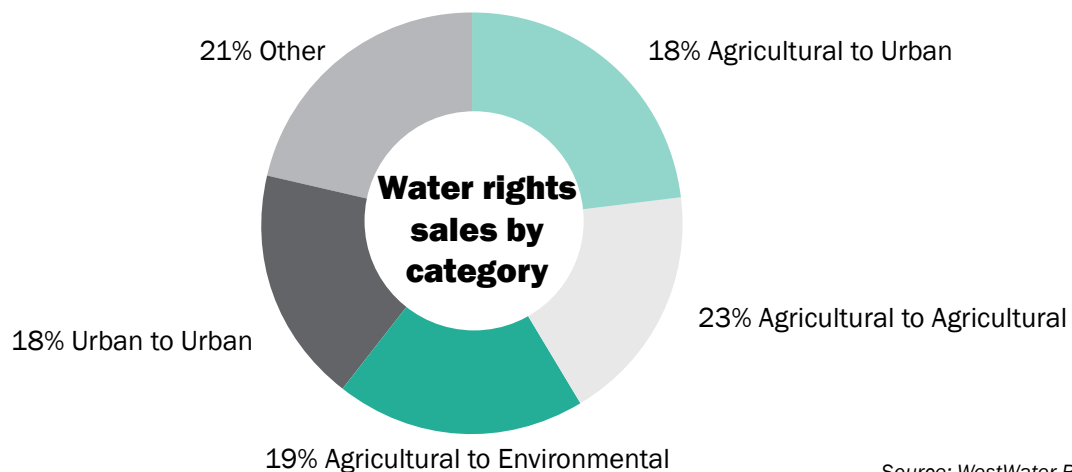
*Clay Landry is managing director and a principal at WestWater Research LLC, a leading advisory firm in the water rights market based in Boise, Idaho. He and research associate Matt Payne, who contributed to this column, can be reached at (208) 433 0255.*

## Mitigation credit banks

**It is a counter-intuitive strategy, but buying and retiring water rights can be profitable.**

Mitigation credit banks are one of the more recent opportunities to emerge in the water resources sector. While bank structures vary based on local regulations, investors are buying up and retiring water rights to generate credits that can be used by new water users to offset environmental impacts. One of the newest banks financed by the master-planned Suncadia Resort development opened for business in 2009 by offering credits to new groundwater users in Washington’s Yakima Basin. Washington requires that all new groundwater users in the basin offset impacts to the river by purchasing and retiring water rights. Suncadia converted 353 AF of irrigation water rights to an “instream,” or environ-

## WHO IS BUYING AND SELLING WATER?



Source: WestWater Research