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Committee on Natural Resources, House of Representatives

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**BUREAU OF
RECLAMATION**

**Information on the Federal
Financial Commitment and
Repayment Status of the
Central Arizona Project**

James Duffus III, Director,
Natural Resources Management Issues,
Resources, Community, and Economic
Development Division



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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our ongoing review of the Department of the Interior's Central Arizona Project (CAP). My comments today, Mr. Chairman, reflect our preliminary observations on some of the issues you asked us to examine. Earlier this year, you requested that we review various issues relating to CAP, including: (1) the total financial commitment of the federal government to construct CAP and (2) the Central Arizona Water Conservation District's (the District) ability to fulfill its obligation to repay allocated project costs.¹ In addition, Senator Dennis DeConcini asked us to look into the benefits of CAP as well as other issues.

In summary, we have found the following:

- CAP's total construction cost is expected to be \$4.7 billion by the time CAP is completed, currently estimated to be in 1999. According to Interior's Bureau of Reclamation, the estimated federal share of these costs is \$1.7 billion.

The federal share could increase, however, to over \$2.8 billion, depending primarily on three matters now under review by the Bureau: (1) how a dispute over the maximum amount that the District is expected to repay is resolved; (2) how future increases in water allocations for Indian water-rights settlements and environmental purposes are determined; and (3) whether non-Indian farmers default on water-distribution system loans.

- On the basis of information provided by the Bureau and the District, it appears that the District will be able to repay its allocated construction cost obligation and cover its annual operation and maintenance (O&M) expenses for the 1994-99 period. However, in doing so, the District will substantially reduce its financial reserve fund.

In the long term, several uncertainties could substantially affect the District's ability to meet its repayment obligation and O&M expenses, namely, whether (1) the District has underestimated its reimbursable construction costs, (2) anticipated revenues from power sales materialize, (3) annual fixed O&M expenses can be

¹The Central Arizona Water Conservation District is a multi-county water conservation and public improvement district of the state of Arizona. It is the single entity responsible for repaying reimbursable CAP costs to the federal government. It collects revenue through a local tax and through water and power sales. The District is authorized to operate CAP.

recovered, and (4) water sales to non-Indian farmers meet expectations.

BACKGROUND

CAP was authorized under provisions of the Colorado River Basin Project Act of 1968. The Bureau started construction in 1972, and estimates are that the project will be completed in 1999. CAP includes construction of a 336-mile aqueduct/pumping system and the New Waddell Dam and modification of the Roosevelt Dam. Power for CAP's 14 pumping plants is provided by the Navajo Generating Station, a coal-fired power plant that is partially owned by the federal government.

CAP is designed to pump as much as 2.2 million acre-feet of water annually from the Colorado River on Arizona's western border and transport it as far south and east as Tucson.² According to the Bureau, the expected annual capacity is 1.5 million acre-feet. CAP provides the residents of Arizona with various benefits, including: flood control, fish and wildlife enhancement, recreation, commercial power, groundwater conservation, and water supply. The water supply is used for both Indian and non-Indian agricultural irrigation and for municipal and industrial (M&I) purposes. The District estimates that the project will have pumped about 635,000 acre-feet of water in 1993 and will pump about 750,000 acre-feet in 1994.

The federal government has financed most of CAP's construction and has spent over \$3 billion as of December 1993. As each construction phase is substantially completed, it is turned over to the District, which operates CAP and repays reimbursable costs to the federal government. Some reimbursable costs such as M&I water supply and commercial power are interest bearing. Reimbursable costs for water supply for non-Indian irrigation are noninterest bearing. Construction costs allocated to such purposes as fish and wildlife enhancement and flood control are not reimbursable.

The District's repayment responsibilities are included in a master repayment contract with the Secretary of the Interior. The original contract, which was signed in December 1972 as well as a new contract signed in December 1988 requires the District to repay the costs associated with each construction phase within a 50-year period. On September 30, 1993, the Secretary declared the first phase of CAP--the aqueduct and power system--to be substantially complete. Repayment will begin in January 1994.

In the late 1960s, the Bureau estimated that the project would be completed in about 7 years and would cost about \$932 million,

²An acre-foot is the volume of water necessary to cover 1 acre to a depth of 1 foot--about 326,000 gallons.

including costs for interest during construction and water distribution systems for Indian and non-Indian farmers. The Bureau currently estimates that CAP's construction will be completed in 1999 and that the project will cost about \$4.7 billion. According to Bureau officials, CAP's cost increase is largely due to design changes brought about by a variety of reasons, including cultural and environmental concerns, and to interest and inflation during the extended construction period.

The federal government, as the trustee for the Indian tribes, has an obligation to ensure that Indian water-rights claims are settled in the tribes' best interest. While it is not a stated goal or purpose in CAP's authorizing legislation, CAP has become a major source of water in the settlement of these claims. These settlements, achieved in part through reallocations of CAP water, decrease the reimbursable costs that the District must pay to the federal government. The settlements are negotiated by Interior and confirmed by federal legislation.

The District has about \$160 million in a financial reserve fund, financed mainly from property tax assessments and interest on investments. The District expects to use the fund to pay reimbursable construction costs and O&M expenses.

THE FEDERAL SHARE OF CAP'S COSTS COULD INCREASE SUBSTANTIALLY

The federal share of CAP's costs could increase from the current \$1.7 billion to over \$2.8 billion depending on how three matters now under review by the Bureau are resolved.

Contract Repayment Dispute Could Add \$400 Million to Federal Costs

The first matter under review involves a contract repayment dispute that could add \$400 million to federal costs. According to the Bureau, the District's reimbursable cost ceiling in the December 1988 master repayment contract is \$2 billion. However, the District believes that an exhibit to the contract pertaining to delivery of CAP water to the Gila Indian Tribe reduces the District's repayment obligation to \$1.8 billion--or \$200 million less. If the ceiling is \$1.8 billion, the federal government has already spent about \$150 million more in reimbursable costs than it can legally recover. If the ceiling is \$2 billion, it could be reached in 1994, on the basis of current construction plans.

The other \$200 million relates to the payment of future construction costs. According to the Bureau's September 1993 cost allocation, the District's repayment obligation will be \$2.2 billion by the time CAP is completed in 1999, or \$200 million more than the ceiling in the December 1988 master repayment contract. The Bureau contends that the repayment ceiling can be raised with

the District's agreement, but the District has suggested that it may not agree to a ceiling increase.

The Bureau and the District had not resolved the matter as of December 1, 1993. If they cannot reach agreement to increase the District's ceiling to \$2.2 billion, the Bureau could (1) halt construction prior to CAP's completion; (2) lower the District's reimbursable obligation by reallocating CAP's costs to nonreimbursable purposes, such as settling of Indian water-rights claims; or (3) seek congressional approval to grant relief to the District for some reimbursable costs.

Water Allocations for Future Indian
Water-Rights and Environmental Settlements
Could Add \$585 Million to Federal Costs

The second matter under review involves water allocated for future Indian water-rights and environmental settlements that could add another \$585 million to federal costs. In 1983, the Secretary of the Interior allocated 310,000 acre-feet of CAP water to 12 Indian tribes in order to settle some Indian water-rights claims. Between 1978 and 1992, an additional 140,000 acre-feet of CAP water was allocated to six tribes. Thus, nearly one-third of CAP's anticipated maximum annual water capacity as well as \$980 million in nonreimbursable CAP construction costs has been allocated to settle Indian Tribes' water-rights claims. The federal government also assumed responsibility for substantial O&M expenses in one of these settlements.

Six additional Indian water-rights claims could be settled with CAP water. The Secretary has reserved 200,000 acre-feet of CAP water for future federal use, including Indian water-rights claims, and is now in the process of negotiating settlements. If these six settlements follow the pattern of past settlements, the federal government could assume an additional \$435 million of CAP construction costs.

In addition, CAP legislation included fish and wildlife enhancement as an authorized project purpose. A committee commissioned by the governor of Arizona recommended allocating between 50,000 acre-feet and 150,000 acre feet of CAP water for environmental enhancement. We estimate that construction costs associated with this allocation would range between \$50 million to \$150 million. These costs will be categorized as nonreimbursable and will be borne by the federal government.

Defaults on Water Distribution
System Loans Could Add
\$157 Million to Federal Costs

The third matter under review involves possible defaults on water distribution system loans that could add \$157 million to

federal costs. The federal government made loans to non-Indian irrigation districts for CAP irrigation distribution systems for about \$200 million. These loans are between the federal government and the individual irrigation districts--they do not involve the Central Arizona Water Conservation District. Some irrigation districts have indicated that repayment of the loans is jeopardized because farm incomes are too low and CAP water is too expensive. As of November 1993, one irrigation district had defaulted on its loan of \$17.4 million, and two other irrigation districts were in danger of defaulting on loans totalling \$140 million.

THE DISTRICT'S ABILITY TO MEET ITS
LONG-TERM REPAYMENT OBLIGATION IS UNCERTAIN

Both the Bureau and the District are confident that the District can meet its repayment obligation. However, we analyzed the District's financial plan for CAP and found that, for the 1994-99 period, projected revenue from power and water sales and interest income from investments of the reserve fund will not provide sufficient funding for the District to meet its federal repayment obligation and to pay for annual O&M expenses. As a result, the District may have to use some of its reserve funds to meet expenses. The reserve fund could be reduced from about \$160 million to about \$58 million to \$75 million by 1999, depending on the level of the District's investment income.

Our work to date also has shown that, over the long term, several uncertainties could substantially affect the District's ability to repay.

The District's Repayment Obligation
May Be Understated

As we mentioned earlier, the District contends that its repayment obligation is \$1.8 billion and has based its repayment projections on this amount. The Bureau, however, contends that the District owes \$2 billion and that the repayment ceiling can be raised to \$2.2 billion with the District's agreement. According to District officials, the District has not analyzed its ability to repay either of these amounts.

Projected Power Revenues
May Not Materialize

Another uncertainty relates to future revenues the District expects to generate from power sales. The District plans to use revenues from three contracts for the sale of power from the Navajo Generating Station as a major source of revenue to meet its repayment obligation. Two of the contracts are between the District and the Salt River Project Agricultural Improvement and Power District (Salt River Project). The contracts provide revenue of about \$20 million a year, which will be used solely to retire

debt for bonds used to finance the District's share to construct the New Waddell Dam. The contracts will expire in 2011.

The District and Salt River Project are currently negotiating a third contract for the District's remaining Navajo power that exceeds CAP's operating needs. The Bureau is withholding approval of this contract, pending resolution of several repayment matters. If approved, this contract is expected to provide another \$20 million each year to help the District meet its repayment obligation. The contract, as proposed, will also expire in 2011.

Although the contracts for the sale of Navajo power provide significant revenues, it is not certain that the same amount of revenues can be generated after the contracts expire in 2011. In 2011, the land lease and coal contract for the Navajo Generating Station will also expire. It is unknown whether the land lease and coal contract with the Navajo Tribe can be extended and the power contracts renewed with the Salt River Project at terms equally favorable. The District's financial plan assumes that power revenues will continue at the same level throughout the 50-year repayment period.

Finally, the Department of the Interior's Office of Inspector General reported that the Navajo Generating Station could be inoperable or inefficient to operate in about 25 years unless it is rehabilitated or replaced.³ However, the District has not addressed the issue of its share of power plant rehabilitation or replacement costs in its financial projections.

Uncertainty Over Recovering Fixed O&M Expenses

A third uncertainty relates to recovery of the District's fixed O&M expenses estimated to be \$30 million for 1994.⁴ According to the Bureau, M&I and Indian water users scheduled to buy CAP water in 1994 will pay about \$8 million, but who will pay the remaining \$22 million is uncertain.

A major factor contributing to the uncertainty is the "take-or-pay" provision of CAP contracts with non-Indian irrigation districts. These contracts require the districts to pay the fixed O&M expense allocated to all water not delivered to M&I and Indian customers, whether or not the districts use the water. However, because of declining farm incomes and the high price of CAP water compared with groundwater, the irrigation districts have not

³Cost Allocation and Repayment, Central Arizona Project, Bureau of Reclamation; U.S. Department of the Interior Office of Inspector General, Report No. 92-I-1151, August 1992.

⁴Fixed O&M expenses are those incurred regardless of whether water is delivered.

scheduled deliveries for any CAP water during 1994, and several districts have suggested they will be forced into bankruptcy if "take-or-pay" is enforced.

Another uncertainty is the amount of fixed O&M expenses to be paid by the federal government. The District billed the Bureau \$12.6 million for fixed O&M expenses for a 15-month period in 1993 and 1994. These costs were associated with an Indian water-rights claim settlement (Fort McDowell Indian Community) and water held for future Indian water-rights claims. However, the Bureau has not accepted these costs. The matter is still unresolved.

If the District does not recover its annual O&M expenses through water sales and other revenue sources, then the difference must be covered through payment from its financial reserve fund. Since the fund is to be used to both repay construction costs and pay annual O&M expenses, the long-term payment of O&M expenses from the reserve fund will eventually deplete the fund and could adversely affect the District's ability to repay its federal obligation.

Water Sales to Non-Indian Irrigation Districts Are Uncertain

The final uncertainty relates to water sales to non-Indian irrigation districts. Since the non-Indian irrigation districts have not scheduled deliveries of CAP water for 1994, the District's ability to repay its construction costs could be adversely affected. Having non-Indian irrigation districts buy CAP water is advantageous to the District because construction costs allocated to agricultural water supply are repaid to the federal government without interest. Therefore, the more agricultural water that is delivered, the less interest the District has to pay.

In order to increase the use of CAP water by non-Indian irrigation districts, the District proposed in October 1993 to lower the price of CAP water from about \$61 per acre-foot to as low as \$17 per acre-foot. The District's goal is to stimulate non-Indian agriculture's use to about 400,000 acre-feet of water per year. Under this proposal, the District would save about \$13 million annually in interest expenses, most of which would be used to offset the reduced revenues from the non-Indian agriculture water sales. While the District believes it can change water pricing unilaterally, the Bureau has indicated that its approval is necessary if the change in pricing affects repayment.

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In summary, Mr. Chairman, CAP is almost complete and substantial federal funds have already been spent. The significant uncertainties to be resolved are how the costs will ultimately be

allocated between the federal government and the District, and whether the District will be able to repay its allocated costs.

This concludes my statement. We will be happy to answer any questions that you or other Members of the Subcommittee may have.

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