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Water Security Considerations in Transactional Due Diligence and Facility Siting Reviews

ASSESSMENT OF WATER SUPPLY AVAILABILITY NOW A CRITICAL COMPONENT OF DUE DILIGENCE AND FACILITY SITING REVIEWS

Until recent years, the availability of adequate water supplies with which to operate a business was a straightforward inquiry. Although the volume of water in a given water system may have fluctuated over the years based on seasonal variability, and occasionally other considerations, annual average flows typically varied very little.

Today, the predictability of average rates of precipitation, and thus annual flow rates, can no longer be taken for granted. This new reality, fueled by unprecedented climactic changes and variability, is evidenced most dramatically in California, Washington State, and some of the Colorado River Basin states, where reduced precipitation has translated into low-flow river conditions.

But the problem is not limited to these areas. Indeed, the recent focus on the extreme drought in California has obscured the fact that average annual river and stream flows are decreasing throughout western North America. Climate change has altered the predictability of reliable water supplies in many parts of our Western States, and increasingly elsewhere. Thus, water security has become a critical element when performing corporate or real estate due diligence, advising a client about facility siting, or counseling a client regarding a bond-financed water project where repayment is based on providing water to consumers.

Although the concept of including a water security assessment in a traditional due diligence review may seem novel, it is important to consider that many parts of the country are facing significant challenges in meeting existing demands for water resources. And, as climate-related impacts become more pervasive, new policies, limitations, and restrictions on water consumption are starting to be implemented. Thus, in advising clients on water security, facility siting, and water investment issues, it is important to include an assessment on how governmental directives and policies might affect their future operational plans and water needs, so that they can fully understand the potential risks of moving forward with a project or transaction.

IF YOU WOULD LIKE ADDITIONAL INFORMATION, PLEASE CONTACT:

Jerome C. Muys Jr.
202 370 3920
jmuys@zag-sw.com

Jeffrey M. Karp
202 370 3921
jkarp@zag-sw.com

Victor N. Baltera
617 338 2945
vbaltera@zag-sw.com

Gabriel E. Eckstein
202 775 1204
geckstein@zag-sw.com

George William Sherk
202 775 6806
gsherk@zag-sw.com

James R. Wrathall
202 775 1206
jwrathall@zag-sw.com

BOSTON
ZAG-S&W
One Post Office Square
Boston, MA 02109

NEW YORK
ZAG-S&W
1633 Broadway
New York, NY 10019

WASHINGTON, DC
ZAG-S&W
1666 K Street, NW
Washington, DC 20006

ISRAEL
Zysman, Aharoni, Gayer and Sullivan & Worcester LLP
41-45 Rothschild Blvd., Beit Zion
Tel Aviv, 65784 Israel

KEY CONSIDERATIONS WHEN CONDUCTING WATER SECURITY DUE DILIGENCE

A business with a long history of unencumbered access to a large, free-flowing river or stream, or to a significant freshwater impoundment, might give little heed to concerns that its access to water might one day be imperiled. However, new federal, and in some instances state, claims and limitations on water supplies may put at risk even the most entrenched legal water rights, and these regulatory claims should be considered as part of any water security due diligence assessment. Similar inquiries should be made by users of municipal water supplies as well in those instances when water availability is a critical consideration in the transaction or siting decision.

In some respects, water rights still are highly sacrosanct. Even in today's increasingly water scarce environment, state water rights and permit systems almost always protect existing uses. The prior appropriation doctrine, dominant in the West, generally operates to protect pre-existing water rights from those of more junior users.

And even in the Eastern states, where water generally is apportioned based on equitable considerations, new uses often are disfavored if they would negatively affect existing users. However, there also may be statutory exceptions in those states to the prevailing bias in favor of existing users, and it is possible that a company may have the requisite water rights or governmental permits to operate its business and still not be sufficiently protected from adverse impacts in the event a new upstream water use is proposed.

There are also a number of federal statutes that may effectively override pre-existing water rights or permits. Regulatory claims on water supplies should be examined as part of any due diligence review regarding water security.

For example, the Supreme Court has construed the Federal Power Act, 16 U.S.C.A. Sections 791 et seq., to preempt conflicting state water laws, raising the prospect that water needed for hydroelectric projects licensed by the Federal Energy Regulatory Commission may be accorded a right senior to pre-existing rights under state law. The implications of these rulings would need to be evaluated on a case-by-case basis.

Similarly, Section 404(c) of the Clean Water Act, 33 U.S.C.A. Section 1344(c) specifically provides that it is intended to protect municipal water supplies, as well as shellfish beds, fishery areas, wildlife, and recreational areas. The United States Environmental Protection Agency ("EPA") is expressly authorized under that provision to "veto" a permit issued by the Army Corps of Engineers for the discharge of dredged or fill material into navigable waters if EPA determines that the discharge would have an unacceptable adverse effect on specified water resources. This veto authority has been used, among other purposes, to prohibit the construction of a reservoir that would have addressed a demonstrated need for additional local water supplies.

The requirements of the federal Endangered Species Act, 16 U.S.C.A. Sections 1531 et seq. ("ESA"), and similar state statutes also may operate to create a senior claim over pre-existing users in order to protect a threatened or endangered species. The ESA has become a particularly effective tool for stakeholders advocating for higher flow rates in the nation's waterways.

The Coastal Zone Management Act, 16 U.S.C.A. Sections 1451 et seq. ("CZMA"), is yet another federal program with the potential to affect existing water and permit rights under certain circumstances. The CZMA has been used to impose federally-based restrictions on the use of water originating in an "upstream state" due to impacts deemed inconsistent with a lower basin state's approved coastal zone management plan.

CONCLUSION

Regional changes in the annual amount of precipitation and average annual river and stream flow rates, particularly in western North America, have made it prudent to include water security analyses as part of the due diligence process performed in connection with corporate and real estate transactions, facility siting, and water-related project investment reviews when water availability is a critical consideration. In addition to assessing the likely present and future physical availability of water supplies, these analyses should consider the legal availability of water, specifically the requirements of federal energy and environmental programs, the effects of which may be to protect existing flow rates and water levels with resulting limitations on private water rights and permits.