

# LEGAL BARRIERS TO EFFICIENT REALLOCATIONS OF WATER

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## **Introduction**

Practically all water in the arid Western United States has already been appropriated. Increasing and changing water demands resulting primarily from significant population and economic growth, therefore, can only be accommodated by a high degree of water mobility. Transfers of water involve changes in one or more of the following: the ownership of water rights, the location of water use, the type of use, the season of use, and the point of diversion from a water course.

In all states of the region a high percentage (often over 75 percent) of water is consumed by the agricultural sector, especially via irrigation of crops. Meeting changing demands, therefore, means a transfer of water from agricultural to municipal, recreational, and industrial uses where the value is higher. Unfortunately, these transfers are often impeded, if not prohibited, by institutional policies and legal rulings that prevent the owners of rights from selling water to demanders.

The general public, as well as policy makers and implementers, often underappreciate the importance of property rights in a market economy. “Property refers to the right of the owner, formally acknowledged by public authority, both to exploit assets to the exclusion of everyone else and to dispose of them by sale or otherwise” (Pipes (1999), xv). Terry Anderson (1983, 5) indicates the role of property rights this way: “When property rights are well defined, enforced and transferable, individuals will reap the benefits and bear the costs of their decisions and actions. Through this connection, property rights guide the invisible hand of the marketplace.”

This paper discusses some administrative, statutory, and legal constraints on market transfers: the impairment rule and changing approval criteria relating to water transfer applications, forfeiture provisions in prior-appropriation law, and uncertainty as to the ownership of irrigation water rights.

### **The Changing Regulatory Environment Affecting Water Transfers**

Under the prior-appropriation doctrine, utilized in most Western states, a water right specifies the purpose of water use, the quantity of water diverted from the source, the point of diversion, and the season of use. If alterations are proposed in any of these items, a change application must be submitted to and approved by a state regulatory agency (Gardner 2001). The agency assigned this task varies among states--in most it is the office of the State Engineer or some comparable agency in a State Department of Water Resources, but in California it is the Water Resources Control Board and in Colorado it is water courts specifically established to regulate transfers. In this paper, constraints on market transfers will be discussed in the context of Utah law and institutions, but the findings should be broadly applicable to other Western states where the prior-appropriation doctrine is the legal basis for water appropriation and allocation.

It has been recognized everywhere that moving water in response to changes in demand might have effects on third parties not directly involved in negotiations for these transfers. The principal reason for these third-party effects is that diversions of water are almost never matched by consumptive use—hence, the unused water becomes incorporated into the right of successive users. Therefore, there was deemed to be a need for a regulatory authority to monitor and authorize proposed transfers to make sure that all water rights were protected. The criterion utilized by most of these state agencies to

approve or disapprove water change applications was whether other water rights would be impaired (U.C. 73-3-3). If so, the impaired party was given legal standing to protest the change application, and the State Engineer was required to investigate the merits of the protest. If no significant impairment of other rights were found, the change application would be approved. If there were impairment, however, the application normally would be denied unless the injured party was made whole, either by monetary compensation or by limiting the amount of water transferred so that the quantity available to other rights was not diminished. If the protestor were not satisfied with the decision of the State Engineer or the proposed remedy, he could resort to tort law and sue the State Engineer and the applicant perpetrating the injury.

Two characteristics of these “impairment” procedures are significant. First, determining impairment of other water rights is principally a hydrologic question; i.e., how the quantity (and perhaps quality) of water available to other rights might be affected by a proposed change? Hence, the State Engineer’s office employed experts in hydrology to analyze these effects. Second, as the region changed demographically and economically it became increasingly apparent that some parties might be affected by water reallocations that were not existing holders of water rights and, therefore, lacked legal standing to protest change applications. These other “stakeholders” might include in-stream water users (primarily recreational users), those responsible for protecting fish and wildlife habitat, endangered species, and wetlands, and proximate property owners of land who could be affected by the water changes proposed.

The Utah law requires any person seeking to appropriate water to file an application with the State Engineer describing the proposed appropriation (U.C. 73-3-2).

Information required is similar to that required for a change application: the quantity of water being appropriated, the time during the year when the water would be used, the water source, the place of diversion and use, the diverting works, and a few other facts disclosing the purpose of the proposed appropriation (Jensen 1999).

The Utah law also specifies the criteria the State Engineer must use in evaluating the appropriation application as well as protests that might be made. Included are: unappropriated water must be available, the proposed use must not impair other water rights or interfere with a more beneficial use, the proposed plan must be physically and economically feasible, and not be detrimental to the public welfare, public recreation, or the natural stream environment (U.C. 73-3-8). Just as for change applications, if the State Engineer were to reject any protest to a proposed appropriation, his decision may be appealed in district court.

The phrase “not detrimental to the public welfare” is the source of much of the current controversy. What does the term “public welfare” mean? Is it different from what follows in the statement of the code; namely, “public recreation, or the natural stream environment?” Is private wealth creation included in public welfare, or are they mutually exclusive? The statute is silent on these crucial questions.

The Utah Code further specifies that water may be transferred “by deed in substantially the same manner as real estate” (U.C. 73-1-10). As indicated above, however, just as an original appropriation must be approved, so a proposal to change the point of diversion, the place of use, or the purpose of use, must also be approved by the State Engineer (U.C. 73-3-3). And as also indicated earlier, a change application normally will be approved if it does not impair any existing vested water right. But with

a change application there is no requirement for considering the public welfare. These procedures for new water appropriations and change applications were followed in Utah, and most other Western states, for nearly a century before 1980 (Davis).

Because water allocations have come to affect so many interests, however, it seems inevitable that the “narrow” impairment criterion would be challenged, and indeed it was in Utah. In 1988, a non-owner of a water right (Stanley Bonham) protested a proposed transfer on the basis that his land would be affected. His protest was denied by the State Engineer, however, because he lacked legal standing under the impairment rule since he did not have a water right that could be impaired (Gardner 2001). Bonham sued. Since it was clearly recognized that this would likely turn out to be a landmark case testing state water transfer procedures, Bonham was joined in the suit by an environmental organization that perceived it had an important stake in water re-allocations. Likewise, the irrigation companies seeking approval of the transfer application (and were joint defendants with the State Engineer, Mr. Morgan) were joined in the suit by other water companies that wished to minimize transfer impediments as conditions might become propitious sell their own rights.

The suit finally went to the Utah Supreme Court, which ruled that the State Engineer must use a public welfare criterion to approve water change applications, just as he was required to do when approving new water appropriations (Bonham v. Morgan). It is far from clear at the present time, however, how the State Engineer will respond to the court’s directive, and even if it is possible for him to do so (Gardner 2001). Obviously, evaluating changes in public welfare resulting from a water transfer will require a large change in the way the State Engineer’s office operates including an

expansion in expertise in a wide variety of disciplines. It is not at all clear that this is operationally feasible, given personnel and budgetary constraints. An implication of all this for efficient water allocations is that as soon as it is realized that almost anyone has legal standing to protest, there will be more protests. Moreover, the approval process for each application will be much more complex, leading to costly delays and probably more disapprovals.

It is interesting that a similar case was heard by the Nevada Supreme Court in the 1990's (Gardner 2001), and that court ruled that the State Engineer was not required to change the criteria for considering water change applications. That court held that the standard requirements of beneficial use, the financial capability of the proposed users, and "impairment" (all standard requirements in most Western states) were perfectly adequate indications of the public interest. It must be noted, however, that two justices wrote a biting dissent. A safe conclusion is that neither the Utah court nor its counterpart in Nevada will be regarded as the last word on the matter, even in those states.

### **The Law of Forfeiture**

Early legislatures in the prior-appropriation states enacted statutes that required water to be put to actual use or the right would be forfeited. Such a requirement would seem to have been desirable for several reasons. The recording of a water right and the requirement that water be put to beneficial use was a way both of legitimizing the right and providing a low-transactions-cost tool for keeping track of the identity of the water users. In addition, it was believed that economic development would be promoted by requiring that water actually be put to use within a specified time rather than hoarded and held for speculation.

The Utah Code (73-1-4) specifies that water rights may be forfeited under the following conditions: “When an appropriator or his successor in interest shall abandon or cease to use water for a period of five years the right shall cease and thereupon such water shall revert to the public, and may be again appropriated as provided in this title, unless before the expiration of such five-year period the appropriator or his successor in interest shall have filed with the State Engineer a verified application for an extension of time, not to exceed five years, within which to resume the use of such water and unless pursuant to such application the time within which such nonuse may continue is extended by the State Engineer as hereinafter provided . . . Such applications for extension shall be granted by the State Engineer for periods not exceeding five years each, upon a showing of reasonable cause for such nonuse.” An exception is made, however, for municipalities looking towards future growth: “The holding of a water right without use by a municipality . . . to meet the reasonable future requirements of the public, shall constitute reasonable cause for nonuse” (Utah Code 73-1-4).

The forfeiture rule has produced results that have turned out to be at variance from those intended by the originators. Forfeiture amounts to a “use it or lose it” rule. For many reasons it may be economically inefficient to require that a fixed water quantity as specified in a right be put to actual use. Consider the problem of water application by a typical irrigator. Water needed by crops can be satisfied by precipitation as well as from an irrigation right. If a farmer had complete freedom to use water from the right in profit-maximizing quantities, he would apply it until marginal benefits equaled marginal costs. Irrigating crops involves variable labor and energy costs, even if the capital costs are largely fixed. In the event of high precipitation, the marginal benefits from applying

irrigation water would fall, implying that the optimal quantity of water applied from the right would fall. However, if all the water in the right must be used or run the risk of forfeiture, economically excessive water could be applied resulting in reductions in crop yields as well as water-logging of soils and perhaps excessive run-off. Of course, this implies that a record of water use is kept and is available to parties who might be interested in invoking the forfeiture rule.

Perhaps even more importantly, since the right specifies the purpose and season of water use as well as the point of diversion, the threat of forfeiture may mean that water would be locked into a given use, time, and place when economic efficiency might require short-run or long-run transfers. Short-run transfers generally take the form of annual water rentals without the right changing ownership, while long-run transfers involve the outright sale of the water right. Efficient transfers of water are especially valuable under water-shortage or drought conditions, since irrigation water may have far less value than water used for municipal and industrial use, including the generation of electricity. This precise situation clearly existed in the summer and fall of 2001 in the Northwestern United States and California, where drought conditions made the value of water for generating electricity many times higher than for growing agricultural crops up-river (Hamilton, Whittlesey, and Halverson). A water exchange to accommodate the difference in water value was hindered because of the risk that the forfeiture law could be used to deprive irrigators of their rights (Economist 2001).

Another consequence of the forfeiture rule results from the development of irrigation technologies that have sharply increased irrigation efficiency. Less water needs to be diverted per acre for the consumptive use of a farmer's crop. So what is the farmer

to do with the water that it is now uneconomic for him to use on appurtenant land? If it might be lost due to the forfeiture law, the farmer may elect to expand his irrigated land base if that option is available. Or, if legally permissible, he may sell or rent the excess water to others without taking cognizance of the effects on other use-dependent water rights (Huffaker, Whittlesley, and Hamilton). Such actions may or may not be economically efficient when considered from the point of view of an entire water basin where return flows from irrigation are significant.

Finally, there is the matter of speculation in water rights that at least partially gave rise to the forfeiture law in the first place. Speculation may make good economic sense for the community as well as the holder of the water right, even if water is withheld from use in a given location at a given time and for a given purpose. A water right is an entitlement in perpetuity to the value of an expected annual flow of water. The owner of a right will continue to hold it so long as the anticipated present value of the future flow is higher than it would be if he sold the right to someone else. However, anticipated income flows from future use are highly stochastic, depending on many factors that are variously evaluated by different potential owners of the right. Evaluating this uncertainty is the special province of speculators. And just as land justifiably may be held idle for speculation in a market where factors affecting land values are variously estimated, so a water right might be held for such speculative purposes. Withholding water from current use, especially if it can be stored and used or sold later when its value is higher, may be quite feasible and a good reason for holding onto the right. (This point has already been recognized in law in the case of municipalities looking toward future growth.) But, if the

right may be forfeited if the water is unused by its owner, the incentive to sell the right is enhanced, even if it made good economic sense to retain it.

Furthermore, is this speculative motive for holding a right necessarily a bad thing from the community's point of view even if the water is not used by the owner of the right? It might be if this non-use created significant negative third-party technological impacts. In fact, however, usually the opposite occurs. If the owner of the right does not use his water, it does not magically disappear from the water supply system. Instead, the probability is high that the water will be used by others. So benefits, rather than costs, accrue to third parties. A good example is provided the Colorado River. At present, some Upper Basin states, such as Utah, Colorado, and Wyoming, cannot economically use their river entitlements that were negotiated by treaty in the 1920s. So the unused water flows down the river and is ultimately used in Nevada, Arizona, California, and Mexico. Likewise, an irrigator who does not use his water potentially confers benefits on other users along the water supply course. But because the right might be forfeited if the water is unused by its owner, the forfeiture rule could produce premature and inefficient water applications and conversions.

Another problem imposed by the forfeiture rule is more long-term. Consider a vested irrigation right on a parcel of land used to grow crops. But then, at a later time, suppose that the land is converted to urban uses. The urban developer might purchase the water right and apply for an application to change the beneficial use and perhaps the point of diversion. But suppose it would be less costly for the developer to hook onto an existing municipal water system to service his urban customers, and the irrigation right becomes inactive. Then, suppose that at some later time (after five years) the owner of

the right wished to sell it. Obviously, the law of forfeiture would come into play, and the State Engineer could deny the change application, and the water could then be available for re-appropriation. Through forfeiture the owner of the old right would be deprived of the wealth incorporated in the right. The threat of this outcome could induce the owner of the right to either use the water in economically wasteful ways in order to circumvent forfeiture, or might induce him to sell the right, perhaps economically prematurely. In fact, some municipalities have imposed the requirement that developers acquire water rights as a precondition for approval of development plans. Then, if the developer hooks onto a municipal water system, the right would be turned over to the municipality. In principle, however, there are no reasons for believing that such requirements generally will be economically efficient.

As with other issues discussed in this paper, precedent court cases have put “teeth” into the law. Such a case on forfeiture was provided in Utah in the 1989 (*Nephi City v. Hansen*). Early in the 20<sup>th</sup> century, Nephi City in central Utah acquired four water rights on Salt Creek. The city employed the water to generate electricity, a beneficial use under the law. In the early 1950’s a flood on Salt Creek destroyed the diversion and conveying works. For more than thirty years, therefore, these water rights were not beneficially used by Nephi City. In 1982 the city proposed to construct a new hydroelectric facility. Believing that its rights were still valid, the city filed applications with the State Engineer to change permanently the points of diversion.

The change applications were protested by the Utah State Division of Wildlife Resources on the basis that a renewal of water use would diminish habitat for wildlife. After a hearing, the State Engineer rejected the change applications on the grounds that

the water rights had not been used for a period exceeding five years and thus were forfeited. Because there were no subsisting water rights, there could be no change in points of diversion.

Nephi City disagreed with the State Engineer's decision and brought an action in district court for a review. The city did not challenge the forfeiture law directly, but instead argued that forfeiture of its water rights was unconstitutional under Article XI, section 6, of the Utah State Constitution. This article provides that "no municipal corporation, shall directly or indirectly, lease, sell, alien, or dispose of any waterworks, water rights, or sources of water supply now, or hereafter to be owned or controlled by it; but all such waterworks, water rights and sources of water supply now owned or hereafter to be acquired by any municipal corporation, shall be preserved, maintained and operated by it for supplying its inhabitants with water at reasonable charges; provided, that nothing herein contained shall be construed to prevent any such municipal corporation from exchanging water rights, or sources of water supply, for other water rights or sources of water supply of equal value, and to be devoted in like manner to the public supply of its inhabitants." In short, Nephi City argued that the constitution prohibited it from disposing of any water rights owned or controlled by it, and therefore, it could not forfeit water rights it could not legally dispose of.

The district court granted the motion of the State Engineer and the Utah State Division of Wildlife Resources for summary judgment. It held that there were no disputed issues of material fact, and that the State Engineer was correct in concluding that the water rights had been forfeited by nonuse. In addition, there was no conflict between article XI of the constitution and section 73-1-4 of the code because the constitution only

prohibits the voluntary, intentional disposition of water rights, whereas forfeiture under section 73-1-4 is involuntary. Nephi City appealed to the Utah Supreme Court.

The Supreme Court held that the question was purely a matter of law, and that there could be no dispute that section 73-1-4 works a forfeiture of Nephi City's rights since they were unused for thirty years. No extension of rights was sought by or granted to Nephi City. Therefore, under the plain terms of section 73-1-4 the rights were forfeited for nonuse by operation of law.

But there was also the matter of whether section 73-1-4 of the code is inconsistent with article XI of Utah's constitution. As the court saw it, the question was whether the article bars all transfers, voluntary or involuntary, or whether it is limited to voluntary transfers as the State Engineer and the district court implicitly held. The Supreme Court held that article XI, section 6, is applicable to voluntary transfers only. The Court found that involuntary forfeiture of rights has been a basic part of Utah water law since 1880, and the law was in effect when the Utah Constitution was adopted in 1896. It must be presumed, therefore, that the framers of the constitution were aware of the forfeiture provision in the then-existing statutory law. The summary judgment, therefore, upheld the State Engineer's decision rejecting Nephi City's applications to change the points of diversion of the four claimed water rights (*Nephi City v. Hansen*).

For Utah, this case seemed to settle the validity of the forfeiture law even when applied to municipalities. What remains unresolved is the effect of the forfeiture rule on whether or not water is efficiently allocated. By losing the water right, Nephi City had to make other (and presumably more costly) arrangements for providing power to its customers. There do not appear to be provisions in appropriation law that would prohibit

the city from applying for a new appropriation, but the application probably would have been protested by the same interests that gained from forfeiture of the right.

All of which raises an important question. Precious little empirical information is known regarding the economic misallocations induced by the forfeiture rule. One issue is what happens to the water that might be legally available for re-appropriation as a result of a right forfeiture? In the current environment of tight water supplies, appropriation of available water is not so easy as it once was. The point has already been made that if a right is not exercised for a given time period the water simply does not disappear. It will be available to be used by others on the water system, even if they do not have legal rights to it. This will be particularly true for instream uses and wetlands used for wildlife habitat. If a new party attempts to re-appropriate the water, those who were benefiting from the previous nonuse of the right will be affected and likely will protest the new appropriation. Recall that the criteria for granting new appropriations are much broader than for change applications, especially before the Bonham challenge. But in a post-Bonham world, however, it is far from clear how both the State Engineer and the courts will respond to future protests. The legal situation is likely to be murky at best.

Another complicating factor is that the status of a water right with respect to forfeiture may not be evident until a change application is filed. The State Engineer does not monitor water rights to determine if water is being used according to the law. Only when a change application is filed and protested is a forfeiture allegation likely to arise. Therefore, it is unclear how much water could be potentially affected by the forfeiture rule. What is clear is that urban water delivery is very complex in Western states with a host of municipal public utilities, water conservancy districts, and private water

companies all vying for customers and all concerned with the acquisition and maintenance of water rights.

### **Who Owns Irrigation Water Rights?**

A third major issue affecting market transfers of water to higher-valued uses is the ownership of the water rights, and therefore who controls market exchanges. Because agriculture is the marginal user (the user of lowest value) of water in most areas, especially those experiencing rapid urban development, the most frequent transfers are those from agricultural to urban uses. And because agriculture was the dominant industry in the settlement period of most Western states, and is still the dominant consumptive water user, problems with the ownership structure of water rights in this sector could lead to inefficient allocations of water.

The primary organization distributing water for irrigation in Utah and most other Western states was and still is the private mutual irrigation company (or corporation). These companies issue water shares to individual farmers in the company, generally in proportion to the acreage served. But it was usually the company that received and held the appropriative water rights, and the officers of the company, representing the shareholders, naturally assumed the authority to negotiate transfers of these rights. But this authority has been challenged in recent years as conflicts have arisen between individual shareholders and the company officers as to who controls the rights. This is an extremely important matter when considered in light of the question raised earlier as to what is a property right. To recapitulate, a non-attenuated property right must be clearly defined so that it is evident what can be traded, it must be defensible against possible encroachments, and it must be divestible at the discretion of the owner. If any

component is missing, a serious attenuation in the right exists and the market cannot be expected to be efficient in transferring the asset incorporated in the right to its highest-valued use. As with other issues discussed above, ownership of water rights has been tested in Utah's courts, but the court ruling does not appear to have settled the question as evidenced by the fact that the issue has been taken up by a recent Utah legislature.

The court battle in Utah (*East Jordan Irrigation Company v. Morgan and Payson City*) is especially instructive because so many factors of interest were present: a proposed transfer from agricultural to urban use, a surface-water ground-water trade, and a change in diversion from a point on the water course to one nearly fifty miles distant.

East Jordan is a nonprofit mutual water company and was established to supply water to its shareholders, principally irrigators. The company owns legal title to water rights in Utah Lake and the Jordan River that connects Utah Lake, in Utah County, to the Great Salt Lake. The company diverts water from the Jordan River to a canal and delivers it to about 650 irrigator shareholders in Salt Lake County. Each of the 10,000 shares entitles a shareholder to receive a pro rata share of the company's canal water (*East Jordan v. Morgan*, 311).

Payson City, located about 15 miles south of Utah Lake, bought 38.5 of East Jordan's shares in 1987, representing the delivery of an average of 186.34 acre-feet of water annually (*East Jordan v. Morgan*, 311). Following the law, Payson filed an application with the State Engineer to change the point of diversion to a city-owned well near the city that draws water from a basin connecting to Utah Lake. Payson also sought to use this water for year-round municipal purposes.

East Jordan protested the change application on two grounds: (1) that the change application should have been filed by East Jordan as owner of the water right, and (2) the proposed change would impair the company's vested water rights in Utah Lake. The State Engineer held two informal hearings and then approved Payson's change application. As for the objections raised by East Jordan, the State Engineer concluded first that Payson held a vested water right by virtue of its ownership of East Jordan stock and, therefore, could legitimately file a change application in its own name. And second, the State Engineer considered a number of hydrologic factors relating to impairment of other rights: the amount of water consumed by irrigation, the amount of water that would be returned to Utah Lake from municipal use, and the seasonal variation in water use. The State Engineer ordered that Payson be allowed to divert 144 acre-feet between April 15 and October 31 and 38 acre-feet the rest of the year, and that East Jordan reduce the diversion into its canal by 186.34 acre-feet per year. In addition, the State Engineer required that Payson install a meter on its diversion well that would be available for inspection by East Jordan, and that Payson be liable for assessments and any other obligations it may incur as a shareholder in the company (*East Jordan v. Morgan*, 311).

This ruling by the State Engineer demonstrates how hydrologic factors, including consumptive use and return flows, are taken into account in his decisions. In the ensuing court actions, these determinations by the State Engineer were never challenged.

In response to the State Engineer's decision, however, East Jordan sued in district court. In fact, the parties filed cross-motions for summary judgment on the stipulated issues: first, whether Payson as a shareholder in the corporation had the legal right to file a change application in its own name without consent of East Jordan. And second,

whether the State Engineer had jurisdiction to consider such an application. The district trial court denied East Jordan's motion and granted Payson's cross-motion. East Jordan then appealed to the Utah Supreme Court.

East Jordan argued that the trial court had erred on both points at issue (*East Jordan v. Morgan*, 311). Basically, East Jordan's argument was that since the company was the legal owner of the water rights, only it had the right to change the point of diversion. East Jordan also asserted that allowing shareholders to file change applications in their own names would violate the corporate structure of such companies and make it impossible to manage them. East Jordan further argued that its articles of incorporation and company policies contain a specific restriction preventing a shareholder from filing a change application without the company's consent. Moreover, the company stipulated that the specific change application would impair the vested rights of the company and its other shareholders, and that the State Engineer's ruling in effect would wrongfully partition the company's title to its water rights. On the second issue of jurisdiction, East Jordan contended that the State Engineer lacked authority to approve a change application in such a complex situation because he fulfills only an administrative function and lacks the authority and training to adjudicate the legal rights of the parties.

Payson City countered that mutual irrigation companies are fundamentally different from other types of corporations since shareholders have direct interests in the water rights held by the companies, and that among these interests is the right to change the point of diversion. Payson also argued that while East Jordan may have legal title to

the water rights, it is the shareholders who really have equitable title (East Jordan v. Morgan, 312).

The Utah Supreme Court first addressed the issue of whether Payson had the legal right to file a change application with the State Engineer in its own name without the consent of East Jordan, and held that it had no such right. The court said that it based its decision on the “statutory scheme governing the appropriation of public waters, the principles of corporate law bearing on the function and power of boards of directors to manage corporate affairs in the interest of shareholders as a whole, and the dictates of sound public policy” (East Jordan v. Morgan, 312).

The court granted that the Utah Code 73-3-3 (2) provides that any person entitled to the use of water may petition for changes in the point of diversion, the place of use, and the purpose of use. And, of course, Payson had argued that it had the right to change its point of diversion over East Jordan’s objection. But the Supreme Court held that section 73-3-3 (2) must be read in light of the entire set of statutes, and that Payson had failed to prove that it was entitled to the use of water. The water rights belonged to the company, a point that had been affirmed in previous legal decrees. Hence, Payson’s ownership of shares in the company did not give it a right conferred by the state to the use of water as contemplated by 73-3-3 (2). The court found it necessarily follows that any change in the point of diversion could be initiated only by East Jordan itself, since it alone owned the right as an appropriator to the use of public waters.

Further, even though Payson claimed to be the “equitable owner” of its shares of East Jordan’s water rights, the court held that its equitable ownership remained subject to the general rule governing corporations that directors, rather than shareholders, control

the affairs of the corporation. East Jordan had been organized under the territorial laws in 1878 and was governed by the Utah Nonprofit Corporation and Co-operative Association Act. Section 16-6-34 of that act specifies that “the affairs of a nonprofit corporation shall be managed by a governing board” (East Jordan v. Morgan, 313). In addition, Article VII of East Jordan’s articles of incorporation provided that “the Board of Directors shall have the general supervision, management, direction, and control of all the business and affairs of the company, of whatever kind” (East Jordan v. Morgan, 313-314).

The Utah Supreme Court reasoned that what Payson gained by its purchase of East Jordan shares was only the right to receive a proportionate share of the water distributed by the company out of its system. Since Payson was seeking a point of diversion, a place of use, and a nature of use that were substantially different from those of the other shareholders, as well as those anticipated in East Jordan’s articles of incorporation, the city was asking more than its legal entitlement allowed. Payson wanted to divert its share of the water before it entered East Jordan’s delivery system, to transport the water outside of the company’s service area, and to use it for municipal purposes—all beyond its authority as a single shareholder.

The court’s ruling has far-reaching implications for economically efficient transfers of water. Indeed, at least part of Payson’s proposal is the *sine qua non* of all rural-to-urban water transfers that are required to accommodate changes in demand. If the court’s finding in this suit were to hold in all transfer cases, then it is clear that boards of directors of irrigation companies could block efficient water transfers.

But the court wasn’t finished. It held that the agreement between East Jordan and its shareholders imposes the duty on the company to manage its affairs in the interest of

the shareholders as a whole, and that this duty must not be infringed by the State Engineer. It went even further to suggest that any dispute that might arise between the company and its shareholders should be resolved, not by a state administrative agency, but by a court of competent jurisdiction. The court believed that this was necessary because Payson City had argued that a precedent case in Colorado had settled this issue in its favor. In that case (*Wadsworth Ditch Co. v. Brown*) a Colorado court held that a shareholder had the right to change a point of diversion over the objection of an irrigation company in which the shareholder had shares

However, in response to Payson's argument, the Utah Supreme Court pointed out that unlike Utah law, under the Colorado appropriation scheme the change process is commenced in a court of competent jurisdiction rather than with the State Engineer. The Utah court opined that a court is better suited to construe a company's articles of incorporation and bylaws than a State Engineer, who merely performs an administrative function. Therefore, the Utah Supreme Court found the Colorado case inapposite (*East Jordan v. Morgan*, 315).

What may be most significant in the long run about the Utah Supreme Court case discussed above is the compelling minority dissent of Justice Christine M. Durham (*East Jordan v. Morgan*, 316-321). It is not uncommon for some justices to disagree with the majority. But her arguments are so convincing that it would be difficult not to expect them to surface frequently in the future, and indeed, they have in recent legislative action that will be discussed later.

Durham argued that the majority had crucially erred in a number of its findings (*East Jordan v. Payson City, Morgan*, 316):

- 1) Water was improperly treated like an ordinary corporate asset, and mutual water companies were assumed to be the same as other corporations.
- 2) Long-established Utah case law was ignored holding that mutual water companies may not interfere with a shareholder's use of his shares of water unless the shareholder's use harms the corporation or other shareholders.
- 3) The majority's holding was bad policy since it assumed without adequate analysis that allowing shareholders to change their points of diversion would destroy water corporations, and it ignored the need for flexibility and transferability of water rights.

In short, it appears that Durham's dissent indicated a more thorough understanding of the nature of water property rights (definable, defendable, and divestible) than was found in the majority opinion. She cited previous Utah Supreme Court rulings that "Water rights are pooled in a mutual company for convenience of operation and more efficient distribution of water, and perhaps for more convenient transfer. But the stock certificate is not like the stock certificate in a company operated for profit. It is really a certificate showing an undivided part ownership in a certain water supply" (*East Jordan v. Morgan*, 318). She also pointed out that on numerous occasions "we [the Utah Supreme Court] reiterated the principle that shareholders in a mutual water corporation actually own water rights" (*St. George City v. Kirkland*). In *Kirkland*, for example, a mutual water company's charter lapsed in 1953 after 50 years of existence, and the company did not reincorporate until four years later. A number of people filed claims to the company's water, arguing that the corporation had forfeited its water claims. The Utah Supreme Court rejected these claims, holding that the shareholders continued to own the water rights, although the company charged with delivering the

water was defunct. The court thus held that the company was not the owner of the water rights—it simply provided a method for the shareholders to distribute water among themselves.

In *East Jordan v. Morgan* the majority held that East Jordan was the sole owner of the water rights because it was named as the owner in the water decree. Justice Durham rejected this claim on the grounds that ownership of water is far more complex than ownership of other forms of property, and that the mere existence of legal title did not determine the rights of ownership. Justice Durham opined that while a water right is considered a “property right,” certain legal principles regarding water have developed in the West that differ significantly from those regarding other forms of property. A private person does not really “own” the water itself, the acquired usufructuary right depends on putting the water to beneficial use, and the rights may be forfeited to the state if the water is not used for five years. Durham argued that these differences are crucial in determining the respective rights of mutual water companies and their shareholders. While the water right may be held in the company’s name, only the shareholder has the right to use the water and hence must decide whether, how, and where to use it. Furthermore, the mutual company is under a perpetual duty to deliver water to the shareholder, but may not decide that it would rather deliver water to someone else or for some other purpose. So if the company has the right, what does the right allow the company to do? Very little it seems. Moreover, the company cannot even maintain the water rights unless its shareholders use the water, and Justice Durham pointed out that even East Jordan had conceded this point (*East Jordan v. Morgan*, 317). For Justice

Durham, therefore, the correct inference must be that the shareholders owned the water rights, *de facto*.

To buttress her conclusion, Ms. Durham asserted that the majority opinion failed to recognize case law that had developed regarding the relative rights of mutual water companies and their shareholders. While she acknowledged that the Utah Supreme Court had never explicitly faced the issue of whether a shareholder may change the point of diversion without company consent, it had considered the relationship in a number of other contexts. For Durham, these cases clearly established that a shareholder has a right to do whatever he wants with his shares of water, and the company may not interfere with this right. For example, in *Baird v. Upper Canal Irrigation Company*, the court found that water becomes the shareholder's property once it is delivered to him, and that the shareholder has the right to use it as he wishes as long as it does not interfere with the rights of others. And Justice Durham further argued that *Baird* was binding in *East Jordan v. Morgan* for three additional reasons: 1) *East Jordan* complained that Payson's proposed change would result in the removal of water from *East Jordan's* service area and would thus change from irrigation to municipal use. But, *Baird* demonstrated that these are not the valid concerns of the company. 2) *Baird* implied that a shareholder would not need the company's permission to file an application for a change in place and purpose of use. And most importantly, 3) *Baird* suggested a practical reason to allow a shareholder to change his point of diversion over the company's objection (*East Jordan v. Morgan*, 319). Under its own reasoning, *East Jordan* could not object if Payson took its share of water through the company's canal, and then somehow delivered it to the city through its own facilities. Since Payson had the right to take its water wherever it wanted

after the water entered its own pipes and ditches, surely the city should also be allowed to take the water from further up the natural watercourse.

Justice Durham also argued that the precedent cases had established that a shareholder's interest in the water of a mutual company must include the right to decide where the water is received and how it is used, so long as a proposed change did not increase the company's costs or otherwise interfere with its ability to manage the water supply for the benefit of all shareholders. The State Engineer's order did not interfere with East Jordan's ability to manage the company's water supply, but did provide that both East Jordan and the Utah Lake and Jordan River commissioners had the right to inspect Payson's meter to ensure that the city did not take more than its share of water. The order also provided that Payson's stock remain liable for assessment to maintain East Jordan's canal and other company assets. If there were a water supply shortage, East Jordan could limit the amount of water Payson took through its well in the same proportion as applied to the other shareholders. The only difference was that Payson would take water from its own well rather than from the company canal. In Justice Durham's view, the court majority's approach increased the costs for everyone involved without providing any benefits.

In conclusion, preventing shareholders from changing the points of water diversion interferes with the ability of individual users to respond to new demands. In short, it prevents the market in water rights from allocating water to its highest and best use. Unhappily, the Utah Supreme Court decision prevented this salubrious result from occurring.

Despite the Supreme Court ruling, the matter of who owns the water rights is still alive in Utah. In the 2001 legislative session, Senate Bill 51 was introduced that would permit individual irrigators to transfer water rights without company approval. Given the controversy surrounding the East Jordan v. Payson case, it should come as no surprise that the bill was opposed by officials in many water companies, and even the State Engineer expressed doubts about it (Spangler). In the end, however, the bill was not brought forward for a vote, and the entire matter has now been referred to a special task force on water rights. Appointed by the Governor, this body will make recommendations to the legislature for future action.

### **Conclusions and Recommendations**

What conclusions can be drawn from the issues discussion presented above, and what institutional changes are required to effectuate desirable changes?

The office of the State Engineer is not now equipped to implement a social welfare criterion for assessing applications to transfer water rights, nor can it be expected to do so in the future without a significant expansion in personnel and budget. Even so, the concept of social welfare is much too broad and too murky to be a workable standard for a regulatory agency evaluating thousands of change applications each year. A huge bureaucracy of hydrologists, economists, sociologists, and perhaps others would be required, and even then, it is likely that few would be satisfied with the results. Even though the pre-Bonham criterion of “impairment” of other water rights may neglect important factors in some instances, at least the impairment criterion is operational and is buttressed by hydrologic science that the State Engineer is fully capable of applying.

Many of the challenges to the impairment rule come from interests that are concerned with potential harmful effects of water transfers on fish and wildlife habitat and recreation. However, if in-stream users were legally eligible to compete for water rights, then the market would properly account for these uses that now may be neglected in the market that permits only water diversions.

The argument that state administrative agencies, such as the State Engineer, can utilize the impairment rule to protect existing water rights has been challenged by prominent water economists (Huffaker, Whittlesey, and Hamilton). They believe that the impairment rule under prior-appropriation law needs to be substantially modified and supplemented by public-trust criteria that give due regard to “public” values. “The modern-day erosion of the prior-appropriation doctrine’s past virtues undermines the doctrine’s prospective utility as the pre-eminent water allocation mechanism in the West into the 21<sup>st</sup> century, and thus increases the necessity for operating a more flexible version of the doctrine in conjunction with parallel allocation doctrines better equipped to distribute water to a number of meritorious competing public uses. . . . (e.g. the public-trust doctrine and the emerging doctrine of federal regulatory rights” (Huffaker, Whittlesey, and Hamilton: 271). The primary basis for this conclusion is that “changes in on-farm irrigation technology have increased consumptive water use at the expense of other use-dependent rights, and have resulted in illegal water spreading with the blessing of state and federal water agencies. In short, the impairment rule has ceased to operate well, and consequently, should not be allowed to severely restrict water transfers” (Huffaker).

These scholars may well be correct that prior-appropriation law (including impairment rules) have ceased to function well in some areas under specific circumstances, but more empirical evidence is needed from across the region before definitive conclusions can be drawn for the entire West. It is quite possible that regulatory agencies in some states perform impairment evaluations under tighter rules and with higher degrees of objectivity (less political influence) than they do in others. The prior-appropriation doctrine and the impairment rule seem to have worked rather well in Utah. These state differences in water institutions provide an important laboratory for research. A comparative study among states may turn up empirical evidence of what is working and what is not in terms of efficient water re-allocations. States can learn from each other, and the promise for improving the efficiency of water allocation is much greater than would be true if water policy had been federalized and identical everywhere in the country.

And what if the State Engineer utilizing the “objective” impairment rule to evaluate change applications were replaced by an agency with public-trust responsibilities? This would clearly lead to a higher degree of politicization of water allocation decisions. If public-trust evaluations were to replace, or even complement, impairment rules, some political body would decide what is in the public interest and what criteria would guide its decisions? Which body would do that and how would relative “values” of alternative allocations be determined? This is an enormously important issue. Economists have long argued that only buyers and sellers of commodities can possibly know the values of that which is traded. Cost and utility functions are intrinsically subjective, and no outsider can know what they are. In such an

environment, opportunities for political rent-seeking by interest groups and rent-extraction by politicians would be rampant and very costly (McChesney 2002). And, in the end, it would probably come down to what political interests will trump other interests?

In a time when competition for water is growing rapidly, forfeiture laws serve no purpose and should be repealed. Incentives to transfer water rights prematurely and inefficiently would be thus largely removed. Especially conducive to economically efficient water allocations would be modification of beneficial-use rules to permit short-run transfers of water, such as annual rentals that would occur during times of drought and pressures on supply. This might be accomplished by allowing water use of the renter to be regarded as beneficial use under the current rules. However, it is time to ask whether the beneficial-use requirement itself ought to be repealed. In the current era of higher water values and emerging water markets, it is difficult to see how any use that could successfully bid water away from other uses could not be considered as “beneficial.”

As to who should hold the right to transfer water in the case of mutual water companies, it is evident that it is the individual shareholders who already have the legal responsibility (right) to determine the point of diversion, the season of use, and the type of use. These are significant rights, but the most important right is missing if water is to be efficiently allocated--the right to transfer water to a higher-valued user. It is highly unfortunate that the Utah Supreme Court chose to give this right to the irrigation company—an entity that cannot possibly know what water is worth in alternative uses, and therefore cannot make economically efficient market decisions. Only the irrigator

shareholders bear the opportunity costs and capture the benefits of water use. Therefore, it is they, and not the officials of the company, who should determine whether they should keep or dispose of the water right. It must be granted, however, that water transfers may produce effects on third parties, due mainly to alterations in return flows. These third-party problems can be largely overcome, however, by limiting water transfers to historic consumptive use, a practice already implemented by the State Engineer in Utah as the *East Jordan v. Payson* case demonstrates. Furthermore, the impairment rule as employed in Western States for over a century to evaluate both water appropriations and change applications is designed primarily to deal with these return-flow problems.

It appears that none of the existing problems associated with the legal impediments to water transfers discussed in this paper requires more than minor changes in water law and administrative practice. State legislatures should move post haste to fix these impediments. Only markets can produce the movement of water that is required to maximize economic growth and associated wealth creation.

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