



San Jacinto River Authority

ADMINISTRATIVE OFFICE
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March 1, 2010

Dear Montgomery County Large Volume Groundwater Users and Stakeholders:

Since November 2, 2009, the San Jacinto River Authority has attempted in good faith to negotiate the terms of the proposed GRP contract with the City of Conroe. Unfortunately, we have received no constructive comments from Conroe on the contract since our lengthy, written responses delivered on December 21, 2009, until last Thursday evening. Instead, the Authority's written and verbal attempts to pursue discussions with Conroe have been met with a media and political campaign designed to mislead you and our elected officials.

The most recent example of this campaign is Conroe's unilateral rewrite of the GRP contract and its distribution to you this morning, even before our first scheduled meeting this evening with Conroe's new City Council Committee that was appointed last Thursday to resume talks with the Authority. We regret Conroe's efforts to embroil you in their unresolved issues with the Authority. In an effort to spare you further review, confusion, and legal expense, and to set the record straight, we have set forth below in summary form the issues that we must assume, from their sheer repetition, Conroe has:

Background: More than 3 1/2 years ago, when Lone Star first proposed draft regulations to require a significant reduction in groundwater usage in Montgomery County, the Authority proposed a countywide compliance plan very similar to what was reflected in the Water Resources Assessment Plan completed last March and in the draft GRP contract. This plan was offered by the Authority based on several fundamental principles: (i) a **non-profit operation** and administration by the Authority of the plan; (ii) the sale of raw water to supply the plan by the Authority at its **published raw water rates** applicable to the Authority's highest volume users; (iii) the **commitment by the Authority of all unsold water in Lake Conroe** to supply the plan; (iv) the use of the **principles of overconversion** of the densely populated areas of the County to treated surface water, in order to save costs of construction and to allow other areas of the County to continue to use groundwater, **and of pumpage fees** for groundwater usage to **equalize the costs** of groundwater and surface water and make overconversion viable; and (v) **uniform charges to and treatment of all LVGU's**, without regard to their size, type or geographical location within the County.

Even Conroe now acknowledges publicly that this is the least cost, most efficient, and most timely plan for compliance. But with an average daily usage of groundwater in 2009 of approximately 15% of the countywide total of some 30 million

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gallons per day, and having invested nothing in alternative water supplies, Conroe seems to believe that it should have a controlling position in how the Authority's plan and water resources should be administered. By contrast, the Authority has conceived, developed and funded this plan and has invested well over \$100 million over the last 40 years in operating and maintaining Lake Conroe, securing additional water rights in the Trinity River basin to "free up" water in Lake Conroe for local use, and securing the right to purchase all of Houston's two-thirds of the yield of Lake Conroe---all without any taxpayer funding, to make this plan possible.

Conroe Issues: In summary, the issues seem to be: (i) **liability** of the Authority in administering the plan; (ii) **governance** of the plan; (iii) specification of **special standards** for review of the Authority's rates, both for pumpage fees and treated surface water and for raw water supplied to the plan; (iv) **ability to annex** additional territory and remain in plan compliance; (v) **reuse of surface water**; (vi) **ability to pursue future brackish water alternatives** and to terminate the GRP contract; and (vii) fear of **preferential treatment** of others in the plan, namely, The Woodlands. It appears that almost all of Conroe's proposed revisions to the GRP contract stem from these issues. The remaining proposed revisions are typographical, semantical, clarifying, or based on legitimate, fact-based misunderstandings between the parties.

Liability: From the outset, the Authority has offered to administer and operate this plan **only on a non-profit basis**—not because we are obliged to do so, but because it is the lowest cost alternative for Montgomery County. Since 1946, the Authority has operated a raw water system for delivering nearly 75 million gallons per day of water to the Ship Channel industries, including Exxon Baytown at approximately 55 million gallons per day. The revenues generated from this and other programs provide the Authority with the capital and reserves to develop and acquire water resources, such as Lake Conroe, and to make it possible to offer this GRP plan to Montgomery County on a non-profit basis. But in any business transaction, **risks must be balanced against reward**. Since there is no reward from a non-profit operation, it only stands to reason that the risks of the program must be limited.

In the GRP contract, the Authority has waived its governmental immunity and is willing to take the risks for any act of gross negligence or intentional misconduct on its part, but the Authority does not take the risk of simple negligence. By contrast, **the City of Conroe**, or any so-called regional water authority, **retains its governmental immunity** in its water system operations **and passes all the costs of its mistakes to its ratepayers**. There is simply no recourse to a city, a regional water authority or any similar governmental entity that is not borne by its ratepayers. So, in fact, **what the Authority is proposing actually offers more recourse and accountability to the ratepayer** than does a city or regional water authority. To suggest otherwise, or that the

Authority has broader immunities or powers under the GRP contract than a city or a regional water authority, is simply not correct.

For over 50 years, the Authority has operated its raw water system serving some of the largest industries in the world without incident, complaint, litigation, arbitration or rate appeal. For some 35 years, the Authority has operated on a similar non-profit basis the wholesale water and wastewater systems serving nearly 100,000 people in The Woodlands without incident. Based on this long record of performance, the Authority is willing and able to offer this plan on a non-profit basis and to assume greater responsibility than would Conroe in a similar situation. Conroe's insistence on increasing the Authority's risks even more can only lead to withdrawal of the non-profit aspects of the plan or to the purchase of insurance against risks, **which will only increase the costs of the program to you.** This, the Authority is unwilling to do.

Related to this overall liability issue is Conroe's insistence that the Authority must "guarantee" compliance with Lone Star's rules and must guarantee additional water supplies beyond Lake Conroe. The Authority has agreed in the GRP contract, if requested by the Participants and if the Participants are willing to bear the costs, to use its best efforts to secure additional water resources for the distant future. But guarantees are issued by insurance companies in return for payment of a premium, not by non-profit organizations with no return. Perhaps, that is why it is called a "premium". The Authority has offered its experience, record and water resources to the solution of this problem. **We fail to see how Conroe expects to improve upon non-profit.**

Governance: Under the Authority's legislative proposal to implement this program, which was supported by Conroe and more than 85% by volume of the water users in Montgomery County, the Authority would have administered this program through its Board of Directors and its professional staff by means of published rules and regulations. The failure of this legislation makes it necessary to implement the program by means of the GRP contract. While the legislation did not include a means of user participation in the administration of the plan, other than by open meetings, open records and public hearings on proposed rules, **the GRP contract added an Advisory Committee procedure** to review and provide comment on the most critical aspects of the plan. Rather than applauding this addition to the program, Conroe insists that decision-making power over the plan should be vested in the Advisory Committee, not the Authority's Board of Directors.

Under Texas law established more than 130 years ago, the Authority, or Conroe, or any regional water authority, **cannot delegate**

its governmental discretion to a third party or committee. To attempt to do so is simply void as against public policy. Nor could the Authority responsibly do so without violating its sworn duty to develop and beneficially apply the water resources of the San Jacinto River basin. Finally, the Authority cannot morally do so without breach of the fundamental principles of this plan---the LVGU's must have input into the plan, but **final decisions cannot be delegated to a group that favors large volume users over smaller volume users, or that pits one geographical area of the County against another, or that gives one or more types of users different treatment than other types.** This, the Authority is unwilling to do. The Authority's Board of Directors has acted with foresight, fairness and decisiveness in preparing to meet this water shortage crisis. Its 73-year record of effective, impartial, unbiased and efficient performance for the benefit of all of Montgomery County will not be surrendered to those who have invested little or nothing and have done little or nothing in the face of this crisis for nearly four years, but who now cry the loudest that they somehow should be in control.

The LVGU's, Conroe and the Authority have all offered suggestions to improve the Advisory Committee procedure under the GRP contract to ensure that the views and opinions of all LVGU's are brought most effectively to the attention of the Authority's Board of Directors and to eliminate any presumption in favor of the Authority's Program Administrator or staff. **These changes will be forthcoming in the Authority's revised draft of the GRP contract.** Because of Conroe's peculiar circumstances with multiple water plant sites that may receive treated surface water (similar to The Woodlands), the Authority has also offered to enter into a more specific supplemental agreement with Conroe to provide more details as to where, when and how surface water will be delivered. It is up to Conroe to determine whether to take advantage of these suggestions.

Special Rate Review Standards: In its comments to the GRP contract, Conroe has requested special procedures and standards for its review of the Authority's rates under the plan. The GRP contract already includes detailed standards and review procedures for establishing surface water rates and pumpage fees---all to the end that those rates will be **the lowest consistent with good business management practices.** The GRP contract also commits the Authority to sell raw water into the plan at the same system-wide, published rate as is applicable to the Authority's large volume raw water customers. You should be aware that this rate is approximately 60% of Houston's raw water rate. Any dispute concerning this raw water rate is subject to appeal to the TCEQ under well established Texas law and procedure.

In other words, the Authority is agreeing to sell raw water for this plan at the same rate that is applicable to its industrial customers of more than 50 years that already purchase some 75 million gallons of water per day from the Authority. The Authority could have offered to sell raw water at a price equal to its sunken and ongoing costs in building, operating and maintaining Lake Conroe for over 40 years, and we can assure you that the rate would have been substantially higher. This, the Authority is unwilling to do. In more than 50 years of water sales to Exxon, Chevron and other large industrial users with talented accountants, attorneys and managers, **the Authority has never been involved in a rate dispute or appeal.** We think the reasons are self-evident. The Authority cannot agree that a 5 million gallon per day user, such as Conroe, has earned the right to dictate special rate review standards that are not applicable to the Authority's customers purchasing 15 times this volume or that are not typically used under Texas law.

Annexation: Conroe is understandably interested in its future growth and expansion through annexation. We have offered to Conroe's counsel and to other LVGU's with similar concerns to make revisions to the GRP contract on this subject. Generally, **it is of little concern to the Authority whether an LVGU expands its boundaries or service area within Montgomery County**, so long as the Authority is given notice of these changes for accuracy in the administration of the plan, and the expansion does not result in a contested overlap of another LVGU's service area or boundaries or a duplication of groundwater or demand for treated surface water. Since the water resources available to this plan are restricted to Montgomery County by the GRP contract, the Authority will not undertake to administer a plan or to deliver water outside of the County. These revisions will be forthcoming in the revised version of the GRP contract from the Authority.

Re-Use: Conroe has proposed a number of revisions to the re-use provisions of the contract that ignore well-known constraints on the reuse of surface water. Under the contract, **groundwater-based effluent may be reused without limitation or the consent of the Authority.** If an LVGU is provided surface water from the Authority, the pro-rata share of the LVGU's **effluent that is derived from surface water may be (i) reused directly without Authority consent, or (ii) reused indirectly, but only with Authority consent.** The rationale for requiring consent in this single circumstance is that the Authority's contract with the City of Houston for water in Lake Conroe limits indirect re-use of such water and, with respect to the Authority's water in Lake Conroe, indirect reuse requires consent in order to avoid negative impact on the Authority's senior downstream water rights.

Brackish Water Alternatives: Conroe has suggested that should the City determine to develop brackish water alternatives in the future, it should be able to withdraw from the GRP contract. It should be obvious that **a plan cannot be designed, financed and constructed under circumstances where the Participants can freely withdraw** to pursue other alternatives. The Authority's position on the so-called brackish water alternative is well known. There is no credible evidence to suggest that brackish water is feasible, from either an engineering or economic standpoint, at this time. There are also serious issues about disposal of brine waste by deep well injection. **The time to have investigated this possibility was the last four years**, not the last four months before the Lone Star deadline for submitting a declaration of intent for rule compliance. The Authority remains open to the possibility of using brackish water in the future if the regulatory, environmental, economic and engineering issues can be overcome. **Free withdrawal from the GRP plan by an LVGU simply weakens the plan**, incurs delay and re-engineering costs, and threatens the financial basis of the GRP for the remaining LVGU's. This, the Authority is unwilling to do.

Preferential Treatment: Apparently there are still lingering concerns by Conroe and other LVGUs that The Woodlands is somehow receiving a special benefit under the GRP, because the proposed surface water delivery pipeline to The Woodlands is longer than the proposed pipeline to Conroe, or for other perceived reasons. This is another misconception based on a superficial examination of the GRP. It does not take into account right-of-way availability or congestion, the costs of delivering water to Conroe's several plants, traffic mitigation during construction, and a number of other issues. A more detailed analysis shows also that **having The Woodlands included in the GRP, with its 100,000 ratepayers, is more economical and efficient, to both The Woodlands and to the County as a whole, than excluding The Woodlands**. Considering that The Woodlands is a prime location for overconversion (far more than the minimum 30%) to surface water, the rest of the County is then benefitted by being relieved of having to reduce its groundwater pumpage and connect to surface water facilities. The cost to all LVGUs is less than stand-alone surface water systems converting each LVGU only 30% to surface water. This is known in the trade as a "win-win" situation.

Conclusions: Properly understood and presented, the GRP contract, as originally provided to you, and with the revisions that the Authority has committed to make above, still represents the best, fastest and cheapest alternative for achieving compliance with the Lone Star rules without an interruption in essential water supplies in

March 1, 2010

Page 7

Montgomery County. The Authority will continue to insist on advancing the interests of all LVGU's on an equal and uniform basis, regardless of site or type. March 1 has now arrived, and the Authority has received and thanks you for the many useful and constructive comments to the GRP contract. We are committed to adding these suggestions to the GRP contract, providing the revised GRP contract to you by mid-March, and assisting you in completing and executing the final GRP contracts by the May 1 deadline in order that the plan can move forward on schedule and in compliance with the Lone Star's rules.

For the reasons discussed above, we believe that the remaining "issues" are not issues at all. We hope that you, Conroe, and all other LVGU's will take advantage of this proposal in a timely way. Please be assured that the plan will go forward in either event. We look forward to your participation.

Yours very truly,

A handwritten signature in black ink, appearing to read "R. Gary Montgomery". The signature is fluid and cursive, with a long horizontal stroke at the end.

R. Gary Montgomery
President, Board of Directors