

## Review of Legal Developments

ROBERT H. ABRAMS, *Legal Developments Editor*

### **Leasing Water for Instream Flows: The Montana Experience**

By Matthew J. McKinney

*Montana Department of Natural Resources and Conservation  
1520 East Sixth Avenue  
Helena, Montana 59620*

The State of Montana, the "Last Best Place" (Kittredge and Smith 1988), is currently experimenting with an innovative strategy for increasing water flows in dewatered streams. The idea is to lease water that has been historically diverted out of the stream and to leave it in the stream to support valuable fisheries. Although this idea is simple enough, the design and implementation of Montana's water leasing program is fraught with problems.

The idea of leasing water for instream flows emerged from the state water planning process in 1988 (McKinney, in press). After the original water leasing bill (H.B. 707) was significantly modified by agricultural interests during the legislative process, it appeared to be dead in March 1989 (Fifty-first Legislature of Montana 1989:478). It was resurrected, however, after lengthy debate, amendments, and procedural maneuvering. The amended bill eventually proved acceptable to enough parties and was passed by the Montana legislature. It was signed by the Governor on 11 May 1989 and amended by the legislature in 1991.

#### **THE WATER LEASING STATUTE**

The water leasing statute (M.C.A. 85-2-436) created a temporary program that allows the Department of Fish, Wildlife, and Parks (DFWP) to lease water rights for the purpose of maintaining or enhancing streamflows to benefit fisheries. The leasing program was designed to provide an opportunity for all affected interests in the state to study and evaluate the social, economic, and environmental impacts of transferring water from traditional uses to instream uses.



# Review of Legal Developments

ROBERT H. ABRAMS, *Legal Developments Editor*

## **Leasing Water for Instream Flows: The Montana Experience**

By Matthew J. McKinney

*Montana Department of Natural Resources and Conservation  
1520 East Sixth Avenue  
Helena, Montana 59620*

The State of Montana, the "Last Best Place" (Kittredge and Smith 1988), is currently experimenting with an innovative strategy for increasing water flows in dewatered streams. The idea is to lease water that has been historically diverted out of the stream and to leave it in the stream to support valuable fisheries. Although this idea is simple enough, the design and implementation of Montana's water leasing program is fraught with problems.

The idea of leasing water for instream flows emerged from the state water planning process in 1988 (McKinney, in press). After the original water leasing bill (H.B. 707) was significantly modified by agricultural interests during the legislative process, it appeared to be dead in March 1989 (Fifty-first Legislature of Montana 1989:478). It was resurrected, however, after lengthy debate, amendments, and procedural maneuvering. The amended bill eventually proved acceptable to enough parties and was passed by the Montana legislature. It was signed by the Governor on 11 May 1989 and amended by the legislature in 1991.

### **THE WATER LEASING STATUTE**

The water leasing statute (M.C.A. 85-2-436) created a temporary program that allows the Department of Fish, Wildlife, and Parks (DFWP) to lease water rights for the purpose of maintaining or enhancing streamflows to benefit fisheries. The leasing program was designed to provide an opportunity for all affected interests in the state to study and evaluate the social, economic, and environmental impacts of transferring water from traditional uses to instream uses.



The DFWP, with the consent of the Fish and Game Commission, must submit potential stream reaches to the Board of Natural Resources and Conservation (BNRC). The BNRC may declare a stream reach eligible for leasing only if it finds that water leasing is "necessary" to maintain or enhance streamflows for fisheries. The original statute specified that the BNRC may designate no more than five stream reaches where water leasing may occur in the state. However, the Montana legislature amended the statute in 1991 to allow up to 10 stream reaches on which leasing could occur.

Once the BNRC designates a stream reach on which leasing may occur, the DFWP must then prepare and submit an application for a lease authorization to the Department of Natural Resources and Conservation (DNRC). The application must include specific information on the length and location of the stream reach in which the streamflow must be maintained or enhanced. It must also provide a detailed streamflow measuring plan that describes where and how the streamflow will be measured. The maximum quantity of water that may be leased is the amount historically diverted by the lessor. However, only the amount historically consumed, or a smaller amount if specified by the DNRC in the lease authorization, may be used to maintain or enhance streamflows below the lessor's point of diversion.

A proposed water lease must be processed through the same change-of-use procedures as any change in water right. Upon receipt of an application for a lease authorization, the DNRC must publish a notice of the application consistent with M.C.A. 85-2-307. Parties who believe they may be adversely affected by the proposed lease may file an objection as provided in M.C.A. 85-2-308. A lease may not be authorized until all objections are resolved. The priority date for a lease authorization is the same as the priority date of the leased water right.

According to the original statute, a lease could not be issued for a term of more than 4 years, but could be renewed for up to 10 years per renewal. However, the Montana legislature amended the statute in 1991 by allowing initial leases for up to 10 years (except for a lease of water made available from a water storage or conservation project, which may be leased initially for up to 20 years), along with one renewal for up to 10 years. The DFWP must notify the DNRC of their interest to renew a lease authorization. Upon receiving notice of a lease renewal, the DNRC must notify other appropriators potentially affected by the lease and allow 30 days for submission of new evidence of adverse effects. A lease authorization is not required for a renewal unless an appropriator with a priority senior to the lease authorization submits evidence not previously considered that shows adverse effects to his rights. If this happens, a new lease authorization must be obtained according to the requirements outlined above. Neither a change in an appropriation right nor any other authorization is required for the reversion of the leased water right to the lessor's previous use.

During the term of the initial lease, the DNRC may modify or revoke the lease authorization if an appropriator, other than one involved in the initial change-of-use proceeding, proves by substantial, credible evidence that his water right is adversely affected. A person issued a water user permit with a priority date after the filing date of an application for a lease authorization may not object to the exercise of the lease, the renewal of the lease, or the reversion of the water right to the lessor.

Although the DFWP is the only entity allowed to lease water for instream flow purposes, it may accept contributions from public or private entities for such purposes. The Montana Office of the Nature Conservancy signed an agreement with the DFWP to help raise money for the Montana Water Leasing Trust Fund (Draft Agreement 1989). The fund, which currently has about \$2,500, will serve as a repository for contributions from private individuals, foundations, and corporations who wish to help implement the water leasing study by providing funds to lease water rights for instream flow purposes.

#### LIMITATIONS IN DESIGN

Montana's water leasing program represents an incremental step in the right direction. It provides an opportunity to explore the costs and benefits of transferring existing



water rights to instream flow uses. It is a potentially useful mechanism, in Montana and throughout the West, to increase flows in dewatered streams while protecting existing water rights.

Although the water leasing program provides an additional tool for managing instream resources in Montana, it has several limitations in design. First, it is an administratively cumbersome process. It requires the DFWP to receive approval for an instream flow lease from both the Fish and Game Commission and the BNRC—in addition to going through the change-of-use process. Although such checks and balances may be politically expedient, they indirectly increase the transaction costs of instream flow leases by increasing the time required to process such a lease. Moreover, they create a process in which streams are more likely to be leased for political than for biological and technical reasons.

If instream flow leasing is supposed to represent a free market approach to resource management, it would make more sense to eliminate the roles of the Fish and Game Commission and BNRC; allow the DFWP to identify the streams on which leasing may be needed; negotiate with existing water rights holders on the feasibility and terms of a lease; and resolve any potential adverse impacts to third parties through the change-of-use process, as is done with other water rights transfers and changes. Such an approach would let biological variables and market forces, rather than politically appointed boards and commissions, dictate where and when instream flow leases might occur. It would also protect existing water right holders through the change-of-use process.

A second limitation of the water leasing program, which has been partly corrected by recent legislative amendments, is the program's short duration. Originally, the program was limited to 4 years, from June 1989 to June 1993. Given the politically charged nature of the issue, along with the technical complexities associated with water leasing, it appears that the DFWP will not acquire a lease within the original 4-year time frame. The legislature recognized this problem and amended the statute by extending the temporary water leasing program 6 years, to 30 June 1999. The statute was also amended to allow leases entered into before 30 June 1999 to remain valid until their expiration dates.

Although these amendments allow the DFWP more time to acquire a lease, the lease might not be exercised within its initial 10-year term if, for example, the water level in the stream in question did not fall below a specified level during that period. Although this would make sense from a resource management perspective, it might give some people the idea that the leasing program is not needed. Moreover, it would not provide an opportunity to evaluate the leasing program as it is actually implemented.

Another limitation of the original statute is that it allowed the DFWP to lease water for instream purposes on only five stream reaches. While this was politically expedient and perhaps appropriate for a temporary study program, it severely limited the DFWP's ability to enhance instream flows in many dewatered streams. Although the department might not have the funds to lease water on all the streams that need it, other public and private entities, such as the U.S. Forest Service and Trout Unlimited, may be willing to contribute funds for instream flow leasing, as allowed by law. In any case, limiting instream flow leasing to five stream reaches arbitrarily constrained the market's ability to dictate an efficient allocation of resources. Once again, however, the legislature recognized this limitation and amended the statute to allow the DFWP to lease water on up to 10 stream reaches.

A fourth limitation of the water leasing program is that it allows leasing only for fisheries. Although maintaining instream flows for fisheries may sometimes be sufficient to protect other instream benefits, such as water quality and recreational activities, it is not likely to be in all cases. On certain streams, there might be a demand to increase instream flows purely for the other benefits. To restrict the purposes for leasing is to limit the opportunities to manage an important natural resource.

Another limitation of the program is that only the DFWP is allowed to lease water for instream uses. Clearly it is not the only entity interested in managing instream resources. Fishing resorts, rafting companies, outfitters, and other tourism-related busi-

nesses, not to mention conservation groups and other resource management agencies, may all be interested in enhancing instream flows on certain streams and rivers. Several economists have argued that both public and private parties should be allowed to lease water, on grounds that it would allow them to compete equally in water markets and in the water rights appropriation process with municipal, industrial, and agricultural interests for scarce water rights (Anderson 1983; Colby 1989).

Although there are several persuasive arguments for allowing all public and private entities to lease water rights (Gray 1989), there are also several arguments against the idea (DeYoung 1989). Opponents argue that (1) if private parties were allowed to lease water for instream flow purposes, all of the waters in a particular basin would eventually end up as instream water rights, and this would adversely affect the local economy and lifestyle; (2) allowing private parties to lease water for instream flows would create a market for the speculation of water rights in which traditional water users, such as agricultural irrigators, could not afford to participate; and (3) private entities could not adequately promote the so-called public goods benefits of instream flow. Though all of these arguments raise important points, they do not reflect the financial, economic, or environmental realities of the situation. Moreover, these concerns could be addressed in the allocation and administration of an instream flow water right or lease.

A final limitation of the water leasing program is that it is confined to leasing and does not allow for gifts or purchases of existing water rights for instream uses. Although such permanent transfers might limit the possible modifications should third parties' water rights be adversely affected, they would protect the instream resource more securely. Moreover, transaction costs might decrease because fewer change-of-use proceedings would be required. Several western states, including Colorado (C.R.S. 37-92-102[9][a]), Oregon (O.R.S. 537.348), Utah (U.C. 73-3-3), and Wyoming (W.S. 41-3-1007), are currently experimenting with a variety of mechanisms that provide for more permanent transfer of water rights from offstream to instream uses.

#### IMPLEMENTATION PERFORMANCE

After the Governor signed the water leasing bill, the DFWP generated a tentative list of streams for the water leasing program (BNRC and the Fish and Game Commission 1990). It also developed a list of biological criteria for selecting streams. The DNRC developed a similar list that additionally includes several water management and water rights criteria. Both sets of criteria were adopted by the Fish and Game Commission and the BNRC by September 1990 (BNRC and the Fish and Game Commission 1990).

During the last months of 1989, the DFWP contacted persons located on several of the streams where water leasing would be desirable. Some water users were receptive to the possibility of leasing; others were not. On some streams, the DFWP decided that the complexity of water use and the potential conflict among users precluded leasing.

By the end of 1989, two streams emerged as candidates for water leasing. The first was Swamp Creek, a tributary to the Big Hole River. The DFWP negotiated for nearly a year with one water right holder on Swamp Creek to lease just over 3 cfs to enhance critical spawning and rearing habitat for the Arctic grayling. The negotiations collapsed in late 1990, however, when the water right holder requested \$200,000 per year for his water right despite its estimated market value of less than \$10,000 annually (Duffield et al. 1991).

The second stream is Big Creek, a tributary of the Yellowstone River. The DFWP is working with nine water users on Big Creek to improve the efficiency of the existing irrigation system and then to lease the salvaged water to improve the spawning habitat for cutthroat trout. Water users, in cooperation with the DFWP, are planning to replace inefficient ditch systems with two pipelines. Given the physical complexity of this project, water is not likely to be leased for instream flows in the near future.

After several meetings with the water users on these two streams, the DFWP and the DNRC prepared a report for the Fish and Game Commission and the BNRC explaining the potential water leases on Swamp Creek and Big Creek. The report supported approval

of the two streams for further study, which the Fish and Game Commission granted in February 1990. In March 1990, the BNRC held a public hearing on the proposed stream reaches and, following public comments, approved both stream reaches. Throughout this approval process, the DFWP and the DNRC discussed the water leasing study with the legislative Water Policy Committee and several agricultural and environmental interest groups.

Shortly after approval by the BNRC, the DFWP decided that, as part of the water leasing program, two studies should be conducted before pursuing any leases. The first study would determine the market value of agricultural water, and thereby help the DFWP decide how much they should be willing to pay to lease agricultural water rights for instream flows (Duffield et al. 1991). The second study would evaluate the hydrologic effects that leasing water on specific streams would have on other water users, particularly the potential changes in return flows (GeoResearch 1980; HKM Associates 1991). Both studies on Swamp Creek have been completed.

The DFWP, in cooperation with the DNRC and the legislative Environmental Quality Council, also prepared an outline of the progress report required by the statute. After some changes, the outline for the report was approved by the Fish and Game Commission in May 1990, and by the BNRC and the Water Policy Committee in June 1990. Reviewing a draft of the report itself in late August 1990, the BNRC was extremely concerned about the lack of substantive progress toward acquiring and exercising a lease. The DFWP explained, in the report, that the program has been proceeding slower than anticipated primarily because of their decisions (1) to proceed at a cautious, deliberate pace, given the controversy and concern surrounding instream flow protection; and (2) to conduct the studies on the impacts of water leasing before applying for a change of use for a water lease.

In response, the BNRC strongly recommended that the DFWP immediately initiate the change-of-use process on the two streams that had been approved for the water leasing study. More importantly, the BNRC asked the DFWP to provide it information on the adverse hydrologic impacts, if any, of water leasing after the leases have been exercised. The BNRC also encouraged the DFWP to identify and seek approval on at least one additional stream reach by the BNRC's next meeting.

The Fish and Game Commission considered the draft report and the BNRC's comments in September 1990. Rather than responding to the draft report or the BNRC's comments, the Commission called for a meeting in October 1990 with the BNRC and the Water Policy Committee. As a result of that meeting, the draft report was modified, approved, and adopted by all parties (BNRC and the Fish and Game Commission 1990). The report recommended (1) to amend the water leasing statute to allow any leases approved during the 4-year temporary program to continue past 30 June 1993, the date the program expires; (2) to require the DFWP to provide the BNRC with available information on the adverse hydrologic impacts, if any, to other water users after the leases have been exercised; (3) to require the DFWP, in cooperation with the DNRC, to hold public meetings—intended to provide an opportunity for water right holders and others to comment on the social, economic, environmental, and hydrologic impacts of the exercised leases—in appropriate communities after any leases have been exercised; and (4) to require the BNRC and the Fish and Game Commission to present a final report on the water leasing program to the legislature in 1993.

In response to the BNRC's comments, the DFWP requested and received approval in November 1990 from both the Fish and Game Commission and the BNRC to study the feasibility of water leasing on Mill Creek, another tributary to the Yellowstone River. The DFWP is working with a group of water users on Mill Creek to improve the existing irrigation system and then to lease the conserved water to enhance the spawning habitat for cutthroat trout. This project, which is similar to that on Big Creek, will replace three inefficient canals with a variety of new diversion structures, canals, and pipelines to improve delivery and on-farm irrigation systems. It, too, is likely to take a considerable amount of time.

In sum, the DFWP is currently studying the feasibility of leasing water rights for

instream purposes on two stream reaches, and has recently terminated negotiations on one other. To date, however, no water rights have been leased under the temporary program, nor has the DFWP yet submitted a change-of-use application for a water lease. Nonetheless, three important lessons have emerged from Montana's first 2 years of trying to implement this innovative strategy for increasing flows in dewatered streams. First and foremost, everyone involved has realized that such transactions are likely to take much longer than anticipated, particularly because of their controversial nature. Although water right holders are justifiably concerned about leasing's impact on existing water uses, there is often considerable confusion and misinformation about what the potential impacts might be. Water users, environmentalists, and water managers alike need more information regarding not only those impacts but also one another's interests and constraints.

Second, the most promising source for leasing appears to be water salvaged by improving the efficiency of existing use. Water users seem to favor this approach because they can continue their own use and still make a profit by leasing salvaged water to the DFWP. A bill recently passed by the Montana legislature (S.B. 313 1991) maintains water users' rights (including selling or leasing) to water saved by improving the efficiency of their operations. How salvaging and leasing water might impact other water users, particularly through return flows, remains a thorny question.

Finally, it is becoming increasingly apparent to all interests in Montana that water leasing, although it may be effective in certain situations, is not a panacea for maintaining and enhancing instream flows. Other strategies, including releases from water storage projects and cooperative timing of irrigation withdrawals, must also be pursued.

#### WHERE FROM HERE?

In response to the implementation status of the water leasing study, during the 1991 session the Montana legislature considered two major proposals for improving the protection of instream flows. The first and most radical, sponsored by the Montana Wildlife Federation, was to allow any public or private entity to appropriate unappropriated water, and to purchase or lease existing water rights, for instream flows (S.B. 212 1991). After nearly 500 angry farmers and ranchers testified against this bill at a public hearing, it died without much of a whimper in the Senate Natural Resources Committee.

The second proposal, S.B. 425, supported by both agricultural and environmental interests, amends the water leasing program in a variety of ways. The bill extends the water leasing program (and therefore the ability to acquire leases) by 6 years, to 30 June 1999; increases the number of stream reaches on which leasing may occur to 10; allows initial leases for up to 10 years, except for leases of water from a water storage or conservation project, which may be leased initially for up to 20 years; allows leases to be renewed only once, for up to 10 years; requires the DFWP to submit an annual progress report on the water leasing program to the Fish and Game Commission, the BNRC, and the Water Policy Committee; and requires the Commission and the BNRC to adopt a final report on the water leasing program and to submit it to the Water Policy Committee by 1 December 1998.

Although these amendments improve the water leasing program slightly, they do not address the fundamental problem to date, namely, that no water rights have been leased to protect instream flows. Consequently, it has not been possible to evaluate the actual impacts of water leasing on existing water users—which is the primary objective of the program. There seem to be six principal reasons for the lack of results.

First, the statewide controversy over instream flow protection has forced many interests, particularly the DFWP and water right holders, to proceed very slowly and cautiously. Second, as described earlier, the process for approving a water lease is extremely cumbersome. Third, several streams investigated by the DFWP for the water leasing program proved infeasible for various reasons (Montana DFWP 1991a). Fourth, finding water right holders who are serious about leasing their water to the DFWP for

instream flows has been difficult, as illustrated by the behavior of the one on Swamp Creek. Fifth, the potential leases on Big Creek and Mill Creek will not be finalized for several years because of the complexity of improving the irrigation systems. Finally, although it has taken a variety of steps to implement the program, the DFWP has not been as aggressive as it perhaps could be. Statewide, the DFWP has identified over 2,500 mi of stream reaches that are chronically dewatered, and over 1,200 mi that are periodically dewatered (Montana DFWP 1991b). Though the state's political culture is in general far from supportive of instream flow protection (McKinney, in press), surely there must be at least one stream reach in Montana where water is needed to improve instream flow values and there is a water right holder willing to participate in the program!

One way to resolve the last problem would be to allow private entities, such as Trout Unlimited, The Nature Conservancy, or the Montana Wildlife Federation, to lease water rights for instream flows and then to donate the leased water rights to the DFWP. This private-public partnership would take advantage of the private sector's ability to conduct business without the political and administrative constraints of the public sector. It would also satisfy the concerns of agricultural water users by allowing only the DFWP to hold a water lease for instream flows. The private entities would be motivated by their commitment to the resource. They might be further motivated if allowed—along with the DFWP—to enforce the leased water rights.

Regardless of the legislative changes to the water leasing program, the protection of instream values is inevitable in Montana, as throughout the West, given the changing values and demands of the public (MacDonnell et al. 1989). Although it is imperative to protect existing uses of water, Montana's laws and institutions must, and will, be adapted to these new values and demands. The only outstanding question is whether the changes will foster destructive or constructive relationships among diverse interests. To avoid the potentially disruptive alternatives of the public trust doctrine or a constitutional initiative, we critically need information exchange, education, and a neutral forum for consensus building at the local level (Kemmis 1990). Although there are obvious differences among the affected interests, let us hope that their common commitment to the land, water, and quality of life in the "Last Best Place" will provide the foundation for developing innovative water policies.

#### REFERENCES

- Anderson, T. 1983. *Water crisis: Ending the policy drought*. Washington, DC: Cato Institute.
- Board of Natural Resources and Conservation and the Fish and Game Commission. 1990. A report to the Water Policy Committee of the status of the water leasing study and the pilot program. Helena, MT: Board of Natural Resources and Conservation and the Fish and Game Commission.
- Colby, B. G. 1989. The economic value of instream flows—Can instream values compete in the market for water rights? Pages 87–102 in L. J. MacDonnell, T. A. Rice, and S. J. Shupe, editors. *Instream flow protection in the West*. Boulder: University of Colorado School of Law, Natural Resources Law Center.
- DeYoung, T. 1989. Instream flow protection in a water market state: The case of New Mexico. Pages 331–356 in L. J. MacDonnell, T. A. Rice, and S. J. Shupe, editors. *Instream flow protection in the West*. Boulder: University of Colorado School of Law, Natural Resources Law Center.
- Duffield, J., C. Neher, M. Josephson, and R. Josephson. 1991. Market value of agricultural water leased for instream flows. Report to the Montana Department of Fish, Wildlife, and Parks, Missoula, MT.
- Fifty-first Legislature of Montana. 1989. History and final status of bills and resolutions of the Senate and House of Representatives of the State of Montana. Regular session, January 2, 1989 to April 21, 1989.
- GeoResearch. 1990. Hydrologic analysis of proposed instream lease on Swamp Creek, Wisdom, Montana. Report to the Montana Department of Fish, Wildlife, and Parks, Helena, MT.
- Gray, B. E. 1989. A reconsideration of instream appropriation water rights in California.

- Pages 181-236 in L. J. MacDonnell, T. A. Rice, and S. J. Shupe, editors. *Instream flow protection in the West*. Boulder: University of Colorado School of Law, Natural Resources Law Center.
- HKM Associates. 1991. Engineering aspects of Montana instream flow leasing. Report to the Montana Department of Fish, Wildlife, and Parks, Billings, MT.
- Kemmis, D. 1990. *Community and the politics of place*. Norman: University of Oklahoma Press.
- Kittredge, W., and A. Smith. 1988. *The last best place: A Montana anthology*. Helena: Montana Historical Society.
- MacDonnell, L. J., T. A. Rice, and S. J. Shupe, editors. 1989. *Instream flow protection in the West*. Boulder: University of Colorado School of Law, Natural Resources Law Center.
- McKinney, M. J. Instream flow policy in Montana: A history and blueprint for the future. *Public Land Law Review*. In press.
- Montana Department of Fish, Wildlife, and Parks. 1991a. Streams investigated for water leasing since passage of HB 707. Helena: Montana Department of Fish, Wildlife, and Parks.
- . 1991b. Dewatered streams list. Helena: Montana Department of Fish, Wildlife, and Parks.
-