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Prescott Valley's Effluent Water-Rights Auction is Innovative, Profitable

Town learns strategy as it plans, researches, and conducts auction

by Joe Gelt

Prescott Valley town officials are pleased with the results of an auction of 2,724 acre-feet of effluent water rights that could net the town over \$67 million, funds the town will use to acquire needed water supplies for the rapidly growing area. The favorable results at auction have been attributed to the careful planning and calculated efforts that went into researching and structuring the unprecedented water marketing transaction.

Developing the auction structure, terms and procedures required a special effort because there were no previous examples to use as a model; the town was breaking new ground. "This is the first auction of its kind, size and magnitude to create an economic value for effluent or wastewater. It is also unique since it involved capital markets in a sophisticated way," says Clay Landry, managing director of WestWater Research, the consultant hired by the town to market the effluent auction nationally.

The auction, conducted Oct. 29-30, 2007, attracted local and national interests. Water Property Investors, LLC, a New York water investment firm, submitted the winning bid of \$24,650 per acre foot to acquire the water rights developed by the town through its wastewater treatment and recharge program. As the winning bidder, WPI purchased the 1,103 acre feet of water rights currently in the ground and available together with an option to purchase additional supplies as they become available, up to the 2,724 acre feet approved by the Arizona Department of Water Resources in Physical Availability Demonstration No. 20-402187.0000

WPI will receive notice from the town as additional supplies become available and will have 5 years to exercise the option to purchase those water rights. If WPI fails to timely exercise one or more options, the associated water rights will revert back to the town. WPI, however, retains the right to exercise future options until the entire 2,724 acre feet has been tendered. If WPI elects to exercise all options, it will pay the town over \$67 million.

Whether WPI uses or sells the water rights to another party, those rights must be put to beneficial use within the town. The water rights can be pledged to meet ADWR's 100-year-assured-water-supply for residential and commercial subdivision within the town. Or, with town approval, the water rights can be used for other purposes such as recreation and wildlife.

According to Colleen Auer, Assistant Prescott Valley town attorney, "A lot of time went into structuring the auction so that it would make sense for the town as well as the purchaser. ... It was designed to be a win-win situation for both sides."

Minimum bid price set

The first step in working out a mutually advantageous water marketing transaction was to establish a minimum-bid price for the water rights at auction; i.e. a price that would ensure that the town received adequate compensation for the resource without exceeding what buyers would be willing to pay. This presented a challenge.

To help determine this minimum-bid price, the town's consultants performed a market analysis of water rights sold in the area. This provided limited guidance since sales were infrequent and did not involve large quantities of water. Auer says, "We were not comparing apples to apples. There was not a lot in regional water market

transactions to provide us a road map.”

Auer says the information provided by the analysis was taken into consideration as the consultant and town officials applied their own insights about the current water market and the limited resources and supplies available in the region. “We established through our consultant and staff a feeling about where we thought the water price per acre foot should be.”

Negotiations with Aqua Capital Management LP, a Nebraska-based water resource and management company, also helped the town arrive at a minimum-bid price for the water rights at auction. This was a key negotiation worked out over a nine-month period that resulted in a price floor agreement guaranteeing the town \$19,500 per acre-foot in the event no higher bid was received at auction.

“An auction format with a price-floor agreement is an innovative way to address the increasing water needs in the Southwest and to create a market environment for water trading,” says Landry. “The Aqua Capital price-floor agreement provided financial security for the town and created an auction format that encouraged a competitive-market outcome that generated an additional \$14 million.”

Purchase terms developed

The purchase terms also had to be worked out and, as with setting a minimum-bid price, Prescott Valley wanted to come up with terms suitable to both town and purchasers. For example, a payment schedule needed to be adopted.

Auer says, “We wanted to be paid up-front but in the reality of the development market these costs tend not be carried prior to build-out. We had to appreciate the fact that we were dealing with a business model different from a pay up-front scenario. We changed our payment requirements to a pay-out structure, with payment over time at certain trigger points. ... It was a process that evolved.”

A key element of the purchase terms is the option concept that allows the purchaser to test the market and use of the water rights for development purposes before committing to purchase the full 2,724 acre-feet. The developer then has the opportunity to determine if profits from the use of the initial purchase justify exercising the option.

Auer says, “If they don’t exercise an option at the end of five years, the water rights revert back to the town and become part of our portfolio again, to be used down the road for other purposes.”

The very limited alternative water supplies available in the area add value to the water rights purchased. A future source of water in the offing is a joint importation project, with Prescott Valley partnering with the City of Prescott to pump water from the Big Chino Ranch. Prescott Valley intends to pay its share of the infrastructure costs of the project, which involves constructing a 30-mile pipeline to deliver supplies to the water-strapped communities, with funds derived from the auction.

Auer says, “Our importation project has a lot of hurdles to overcome before we can put it in place. If you are a developer looking to build in the next 3 to 5 years ... you have to be planing for a resource within that time frame. And unless you want to pay a premium and wait for the Big Chino water you are going to be looking at the water rights sold at auction..”

The terms of the auction agreement protect the purchaser’s investment when Big Chino Ranch water eventually comes on the market. Auer says, “Whatever water comes into the market place during the time the 2,724 acre feet of water rights are being marketed will be sold at 10 percent above the then-current market price. We are not going to use our eventual supply from the importation project to undercut or compete in the market place.”

Price sets benchmark

Auer says the auction’s winning bid set a benchmark for other water sellers in the area. She says, “It is comparable to the situation where someone sells a house in your neighborhood for a hundred grand more than you paid for the same type of house. If you decide to sell your house too that previous sale is a benchmark. You may not get the full hundred grand above your purchase price but you are going to be able to point to that sale as a benchmark for what your house is worth.”

The sale is not likely to have the same effect throughout the state; the value of water varies widely in different locations depending upon, among other factors, available water supplies and projected growth. Water rights auctioned in the Phoenix area would not likely attract the same high bids cast in the Prescott area.

Landry says that the Prescott Active Management Area is one of the hottest markets in the country where the price of water is greatly appreciating and investors expect continued growth and development. They are unlikely to be disappointed if projected figures hold up. With its population having increased 52 percent between 2000 and 2007, Prescott Valley is projecting another 55 percent increase over the next 20 years. The auction price of its effluent water rights reflects this situation.

Auer summarizes what she believes the Prescott Valley auction accomplished. “What it has done in my opinion — this is one person speaking — is fleshed out through the competitive market place the true value of this commodity because it was sold outright, not sold in conjunction with development or real property. It was just the asset, the right itself out there for competitive bidding. That enabled us to determine at this time, in this economy with this type of resource and the future growth that is anticipated here and the scarcity of alternative supplies what the marketplace thinks it is worth.”



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