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VIA EMAIL (mgpage@sphllp.com) AND REGULAR MAIL

San Jacinto River Authority Board of Directors and General Manager

Through
Mr. Michael Page
Schwartz, Page & Harding, LLP
1300 Post Oak Blvd., Suite 1400
Houston, Texas 77056

RE: Comments to GRP Contract, as Made Available December 2009

Dear Michael:

This letter submits comments and questions on behalf of Montgomery County Municipal Utility District Nos. 8&9 ("MUDs 8&9") to San Jacinto River Authority's ("SJRA") proposed Contract for Groundwater Reduction Planning, Alternative Water Supply, and Related Goods and Services ("GRP Contract"), as first made available to the public in late December.

In general, MUDs 8&9 object to late release of the contract draft. Two months is insufficient time in which to consider and negotiate such a complicated water supply arrangement under the best of circumstances. We also understand from developments, apparent from public meeting on February 16, 2010, that significant standard contractual provisions are likely to be revised in negotiations between SJRA and the City of Conroe. Substantial revision of the contract is necessary, and MUDs 8&9 trust that negotiation will result in a standard contract that is more reasonably crafted. However, SJRA has not extended today's deadline for comments accordingly. The comments and questions below are stated in mostly general terms for that reason. MUDs 8&9 also reserve the right to make additional comments, after more is known about the negotiated GRP Contract itself, as well as the circumstances of agreement.

Where the comments below use terms that are employed in the GRP Contract, it is the intent that the terms have the same meaning as in that contract, without need for further definition or reference.

General Comments.

1. Elements of the GRP Contract appear to be voidable.

MUDs 8&9 are concerned that the GRP Contract goes too far in allowing SJRA to make decisions regarding the Participants' water supply systems and, in that respect, illegally requires participating cities and districts to give up certain fundamental responsibilities and duties. Generally, contracts which interfere with a governmental entity's duties to the public are illegal or void, or at least unenforceable. SJRA stated firmly during the February 16, 2010, public meeting that SJRA would not agree to terms that would essentially abdicate certain of its governmental responsibilities. In the GRP Contract, however, SJRA proposes terms that, by their nature, do not meet SJRA's own standards.

Also, GRP Contract § 9.05 allows the biggest water users to go together to amend the contract in *any way* and to bind all of the Participants to that amendment without regard to whether or not they agree. In this sense, the GRP Contract should not even be considered to be "in writing," given that such terms as may be "amended" are not even knowable at this time. While there may be administrative conveniences to amendment on less than unanimous consent, the categories of provisions that would be subject to such amendment must be clearly limited and reasonable. Generally, those participants who do not vote in favor of an amendment, or at least of a category of amendments, should be able to be released from the GRP Contract within a reasonable time if they so choose.

2. SJRA should not pursue the GRP Contract without legislative authorization.

Legislation proposed last regular session to authorize SJRA to take the actions that it proposes in the GRP Contract failed amid continuing and fundamental community disagreements about the authorities proposed. SJRA, however, continues to pursue a contracting scenario and timeline under which, to use SJRA's recent words, it is "essential" that area groundwater users be "not permitted" to pursue water supply outside the GRP Contract. A number of shortcomings in the GRP Contract, including local accountability, would best be addressed through legislation. Absent such local accountability, the existence of conflicts of interest in the provision of water supply and the lack of cost controls in the contract create an untenable position for those who otherwise would be Participants. MUDs 8&9 have no doubt that if SJRA joined others in the community that already seek extension of the planning deadlines under the Lone Star Groundwater Conservation District's rules, such rules would be extended to allow further consideration of Montgomery County's issues in the next regular session.

3. The GRP Contract fails to establish a fair and appropriate rate methodology, or any methodology that is capable of specifying a contractual rate.

MUDs 8&9 also object that the proposed GRP Contract is virtually devoid of the specificity regarding rate methodology and cost allocation that are required for a rate that is to be set according to contract. Nor do MUDs 8&9 concede that uniform rates and charges are appropriate under the circumstances of groundwater withdrawals and alternative water supply in Montgomery County. The Texas Water Development Board funded study that was conducted in 2006 as SJRA and the Lone Star Groundwater Conservation District were working together to lay the groundwork for

groundwater reduction requirements gives evidence *against* the current GRP Contract and the groundwater district's rules in this regard. A single management zone for all groundwater in Montgomery County is not based on the science of aquifer management and contributes to the conversion "crisis" that SJRA then relies on for its conversion plan. Groundwater reduction recognizing that all entities in Montgomery County are not equally responsible for the costs that will be incurred for alternative water supply is justified by that same Texas Water Development Board Study, as published on the SJRA website.

SJRA and Lone Star Groundwater Conservation District have *chosen* not to recognize the great disparity of growth, characteristics of commercial and industrial customer base, and other circumstances throughout Montgomery County. The long-term effects of this choice are exacerbated by the fact that the GRP Contract fails to establish any meaningful limitations on the cost of conversion.

4. The GRP Contract greatly disadvantages those that will continue to rely primarily on groundwater.

The GRP Contract works to the great disadvantage of any Participant who continues to rely primarily on groundwater. It appears from SJRA's own comments in public meeting that SJRA is seeking to advantage those entities in Montgomery County, perhaps itself, that currently are facing a particular need to drill new wells or rehabilitate existing ones. SJRA's principles about not allowing any advantage based on proximity then fail from the outset, as groundwater users in other parts of the county are left to pay the well costs to meet their total need (not just peaking) and also to subsidize the conversion of others who get to avoid additional well costs through the GRP. Comments made during the February public meeting indicate that it is this avoidance of well costs *for some* that is contributing to the rush to require contracting.

There also appears to be a particular oversight in the GRP Contract with regard to how SJRA proposes to determine the amount of groundwater that it will permit a Participant to use. For example, Section 6.03 of the GRP Contract discusses certain penalties for taking more groundwater than is authorized under the GRP, but where does the GRP Contract sufficiently address how a groundwater user's interests in that determination of quantity are to be protected?

Specific Comments.

5. Provisions of the GRP Contract that propose to give SJRA seemingly unlimited authority over the Participants' use of groundwater and treated water must be modified.

GRP Contract § 2.02 is one example of such provisions, where it states that the Authority will require Participants to utilize surface and groundwater resources "in a manner" as to allow other Participants to continue to develop. Powers over *how* the Participants utilize water, including how much water one or another will be allowed to have, should in no event be exercised by anything less than a reasonableness standard if it needs to be exercised at all. Section 2.02 should be particularly struck from the GRP Contract also because it is overly broad. Taken literally, that provision could be interpreted by SJRA to allow it to require groundwater users to convert even more than 30%, if SJRA decides that a more aggressive conversion is in the best interest of the continued growth of new Participants.

Any opportunity under the GRP Contract for SJRA to have control or discretion over how and where Montgomery County will develop must be eliminated.

6. In Order for SJRA to honor its representations to the public regarding TCEQ oversight of the rates and fees charged pursuant to the GRP Contract, the GRP Contract must be revised.

GRP Contract § 11.01(d) states that "The Parties acknowledge and agree that the fees, rates, and charges established by the Authority hereunder . . . are contractual in nature and that the sole remedy to any Party for any dispute arising hereunder with respect to such fees, rates, and charges shall [be] mediation and/or civil litigation, as provided herein." Despite the language of § 11.01(d) and other circumstances, SJRA has created an impression in the public that SJRA intends the rates charged under the GRP Contract to be fully reviewable by the Texas Commission on Environmental Quality ("TCEQ").

Considering the circumstances of the groundwater district's regulations in alliance with SJRA dating back to their 2006 joint study, the fact that SJRA has sole control of the water in Lake Conroe, and the circumstances and deadlines under which the GRP Contract is proposed, the public interest requires meaningful oversight, by the TCEQ. A Participant must have access to administrative relief against rates, charges and fees, established from SJRA initially and from time to time throughout the term of the Contract, if they are unreasonable, unjust, or discriminatory. MUDs 8&9 understand the value of preserving bargains that are struck between willing buyers and willing sellers; however, that is not the situation in Montgomery County today with regard to SJRA's proposed GRP.

7. Elements of the Proposed GRP Contract that create unfairness in the rate-setting *process* must be modified.

The provision of only 10 days notice of a proposed rate increase, pursuant to GRP Contract § 6.04 (g), is an example of unreasonableness in the rate-setting process. In no event should there be less than 60 days notice of a revised rate order, and SJRA should be required to accompany that notice with sufficient detail about the basis of a rate increase that the Participants are afforded a meaningful opportunity for review and comment.

8. It is inappropriate to manufacture a situation where the single-largest wholesale customer of a raw water supply can never meaningfully question the rate charged for that water.

The water appropriated in Lake Conroe, does after all originate as water of the State. With almost all of Montgomery County now to be directly affected by the cost SJRA charges for that water, as a component of the costs of participation in the Project, there also must be oversight of those raw water charges. Instead, the GRP Contract effectively assures that SJRA will be absolutely unaccountable for the costs of raw water. An example of this exists in § 6.04, under which the opportunity to review raw water rates is to be at SJRA's sole discretion. GRP Contract § 2.11(b) inappropriately restricts the ability of even the Review Committee to review the rates that SJRA sets for raw water. It is fair to assume that SJRA, as the GRP Administrator, will never challenge SJRA, as the raw water provider, under the terms of SJRA's GRP Contract.

9. It is unreasonable for SJRA to suggest that a Participant should be held equally responsible for the terms of the GRP Contract, when SJRA withheld the draft contract from meaningful public review and has far superior if not sole access to critical information related to the Project.

A general principal of law would allow a court that is interpreting a contract in a dispute to construe an ambiguous provision in the light most favorable to the contract participant that did not draft the provision. The proposed GRP Contract and the circumstances surrounding its proposal are an example of exactly why a court would have this ability. GRP Contract § 1.03(d), however, requires a Participant to agree that if there is a question about the interpretation of the Contract, a reviewing Court should hold the Participant equally responsible with SJRA for the way the provision was drafted. GRP contract § 1.03(d) should be removed to let the law function as intended.

10. SJRA should not be able to shield its acts of gross negligence, willful misconduct, and breach of contract by reliance on the advice of engineers or attorneys.

GRP Contract § 1.03 (c) states that "In determining whether an act or omission of the Authority hereunder constitutes a breach or violation hereof, or constitutes negligence, gross negligence, or willful misconduct, reliance in good faith on the advice of opinion(s) of experienced counsel or upon any good faith application or interpretation of the provisions of this Contract shall be an absolute defense of the Authority." Not only does this provision overreach, it also is unworkably ambiguous.

Also, GRP Contract § 4.10 should be clarified such that it does not release SJRA from failure of the GRP to satisfy the requirements of the Lone Star Groundwater Conservation District.

11. SJRA should not be able to shield itself from proper water supply management by reference to its *force majeure* provisions.

Generally, GRP Contract § 10.01 goes beyond what is reasonable to excuse a municipal water supplier from meeting its obligations under a contract. For example, SJRA seeks to excuse itself from its obligations in any circumstance considered "drought." The Participants have a right to expect that SJRA will manage the water supply on which the Participants depend to be reliable in times of drought, at least in times of drought that are not more extreme than is forseeably in excess of the drought of record.

12. The GRP Contract leaves the GRP Administrator with far too much discretion for favoring some Participants, including itself, over others.

Examples are found in currently drafted § 4.02, where SJRA reserves the right and discretion to design, permit, and construct the Project as it chooses, even if other designs could achieve overall compliance with the Plan at a lower cost. While various provisions of the GRP Contract set forth principles for not favoring one Participant over another because of this issue or that, the fact is that the GRP Contract's express reservations and exceptions are crafted to give SJRA unbridled authority over the Participants costs, systems, and water supply.

GRP Contract § 4.05(b) and § 4.08 include other examples. Under the latter section, SJRA could choose even to pay for a Participant's facilities that are not related to other parts of a Participant's

system if *SJRA* determines that it is beneficial to the Participants. We also note that the accommodation of expenses related to on-site facilities is not clear in provisions of the GRP Contract that are related to SJRA's Rate Order. GRP Contract § 7.02 appears to allow SJRA to, as part of the Project, undertake improvement projects that confer a special benefit on a Participant. The extent to which the Participant then pays periodically or otherwise for the improvements depends on whatever agreement the Participant makes with SJRA. In this regard subsection (c) that disallows the costs to be considered Project costs may be inconsistent with subsection (a) that allows the improvements to be made part of the Project.

13. GRP Participants must have greater protections related to SJRA establishment of easements for Project purposes.

GRP Contract § 4.03 addresses SJRA use of easements for any purpose that serves the Project. The amount of property needed for the Project could, of course, vary considerably from Participant to Participant. Where one Participant's property is being used and another's is not being used, then Participants are being treated differently based on their proximity to the project, unless the Participant whose property is being used is fairly compensated. Section 4.03 does not address the price that SJRA will pay for use of Participant property, nor indemnification, etc.

14. More assurance must be provided up front that groundwater users won't be paying more for their water use than are those who receive surface water.

The GRP Contract represents that charges will be equitably distributed so that there is no net benefit to receiving surface water. The GRP *circumstance* is, however, that those who are never converted to surface water are in the worst possible position under the contract. GRP § 6.04 (b), for example, limits the category of groundwater costs to be considered in setting fees. SJRA staff has explained only that there will be a one-size-fits-all offset fee for groundwater use that will be within a range. Based on the best information that SJRA has been willing to make available about costs and pricing, and including the highest differential within SJRA's range, MUDs 8&9 are advised by their engineering consultants that those who receive treated surface water late or never are *significantly* financially disadvantaged under the GRP Contract.

15. SJRA must not be allowed to deny Participants water from the Project and also deny Participants the right or ability to obtain water on reasonable terms either from inside or from outside the GRP.

GRP Contract § 4.04 gives SJRA "sole discretion" to deny a Participant's request to receive water from the Project. SJRA also has apparent discretion to grant such a request but make it economically infeasible for the Participant to receive water. GRP Contract § 4.05 contemplates that, when a Participant will be connected to the system, SJRA will determine the quantity of water that will be delivered after giving the Participants wishes "due consideration."

A Participant must have complete assurance that, in any circumstances when it is not being provided the water that it requires, it will have the right to increase its groundwater pumpage, within the bounds of reasonable conservation. If a Participant is denied water pursuant to § 4.04 or § 4.05, it also should have specific relief from those provisions of the Contract that would also directly or indirectly deny it the opportunity to obtain water outside the GRP without penalty. Among other

things, SJRA should be required to provide its consent to sales of water from Lake Conroe, by Houston.

16. Participants deserve assurances of fairness as SJRA purports to require Participants to meet planning and construction milestones that SJRA sets in its sole discretion and reserves the right to enforce with penalties.

In this regard, GRP Contract § 4.07 should require that the milestones will be reasonable and that the Participant has a fair process through which to contest them. Also, § 4.07(c) declares that a Participant is in breach of contract if its on-site facilities are not prepared in time; however, SJRA is not in breach of contract if it refuses to approve the facilities. If the GRP administrator can cause Participant's breach of contract by failing to approve facilities that don't meet his or her "requirements," then there must be an affirmative protection that those requirements, and any determination that they have not been met, must be reasonable. We also note that SJRA should not have the protections of GRP Contract § 4.11 if the claims by third parties are the results of matters that were required or overseen by SJRA for approval of on-site facilities.

17. Various provisions of the GRP Contract continue to be generally contrary to achieving water conservation.

One such provision is in § 4.09, wherein SJRA retains the right to require a Participant to receive a certain amount of water from the Project. While the 90% clause may have the effect of allowing some level of conservation still to occur, there should be a provision for variances to the provision's requirements, for example if a large-volume customer were to go off line. Generally, a Participant should never be *required* to take more water than it can put to actual beneficial use consistent with reasonable conservation.

18. The GRP Contract should not include provisions that are intended to be, or have the effect of being, punitive.

For example, GRP Contract § 6.01 clearly is intended to force large-volume groundwater users to sign the GRP Contract on SJRA's timetable, without regard for their own due diligence regarding alternative water sources. *New* large-volume groundwater users (as that term is used in the groundwater districts rules) are not charged any sort of catch-up fees at all, even though they benefit in concept from any improvements that have been designed or constructed prior to their joining the GRP. On the other hand, an existing large volume groundwater user who met all of its conversion requirements for years, and paid for its own conversion facilities without burden to the rest of the GRP, but then experienced a failure of supply could be charged exorbitant catch-up fees *in addition to* any actual costs incurred in joining the GRP. This circumstance is contrary to GRP Contract § 6.04(e) regarding fees, rates, and charges being without regard to the time of inclusion within the GRP. In this regard, SJRA should exclude, from catch-up fees, any period of time before which and during which a large-volume groundwater user participated in another compliant GRP.

GRP Contract § 6.01(b) also should be clarified such that the part of the equalization fee that is based on payments that would have been made does not have the potential to include "charges" pursuant to § 6.03.

GRP Contract § 6.01(b) should be modified further to place a duty on the GRP Administrator to try to minimize the costs to late Participants, and his determination of costs should not be subject to sole discretion, but should be considered by the Review Committee.

GRP Contract § 6.03(b) should be clarified such that fines and other costs "recovered" by SJRA from a Participant in violation go to the benefit of the Project, not SJRA, unless SJRA is going to be solely responsible for paying those fines and costs without pass-through to the Project.

Questions:

19. Does the GRP Contract allow SJRA to require a GRP participant to extend retail service to new customers?

20. GRP Contract § 2.02(b) states that SJRA's determination as to which Participants will receive water will be based in part on the capital investment of the Participants in water supply infrastructure. Please explain what particular consideration of this issue is anticipated and how it might affect SJRA's water supply decisions.

21. Does GRP Contract § 3.05 mean that a Participant which is not required, because of its size, to file a conservation plan with TCEQ now must file such a plan consistent with the minimum standards for content of a TCEQ conservation plan?

22. What price will SJRA pay Participants for easements across their property pursuant to GRP Contract § 4.03?

23. Why should SJRA be able to deny a Participant connection to the Project under § 4.04 if that Participant is willing to pay the extra costs?

24. Why do GRP Contract § 4.04 and § 4.09 contemplate that some people may be required to connect to the Project as early as year-2014? Is there intent to begin groundwater reduction before it is necessary for compliance with the groundwater district's rules?

25. To what conditions and standards does GRP Contract § 4.05 refer? Is it state standards?

26. Please disclose specifically, any existing limitations in a permit, certificate, or agreement with a third party that would be within the meaning of GRP Contract § 4.12.

27. Is it correct that "On-site Facilities" are not part of the "Project" even if Project funds are used to pay for them?

28. References are made throughout the GRP Contract to "imported" water, but that term is not defined. For example, GRP Contract § 6.03 refers to a charge on imported water. MUDs 8&9 understand that the term "imported water" does not refer to water reuse, but what does it mean?

29. To what extent will the GRP reimburse the fees that a groundwater user pays to the Lone Star Groundwater Conservation District?

30. GRP Contract § 9.01(d) goes to reimbursing the Authority for the costs of development, including for water supplies of the Authority from the permitted yield of Lake Conroe, both those inside and outside of the Houston contract. How far back is SJRA intending to go under this section in terms of getting reimbursement for expenses incurred before the GRP is effective?

31. It appears from GRP Contract § 9.01(d) that SJRA could compete against the Project for developing new water. Is this the case, or does SJRA have a fiduciary responsibility to the Participants to pursue available water supply first for the Project?

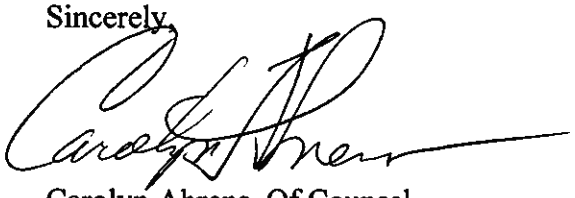
32. It appears that SJRA claims that there is no duty under the GRP Contract to develop new water unless SJRA is reimbursed for doing so, but SJRA can decide when to use Project funds to reimburse itself. How is this loophole reconciled with a good faith obligation under the contract to obtain additional water supplies as needed by the Participants?

33. GRP Contract § 9.05 allows the biggest water users to go together to amend the contract in *any way* and to bind all of the Participants to that amendment without regard to whether or not they agree. How was the 85% figure derived, and what voting blocks does it allow? In a technical respect, it is confusing that this section refers to water usage when "Water" also is a defined term.

34. With regard to GRP Contract § 11.06, why is Board approval not required before a Participant is declared to be in default of the Contract?

Thank you for your consideration and response to these comments. Again, we anticipate making additional comments after an opportunity to review a contract that has been revised through negotiation.

Sincerely,



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