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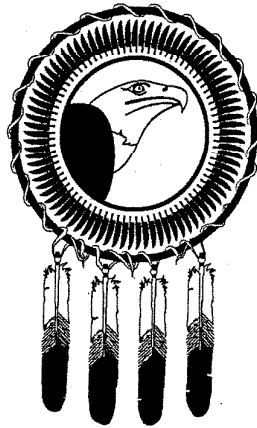
*An Analysis of the Proposed Yellowtail Afterbay Dam
Hydroelectricity Plant on the Bighorn River in Montana*

by

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Executive Summary

At the request of Montana's Crow Indian Tribe, I worked this month on an analysis of their plans to build an 8-megawatt hydropower plant (cost \$20.25 million) and a bypass of the existing Yellowtail Afterbay Dam (cost \$4.75 million) on the Bighorn River.

Crow leaders believe the project, which is needed to help alleviate an environmental problem on the Bighorn River, will be an important source of revenues and employment for tribal members.

My report presents a feasibility study of the project, and outlines expected cost and revenue considerations as well as political issues that may eventually determine the outcome of the project.

Based on estimated project costs and revenues, and on the current low-price abundant power northwest energy market, I have concluded that it would be risky to build the hydro plant with the expectation of marketing electricity to either out of state consumers or Montana electric utilities.

From the standpoint of guaranteeing a secure market, it would make sense for the Tribe to support the passage of congressional legislation allowing the Western Area Power Authority (WAPA) to purchase power from the plant. Unfortunately, the price that WAPA is willing to pay for power at this time is well below rates that would make the project profitable. Therefore, the legislative package would have to include a subsidized rate of payment.

If profitable marketing deal with WAPA can be worked out, there is a legislative precedent for such an arrangement - late last year Congress authorized the Southwestern Power Administration to purchase electricity from a hydro generating facility being built by the Cherokee Nation of Oklahoma along the Arkansas River.

However, before the Crow Tribe can even begin an effort to

influence the passage of any legislation, a jurisdictional dispute needs to be resolved between the Department of Interior's United States Bureau of Reclamation (USBR) and the Federal Energy Regulatory Commission (FERC). The USBR, whose parent agency (Department of Interior) has a trustee relationship with the Crow Tribe, wants to partner with the Crow, and claims jurisdiction for the project based on a legislative mandate to conduct power development operations in the lower Bighorn Region. FERC, however, asserts that it has sole authority license hydroelectric facilities, and is currently considering a license application from the Mitex Energy Corporation of Boston. The outcome of this jurisdictional dispute could be delayed by lengthy court action.

Finally, even if the jurisdictional issue is settled in the USBR's favor, the project will face a major political hurdle. Senator John Melcher (D,MT), the key member of the state's congressional delegation in Washington, is currently unwilling to sponsor legislation that would allow the project to proceed under favorable conditions. Without Melcher on board, hopes for a primary role for the Crow in development of hydroelectric power at the Yellowtail Afterbay Dam are slim.

In summary, there are many tall hurdles that will have to be jumped if the Crow's are to play a major role, and hopefully a successful one, in the development of hydroelectric power at the Yellowtail Afterbay Dam. I would recommend that the Tribe approach its involvement in the project with great caution.

Finally, it should be noted that the appendix of this report contains several letters and documents. I have included this material in accord with Professor Henry Lee's request that this Spring Exercise be organized so as to contribute to the Crow's "institutional memory" about the Yellowtail Project.

BACKGROUND

THE PROBLEM

The Yellowtail Afterbay Dam is part of the USBR's Yellowtail Unit, which also consists of the Bighorn Lake on the Bighorn River, Yellowtail Dam and Yellowtail Powerplant at the toe of the dam. Operations of these facilities provide Montana residents with irrigation water, flood control, and power generation.

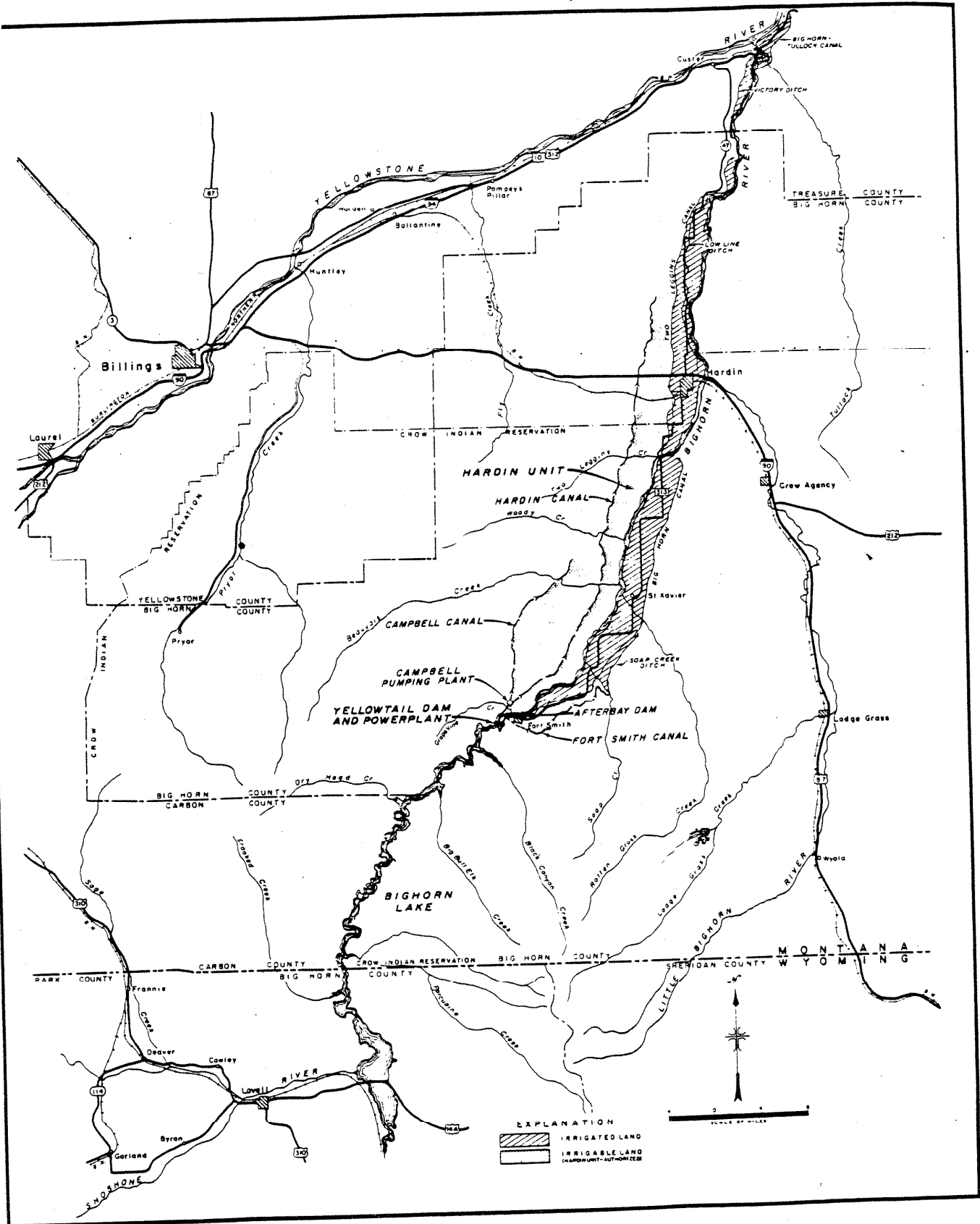
In the 1970's studies conducted by the USBR, the United States Fish and Wildlife Service, and various Montana agencies recognized that discharges over the 3,600 ft. spillway and through the sluiceway of the Afterbay Dam were causing serious nitrogen supersaturation problems downstream in the Bighorn River. Nitrogen supersaturation is most commonly known as the condition that causes deep sea divers to suffer from 'the bends'. In this case, a 'gas bubble disease' causing the deaths of large numbers of downstream 'blue ribbon' brown trout, has been blamed on the condition.

According to a 1984 USBR study, "The best solution to the nitrogen supersaturation problem would be to construct an eight megawatt powerplant and 2,600 ft. 3/s bypass of the afterbay dam." The USBR concluded that construction of both the powerplant and bypass would maintain the gas saturation levels of the Bighorn River about the same as in the afterbay (100 percent), thus eliminating gas bubble disease in the river, and meeting Montana state water quality standards.

THE OPPORTUNITY

There is general political support in Montana for going forward with the construction of a Yellowtail Afterbay Dam hydro plant and bypass. For example, Montana Governor Ted Schwinden, has stated the proposed hydropower plant "promises to solve the (environmental)

PSMBP, Yellowtail Unit



Yellowtail Unit

problem and yield the greatest net benefits." Additionally, Senator Melcher is on record as supporting construction of the hydroplant "as a federally authorized project." (See Appendix VI, Letter Number 1.)

Legislative language authorizing the "Yellowtail Afterbay Power Plant Unit" was approved by the Senate in 1983 (Senate Report #98-137), but later deleted by House-Senate Conferees. In 1984 Senator Melcher worked to obtain a Congressional authorization allowing the USBR to "reprogram" \$100,000 in its Fiscal Year 1985 budget for needed feasibility assessments. At that time officials of the Office of Management and Budget reportedly told the USBR that the agency could not proceed with the study and project development until it lined up a partner to share costs on a 50-50 basis. (See Appendix I., Letter Number 3)

In response to this requirement, the USBR turned to several possible partners, including the Crow Tribe, whose 3,500 square mile reservation surrounds the Yellowtail Unit. Rick Aldridge, an attorney with the Department of Interior Field Solicitor's Office in Billings told me that the USBR decided to partner with the Crow Tribe "primarily because the Department (through the Bureau of Indian Affairs) and the U.S. have a trust relationship with Indian tribes."

The Crow Tribe is interested in the proposed project primarily for economic reasons. The Tribe recently declared bankruptcy and the unemployment rate for the approximately 6,000 tribal members on the reservation is over 70 percent, one of the highest Indian unemployment rates in the country. The project could create job opportunities for about 300-600 workers in the two year construction phase and for a smaller group who would assist with operations over a longer period of time.

PROJECT LICENSING AUTHORITY

BUREAU OF RECLAMATION INVOLVEMENT

The USBR's Yellowtail Unit is a part of the Pick-Sloan Missouri Basin Program. Construction of the Yellowtail Dam was authorized by the Flood Control Act of December 22, 1944 (Public Law 534), which approved the USBR's general comprehensive plan for development of water resources in the Missouri Basin region, of which Pick-Sloan is a part.

Under Section 9 of the Flood Control Act, the USBR was authorized to conduct all power development in the Lower Bighorn River Region. Department of Interior Solicitor's Office Attorney Jan Wade told me that her organization believes the legislation gives the USBR full authority to either build the powerplant itself or allow the construction and operations to be conducted by a non federal party through a "lease of power privilege" (Section 9c of the 1939 Reclamation Act) which is similar to a license. Furthermore, the USBR contends that FERC has no jurisdiction over federal projects where power is an authorized purpose of the project.

The technical planning division of USBR, along with the Western Area Power Authority (WAPA), are ready to write up draft legislation to authorize the project. The draft legislation will designate the Crow's as powerplant and bypass builders under USBR supervision and will authorize WAPA to purchase power at a rate which would provide the Tribe an adequate return on their investment. Furthermore, the Bureau has offered to pick up the costs of constructing the bypass (\$4.750 million).

The Bureau is waiting for the Tribe to demonstrate that is has 100% private sector financial backing for the project design and construction. USBR would also like to see a firm commitment from a

member or members of the Montana congressional delegation to sponsor the legislation.

While the USBR feels there is no need for legislation to grant it authority to allow the Crow Tribe to build the hydro plant, it does feel that congressional approval is required for the private financing arrangement and for authorization of the bypass.

Currently, the Tribe has agreed to put up \$8,000 to finance an economic analysis to see if it is worthwhile to complete feasibility studies and then begin construction.

THE FEDERAL ENERGY REGULATORY COMMISSION POSITION

The Federal Energy Regulatory Commission (FERC), the agency which succeeded the Federal Power Commission, claims that it has sole authority to license hydroelectric facilities.

In 1981 FERC first solicited for applicants to bid on the powerplant and bypass project licenses. Applications were received from the Mitex Energy Co., Energenics Systems Inc. and the Central Montana Electric Generation & Transmission Cooperative. At the time, the Crow Tribe declined to apply, believing that the matter was under USBR jurisdiction and that they had a "first shot" at doing the project with USBR. The Mitex Energy Corporation of Boston was issued a preliminary permit for a major license on May 7, 1984 and a renewed preliminary permit on April 30, 1987 (FERC project application 3749-000).

The Crow Tribe challenged the initial license permit and then also filed an application for license for the site (Project No. 8341-000). In an administrative order on April 30, 1986 the FERC commissioners rejected the Crow's challenge to the Mitex license permit and dismissed their license application. (See Appendix IV, FERC Document Number 5)

FERC environmental and engineering staff members will review the current Mitex application over the next two months to look for possible environmental and safety and adequacy impacts. The staffers will then issue a finding that the application is either acceptable, deficient or moderately deficient, in which case, Mitex will have 90 days to file a revised application. If the application is deemed acceptable, FERC will file public notices in the Federal Register and local newspapers asking for interested parties to comment. Fish and Wildlife agencies would have 30 days to comment.

If there are no negative comments, the FERC staffs will prepare a final report and the licensing order would be issued by the FERC division director in about nine-twelve months. The licensee would be allowed two years to begin construction and four years to complete the project. If objections to the application are raised, or a competitor for the license appears on the scene, the matter would be adjudicated by FERC's Chairman Martha Hesse, and the four senior board members of the Commission.

CHALLENGE TO FERC AUTHORITY

The Bureau of Reclamation challenges the authority of FERC to issue a license for the powerplant and bypass projects, based on its previous legislative authority to manage power generation projects in the Pick-Sloan Missouri Basin Program. Department of Interior Solicitor Attorney Jan Wade says that if FERC does not defer to the USBR's authority on this matter, the Interior Department will likely take FERC to court.

Additionally, the National Park Service has reportedly sent a letter of protest to FERC about the matter. The Park Service is a party in the dispute because the Yellowtail Afterbay Dam and bypass lies within the Bighorn National Recreation Area. The Park Service

also claims that FERC lacks sole authority to issue licenses on land administered by the Park Service. This issue is also the focus of a dispute about the Lake Powell Recreation Area in Arizona.

Due to its limited financial resources, the Crow Tribe has not taken legal action to challenge FERC licensing authority. Additionally, I was told by John Chapman of the Interior Department's Field Solicitor's Office in Billings that "Crow (legal) involvement wouldn't help...FERC seems to be walking by its own drummer, and is not concerned about how many opponents it has."

SUPREME COURT RULING

It is important to note that other Indians Tribes have taken FERC to court, and have won cases that have resulted in limitations to the Commission's powers.

In a 1984 Supreme Court decision that is relevant to the Yellowtail situation, the high court affirmed a 9th Circuit Court ruling that the Federal Power Act did not allow FERC to reject conditions specified by federal land managers to protect reserves under their jurisdiction. The case was Escondido Mutual Water Co. vs. La Jolla Band of Mission Indians (104 S. Court 2105 - 1984.) The court challenge was based on FERC's refusal to concede that agencies such as the Department of Interior and Forest Service function in more than an advisory capacity in the matter of license issuances. The Supreme Court unanimously rejected FERC's reasoning, with Justice Byron White writing the majority position that the Federal Power Act's legislative history "plainly supports" a major role for the federal and management agencies in formulating license conditions.

Based on this ruling, and on the legislative history of the Federal Flood Control Act, I believe a strong legal case can be made

by the USBR to assert its right to issue a license for the project. However, even if the USBR's position is upheld, the issue is likely to be the subject of lengthy litigation. Thus, the first hurdle to the Crow's conducting this project may well be a big one.

ECONOMIC FEASIBILITY

The second major hurdle for Crow involvement in the Yellowtail Afterbay Powerplant Unit are the long term economics of the project. The Tribe asked me to look into the potential for marketing electricity from the project to either out-of-state sources or to public utilities in Montana. I found both options to be potentially promising, but risky at this time.

USING PURPA TO MARKET POWER

One option my study considered was to base marketing of power from the Yellowtail Afterbay hydro plant on provisions of a bill that encourages the construction of small power production units. The legislation, titled the Public Utilities Regulatory Policies Act (PURPA) was passed by Congress in 1978 as part of President Carter's comprehensive energy plan. The intent of the bill is to provide small scale power producers with a guaranteed market by requiring electric utilities to purchase power produced from qualifying cogeneration and small production facilities at a rate not to exceed the "incremental cost to the utility of alternative electric energy". This "full avoided cost" is defined as the cost to the electric utility of the electric energy it would generate or purchase from another source if not purchased from the cogenerator or small power producer. The "avoided cost" includes the capital costs and fuel costs that the utility can avoid by buying power rather than building its own new plants.

If the Crow Tribe decides to develop the powerplant solely with its own resources, or with an assist from another private backer, the Tribe would be eligible for the benefits of the PURPA regulations. This is because 1) The Tribe is not solely in the business of marketing power; 2) The powerplant would produce less than 80 megawatts at the site and 3) The power will be supplied from renewable resources. The benefits of marketing power through PURPA regulations include exemption from regulations that cover the electricity utility industry. Another provision in the PURPA law, providing for promised loans to project developers for feasibility studies and construction costs (Sections 402 and 403 of PURPA 2702 and 2703), unfortunately has not been funded by Congress.

Marketing power under PURPA can provide long term benefits. Contracts for energy providers under PURPA contain clauses for escalating prices with inflation. Also, if the hydro plant can be constructed and operated well under the cost that utilities have to pay to build additional generating facilities, the small power generator stands to make a large profit. The downside of marketing power under PURPA is also great. If the price of electricity is very low, as it is now in the northwest, initial revenues may be dwarfed by debts. Unanticipated construction and operations costs can also lead to excessive 'red ink'.

Due to the current cheap and plentiful status of power in the northwest, it does not appear that the Tribe could market electricity under PURPA regulations at a break even rate. In 1986, the Montana Power Company calculated the avoided cost for power from the Yellowtail Afterbay Powerplant in October 1986 at 41 mills/kilowatt hour. The USBR concluded in a study for the Tribe that, "In the private market, the power could be marketed for an estimated 41

mills, as stipulated by PURPA, at a rate of return of about 4.4 percent. At higher rates of interest, the income from the powerplant under PURPA would not be adequate to pay off the loan."

Even with a rate of return of about 4.4 percent and with a low interest rate, the Tribe would be in danger of losing the opportunity to earn more income, depending on the return they could receive from other viable projects or investments such as treasury bills or money market funds. For example, the federal government generally engages in major capital projects if the expected rate of return is greater than 10 percent. If the rate of return is significantly lower, a so called "opportunity cost" for losing more lucrative investment options is incurred.

Based on the analysis conducted by the USBR, I have drawn up a preliminary chart that shows healthy revenues can only be achieved by mill rates over 48 mills per kw/hr:

Mill Rate	Total Annual Income (After Year One)	Investment Cost	Internal Rate of Return
48	\$1,947,000	\$20,250,000	8.71%
54	\$2,050,000	\$20,250,000	9.86%
56	\$2,312,000	\$20,250,000	10.28%

REGIONAL POWER NEEDS

Western power experts I talked to believe that in the long term, user demand for power in the area will not increase significantly. Van Jamison, Director of the Energy Division of the Montana Department of Natural Resources notes that the North West Power Planning Council expects "medium load growth will not require new power generation facilities out into the 1990s and perhaps up until

2002."

Current inexpensive power rates are due in part to reduced demand for electricity in the stricken Montana aluminum and lumber industries.

In order to sell off its surplus power, the Montana Power Company is trying to market energy produced by its coal fired plants to a number of California utilities. As part of this strategy, Montana Power will purchase backup power from a number of PURPA qualified utilities. Contracts for these purchases have already been let. Therefore, it is unlikely that Montana Power would have a strong interest in purchasing electricity from the Yellowtail Afterbay Hydro Plant, unless any of Montana Power's current contracts fall through.

OUT OF STATE MARKETING

The power supply in the northwest is so overabundant that the adjacent Boneville Power Administration's 1986 budget cut conservation programs in half. Turning east, base officers at Ellsworth Air Force Base, South Dakota told me that their energy needs are well taken care of.

Given this situation, it does not make much sense for the Tribe to attempt to market the power to out of state sources by entering into a "wheeling" agreement with the Montana Power company to carry the electricity on their lines to an out of state source for a fee.

LEGISLATIVE PRECEDENT

The most direct, and perhaps only viable way to make the Yellowtail Afterbay Hydro plant and bypass profitable, is to seek legislation that guarantees a power user will purchase the generated electricity at a subsidized rate. The USBR believes that based on a 50 year lifetime the rate to cover power costs would be 49 mills for

the powerplant.

The Crow's are basing their legislative strategy on the success of the Cherokee Nation in gaining passage of legislation (Senate Bill 1724) allowing them to work with the Army Corps of Engineers to build a hydro project at the W.D. Mayo Lock and Dam along the Arkansas River. The legislation, which was co-sponsored in the Senate by Senators David Boren (D,OK) and Don Nickles (R,OK) and sponsored in the House by Representative Mike Synar (D, OK-Tulsa), allows the Cherokee Tribe to build the project, and once completed, turn it over to the Corps of Engineers for management. (See Appendix III, Document Number IV.) The power for the project will be marketed to the Southwestern Power Administration, which will pay a subsidized rate for the power that will allow the Cherokee to repay the principal and interest and gain a reasonable royalty. The legislation releases the U.S. government from responsibility for any claims or liabilities which may arise from the design and construction of the plant.

There were four main reasons for the passage of this legislation. First, the Cherokees' had the benefit of a Supreme Court ruling that they own the riverbed under the dam in question. Second, they had **complete underwriting** from the investment firm of Smith Barney. Third, the economics of the marketing arrangement were solid, based on a **high avoided cost** for power in the region, due to the reliance of utilities on **relatively expensive** oil and gas power sources. And finally, the Cherokee Nation cultivated **good relations** with their congressional delegation.

PITFALLS OF LEGISLATION

Although some of the provisions in the W.D. Mayo Lock and Dam legislation may be applicable to the Yellowtail situation, there are also some 'trap doors' in the bill that are worthy of mention.

Douglas Yorke, Vice President of Public Finance for Wertheim Schroder & Co., notes that the "no federal indemnity" clause of the Mayo bill means that the Cherokee Nation is liable if cost estimates are understated, or if the hydro plant design turns out to be faulty.

Additionally, as is noted above, the Oklahoma project is being conducted in a region where power rates are much more favorable to small power generators. Conversely, the Western Area Power Administration, which relies chiefly on cheap hydroelectric power, purchases electricity for a very low rate. WAPA's Dale Corey quoted a price for me of 7.44 mills per kilowatt/hour and said a special arrangement would probably have to be worked out to get the price up to 49 mills per kilowatt/hour.

CONGRESSIONAL REACTION

If the hurdles of jurisdiction and economic viability are surmounted, the matter of acquiring congressional support for desired legislation must then be addressed. All parties I spoke with agreed that Senator John Melcher (D,MT) will be a vital player in this process.

Crow members acknowledge that the tribe has recently had a rocky relationship with Senator Melcher. Clairra Spotted Elk, a legislative aide for the Senator, said he has "serious concerns about the financial stability and over all management capabilities of the Tribe...He can't introduce legislation on their behalf until they demonstrate more financial stability." Another problem that she cited as influencing the Senator's thinking was Crow attempts to tax utilities that operate on the reservation.

However, Ms. Spotted Elk did say that the Senator supports the general concept of the project. Also, staff aides to Congressmen Marlenee (R,MT-East) and Pat Williams (D,MT-West) expressed general

support for the project. Williams' aide Kurt Christiansen said, "We would be supportive of what they (Crow Tribe) want to do as long as there is a need. The new tribal council seems to want to do responsible things."

CONCLUSION

The Crow Tribe's desire to achieve revenues and job opportunities from construction of the powerplant and bypass is commendable. However, expectations for this project should be tempered by a critical look at the politics and economics surrounding the matter.

In response to the political issues, there is not much the Tribe can do about the jurisdictional battle between the USBR and FERC. But positive steps can be taken to improve tribal relations with Senator Melcher and the other members of the Montana congressional delegation.

In regard to the economics of the project, my analysis of the power market in the northwest leads me to recommend caution about any final commitment to the hydroplant construction job. Whether power from the hydroplant is marketed to utilities through PURPA or directly to WAPA, the supplier should fully understand current and future estimated cost and revenue projections. Three essential questions need to be answered by the Tribe. First, does a truly profitable market exist? Second, would the potential liability of the tribe for the success of the construction process add significantly to their financial risk? And third, are there other projects or investment opportunities that would provide revenues and job opportunities for the tribe at less risk.

If this report has struck too much of a cautionary note, I accept the responsibility for not thinking with the same vision as

the Crow leadership. If they are able to win out in the jurisdictional battle, gain the passage of legislation that is carefully worded to protect their interests, and line up the necessary financial and hydro plant construction support, the project may well succeed. In any event, I wish them the best in their endeavors.

APPENDIXES

Appendix I. United States Bureau of Reclamation Documents

1. Pick-Sloan Missouri Basin Program Yellowtail Unit Description
2. Letter from Robert Broadbent, Commissioner USBR to Kenneth Plumb, Secretary, Federal Energy Regulatory Commission, February 6, 1982
3. Letter from Robert Madsen, USBR Deputy Regional Director to the Montana Department of Natural Resources, January 17, 1985.
4. Letter from Joseph Marcotte, USBR Regional Director to Montana Governor Ted Schwinden, February 20, 1985.

Appendix II. Department of Interior Documents

1. Letter from Robert Broadbent, Assistant Secretary for Water and Science to Montana Governor Ted Schwinden, July 11, 1985.
2. Letter from the Assistant Secretary for Fish and Wildlife and Parks to William Fowler, Project Manager, Mitex Inc. Boston, December 12, 1985

Appendix III. Legislative Documents

1. Public Utility Regulatory Policies Act of 1978 as Amended (Section 210)
2. FERC Regulations Implementing Section 210
3. House Report 4275. Authorizing legislation (later deleted) for the Yellowtail Afterbay Powerplant Unit (Section 105 (b) (2)). November 1, 1983.
4. Senate Bill 1724, Section 1117. Authorizing legislation for the W.D. Mayo Lock and Dam. October 1986.

Appendix IV. Federal Energy Regulatory Commission Documents

1. Notice of Application for Preliminary Permit Project No. 3749-000 Mitchell (Mitex) Energy Company. February 20, 1981.
2. Order Finding Commission Jurisdiction, Issuing Preliminary Permit and Denying Competing Applications, May 7, 1984.
3. Letter from Charles McManus Jr., Manager Congressional Liaison Staff to Senator John Melcher, June 26, 1984.
4. Terms and Conditions of Preliminary Permit, Oct. 1985.
5. Order Denying Late Intervention, Dismissing (Crow Indian Tribe) Application for Rehearing, and Dismissing License Application. April 30, 1986.

Appendix V. Montana Governors' Office Documents

1. Letter from Governor Ted Schwinden to Secretary of Energy Donald P. Hodel, March 6, 1985

Appendix VI. Senator John Melcher Documents

1. Letter from Senator Melcher to Kenneth Plumb, Secretary, Federal Energy Regulatory Commission, June 7, 1984
2. Letter from Senator Melcher to Jack Acord, Montana Department of Natural Resources and Conservation, June 8, 1984

APPENDIXES CONT.

Appendix VII. Montana Department of Natural Resources and Conservation Water Resources Division Documents

1. Letter from Director Leo Berry to Joseph Marcotte, Regional Director, Bureau of Reclamation, August 30, 1982
2. Letter from Assistant Administrator John Acord to Senator John Melcher, May 8, 1984
3. Letter from Director Leo Berry to William Fowler, Project Manager, Mitex Inc., August 6, 1984
4. Letter from Administrator Gary Frittz to Robert Madsen, Bureau of Reclamation, November 2, 1984
5. Letter from John Tubbs, Research Economist to William Fowler, Project Manager, Mitex Inc., April 21, 1986

Appendix VIII. Montana Department of Fish, Wildlife and Parks Document

1. Letter from Larry Peterman, Water Resources Supervisor, Fisheries Division to William Folwer, Project Manager, Mitex Inc., April 23, 1986

Appendix IX. Mitex Inc. Documents

1. Letter from William Fowler, Project Manager, to Leo Barry, Director Montana Department of Natural Resources and Conservation, July 23, 1984
2. Letter from William Fowler, Project Manager, to Department of Interior, Assistant Secretary for Fish, Wildlife and Parks, January 20, 1986.