



Holden Kidwell
Hahn & Crapo P.L.L.C.
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DEPARTMENT OF
WATER RESOURCES

1000 Riverwalk Drive, Suite 200
PO Box 50130
Idaho Falls, Idaho 83405

Tel: (208) 523-0620
Fax: (208) 523-9518
www.holdenlegal.com
E-MAIL rharris@holdenlegal.com

September 1, 2008

Gary Spackman
Idaho Department of Water Resources
PO Box 83720
Boise, ID 83720-0098

RE: Application for Water Right Permit No. 35-13542 in the Name of South Interchange Properties, LLC.

Dear Gary:

This letter is in response to a draft memorandum dated June 17, 2008, to Jeff Peppersack from Mat Weaver of IDWR regarding multiple mitigation plans presented for Application for Permit No. 35-13542 (the "Application"). We received a copy of this draft memorandum a few weeks ago, without any attachments. We were under the belief that we would receive a final draft of the memorandum, along with the listed attachments. We have not yet received any such materials, but request such materials to be sent.

Assuming that no changes have been made to the memorandum, we wish to respond to some of the information contained in that memorandum. Additionally, we wish to recount the path we have undertaken thus far to try to finalize this matter which has gone on for nearly three years.

The Application was advertised without any protests, and since the application was submitted in 2005, Mr. Kent Foster, who is now retired, and myself, have tried to provide information to the Department which they have requested to satisfy IDWR's mitigation policy. The difficulty we have faced is that the mitigation policy is not contained in any official Department rule, memorandum, or handbook. Mr. Weaver's memorandum provides yet another additional set of information and rules which we have not been aware of. We are frustrated with this process, and from our perspective, the back and forth on this application has gone on for way too long. Further, the level of scrutiny placed by the Department for 7.4 acre feet of consumptively used water under the application is extraordinary.

On October 20, 2005, South Interchange Properties, LLC, submitted the Application, which sought commercial and industrial use for 0.2 cfs and up to 140 acre feet per year. South Interchange Properties, LLC is affiliated with Melaleuca, Inc. Melaleuca is one of the largest employers in

Established in 1896

eastern Idaho, and last year had global sales of 859 million dollars. The Application was necessary for Melaleuca to service a new distribution facility located at the south interchange of Idaho Falls on Interstate 15. In the Application submitted by Mr. Kent Foster, we provided information to IDWR regarding what we anticipated would be the annual consumptive use for the water. The total predicted consumptive use, was five percent (5%) of the 140 acre feet per annum volume requested, which equates to 7.4 acre feet. We also informed the Department that the remaining 132.6 acre-feet would be treated a new state-of-the-art wastewater facility, the Oxbow Wastewater Treatment Facility, which is located near Shelley, Idaho. In Mr. Weaver's memo, he notes that the point of diversion requested in the Application is located near the town of Shelley.

Based on some of the initial conversations Mr. Foster and myself had with Mr. Shelley Keen of your office, the short travel distance for the wastewater between the distribution facility and the Oxbow Wastewater Treatment Facility of a few miles was enough for Mr. Keen to raise concerns regarding appropriate mitigation. From our perspective, the location of the point of diversion and discharge into the Oxbow facility, where it will be treated, is so close that any effects on any of the river reaches or the aquifer would be minimal and unmeasurable. In similar applications which we have processed with the Department, it is our understanding that the Department typically presumes that water treated in a septic system on-site is non-consumptive, and therefore mitigates for any of the effects from the withdrawals caused when the water was diverted in the first place. It seems that the Application should be afforded the same presumption. Nevertheless, IDWR has apparently made a distinction in this case. While we disagree with the distinction, we nevertheless felt it would be a better approach to work with IDWR in good faith to agree on a more acceptable mitigation plan.

Unfortunately, all of our proposals had been met with a resounding "no" response from the Department, and our presumption that IDWR would negotiate in good faith seems to have been a mistake. At this point, to ensure that we are all very clear on IDWR's position on each of the mitigation plans we have proposed, we wish to recount them and have IDWR formally respond to each of them, beginning with the above discussion regarding the location of the Oxbow facility. The below proposals are listed in order of preference. We request that IDWR explain why the Application is not given the same presumption most non-consumptive water rights are given, namely, that on- or near-site return to the aquifer mitigates for pumping effects. To the extent IDWR policy is explained in IDWR's response, we request that any Department rule, memo, or document, whether internal or public, be provided to us in writing so that we can fully understand the Department's mitigation plan review process.

MITIGATION PROPOSAL NO. 1:

In one of the original letters provided by Mr. Foster, he informed the Department that approximately 80 acres of land owned by South Interchange Properties, LLC, would likely be developed, and irrigation on the 80 acres would cease. Mr. Foster asked whether or not the drying up of 80 irrigated acres would be enough to mitigate for 7.4 acre feet of consumptive use.

Based upon information from the ETIdaho website for consumptive use of alfalfa (less frequent cuttings), the consumptive use for an acre of alfalfa, which has been historically grown on the property, is approximately 2.5 acre feet per year. This means that for 7.4 acre-feet, it would be necessary for us to mitigate for approximately 3 irrigated acres of alfalfa. At 2.5 acre feet per year per acre, multiplied by 80 acres, this equals 200 acre feet per year of consumptive use. As we understand the Department's response to this argument, we have heard varying rationales for not accepting the drying up of lands within an irrigation district as appropriate mitigation. These arguments include: 1) without a formal change of the irrigation district's water rights, this cannot be appropriate mitigation; 2) the applicant must be able to guarantee non-diversion at the headgate for the mitigation; and 3) because irrigation districts will simply use the water elsewhere within their service area, the drying up of acres within the irrigation district is not truly mitigation. We would like to briefly respond to each of these criticisms.

The first criticism—that without formal change of the irrigation district's water rights, mitigation is not sufficient—ignores the reality that an irrigation district holds multiple water rights, and it would be necessary to file an application for transfer to split off a sliver of each of those rights for mitigation.¹ Members of the Board of these irrigation districts do not look kindly on any type of administrative action that would further split their water rights.² Therefore, as a practical matter,

¹ This assumes that mitigation must be added formally to a water right. It is our understanding that mitigative uses should be added, but we have heard through informal discussions with non-Departmental individuals that this philosophy may be changing. We note that agreements for ground water users to not divert in response to IDWR water calls does not require a transfer to add a mitigation nature of use. Additionally, when storage water is used for fish flow augmentation, no such transfer is likewise required. It would be help to have an official statement of IDWR present position on this matter, specifically, is mitigation an incidental use of all water rights, or is it necessary to file an application for transfer to add this nature of use?

² This concern has been expressed to Department personnel—specifically, Jeff Peppersack, Shelley Keen, and Ernie Carlson—in preparing a pilot project proposal for the Grand Teton Canal Company. Additional information relative to this concern could be obtained through them.

this is simply not an option because an irrigation district board will likely never agree to the multiple split of their water rights.

The second criticism from the Department—that the applicant must be able to guarantee non-diversion at the headgate—ignores the reality that irrigation districts typically divert water available under the totality of their rights and rotates the physical water diverted amongst its members in times of shortage. Previous to their formation, members of irrigation districts banded together in a cooperative manner so that water could be provided to each of them based upon their individual needs and circumstances, even on a rotation basis if necessary. To reduce the amount that could be diverted simply ignores the internal workings of an irrigation district and the very basis for an irrigation district's formation.

The third criticism—that irrigation districts will simply use the 80 acres of water elsewhere within their service area—ignores the Department's own scientific data. As stated above, irrigation districts will divert the full flow of their water rights, and the patrons will use the water as necessary. The South Interchange Properties, LLC property is located in the New Sweden Irrigation District. As you are aware, New Sweden diverts primarily from two major canals: the Great Western Canal and the Porter Canal. It is my understanding that South Interchange Properties area is serviced by the Porter Canal, which eventually reconnects back into the Snake River where unused water is returned to the river. Therefore, it would be assumed that water diverted fully under the irrigation district's water rights which is not use, would therefore return to the river, and thereby provide mitigation for the Application under the presumption that the water would not be diverted developed property.

In addition, assuming that the water is actually diverted by another water user within the system, there would still likewise be mitigation provided by the retirement of up to 80 acres by the applicant. The water used on the South Interchange property could be used on another property, which would provide additional water for crops, and thereby cause additional consumptive use. However, even with the additional consumptive use, here is still an amount of this water which returns to the aquifer. Based upon our understanding gained through the years, it is our understanding that it is commonly presumed that approximately half of the physical water applied to a crop is consumptively used, while the other half returns to the aquifer. Therefore assuming the 80 acres worth of water historically used on the property is used on another piece of property, approximately 40 acres of that water would return to the aquifer. This amount of return flow would clearly be above and beyond the mere 7.4 acre feet consumptively used historically on South Interchange property. Indeed, it appears that it would mitigate for the consumptive use multiple times over.

We note additionally that there is conveyance loss within New Sweden canals. This recharge water alone would appear to offset the 7.4 acre feet of consumptive use.

In sum, it appears quite clear to us that the drying up of 80 acres would mitigation for the consumptive use of 7.4 acre-feet under the Application. We request that it be accepted as adequate mitigation. To the extent IDWR does not agree that it is adequate mitigation, we request that the Department provide a formal response and/or rebuttal to the above information, and to cite to any administrative policy or procedure it has promulgated, whether public or internal. Further, we request that if this mitigation proposal is unacceptable, that IDWR provide us with suggestions or information that would make it acceptable.

MITIGATION PROPOSAL NO. 2:

The second mitigation plan proposed by South Interchange Properties is one that I believe has been discussed before with Department personnel, but was never formalized in writing to the Department as to this specific Application. This specific mitigation plan is simple: South Interchange Properties, LLC, would join a groundwater district for mitigation purposes in the event administration of the Eastern Snake Plain Aquifer is ordered by the Director of the Department of Water Resources.

The Department is surely aware of the operation of a groundwater district, and we do not intend to recount their workings in this letter. Generally speaking, however, the Director of the Department of Water Resources makes a yearly determination of injury to the surface water coalition members located primarily in southern Idaho, and then assigns to each groundwater district a specific amount of water that must be provided for mitigation. South Interchange Properties, LLC would be willing to contribute to such a groundwater district for mitigation purposes.

Joining a groundwater district is perhaps the most logical approach, as South Interchange Properties would be providing mitigation water at times when water users are actually injured. It is our position that joining a groundwater district would be adequate mitigation. To the extent IDWR does not agree that it is adequate mitigation, we request that the Department provide a formal response and/or rebuttal to the above information, and to cite to any administrative policy or procedure it has promulgated, whether public or internal. Further, we request that if this mitigation proposal is unacceptable, that IDWR provide us with suggestions or information that would make it acceptable.

MITIGATION PROPOSAL NO. 3:

Yet another mitigation plan proposed by the applicant was to have Mr. Frank Vandersloot, the Chief Executive Officer of Melaleuca, Inc., who is the holder of an irrigation groundwater right near the South Interchange Properties area, to dry up four or five acres under his water right to mitigate for the 7.4 acre feet of consumptive use.

In response to this proposal, the Department responded that it would be necessary to dry up approximately 40 to 45 acres of this groundwater right to mitigate for a mere 7.4 acre feet of consumptive use. In reviewing the file, I have not found any written discussion of why such a large amount of acreage would be necessary to dry up. It therefore appears that information relative to this proposal was discussed verbally, and not formalized in writing. Presumably this is because drying up of these acres was modeled under the Department's model. We would request the Department provide to us its analysis of why this mitigation plan would not work. We request that the Department cite to any administrative policy or procedure it has promulgated, whether public or internal. Further, we request that if this mitigation proposal is unacceptable, that IDWR provide us with suggestions or information that would make it acceptable.

MITIGATION PROPOSAL NO. 4:

On September 26, 2006, after receiving multiple denials in response to previously proposed mitigation plans, the Applicant presented an alternative mitigation proposal which would dry up acres on lands with water rights tributary to the Henry's Fork of the Snake River, and release water from Palisades Reservoir for impact on the South Fork of the Snake River.

As we understand the Department's transfer tool, it is primarily based upon a model which predicts impacts from groundwater pumping from the Eastern Snake River Aquifer upon various reaches of the Snake River. Based upon the Department's running of the model as to this application, it determined that the primary reaches it was concerned about were the Rexburg to Henry's Fork reach and the Heise to Shelley reach of the Snake River. We should note that no resident, either above or below the project area, protested the application.

In another mitigation proposal, we proposed yet another mitigation plan wherein lands irrigated water from Blue Creek, which is tributary to the Henry's Fork of the Snake River, would be dried up to mitigate for affects determined under the transfer tool. Additionally, we proposed that the applicant would use up to 13.8 acre feet per year which it would release from Palisades Reservoir, pursuant to its shares in Palisades Water Users, Inc.

Initially, the proposal seemed to be acceptable to the Department. After the proposal was made, we were asked to provide delivery documentation proving that water was historically available under the Blue Creek water right. We reviewed Water District 01 records, summarized them in an easy to follow spreadsheet, and provided it to the Department early this year. We heard nothing with regards to this information until we received Mr. Weaver's memo. Based on Mr. Weaver's memo, this mitigation plan has likewise been rejected by IDWR.

In Mr. Weaver's analysis of our mitigation plans, he first takes issue with the stepped up mitigation approach which we have proposed. He would recommend that we mitigate for the entire amount once we begin diverting groundwater. In his words, "this would lead to a simpler implementation of mitigation waters on the part of the applicant, and a lesser effort required by the watermaster in ensuring the water has proper volume is being used for their intended purpose." Later on, Mr. Weaver also proposes that rather than using a full consumptive use volume, he would prefer to take an average. This appears to be an attempt by the Department gain a double benefit on the amount of acres that would be necessary for mitigation, but nevertheless note that Mr. Weaver would propose we dry up 10.4 acres of ground, where we proposed to dry up 10. We would certainly agree to the drying up of 10.4 acres, if this would satisfy the Department.

Additionally, Mr. Weaver indicates that no consent document signed by Palisades Water Users has been provided to IDWR. As the attorneys for Palisades Water Users, Inc., we can represent to the Department that it is the policy of Palisades Water Users, Inc. to allow their shareholders to use their shares as they see fit, as long as such use does not violate Idaho law. It is our understanding that mitigation is a recognized beneficial use, and as such, can represent to the Department that the company has no issue with the applicant's proposal.

In addition, Mr. Weaver states that:

"In a phone conversation with Joe Kauffmann, he indicated that Water District 01, will not accept the use of storage rights in the Palisades Reservoir for mitigation unless a specific entity has been identified as being injured and the recipient of mitigation water. Currently the accounting system and software for Basin 01 cannot accommodate the delivery or accounting of mitigation water to a general reach of the river as proposed by the applicant."

Additionally, Mr. Weaver apparently takes issue with the fact that the mitigated water to the reach of the Snake River is some miles from the actual location of the groundwater diversion. We are puzzled to say the least. As I understand the groundwater model, reaches of the Snake River

delineated under the Department's model extend over large distances of the Snake River. There is no policy or procedure which we are aware which indicates we have to deliver any mitigation water to a specific point along that reach. Presumably, retiring acres or releasing water within that reach would mitigate for the effects groundwater pumping would have on that reach. In other words, releasing water to the river, or retiring acres that could use water which would eventually make its way to the river, is adequate from our perspective. We do not need to deliver it to a specific point.

Additionally, we are at a loss in how to respond to Mr. Weaver's recount of his phone conversation with Mr. Kauffmann. Basically, it sounds as though the Department will not accept a mitigation plan until and unless we identify a specific canal heading with which to provide the mitigation water. Presumably the canal would be owned by the person or entity who is alleged to have been injured by the applicant's application. No such protestant exists.

In the context of this Application, the only protestant is IDWR. We therefore request that the Department, as protestant, inform us of the canal heading or other structure with which it desires to have storage water delivered from Palisades Reservoir if it determines that this mitigation plan would be acceptable.

Additionally, we have heard that the Department has recently accepted mitigation proposals which combine modeled impacts from two or more reaches of the Snake River. We have received no written document providing for such a policy, or written document recounting such policy, and indeed, acknowledge that such a policy may not exist, and perhaps we have been incorrectly informed. Nevertheless, to the extent this policy is in effect, it would be our preference to combine the Henry's Fork of the Snake River with the South Fork of the Snake River as one reach, and provide mitigation simply by drying up acres on Blue Creek—which would presumably be more than the acreage initially proposed— and avoid the release of storage out of Palisades Reservoir. This would procedurally and administratively be the simplest way to mitigate for the perceived impacts from the Application.

To the extent IDWR does not agree with this mitigation plan, we request that the Department provide a formal response and/or rebuttal to the above information, and to cite to any administrative policy or procedure it has promulgated, whether public or internal. Further, we request that if this mitigation proposal is unacceptable, that IDWR provide us with suggestions or information that would make it acceptable.

CONCLUSION

We are now approaching the three year anniversary of when the Application was originally submitted to IDWR. While we would prefer to wait to receive the Department's response in writing, if the Department's response is anything like the draft memo we recently have received, we anticipate we will receive multiple denials of the above mitigation proposals. In that event, we request that the Department submit to us a reasonable and acceptable mitigation plan. We understand this is not normal or typical Department procedure. Nevertheless, we, as consultants for South Interchange Properties, are at a loss as to how we move forward from here. Typically, in a legal context, the parties come to the table and clearly express their concerns and what would be acceptable to the other party to resolve a potential dispute. Resolution is never reached by trying to read the other party's mind. We have done our best to provide multiple mitigation plans to the Department, all without success.

At this point, it appears the best course for both parties would be for the Department to provide to us a mitigation plan that would be acceptable. Such a mitigation plan should address issues such as water delivery location, and other issues typically raised when a separate party protests an application for permit. Given the long time frame that has passed with regards to this Application, this seems to be the most efficient way to finally bring this matter to an end.

Alternatively, if IDWR refuses to provide a mitigation plan to us, please provide us a list of consultants that we might employ to produce a mitigation plan acceptable to IDWR. When we began this process nearly three years ago, we presumed that based upon our understanding of IDWR's policies and procedures and Idaho water law, we would be able to assist our client accordingly. Perhaps times have changed such that only a select few can actually navigate their way through the mitigation process. If so, please provide us the list of the select individuals who have had success in this process.

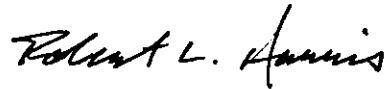
We are providing copies of this letter to individuals at the Eastern Region office of IDWR, and to Director Tuthill, so they can be aware of the current status of the Application. We believe it will be helpful to involve Director Tuthill in the review and analysis of these discussions. It would not be in the best interests of the State of Idaho for a company like Melaleuca to be delayed in its economic progress by 7.4 acre feet of consumptively used water .

To the extent you would like to have any meetings to discuss the proposed mitigation plans, either by phone or in person, we would be happy to accommodate such a request, and would

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encourage such meetings so we can discuss these issues and finally bring this matter to close. We certainly look forward to your response.

Best Regards,



Robert L. Harris
HOLDEN, KIDWELL, HAHN & CRAPO, P.L.L.C.

c: Ernie Carlsen
Troy Petersen
Director Dave Tuthill