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## liquid assets: turning water into gold part II

### **A radical new vision**

**One ambitious man turns 1 acre of rural land into a tiny government with big powers to buy water to resell it to future developments. Some see a novel solution; others protest that it's plain old speculation.**

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In a conference room of a plush law office at Denver's Tabor Center, officials from a groundwater-dependent Arapahoe County water district waited to buy rights to draw nearly 2 billion gallons of water a year from the South Platte River basin. In another room down a sleek, curving hallway sat T. David Perkins, the seller of a defunct Colorado hog farm that came with abundant water.

Between them, a serious, stocky man made numerous trips over smoke-gray carpet from room to room, poring over maps and contracts. That man, Robert Lembke, is more than your average businessman. He had also formed a special government district, on a little patch of land in Elbert County, whose mission is to become an unprecedented Colorado wholesale water network.

When they were done, 12 hours later on that day two years ago, a Lembke company pocketed an immediate \$1.2 million - and a written commitment of \$20.5 million more from his newly created government. The East Cherry Creek Valley Water and Sanitation District got rights to a renewable water supply, but the cost of each new home in the district shot up \$3,000 and continues to grow \$1,500 a year. Water rates for 50,000 people jumped \$22 a month.

And Colorado's century-old system of allocating water was facing the prospect of radical change.

"Some think this is brilliant and wonderful," Lembke said. "Some think I'm the devil incarnate."

There's not much to see at the United Water and Sanitation District.

It consists of a 1-acre patch of grass and thistles in rural Elbert County. No one lives there. There are no buildings - not even a shed - in this special government district. No water or sanitation lines run through it. There is no reservoir or water tank. Nor are there plans for such things.

The district has no customers in the county that authorized its creation. Elbert County records list the acre as a helicopter pad site.

It's just a piece of ground to meet the legal requirement that special districts have defined boundaries. Yet it serves as the vehicle for an ambitious scheme to create a water network serving future developments throughout Colorado's booming Front Range.

"United," Lembke said, "is an animal no one has seen before."

Already, every East Cherry Creek Valley homeowner is paying a monthly surcharge for a pipeline and other facilities needed to bring the water Lembke sold, and his district gets \$6,600 of the \$16,500 hookup fee on every new house. Ultimately, Lembke's district could reap close to \$22,000 from each new home in the valley.

In return, Lembke has promised to turn the water rights he bought from Perkins, and water rights he is buying from farmers along the South Platte River, into much-needed water for their faucets.

One other developer already is looking at Lembke's model and has formed a 1-acre wholesale water

district.

Water brokers make millions in Colorado by navigating the state's jumbled water ownership records to connect sellers who no longer need their water and buyers who do. But if Lembke's plan survives the court challenges that await, he would take that business model a step further: He could buy and hold water, then find customers for it, the same way a gas or electric company does.

But unlike the gas company, Lembke has taken on the form of a government. As a private company, he wouldn't be allowed to amass water rights for prospective customers because that would violate the long-held Colorado legal principle barring "speculation" in water ownership. As a government, he could.

"It's the great-and-growing cities doctrine," said state engineer Hal Simpson, who administers Colorado's water rights system. Like more traditional governments, special districts are "the one group out there that can get around the anti-speculation doctrine."

Critics decry Lembke's special district as a business masquerading as government. They fear it could lead to private water monopolies and unconscionable profits from a treasured public resource.

"Everybody calls Bob Lembke a big speculator up and down the river," said Steven Sims, a water attorney for Aurora, which is challenging Lembke in state water court. "He's going out and offering to buy a lot of water rights. And he's going out and offering to sell a lot of water rights."

Advocates say Lembke's ideas are just the kind of innovative problem-solving needed to deal with the pressures a growing population puts on Colorado's complex water rights system.

They contend his model can bring water to homeowners at competitive prices and simultaneously offer more money to farmers and ranchers, who use about 85 percent of Colorado's water.

David Kaunisto, East Cherry Creek Valley's manager, said farmers north of the district had talked for years about offering water for municipal use. But until Lembke came along, "we were just kind of spinning our wheels and never got anywhere," he said.

Lembke's acre and the vision it represents sprang from the former tax and real estate attorney's introduction to the world of developers.

He and Theodore Shipman, owner of several Colorado Wendy's restaurants, bought thousands of acres of cheap land as courts auctioned and sold properties financed by savings and loan institutions that failed in the late 1980s.

With little experience, they scooped out the footprint for what is now the Bromley Park development in east Brighton.

Today, Lembke and his partners own about 19,000 acres in booming Adams, Elbert and Weld counties.

He quickly learned the importance of getting water to his developments.

With water and infrastructure, a \$300,000 chunk of dry land can become a \$30 million property, he said. Without it, it's just dirt.

Lembke also learned the importance of special districts. He decided to form his own - with a twist.

"The thing that made United unique," he said, is that it was not designed to serve a particular development. "We disconnected it from land."

Special districts have become a powerful force in Colorado, especially since the Taxpayer's Bill of Rights reined in the spending power of local governments.

Developers have used them to build everything from golf courses to wastewater treatment plants and recreation centers.

But, with his plan to go statewide, Lembke is using his as they've never been used before - and drawing fire.

"He is trying to cloak water speculation in the clothes of Colorado municipal government," said Jim Witwer, a Denver lawyer who represents major water users. "Personally, from what I've seen, I think it's abusive."

Traditional special districts provide a specific service to a specific group of residents, who pay fees for that service. They must show a need for the service and an ability to provide it, and a county government must authorize them.

Like regular governments, special districts gain powers to condemn land and tax residents.

Lembke devised a special district with no residents - and a potential statewide service area. His revenues come from ratepayers in other districts.

The contract he signed Dec. 18, 2003, with East Cherry Creek Valley could yield \$76 million in water payments from Arapahoe County residents.

But it was enabled 14 months earlier by a government with no other ties to the deal.

### **Despite doubts, Elbert County gives its blessing**

But the record is blank on how and why a rural county helped put in motion a new approach to water sales.

Elbert County is home to 22,000 of Colorado's 4 million people - and a Lembke development.

The acre that serves as his launching pad for a water network was carved out of his Elkhorn Ranch project at the northwest end of the county.

He approached Elbert officials with a rough sketch of his idea for a new kind of district in 2002. From the outset, he had to overcome doubts about its legal acceptability.

Before Elbert County commissioners voted on the United district, their consultant reviewing the application questioned whether Lembke had met state standards.

Its report noted that his proposed district did not identify whom it would serve, failed to identify a water source and had not demonstrated that its service was needed.

Because of "the unique nature of this request," the Chesney & Associates report recommended the commissioners should "hold a hearing to take testimony" to satisfy those concerns.

How the county commissioners did that is unrecorded.

The tape of the meeting at which Lembke's district was unanimously approved is blank. County employees can't explain why. Written notes of the meeting simply state that no member of the public spoke before the commissioners voted to accept Lembke's plan with seven conditions,

including yearly reports.

John Metli, one of the commissioners who authorized Lembke's district, said commissioners focused on protecting their own water supply, not the regional implications of this new political entity.

"He promised he wasn't going to be shipping water out of Elbert County," Metli said. "I thought it was a viable project. I saw no harm in it to the county."

With Elbert County's stamp of approval, Lembke registered his new quasi-municipal district with the state.

The district is run by Lembke, Shipman and others who also benefit from a limited-liability company Lembke calls United District Water Providers (UDWP). Lembke said UDWP holds individual, tax-deferred retirement accounts for him, his family and some of his associates and employees. He formed it in 2003, after Elbert County approved his United district.

Colorado has more than a thousand special districts. Many benefit investors who create new subdivisions and provide services to them. But as the population of those districts grows, residents commonly take over the quasi-government's board of directors. Not so with United, which deliberately excludes residents from its plans.

Lembke's district sent ballots to nine voters - its own investors and their spouses - who unanimously elected them. While they were at it, they agreed to waive any limits on the number of terms United's officials could serve.

Lembke, meanwhile, had persuaded the leadership of one of the state's largest irrigation companies to partner with his district. The relationship allows Lembke to use the Farmers Reservoir and Irrigation Company's (FRICO) vast network of reservoirs and canals and effectively gives him special access to an immense supply of South Platte River water.

In return, FRICO shareholders - most of them farmers who have depended on the cooperative for water - get an opportunity to sell their water to the United system, and FRICO stands to get millions of dollars to improve its facilities.

With his investor group duly sworn in as government officials, and FRICO standing beside him as a partner, Lembke used his retirement-plan company to sell his new district water.

At the Tabor Center closing, Perkins sold water rights to his 70 Ranch, the former hog farm, for \$16.75 million. The private retirement-plan company held the contract for those rights. According to Lembke, it was formed specifically for that purpose. It handed the contract to the United district, which immediately sold the water rights to the East Cherry Creek Valley district for \$45 million.

East Cherry Creek Valley also agreed to a second phase of purchases, valued at \$31 million, for water United would acquire from FRICO farmers.

That left some room for profit.

For the work, risks and private investments that "made the United-FRICO system possible," Lembke said, the United district - a government run by Lembke - paid UDWP - Lembke's retirement fund company - an immediate \$1.2 million. It also agreed to pay \$20.5 million more out of available district funds.

Lembke said about \$7 million of that goes to FRICO - leaving \$14 million in profits "if all goes well," and he has not taken a nickel of that money since the closing.

He called that a modest yield, given the size, risk and duration of the project.

"If we take a risk," he said, "we're going to expect a return on the risk."

Perkins, the former hog farm owner who lives in Missouri, said he considered Lembke a developer who needed water and did not know his water rights were destined for a southeastern Arapahoe County district where Lembke owned no land.

"I suspicioned he was selling that day, but I didn't know for how much or to who," Perkins said. "I didn't care, as long as I got a check."

Lembke said concealing the identity of a third party is simply good business.

East Cherry Creek Valley bought more than just water rights. It also bought Lembke's promise to seek water court approval of a complicated plan to deliver it.

The water would not come directly from the 70 Ranch. Located in Weld County, the ranch got its name because it is said to be 70 miles from everywhere. East Cherry Creek Valley, which got title to the water rights at the 70 Ranch, won't use that water, which comes from the South Platte. Organizers hope a water court will allow them to draw an equivalent amount of water from the South Platte at a spot closer to their service area.

There should be no net loss of water in the river, according to the complex arrangement.

Lembke has agreed to build a well field north of Barr Lake in a historic channel of the South Platte, called the Beebe Draw. Those wells would pump water from the ground into a treatment plant that East Cherry Creek Valley would build. Because the wells would consume water that otherwise would trickle back to the South Platte, state water law requires the United district to replace each gallon piped to East Cherry Creek customers. United plans to do so from several locations on the South Platte, from a gravel pit it owns by the river to the 70 Ranch.

East Cherry Creek Valley is laying a 31-mile pipeline to take the water from the Beebe Draw to its customers.

### **Entrepreneur finds good partner in himself**

Some praise his creativity, and the many hats Lembke wears offer plenty of opportunity for profit.

Lembke says Colorado law allows him as a special district official to do business with himself. He says it's OK for his investment group to make as much as \$14 million through his government body.

In cases where developers create special districts to provide services to communities, conflicts of interest are unavoidable, he said.

"It's the norm of special districts that you deal with yourself," he said.

The United district, like many other special districts, regularly discloses its conflicts to the secretary of state's office, as state standards of conduct require. In two years, Lembke and his partners have filed 83 statements of potential conflicts, generally with little explanation of the conflict.

Among other things, Colorado law states that a government official shall not perform acts that "directly and substantially" affect a business in which he "has a substantial financial interest."

The law calls voluntary disclosure an "affirmative defense" to any complaint but not a blanket excuse for profiting at public expense. If a court found that a special district acted in bad faith, its

contracts could be canceled and reparations made.

A special-districts expert says the market also keeps such quasi- government bodies in line because customers could turn elsewhere if the investors ask too much for their services.

Evan Goulding, executive director of the Special District Association of Colorado, said investors who form special districts commonly benefit financially.

He called Lembke aggressive and creative but fastidious about following the law.

"Based on what I know, I don't see a problem," he said.

Some water lawyers do.

"I have concerns," said Witwer. He said Lembke was taking special districts "to a bizarre extreme" and questioned whether the district is being used to violate the state's anti-speculation doctrine.

"It's an unproven assumption, if they think they can do this," Witwer said.

As a private investor, Lembke could profit in several ways besides direct payments from his government to his retirement- plan company:

United has signed agreements permitting it to borrow money at 7 percent interest from other companies owned by Lembke and his partners.

United's wholesale water network could increase the value of land Lembke and his partners hope to develop.

Lembke has offered 25 acres he owns near Interstate 76, which he bought in the early 1990s, for a new East Cherry Creek Valley water treatment plant. His price: \$1.6 million.

The generous terms that United - Lembke's government - offered FRICO farmers for their water also benefited Lembke, who owned shares in FRICO. Lembke said he and his partners sold their FRICO water to United for \$951,975, about twice what they paid for it.

The United district's contracts also raise questions about the \$7 million that Lembke says the private investors owe FRICO out of their \$21.7 million payday.

One agreement shows United, not the investors, would pay FRICO that money. Lembke said the investors are actually covering those costs and the agreement "probably should be re-clarified."

Lembke said the United district lacks a detailed budget of anticipated expenses because "it costs what it costs," and he does not wish to lay out a road map for opponents challenging him in water court.

Overall, "is there a potential for some profit down the road? Yes," he said.

A self-described libertarian, Lembke called United "looking at the world for what was needed" - a voluntary alternative to municipal monopolies.

Yet he created a new government partly, he said, because East Cherry Creek Valley wanted to deal with a permanent entity. And as United's bonds explain, it could use the government power of condemnation to carry out its projects.

United is offering water at prices competitive with municipal rates, Lembke said, but unlike city

governments, United forces nobody to buy it.

"There's no one out there who we can force to use our system," he said. "Our only role as a government is for those who want to deal with us."

### **Success of venture hinges on court's views**

Criticism is mounting, with Front Range cities challenging the hold he wants to place on water.

The success of Lembke's plans still depend on numerous filings before a state water court, where attorneys for Front Range cities and towns have lined up to challenge him.

Lembke has his critics. They say he is trying to amass water rights for speculative purposes and his wholesale water network would be unprecedented in Colorado.

The Colorado Constitution establishes an undeniable right of its people to divert water from any stream for "beneficial uses."

State legislation and a series of state Supreme Court decisions have since declared that speculation - buying water strictly so you can hold it, then sell it to others for a profit - is not a beneficial use. The court repeatedly has dashed plans of investors who could not prove they had identifiable customers or immediate uses for water rights they tried to claim.

Lembke says United's directors, who have a contract to deliver water to East Cherry Creek Valley and own thousands of acres of developable land, are in no way violating that doctrine.

"We're not seeking to acquire water for speculative purposes. Never have," he said.

United's own documents speak of ambitious water delivery plans.

"The district intends to provide water to various special districts and municipalities throughout the state and serve as a wholesaler of water," one of its bond issues declares. It also says the district could change its policy of buying water only to meet existing contracts.

In addition, United has acquired pipeline rights that could be used to carry water as far south as Pueblo, and one of its court filings seeks a right to store up to 100,000 acre-feet of water - enough to supply hundreds of thousands of people.

Lembke and his partners "are just plain trying to monopolize the rest of the water" in the South Platte, said Sims, the Aurora water attorney.

"How is the speculation doctrine going to cope with this new kind of creature, this water and sanitation district that has an acre of land and no customers but touts itself as a water wholesaler?" he asked. "If that is enough, the speculation doctrine has basically been gutted in this state."

The United deal promises East Cherry Creek 5,500 acre-feet of water a year, or nearly 2 billion gallons. The first 3,000 acre-feet come from the 70 Ranch rights, the rest from water rights Lembke is buying from FRICO.

Critics question whether water in the Beebe Draw - where Lembke is drilling his wells - will need to be treated by highly sophisticated and expensive plants to be drinkable. They point out that Barr Lake, where Denver sends treated wastewater, seeps into the groundwater of Beebe Draw, which is also polluted by agricultural chemicals.

Because of the potential treatment costs, they question Lembke's claim that he is selling water at

competitive rates.

Kaunisto, who served on the FRICO board before he managed the East Cherry Creek Valley district, expressed confidence that the United contract will deliver homeowners from their dependence on deep wells that can run dry.

He called water in the Beebe Draw "remarkably clean" in comparison with the lower South Platte River, which lies downstream of municipal sewage treatment plants. Brighton and Lochbuie already drink from the same draw, he said.

But his district does plan to spend \$20 million in startup costs for a reverse-osmosis plant to filter Lembke's water. Until that plant is complete, East Cherry Creek Valley residents would drink a blend of deep well water and Beebe Draw water treated with chlorine to kill organisms.

The East Cherry Creek Valley district serves about 50,000 people in Centennial and unincorporated areas at the southeastern edge of Arapahoe County - and expects its population to reach 70,000.

Like their neighbors in fast-growing Douglas County, the district's homeowners draw water from deep aquifers unreplenished by a river.

When the district looked at the future of this supply, "it never got to the point where you get no more water out of the ground," Kaunisto said. But "over the next 50 years, we would have had to drill 300 to 400 more wells at a cost of close to \$400 million."

By contrast, Lembke's water comes from the South Platte basin, a supply renewed each year by melting snow and rain. And Kaunisto said Lembke's offer was the cheapest alternative the district has seen.

"What makes this work was working with FRICO and United to move the water. It's a lot more expensive to do it yourself," he said. "To say, 'We've never had these guys before; why do we need them now?' is thinking inside the box too much."

But Kaunisto said his district's future water supply does not depend on their success.

"We will own all the water rights ourselves," he said. "Even if United goes away and FRICO goes away, we have vested interests."

The water won't come cheap. Already, the district has imposed a \$22 monthly surcharge to help cover the costs of the new pipeline and other facilities. It also has been ratcheting up the water hookup fee for each home. To finance its bonds, the district raised the fee from \$12,000 a home when it signed the United deal two years ago to \$16,500 today. It plans to evaluate tap fees each year but could keep increasing them \$1,500 annually for up to eight years.

That could elevate the water connection fee for each new home served by the district to as much as \$28,500 - three times the largest amount charged outside Colorado in a 2004 survey of more than 250 municipalities conducted by the American Water Works Association.

Kaunisto says it is incorrect to assume that house prices rise when tap fees increase because builders pay them, not homeowners, and various market forces affect the ultimate price.

The Home Builders Association of Metro Denver disagrees.

The fees "are passed directly on to the consumer," said Roger Reinhardt, executive vice president of the association. "It's a hard cost."

"The builder doesn't sit back and say, 'I'm going to absorb the water and sewer fees.'"

Tap fees in East Cherry Creek Valley already exceed those of many of its neighbors. Denver and some of its suburbs charge less than \$10,000 for water service. Nearby Aurora plans to raise its residential tap fee to \$16,641 next year but does not expect \$1,500 annual increases.

For the \$45 million first phase of its project, East Cherry Creek Valley gave United \$18.5 million in cash and a \$26.5 million bond. To pay off that bond, it is giving Lembke's district 40 percent of each new connection fee. In the second phase, United could get 75 percent to 80 percent of each tap fee, Kaunisto said - or as much as \$22,800 on each new home built in 2013.

While Arapahoe County residents have yet to taste a drop of Lembke's water, others are already mimicking his 1-acre district.

In nearby Douglas County, the newly formed Dominion Water and Sanitation District borrowed the 1-acre wholesale water district model from the United plan.

But one of its investors, Harold Smethills, said Dominion intends to serve only its own proposed development, Sterling Ranch, and some neighbors who fear their wells are going dry.

"All we want to do is break even," he said. "We're not out to make a profit."

So far, Dominion has no water to serve its potential customers.

East Cherry Creek Valley homeowners say they know little about their district's reliance on Lembke to meet their water needs or about the tap fees financing the water projects.

But the \$22 water surcharge did catch their attention.

"I wasn't happy about it," said Audrey Sewald as she stood holding her baby daughter, Ela, outside the home she and her husband bought three years ago.

"All of a sudden we got this notice" of an increase on every month's water bill, she said.

Her husband called to complain, "and they said we could go to a board meeting. But by then, they had already decided on it."

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## THE TERMS

### **Acre-foot**

A standard measurement in water transactions, it's the amount required to cover an acre of land in a foot of water. It amounts to a little less than 326,000 gallons of water - enough to supply the indoor and outdoor uses of two average urban households for a year.

**Water right**

The ownership right to pull a court-authorized amount of water from a river, reservoir or other renewable source of water. Water rights are administered in a seniority system.

**Water court**

A court devoted to approving water rights and adjudicating disputes relating to water ownership or its use.

**Ditch company**

A cooperative of water users, it maintains a series of

water-filled canals serving farms. Its members may buy and sell shares to one another and sometimes to outsiders.

**Groundwater**

Water pulled from a well instead of directly from a stream or river. Some wells actually take water from the underground reaches of a nearby stream.