

OVERVIEW AND STATUS OF WATER RIGHTS LITIGATION

I. General Overview

The Pondera County Canal and Reservoir Company (“PCCRC” or “Company”) owns and operates a large water supply system which serves water users in the Valier and Conrad area. As part of the system, PCCRC owns water rights on Birch Creek and Duypuyer Creek, and other sources, which supply water to its shareholders who use the water for agricultural and municipal purposes.

As the claimant of numerous water rights filed by its predecessors in interest for the project, PCCRC has been involved in the process of researching its historic water rights as claimed by its predecessors, as well as researching water rights claimed by other parties to Birch Creek, Dupuyer Creek and related sources. The research conducted by PCCRC on the historic water rights which have served the project, and other water right claims in the area, has been necessitated in anticipation of the adjudication of all water rights claims for Basin 41M by the Montana Water Court which is anticipated to begin in the near future. Under Montanan’s general stream adjudication process, adjudication of the claims of PCCRC by the Montana Water Court, and those of others on the sources which supply water to PCCRC, will establish the rights and interests of all users of water for Birch Creek, Dupuyer Creek, and related sources. The adjudication of water rights in Basin 41M by the Montana Water Court will determine the availability, and reliability, of water rights and water supplies used on the project in the future.

As a result of the pending water adjudication process, the Board of PCCRC has determined that defending the validity and scope of the Company’s water right claims is a high priority. Because the water rights adjudication process will determine the water rights associated with the Company’s water supply available to its shareholders, PCCRC has engaged the services of legal counsel and technical consultants who specialize in water related matters to protect the Company’s interests in water rights which supply the Company’s water system.

As part of this work in preparing for adjudication by the Water Court of all claims in Basin 41M, PCCRC’s legal counsel and technical consultants have conducted extensive research

into the Company's water rights claims. In addition, extensive research has been conducted in regards to other water rights claims which have been filed by other water users. This research is expected to be critical to the Company's efforts to protect the water supply available to the Company's shareholders as the Water Court adjudication commences in Basin 41M

II. Specific Litigation

In conjunction with the Company's efforts to prepare for the upcoming adjudication of water rights by the Montana Water Court, PCCRC has also been involved in two (2) specific instances where litigation has been commenced concerning water rights. One matter involves litigation filed by water users situated on Birch Creek which challenges PCCRC's water rights related to that source of supply. The other matter involves adjudication by the Water Court of water right claims made on the South Fork, Dupuyer Creek, which are being determined by the Court in the adjudication of the Basin 41O Water Court Decree. The following summarizes these two matters.

A. Birch Creek litigation filed by Gene and Cheryl Curry and Curry Cattle Co. against PCCRC.

In 2005, a water distribution dispute arose on Birch Creek involving PCCRC and downstream water users, Gene and Cheryl Curry and Curry Cattle Co. ("Curry"). The essence of the dispute involved claims made by Curry to the Company that Curry was entitled to receive more water than they were receiving, and that the priority of Curry's rights were more senior than recognized by the Company. After efforts to negotiate a resolution of the matter failed, Curry instituted a lawsuit in district court against PCCRC claiming that Curry was entitled to significant flows of Birch Creek water in priority to the rights of the Company, and that the Company was interfering with Curry's water right claims. PCCRC counterclaimed in District Court alleging that Curry's water right claims were significantly inflated, and were in fact junior to many of the Company's Birch Creek rights.

After initial proceedings in the district court, in an interim order, the Court ordered Curry to cease interfering with the Company's operations of the headgate and ditch which supplied Curry and PCCRC shareholders water, and for the Company to deliver certain water to Curry at times when the Company's system was in operation. The District Court further

transferred to the Montana Water Court the Birch Creek water right claims of PCCRC and Curry for adjudication.

Upon certification of the Birch Creek claims of PCCRC and Curry to the Water Court, additional efforts to resolve the matter were attempted, but were unsuccessful. As such, proceedings before the Water Court were scheduled, extensive discovery was conducted, and a six (6) day trial was held in August, 2009 before the Water Court. At issue before the Water Court are the claims of PCCRC and Curry to the waters of Birch Creek and the validity, priority, quantification, and parameters of each party's Birch Creek rights. To date, the Water Court has not issued a decision in the matter, although it is expected a Master's Report will be filed in the near future addressing PCCRC's and Curry's claims.

1. Curry's Claims on Birch Creek

As reflected in filings made to the Water Court, Curry claims to be entitled to the following Birch Creek rights:

Claim No. 41M 159114-00:

*Priority Date: **January 14, 1898***

*Flow Rate: **5.00 cfs***

+ Conflicts with PCCRC claim for portion of Lena Taylor Appropriation (Right No. 24).

Claim No. 41M 159115-00:

*Priority Date: **1883 "use" right***

*Flow Rate: **3.01 cfs***

+ As claimed by Curry this right would be the first right on Birch Creek and conflict with the Company's claims to Right No. 1 (Barron & Upham Appropriation).

Claim No. 41M 159116-00:

*Priority Date: **June 4, 1897***

*Flow Rate: **10.02 cfs***

+ As claimed this right conflicts with the Company's claims to the Steel and Morgan Appropriation (Right No. 17)

Claim No. 41M 160284-00:

*Priority Date: **March 18, 1893 “use” right***

*Flow Rate: **10.00 cfs***

- + As claimed this right conflicts with the Company’s claims to the Charles Thomas Appropriation (Right No. 3).

Claim No. 41M 131100-00:

- + Morgan Coulee waste and seepage. No dispute except as to the flow rate (5.00 cfs)

Claim No. 41M 131101-00:

- + “Fagerlie Swamp” waste and seepage. No dispute except as to the flow rate (11.52 cfs)

Claim No. 41M 131105-00:

*Priority Date: **October 12, 1895***

*Flow Rate: **15.00 cfs***

- + This claim was filed on the Messeau and Foust Appropriation (Right No. 10). The Company contends this right is invalid or abandoned.

Claim No. 41M 131103-00:

*Priority Date: **May 19, 1897***

*Flow Rate: **37.5 cfs***

- + This claim is based on the Ryan/Lauffer Appropriation (Right No. 16). The right conflicts with the Company’s interest in the source right. Curry contends to be entitled to 80% of the right.

All totaled, before the Water Court, Curry claims 80.53 cfs of the water of Birch Creek by direct flow. Of the previously filed appropriations on Birch Creek, the Company contends Curry would be properly adjudicated approximately 7 cfs of Birch Creek with a priority date of May 19, 1897 (partition of Right No. 16), and 2.00-2.25 cfs , priority date January 14, 1898 (portion of Right No. 24). The Company also contests the proper acreage irrigated under rights perfected for the Curry property, as well as what water may be stored on reservoirs on the property.

2. Curry's Contentions as to PCCRC claims on Birch Creek.

PCCRC claims to water from Birch Creek, and its claims for storage of water in Swift Dam and Lake Frances Reservoir, are based upon appropriations made by predecessors of the Company and on rights acquired by the Company. These claims form the basis of approximately 85% of the water supplied to shareholders.

Before the Water Court, Curry has challenged the Company's water right claims. PCCRC has claimed a service area for use of water for irrigation by its shareholder which encompasses approximately 85,300 acres. Within the service area, PCCRC claims that irrigation may occur on approximately 72,000 acres within the service area in any irrigation season. Curry contests the place of use being described by service area for use of the Company's water supply, and further asserts the maximum acres irrigated is approximately 37,378 acres. Curry further asserts that irrigation use must only be on lands where shares were appurtenant as of July 1, 1973.

Curry further contends transfers of shares after July 1, 1973 are invalid and would require change of use authorizations by DNRC. This argument would affect share transfers to both irrigation users and the City of Conrad which uses water for municipal purposes. PCCRC has contended the share transfers within the Company's service area for irrigation or municipal use are valid and do not require DNRC approval.

Curry contends that water rights claims for storage in Swift Dam prior to 1912 or for storage in Lake Frances prior to 1902 are invalid. Curry further contends that the Company's claims based upon appropriations filed by PCCRC predecessors are generally invalid. Curry contends the Company's claims should be limited to approximately 20 cfs in Birch Creek with a priority date of 1902, or use rights with a flow rate of 680 cfs with a priority date of July 14, 1913. The Company has provided historic evidence on the perfection and parameters of all the Company's claims based upon previously filed appropriations which establishes both the priority date and quantification of the rights on Birch Creek as senior to claims made by Curry.

The outcome of the Curry litigation will be significant to users of the Company water supply. Depending on decisions made by the challenges of Curry to the Company's claims, and depending on how the Water Court adjudicates Curry's claims, the priority, quantity, and places

where Birch Creek water may be used could be substantially affected. A decision by the Water Court on the Curry litigation is still pending.

B. Water Court Litigation on Claims Made on South Fork Dupuyer Creek

Upon issuance of the water court decree for the Teton River Basin (Basin 410), PCCRC reviewed certain claims filed for the water of South Fork, Dupuyer Creek. Because certain claims on this source take water from the Dupuyer Creek drainage out of basin to the Teton River Basin, PCCRC reviewed claims made on the source as they appear in the water court decree as adjudication of these claims could affect water availability on Dupuyer Creek.

The examination of South Fork claims revealed that parties which had claims in the Basin 410 decree had claimed, and over claimed, substantial quantities of water. As a result, PCCRC filed appearances to the claims in the water court to address issues identified by PCCRC.

As a result, PCCRC was made a party to four (4) cases adjudicating the South Fork, Dupuyer Creek claims which claimed inter-basin use of the water. These are summarized below.

1. Case No. 410-34 (Grove et al.)

This case involved one (1) claim filed for the waters of South Fork, Dupuyer Creek, claimed to be used for irrigation of stockwater from Gansman Coulee via an interbasin transfer from the source. The right claimed 50 cfs of the water of South Fork, Dupuyer Creek and was originally based upon an 1895 appropriation for 50 cfs made by B.P. Clark.

PCCRC and others objected to the validity of the claim. A water court hearing was conducted in May, 2010. After witnesses and evidence was presented, and all submissions to the court made, on June 16, 2010, the water master entered a report finding the claim was invalid or abandoned. After objections to the report, on October 5, 2011, the Chief Water Judge confirmed the invalidity of the claim involved. As such, this claim for 50 cfs of South Fork, Dupuyer Creek water for use out of basin was terminated.

2. Case No. 410-32A, 35, and 38 (Campbell Brothers, Skelton Angus Ranch, Greg Duncan et al.)

These cases involve numerous claims for South Fork, Dupuyer Creek water. Each claim asserts the right to use water from the source out of basin in the Gansman Coulee and Blackleaf

Creek drainages in the Teton Basin. PCCRC appeared before the water court given the magnitude of the water claims, and given numerous issues concerning the validity of the claims as they appeared in the water court decree.

Between the claims made in the three (3) cases, approximately 335 cfs of the water of South Fork, Dupuyer Creek were claimed for use out of basin. The priority dates claimed were between September 19, 1895 to April 8, 1912. In each case the claimants claimed the entire flow rate for previously filed notices of appropriation which in most cases resulted in a “triple” claiming of the previously filed rights.

On February 16-17, 2011 the Water Court conducted a two (2)-day trial on the claims. PCCRC appeared on the invalidity of the claims made. PCCRC generally contends the claims are drastically inflated both in terms of quantity and priority of any use of water from the source. PCCRC also presented evidence of the expansion of the diversion system on South Fork which greatly increased since the days of the original filings.

The Water Court has not issued a decision but a Master’s Report is expected in the near future. The outcome of this case will be important to water supplies of PCCRC, and others, on Dupuyer Creek.

C. Arnold Rohrer v. PCCRC.

This litigation is not directly related to water rights, but concerns operations and maintenance of the Company water distribution system.

On August 16, 2010, Arnold Rohrer (“Rohrer”) filed a petition in District Court against PCCRC. In the petition, Rohrer requested the Court interpret PCCRC’s Bylaws and Articles of Incorporation to impose on the Company duties and obligations requiring PCCRC to maintain all ditches and conveyances which supply Company water to all shareholders. In particular, Rohrer claimed PCCRC is responsible to maintain the lateral ditch which serves the Rohrer property at the Company’s expense. Because the case could substantially increase the maintenance obligations of the Company, and correspondently greatly increase the O & M assessments the Company’s makes on shareholders, PCCRC defended against Rohrer’s claims.

After discovery and motions, on September 16, 2011, the District Court issued an Order dismissing Rohrer’s complaint which prejudice. On September 21, 2011, Rohrer appealed the

decision dismissing his claims to the Montana Supreme Court. The appeal has been fully briefed and awaits a decision from the Supreme Court.

The outcome of this appeal may have significant impact on historic operation and maintenance activities of the Company on distribution systems historically maintained by the Company, and those historically maintained by shareholders. Any decision which would recognize Rohrer's claims would require the Company to maintain many more miles of lateral ditches serving shareholders' lands and would likely greatly increase the Company's ditch maintenance expenditures. An accompanying increase in O & M assessments would be required.