Greater Oilfield Water Infrastructure Connectivity: The Case for a ‘Hydrovascular’ Network In the Permian Basin

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Mr. Collins holds a membership interest in Cactus Water Services, LLC. This relationship is covered by a Rice University conflict of interest management and monitoring plan.
What Is a Hydrovascular Grid?

- Perfect the water midstream model
- Build interconnectivity
- Rationalize CAPEX and system utilization
- Achieve sustainable valuations

"We would create a hydrovascular market, where we would have major arterials to convey water throughout the state. For us to develop this and to develop new water — whether it be desalination or reclaimed water or bring water from out of state — all of that needs to be looked at from a 50,000-foot view." -- Rep. Lyle Larson, R-San Antonio, May 2015

- The idea of large-scale, highly connected water infrastructure to link regions of plenty to regions of scarcity in Texas dates to the 2015 legislative session. House Bill 3298 called for the Texas Water Development Board to study the potential for developing a water market and conveyance network that would eventually become a hydrovascular grid spanning multiple regions statewide. The bill did not become law and the issue has lain dormant for 4 years.

- More interconnected water systems can facilitate wheeling of oilfield water within the Basin, better utilization of disposal well and recycling capacity, and potentially, public-private partnerships that allow water to be moved outside the Basin to the mutual economic and hydrological benefit of multiple stakeholders.

- The oilfield water market in the Delaware and Midland Basins will gradually coalesce into several large “areas of market dominance” (“AOMDs”) as water midstream firms and their E&P customers consolidate.

- The emergence of these broad AOMDs—akin to the watershed feeding a river system—opens the opportunity for optimized pipeline connectivity between the various oilfield watersheds that will, economics permitting, allow wheeling and movement of water in a manner that is largely impossible at present.

Why Talk About This Now?

Scale will matter regardless...

A large-scale, more deeply interconnected Permian Basin water infrastructure opens up doors for optimal SWD use and true “out of Basin” value-added water solutions in a “water wave” scenario and can help optimize CAPEX and costs in a $40-to-45 WTI “water winter” scenario.
Permian Operators and Midstreams Must Now Collectively Handle More Water Than Major Texas Cities

Basin-wide, E&Ps in the Permian used about 5 million bpd of frac water as of 4Q2018. This is equivalent to the average municipal water demand of San Antonio.

On the produced water side—analogous to wastewater in cities—the Permian is huge. Average daily total water injection volumes are more than twice the volume of wastewater Houston (Texas’s largest city and the United States’ 4th-largest) treated on an average day in 2018. The unconventional water share alone is likely more than what Houston treats per day.

If Permian oil output rises to 6.5 million bopd by June 2024 (i.e. 5 years from now) and we assume 4.0 bbl of water per bbl of oil produced Basin-wide, produced water volumes could basically double from where they are today.

For this growth to happen, water midstream and other solutions must economically manage the resulting wall of water.
Accommodating Future PW Volumes Might Require Unorthodox Solutions

**Note—updated from February 2019 presentation numbers to reflect higher capital cost**

Example: *What might the economics of piping produced water down to the Gulf Coast and discharging treated PW into the ocean or disposing of it in depleted offshore fields look like?*

Initial model based on Vista Ridge water pipeline to San Antonio.

- 142 miles
- $930 million project cost
- 54-inch steel line
- Projected to move ~1 million bwpd.

Using Vista Ridge’s economics as a baseline, installing 5 X 54-Inch, 650-mile long water pipelines between Orla and Corpus Christi would cost about $16 billion and financed at a 15% interest rate over 20-years, would yield an estimated CAPEX cost of $1.38/bbl and OPEX cost of $0.23/bbl, for a delivered cost to the Gulf Coast of $1.61/bbl.
“Returns on water midstream around the industry have been comparable to crude gathering—in the mid to high teens unlevered, depending on the contract structure. I am not aware of another manufacturing business in the U.S. with that potential in terms of quantity of capital and unlevered returns. Capital finds a way to get these things done. I don’t see a market where public capital lets private equity have that kind of potential all to itself for the next 10 years.”—Jason Downie, Co-Founder and Managing Partner, Tailwater Capital
The Aggregation Case

- Lots of pipe
- Potential SWD redundancy
- Duplicative CAPEX
- E&P consolidation
- Potential for direct and displacement-based water movements of as much as 50 miles
Jagged Peak reports spending $68 million on water infrastructure as of May 2019.

Felix Water does not disclose total CAPEX, but with 22 operating SWDs and 155 miles of produced water pipelines, it has likely spent more than $150 million (assuming $6 million per SWD and a 4 inch weighted average pipeline diameter @ $35k per inch-mile)
Case Example: Disposal Capacity vs. Utilization Rates

Each neighbor has a 4-car garage, but only two cars and probably won’t buy 4 vehicles anytime soon—argument for capacity sharing.
Benefits of Scale

Food needs as analogous to CAPEX + OPEX

Human being
~17 calories/lb/day

Polar bear
~12 calories/lb/day

Blue whale
~10 calories/lb/day

Source: Australian Antarctic Division (blue whale), Get Drawings (human), World Wildlife Fund (polar bear)
**Key Points**

- Even if an oilfield water company bills itself as a “utility” asset, depreciation timetables suggest significant distinctions that valuation professionals and investors should be aware of.

- Foremost among these is the reality that saltwater disposal wells make up a big portion of total system cost and will likely need to be replaced/worked over much more often than the pipes and pumps in a “traditional” water utility model.

<table>
<thead>
<tr>
<th></th>
<th>Original CAPEX</th>
<th>Depreciation Period, Yrs.</th>
<th>Annual Depreciation Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hard Pipe</td>
<td>$103.0</td>
<td>25</td>
<td>$4.12</td>
</tr>
<tr>
<td>SWDs</td>
<td>$79.5</td>
<td>7</td>
<td>$11.36</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>$18.5</td>
<td>7</td>
<td>$2.64</td>
</tr>
<tr>
<td>Pits</td>
<td>$2.3</td>
<td>10</td>
<td>$0.23</td>
</tr>
<tr>
<td>Layflat</td>
<td>$1.1</td>
<td>7</td>
<td>$0.16</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$204.3</strong></td>
<td><strong>($ Millions)</strong></td>
<td><strong>$18.5</strong></td>
</tr>
</tbody>
</table>

Consider contrast with municipal systems. City of Midland, TX reported owning about $484 million worth of water and sewer infrastructure in 2017. Depreciation for that fiscal year was just under $14 million.
Hydrovascular Grid Case Strengthens When As Expectations for Permian E&P Returns Become More Realistic

- More of these producers will consolidate the “next 80 firms”
- And most pointedly, the 5-7 largest players in the Basin will be the biggest forces for consolidation.
- What happens when investors begin to recognize that Permian unconventional may in fact be a “utility returns play?”
- Opens up a new range of potential capital sources, provided that the current bid-ask difference can be rationalized. In other words, once the “F-150 companies” stop asking for “Ferrari” prices, a whole new range of scale-oriented transactions potentially opens up for capital providers comfortable with long run returns on capital closer to 10-12%.

Source: Company Reports, Texas RRC, Author’s Analysis
The Produced Water Aggregation Case Mirrors Evolving Well Spacing Trends

From Concho’s 2Q2019 earnings deck (30 July 2019)

Dominator Project
- Strong execution across the organization
  - Massive project online ahead of schedule
  - Utilized 7 rigs and 5 frac spreads within 1-mile section
  - ~15% improvement in feet drilled/day vs 2018 area avg.
- Tested dense development of the Upper Wolfcamp
  - Performance indicates project spaced too tight

Elder Project
- Avalon delineation
  - Continue to evaluate multi-zone potential within Avalon

Recent Projects Inform Development Strategy
- Spacing is critical variable to maximizing performance & economics
- Tested upper limits of well spacing 2H18-1H19
- Integrated data & reverting to less dense configuration point forward

Lower density development means midstreams may need to cover larger physical footprints to achieve a given volume and returns profile
The overarching challenge: Offering a reliable, competitively-priced water solution

- Commodity Prices
- E&P thinking about water costs
- Regulatory risks
- E&P drilling and completion schedules
- Landowner rent sharing

Key Challenges for a Hydrovascular Grid
Disposal Costs: Economic Perspectives of E&Ps and Water Midstreams

<table>
<thead>
<tr>
<th>Capital Recovery Fee, $/bbl</th>
<th>Desired Rate of Return</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>7%</td>
</tr>
<tr>
<td>Delaware Disposal Case</td>
<td>($0.37)</td>
</tr>
<tr>
<td>Devonian Disposal Case</td>
<td>($0.46)</td>
</tr>
<tr>
<td>Delaware Disposal Case</td>
<td>($0.24)</td>
</tr>
<tr>
<td>Devonian Disposal Case</td>
<td>($0.30)</td>
</tr>
<tr>
<td>Delaware Disposal Case</td>
<td>($0.18)</td>
</tr>
<tr>
<td>Devonian Disposal Case</td>
<td>($0.23)</td>
</tr>
<tr>
<td>Delaware Disposal Case</td>
<td>($0.15)</td>
</tr>
<tr>
<td>Devonian Disposal Case</td>
<td>($0.18)</td>
</tr>
</tbody>
</table>

What is ultimately carried on the balance sheet?

<table>
<thead>
<tr>
<th>Delaware Disposals</th>
</tr>
</thead>
<tbody>
<tr>
<td>100% Capacity Utilization</td>
</tr>
<tr>
<td>80% Capacity Utilization</td>
</tr>
<tr>
<td>60% Capacity Utilization</td>
</tr>
<tr>
<td>40% Capacity Utilization</td>
</tr>
</tbody>
</table>

- E&Ps commonly discuss internal disposal costs of between $0.20 and $0.40/barrel
- For instance, “Average water acquisition and disposal costs of under $0.10 / Bw and $0.20 / Bw, respectively”—Jagged Peak Energy, 23 March 2018
- The big questions arising from this are: (1) what is the assumed opportunity cost of capital and (2) are these “cost” figures cited by the companies truly “fully burdened” and reflective of operational and capital costs that structurally probably aren’t much different from those of the third-party water midstreams?
Return on capital employed is not a perfect proxy, but gives a directional sense as to how management may elect to deploy capital on projects, especially in a “live within cashflow” environment such as the one E&Ps now must operate in.

Legacy investments in proprietary water infrastructure are tempting monetization targets at present in part because recent comparable transactions suggests a higher ROCE on dollars invested in SWDs and pipelines than for dollars sunk into oil & gas wellbores.

But moving forward, investors are likely to cast a jaundiced eye on additional water system investments that could have gone to oil & gas development.

The more public midstream names there are with meaningful water exposure, the stronger investor pressure will generally become on E&Ps to focus CAPEX on their core business and not plough money into midstream operations.
Disposal Costs: E&P Thinking vs. Water Midstream Thinking

- The big question for E&P managements facing water infrastructure decisions?
  - Do we think in “dollar” terms?
    - What could we have drilled with that $100 million that we spent on a water system last year?
    - Can we plug a balance sheet hole by monetizing out midstream asset and buy a quarter or two of breathing room with Wall Street?
  - Or do we think in “operational assurance” terms?
    - Aren’t we glad a third-party’s operational failure didn’t damage a well and set back our frac schedule for months!

There is no simple answer and these will be case-by-case decisions. Furthermore, the public markets will likely have a limited appetite for water midstream assets sold at 9.0X EBITDA when the underlying oil & gas production assets that are providing the water only command a 6.0X EV/EBITDA value.
Financial Structures Will Evolve With Larger Scale and Increased Connectivity

- WaterCo
  - Dedication/Long-Term Contract
- WaterCo
  - Dedication/Long-Term Contract
- WaterCo
  - Dedication/Long-Term Contract

- WaterCo
  - Dedication/Long-Term Contract
  - Shared storage
  - Interconnector pipeline

- WaterCo
  - Dedication/Long-Term Contract

- Spot water deals
- Capacity reservations
- More dynamic pricing
- Water swaps
- Disposal cost optimization deals
Using Interconnectivity to Optimize Operating Costs

First Choice Disposal Options
Hydrovascular Grid Can Optimize CAPEX In a World of Frontloaded Water Volumes

**First 90 Days of Well Life**

Bilbrey 34/27 B2NC #1H: Lea County, NM
502,000 bbl of water pumped in completion
2nd Bone Spring, 2-mile lateral

**Well Life To Date**

54% of water production to date occurred in first 6 months of well life

Source: Well Invoice Data, NM OCD
Better Connectivity Hedges Cashflow Risk & Reduces Customers’ Flow Assurance Risk

NGL Permian Water Solutions 2018 YTD Volumes Received, By Well (Mmbbl)

Source: Texas RRC

Interconnectivity with other systems can help mitigate the risk of disruptions to key wells/pipelines.

Source: Mayo Clinic
Managing Volume and Price Risk: Timing Matters

**Temporal mismatches**

- Can new SWDs be quickly brought online to serve pad-type drilling developments?
- Deeply interconnected pipelines networks help mitigate this risk on a localized basis by allowing specific pads access to a broader disposal and water-handling network.

**Delaware Basin Wolfcamp Well Spud-to-Sales**

<table>
<thead>
<tr>
<th></th>
<th>Drilling</th>
<th>Completion</th>
<th>Commencing Sales</th>
<th>Total Est. Spud-to-Sales Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>DUC Case</td>
<td>N/A</td>
<td>10-14 Days</td>
<td>5-6 Days</td>
<td>15-to-20 days</td>
</tr>
<tr>
<td>Base Case</td>
<td>20-25 Days</td>
<td>10-14 Days</td>
<td>5-6 Days</td>
<td>35-to-45 days</td>
</tr>
<tr>
<td>Pessimistic Case</td>
<td>30 Days</td>
<td>10-14 Days Frac + ~30 Days to Fill Frac Pit</td>
<td>7-10 Days</td>
<td>80-to-90 days</td>
</tr>
</tbody>
</table>


**Delaware Basin SWD Permit-to-Injection**

- Land Purchase & Permitting: 2-to-12+ months
- SWD Drilling: 1-3 weeks
- Procure and Install Surface Facilities: 2-to-3 months
- Commence Operations

Source: NGL Energy Partners, December 2018 Investor Presentation
Commodity Logistics Pricing at Basin-Wide Level (Case of Crude Oil)

Hayhurst/Pig City Gathering Area
Gathering Charge: $0.73/bbl uncommitted, $0.70-0.72/bbl committed

Hayhurst Stateline Station
- $0.31/bbl from Hayhurst
- $0.95/bbl from Hayhurst

Orla
- $0.68/bbl

Wink
- $0.68/bbl

Midland
- $0.68/bbl
- $1.15/bbl from Eddy County

Source: FERC, Google Earth, PAALP, Author’s Analysis
Large-scale midstream infrastructure has the potential to enable creative new uses of water that go beyond disposal and recycling alone. Here we are talking utility-scale systems with pipelines that could be 36” diameter or larger. These ideas also presuppose two other developments: (1) a higher degree of interconnection between oilfield water handling footprints, which at this point in time are highly fragmented and (2) lower-cost treatments that can provide “upgraded” produced water at scale.

It is also important to start thinking intensively now about re-purposing part of the produced water stream, so that the practices and technologies have a better chance of being in place when oilfield recycling demand begins to slow several years down the road as many parts of the Delaware and Midland Basins begin to mature.

A Few Potential Applications

- Non-food crops
- Pipeline to Gulf of Mexico
- Power plant cooling/industrial use
- Fuel algae

At What Price Would Treated Produced Water Become Practically Useful to Farmers?

For Biofuel Crops

*Probably $0.10/bbl or less, assuming a 75% freshwater/25% treated PW irrigation blend*

Alamo switchgrass grows well in TX climates and can be a feedstock for cellulosic ethanol production.

Source: USDA

For the Highest Value “Non-Food” Crops

*Approximately $0.40/bbl, assuming a 75% freshwater/25% treated PW irrigation blend*

Opium cultivation assuming that farmer sells morphine base instead of raw opium, such as that being harvested below by a farmer in southern Afghanistan.

Source: NPR

Disclaimer: The opium example is for illustrative purposes only.
Permian Oilfield Water Predictions

A. Within 12 months from today (start date August 2018)
   - A major Permian-focused water midstream firm goes public or has a similarly large liquidity event
   - At least 3 additional large private equity companies enter the space
   - At least 3 sizeable (80 kbd+ avg. actual volume handled) water midstream firms in the Permian will be acquired by a larger player
   - Treated co-mingled produced water will began to be re-sold at a commercial price

B. Within the next 12 months (by August 2020)
   - There will have been a billion-dollar oilfield water transaction in the Permian
   - At least five Permian-focused entities other than Pioneer Water Management will be transporting and injecting 500 kbd or more of produced water
   - There will be at least two restructurings of distressed water midstream assets

C. Within the next 24 months (i.e. by August 2021)
   - At least 4 million bpd of incremental produced water (relative to August 2018) must be handled
Cutting-Edge Texas Groundwater and Oilfield Water Research

Supplementary Slides
Produced Water Becoming a Tradable Commodity in the Permian

The Northern Delaware Basin already has “Pipeline Grade” produced water commercially available.

Source: Cimarex, Hart Energy
What Volumes Could Justify a $2.5+ Billion WaterCo Valuation?

<table>
<thead>
<tr>
<th>Sourcewater Sales, Kbd</th>
<th>Produced Water Handled, Kbd</th>
<th>Valuation at 8X EBITDA</th>
<th>Valuation at 9X EBITDA</th>
<th>Valuation at 10X EBITDA</th>
<th>Valuation at 11X EBITDA</th>
<th>Valuation at 12X EBITDA</th>
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<tr>
<td>33</td>
<td>100</td>
<td>$123</td>
<td>$139</td>
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<td>467</td>
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<td>$2,866</td>
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Assume the following parameters:
- 3:1 volumetric disposal/sourcewater sales ratio
- $0.75/bbl gathering & disposal fee
- $0.50/bbl sourcewater revenue
- $0.20/bbl skim oil revenue
- $0.35/bbl OPEX + royalty on disposed water
- $0.25/bbl total recycling cost
- $0.03/bbl well water production cost
- $0.15/bbl sourcewater distribution cost
- $11 million annual staff cost
- D&A equal to 19% of operating income

10X and higher multiples most feasible after significant consolidation.
At What Price Would Treated Produced Water Become Practically Useful to Farmers?  

Data Breakdown

<table>
<thead>
<tr>
<th>Variable Costs</th>
<th>Revenue</th>
<th>Quantity</th>
<th>Units</th>
<th>$/Unit</th>
<th>Total per Acre</th>
<th>Enterprise Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Switchgrass</td>
<td>$140.00</td>
<td>5.668016 ton</td>
<td></td>
<td></td>
<td>$793.52</td>
<td>$396,761.13</td>
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</table>

**Revenue**

<table>
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<tr>
<th>Revenue</th>
<th>Quantity</th>
<th>Units</th>
<th>$/Unit</th>
<th>Total</th>
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</thead>
<tbody>
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**Fixed Costs**

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<tr>
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<th>Revenue</th>
<th>Quantity</th>
<th>Units</th>
<th>$/Unit</th>
<th>Total</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

**Opium poppy cultivation**

Crop Acres  

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th>$/Unit</th>
<th>Total</th>
</tr>
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<tbody>
<tr>
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**Production Costs**

<table>
<thead>
<tr>
<th>Production Costs</th>
<th>$/Acre</th>
<th>$/bbl</th>
<th>Est. Water</th>
<th>Enterprise Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seed</td>
<td>$4.05</td>
<td></td>
<td>22.28 ac-inches</td>
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<tr>
<td>Sowing</td>
<td>$23.76</td>
<td>14,404 bbl/ac</td>
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<tr>
<td>Fertilizer</td>
<td>$207.92</td>
<td></td>
<td></td>
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<tr>
<td>Weeding +</td>
<td>$99.34</td>
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**Irrigation**

<table>
<thead>
<tr>
<th>Irrigation</th>
<th>$/Acre</th>
<th>$/bbl</th>
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<tbody>
<tr>
<td>Water</td>
<td>$5,689.59</td>
<td>$0.40</td>
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**Est. Water**

<table>
<thead>
<tr>
<th>Est. Water</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0.40</td>
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**Estimated Revenue**

<table>
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<tr>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,125.23</td>
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**Total Revenue**

<table>
<thead>
<tr>
<th>Total Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6,526.32</td>
</tr>
</tbody>
</table>

**Total Enterprise Revenue**

<table>
<thead>
<tr>
<th>Total Enterprise Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>$3,263,157.89</td>
</tr>
</tbody>
</table>

**Total Costs**

<table>
<thead>
<tr>
<th>Total Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6,513.33</td>
</tr>
</tbody>
</table>

**Net Income**

<table>
<thead>
<tr>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$12.98</td>
</tr>
</tbody>
</table>
