
WSJ: Why You Shouldn't Throw Sewer Bonds Out With the Bath Water.

Don't flush your sewer bonds down the toilet just yet.

Municipal bonds that are paid by revenues from sewer systems have gotten some bad press in recent years. First, Jefferson County, Ala., filed for bankruptcy in 2011, saying it could not afford to pay back more than $3 billion in debt tied to its sewer system. Now, Detroit has gone bankrupt as well, and emergency manager Kevyn Orr has floated a proposal that could change how sewer bondholders get paid back.

But ask any muni-bond manager, and they will tell you that sewer bonds normally rank among the safest types of muni bonds. Municipalities typically issue bonds backed by sewer revenues to make improvements to their sewer system. The thinking is that even if a municipality is facing financial distress, there will always be revenues from the sewer system to pay back the bonds. After all, everyone needs to use the bathroom.

Sewer bonds are often lumped with debt tied to other essential services, such as power systems or even toll roads serving major metro areas, and considered ultra safe.

"It's primarily services that you really can't do without," said James DiChiaro, a portfolio manager at Cutwater Asset Management, which oversees about $3 billion in munis. "And generally speaking, a lot of those services comprise a small portion of any citizen's monthly income."

Another attractive quality to sewer bonds is that they have been afforded a special status in bankruptcy. The bankruptcy code says that investors who own "special revenue" bonds — which in the past have been considered to include sewer bonds — are entitled to still get paid from the revenues previously slated for bondholders.

Detroit has more than $5 billion in bonds backed by its water and sewer system. Mr. Orr has put forth a plan that envisions these bondholders ultimately getting their money back, but perhaps in the form of new bonds.

Currently, Detroit's water and sewer system — which also serves surrounding suburbs — is run as a city department. Mr. Orr's plan would involve creating a new municipal authority that could then lease the sewer system from the city. This lease payment could be made before money is set aside to pay bondholders. The idea is that there is more money in the water and sewer system than is needed to pay back investors, and Detroit could use the extra cash.

The proposal has miffed some bond investors, who say the city has no right to tinker with the sewer bonds, especially given the special protections in the bankruptcy code. If the city changes how the bonds are paid back, they say, that could spur other municipalities to break their promises as well.

Bill Nowling, a spokesman for Mr. Orr, said he believed the city's water and sewer bonds are still a good investment. He said the city ultimately intends to pay them back in full, and that Mr. Orr's plan is nothing more than a proposal at this point.

“The muni market might be seeing specters where there’s not,” Mr. Nowling said.

Overall, bond buyers note that sewer bonds remain safe, pointing to the fact that Detroit and Jefferson County are likely outliers. Jefferson County’s staggering sewer debt was the product in part of corrupt bond deals that landed some local officials in prison. And Detroit, the center of the U.S. auto industry, was hit particularly hard in the recession.

“We do not have a different opinion on essential service bonds” in the wake of the bankruptcies, Mr. DiChiaro said. “We still regard them as one of the safest asset classes within the municipal sector.”