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Bloomberg: Water Bonds Shrivel as California Sees Driest Year.

The driest year on record for Los Angeles and San Francisco is threatening water supplies to the world's most productive agricultural region and almost doubling borrowing costs on some bonds issued by California water agencies.

Los Angeles, which normally gets almost 15 inches (38 centimeters) of rain a year, got less than 4 inches in 2013, according to the National Weather Service. San Francisco, where 22 inches is typical, got 6. Severe or extreme drought grips 85 percent of California, a federal monitor reported Dec. 24.

The scarcity is depleting California's reservoirs and jeopardizing the credit of at least 30 water agencies that had been considered safe bets because their debt is backed by user fees rather than general taxes. Concern grew in November when the California Water Resources Department, the state's largest supplier, said it was filling just 5 percent of orders from local water agencies, the lowest in five years. Less supply means lower sales and revenue.

"Supply is always at the center of our analysis of California water agencies," said Michael E. Johnson, managing director of Gurtin Fixed Income Management LLC in Solana Beach, California.

"If you don't have water, you just don't have water," said Johnson, whose firm oversees $7.5 billion. "There's not going to be much that mitigates not having water."

Water Network

About two-thirds of Californians get at least part of their flow from northern mountain rains and snow through a network of reservoirs and aqueducts known as the State Water Project, according to a Dec. 16 report by the Water Resources Department. The water content of the snowpack is about 20 percent of normal for this time of year, the department said Dec. 30 in a statement.

The system supplies households and businesses from the San Francisco Bay area to Southern California and irrigates crops in the San Joaquin Valley near the center of the state — the world's most productive agricultural region.

With reservoirs at 66 percent of average, and a third dry year predicted, revenue is likely to fall short for the Water Resources Department and the local agencies that depend on it, Moody's Investors Service said in a Dec. 5 note. That may harm the credit of such authorities as the Metropolitan Water District of Southern California (MWDSCZ:US), rated Aa1, second-highest, the company said.

U.S.'s Largest

The district, based in Los Angeles, is the largest supplier of treated water in the U.S., serving 19 million people — half of California's population — along the coast from Ventura to San Diego. It had

$4.4 billion in long-term debt as of June 30, according to data compiled by Bloomberg.

Since July 10, investors have demanded an average of 2.85 percentage points of extra yield to own tax-exempt Metropolitan Water District bonds maturing in July 2037, up from an average of about 1.5 percentage points in the previous six months, Bloomberg data show.

Still, households in Los Angeles and other urban areas should be spared the effects of the shortage because the district has enough water and cash to cushion it against a few dry years, said General Manager Jeffrey Kightlinger.

The district connects to the State Water Project in northern Los Angeles County at Castaic Lake, which was at 89 percent of capacity as of Dec. 30. The MWD's biggest reservoir, Diamond Valley Lake, was 72 percent full.

"We build our whole system around three- or four-year drought cycles," Kightlinger said by telephone. "We don't see any downgrades from one or two dry years."

Safest Bonds

California agencies are still among the safest for municipal investors, said Craig Brothers, a senior portfolio manager at Bel Air Investment Advisors LLC in Los Angeles, which manages $2.8 billion. Metropolitan Water District and the state Water Resources Department, which has $2.6 billion in long-term debt, are "two of the premier trading credits in the state," Brothers said by telephone.

Agencies can raise fees to compensate for shortages and are thus more insulated from politics than cities and states, Brothers said.

"I don't think there's a reason for people to shy away from these really strong water credits," Brothers said. "If the market prices in a penalty, I'd definitely be a buyer. These are safe."

By James Nash January 02, 2014