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California Water Debt Seen Safe From Drought's Grip: Muni Credit.

While California's water reserves are dwindling amid an intensifying drought, there's no dry spell when it comes to buyers of debt issued by the agency running the water system supplying 25 million people.

The California Department of Water Resources, which oversees a network of reservoirs and aqueducts known as the State Water Project, is refinancing about $640 million of tax-exempt bonds today, said Perla Netto-Brown, the agency's Sacramento-based chief of fiscal services. It's the department's biggest offering since 2011, she said.

The sale is riding demand for California debt, which is on pace to beat the municipal market for the fifth straight year as the state's rebounding finances boost its standing on Wall Street. The department is shielded from the drought: Twenty-nine California agencies pay to use its network no matter how much water they receive.

"The severe drought in California should have no effect" on the refinancing, said Michael Johnson, managing partner in Solana Beach, California, at Gurtin Fixed Income, which oversees about $9.5 billion of municipal debt. "The underlying state water agencies are required to pay the department regardless, if they are delivered water or not. Also, the market is hungry for California bonds, so I would expect this deal to be well-received."

Dry Land

The year ended today is poised to be one of the driest ever for California, according to the Department of Water Resources. About 82 percent of the state is in extreme drought, the second-most severe classification, up from 11 percent a year earlier, according to the U.S. Drought Monitor. Eleven of 12 major reservoirs are below half capacity, state data show.

The Metropolitan Water District of Southern California, which provides water to about 19 million people, including Los Angeles, expects reserves to shrink to about 1.4 million acre feet by year-end, from 2.7 million in December 2012, said Gary Breaux, its chief financial officer. The figure measures the volume needed to cover an acre of land with one foot (30.5 centimeters) of water.

The district, dubbed the Met, is the largest of the 29 public agencies in the state that contract with the Department of Water Resources to use the system that delivers water, bond documents show. The allocation to the agencies is based on how much water is available, depending on the amount of rain, snowfall and reserves in a given year, Breaux said.

Fixed Charge

The department said in April that it expects to deliver 5 percent of the more than 4 million acre-feet of water requested by local agencies this year. The deliveries also help supply almost a million acres of irrigated farmland.

The Met and other agencies that contract with the department must pay a fixed portion, called the capital component, that covers areas such as debt service and the cost of the State Water Project, according to Netto-Brown. The only component of the bill that depends on the amount of water delivered is the transportation cost, she said.

Today’s bond sale is backed by revenue from the agencies’ payments, according to Netto-Brown.

“Our debt service is collected under the capital component, which is basically a fixed charge that’s not dependent on water deliveries,” Netto-Brown said.

Risk Reduced

Moody’s Investors Services rates the bonds Aa1, the second-highest grade. The nature of the contracts lessens the drought risk, and payment delinquencies or defaults aren’t likely, the company said in a Sept. 18 report. Standard & Poor’s gives the debt its top grade.

Department of Water Resources bonds maturing in December 2034 traded this month at an average yield of 3.14 percent, down from an average of about 3.5 percent during the previous half-year, data compiled by Bloomberg show.

The falling yields may deter some investors, said Craig Brothers, a money manager in Los Angeles at Bel Air Investment Advisors LLC, which oversees $2.8 billion.

“We’re not stepping aside because of the issues the state is having with water use and the drought,” Brothers said. “We would be stepping aside because the bonds are being priced at yields too low. It’s almost as if the credit is doing too well.”

The extra yield investors demand to own 10-year California obligations instead of benchmark bonds reached 0.19 percentage point this month, the smallest gap since 2007, Bloomberg data show.

The state’s finances are on the upswing. California has a projected surplus five years after logging a record deficit, and Moody’s raised its grade in June to Aa3, the fourth-highest level and the highest for California since 2001.

Today’s deal is expected to save the department about $50 million, according to Netto-Brown.

“We’re doing our small part on the finance side” to help the state’s water agencies, she said. “I can’t produce water, but I can produce savings for them.”

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