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Latest Victim of California's Drought: Water Bonds.

California's drought is starting to spread to the market for bonds issued by water utilities, long considered one of the safest types of debt sold by state and local governments.

Some investors are steering clear of the bonds from hard-hit areas of the U.S. west, amid concerns that restrictions on water use will drive down water-authority revenue. Some authorities may have a tough time raising rates to offset that lost income.

If shortages persist, credit ratings may weaken and prices for outstanding bonds fall, according to analysts and rating firms.

California water and sewer bonds lost value in April for the second month in three, falling 0.61% after Gov. Jerry Brown imposed mandatory water restrictions. All California municipal bonds posted a 0.55% decline for the month, counting price moves and interest payments, according to Barclays PLC.

California is in its fourth year of drought, one of the worst on record for the nation's most populous state. It is costing billions of dollars in losses in its agricultural sector and prompting the first-ever mandatory statewide cutbacks in water use.

It is also a rare fissure in one of the most-secure and widely traded sectors of the $3.7 trillion municipal-bond market. During last year's rally in bonds, water and sewer debt nationwide outperformed the market, rising 9.7% compared with 9% for tax-exempt bonds overall, according to Barclays. California water and sewer agencies have issued about $28.8 billion in bonds since 2010, according to Thomson Reuters.

Water-utility bonds seldom default because they're typically backed by residents' payments on an essential service. And so far the drought hasn't kept water authorities from tapping the debt market.

But the persistent water shortages show how a market prized for safety and stability can contain hidden pockets of risk, some investors said.

"The way investors have looked at water in California in the past needs to go through some evolution," said Michael Johnson, co-chief investment officer at Gurtin Fixed Income Management LLC, in Solana Beach, Calif.

Mr. Johnson said heavy investor demand for California debt of all types has raised the prices of most water bonds. That means investors may be overpaying for debt from districts with growing but unacknowledged financial problems.

His firm, which manages about $9 billion, has avoided some authorities facing challenges such as limited water storage or small financial reserves.

An April report by Moody's Investors Service warned investors that the state's water restrictions could curb revenue at water agencies. While rate increases can offset declining water use, utilities have little time to make them, and such increases may further discourage consumption.

Fitch Ratings said downgrades could occur if policy makers hesitate to make rate increases.

California isn't the only place these bonds are under scrutiny. Robert Fernandez, director of environmental, social and governance research at Boston-based Breckinridge Capital Advisors, said his firm sold bonds from at least one water authority in Texas because of inconsistent revenue and water supplies.

Breckinridge, which manages about $21.4 billion, uses 11 indicators to analyze how water availability, demand and oversight can affect an agency's ability to repay debt, looking for factors including adequate backup supplies and contingency planning, Mr. Fernandez said.

"We're not looking to say, 'we want to avoid all water systems in this area,'" he said. "We want to look for the ones that are well managed and know how to manage through these issues."

Sharlene Leurig, who directs the sustainable water infrastructure program at Ceres, a nonprofit group that promotes sustainable investing, said that while bondholders are beginning to pay more attention, the threat posed by water shortages is still poorly understood.

"I think we have a long way to go before those risks are properly disclosed and priced," she said.

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Maintaining investor demand will be important in California, where officials are accelerating parts of a voter-approved plan to sell more than $7 billion in general obligation bonds to pay for new water projects. That plan includes grants to local authorities, who may sell their own bonds.

Gary Breaux, chief financial officer for the Metropolitan Water District of Southern California, a consortium of 26 cities and water authorities that provide drinking water to about 19 million people in cities including Los Angeles and San Diego, said he's spoken with investors to reassure them that the triple-A-rated agency has plenty of sources for water and isn't foreseeing effect on its budget. Several water agencies' recent bond sales were well received, he added.

"I think investors feel reassured that we're watching all these different variables and we'll take them into account when we set our next budget, as well as the rates," he said.

Jamison Feheley, head of banking for public finance at J.P. Morgan Chase & Co., said California issuers are well prepared by prior droughts and haven't had to adjust bond offerings, though investors are paying attention.

"There are a lot of discussions with investors and rating agencies about `what's the plan? How do you expect to manage the drought issue?'" he said.

Demand for water utility debt has grown nationwide since Detroit's bankruptcy, because those investors proved better-protected than those holding tax-supported bonds, said Matt Fabian, partner at Concord, Massachusetts-based research firm Municipal Market Analytics. And while water bills may go up as the drought goes on, they're still a small portion of most households' expenses.

"Frankly, they just need to charge more for it," he said. "Once they start laying in new capital, either to fund conservation, or reuse, or desalination or whatever, it's just going to cost a lot more money."

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