Another Climate Risk for Cities: Higher Borrowing Costs.

The severe drought covering the Western U.S. threatens the economic health of municipalities and may force them to pay more for bonds that fund local projects.

The extreme drought that has gripped much of the western United States has shriveled crops, stoked wildfires, and drained reservoirs across several states. According the U.S. Drought Monitor, more than 60 million people are currently living under drought conditions in the region. For some cities, lack of water could be a fiscal as well as an environmental disaster: Prolonged droughts are threatening the creditworthiness of local governments, utilities and irrigation districts.

According to a new report from S&P Global Ratings analysts Jane Ridley, Chloe Weil and Nora Wittstruck, drought-struck municipalities may generate less income from their water systems because there's less to sell or they may have higher costs to provide adequate supplies. While cities and utilities can manage a year of dry weather, the drought conditions west of the Rocky Mountains have persisted since May 2020, with no end in sight. These conditions could slow overall local economic growth and dent property values, creating "revenue implications that can lead to rating changes."

Lower credit ratings would force local governments and utilities to pay higher interest rates on bonds they issue to fund general operations and special projects. "Cities finance their infrastructure projects with debt, so this could have a significant impact on their ability to do so," said Danielle Spiegel-Feld, executive director of the Guarini Center at New York University's law school, which focuses on sustainable energy and environmental practices.

Cities may also need to restrict water use for residents and farmers, as well as limit commercial and residential development in areas where the water supply may be insufficient to sustain additional growth, S&P said.

"In some ways, cities are between a rock and a hard place in terms of financing their debt," Spiegel-Feld said. They need to limit development in areas prone to flooding, for example, but also need the property tax revenue from building on valuable land.

But lower ratings shouldn't be a near-term problem for cities, said Bloomberg Intelligence analyst Eric Kazatsky. "Credit spreads in munis are at all-time lows, across the curve and credit spectrum," he said.

Higher borrowing costs from extreme dry weather would add to expenses governments are already shouldering to shore up infrastructure, deal with damage from other extreme climate events such as floods and wildfires, and supply adequate power.

California's hydroelectric production in the first four months of this year is 29% of that generated in the same period two years ago; the hydroelectric facility on Lake Oroville, for example, was forced to shut down for the first time when water levels dropped too low at the beginning of August. In Nevada, Lake Mead's capacity is at 35%, the lowest since the area that sends water and power throughout the Southwest was created. Both situations could force local utilities to turn to more expensive — and less climate-friendly — options, such as natural gas powered plants, S&P said.

The water problem is part of a bigger puzzle for cities to solve on the overall environmental, social and governance front, with the S&P analysts writing that water considerations “will be part of issuers’ ESG planning as they address what could become the ‘new normal’ across the West.”

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By Lauren Coleman-Lochner

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