Bond Case Briefs

Municipal Finance Law Since 1971

Climate Change Could Swamp Your Muni-Bond Portfolio.

California localities warn of disaster when suing oil companies. So how come they don't tell investors?

By the end of this century Oakland, Calif., will be experiencing a "100-year flood" every week. At least that's what the Oakland city government argued last year, when it filed a lawsuit against several oil companies for contributing to climate change. The city forecasts that rising water levels in the San Francisco Bay will threaten the sewer system and other property "with a total replacement cost of between \$22 billion and \$38 billion."

Suppose you hold some of Oakland's municipal bonds. This climate apocalypse sounds like a serious risk, right? Yet a recent prospectus for Oakland's general-obligation bonds shrugs off the threat. "The City is unable to predict when seismic events, fires or other natural events, such as sea rise or other impacts of climate change or flooding from a major storm, could occur," the prospectus states. And even if such events occur, the city can't be sure "whether they will have a material adverse effect on the business operations or financial condition of the City or the local economy."

Other California localities have told courts one thing and investors another regarding climate change. In a similar lawsuit, San Francisco claims it faces "imminent risk of catastrophic storm surge flooding." But in a bond offering last year, the city said it is "unable to predict whether sealevel rise or other impacts of climate change or flooding . . . will occur." San Mateo County claims in another suit that there is a 50% chance that a "devastating three-foot flood . . . occurs before 2030." The county uses boilerplate similar to San Francisco's to play down such risks in its communications to bondholders.

These jarring inconsistencies have led Exxon Mobil , a target of the lawsuits, to seek judicial relief. In a petition to a Texas court, the company states: "The disconnect . . . indicates that the plaintiff municipal governments do not actually believe the allegations in their complaints and that the allegations were not made in good faith." Exxon is also asking for permission to depose the lead plaintiff's lawyer, along with 15 California officials involved in filing the lawsuits.

It is possible the California officials were truthful in their attestations about their forecasts. But that means they seriously misled their investors, hoping they could ding deep-pocketed oil companies while continuing to borrow cheaply in the municipal bond markets.

This is not an uncommon practice. As a longtime investor in sovereign bonds, I can attest to the "flexibility" politicians demonstrate when approving prospectuses and agreeing to bond covenants. Reneging on contracts and explaining away misrepresentations are standard operating procedure for the political class in localities, states, countries and territories such as Puerto Rico.

Investors are relatively powerless in the face of such government dissembling. Besides selling their bonds, their only recourse is the courts. And because politicians readily spend taxpayer money to draw out the legal process, this option is generally too lengthy and unpredictable to be worthwhile.

But this case may be different thanks to the astonishing presence of contemporaneous, and directly contradictory, legally binding statements. This could prompt the Securities and Exchange Commission to abandon its hands-off approach and require state and local governments to disclose to investors risks arising from climate change, rather than allowing them to equivocate.

States and municipalities facing climate-change-associated risks would suffer a significant blow to their credit ratings, according to a Moody's Investors Service report issued in November 2017. Municipalities that sought big paydays from major oil companies may end up with a bitter second prize—more disclosure and higher borrowing costs.

Plaintiffs' lawyers probably never intended that their war on the fossil-fuel industry would end up shining a light on the perilous state of local public finances. But wars have a funny way of creating unintended consequences. If the unqualified statements made in court about the impact of climate change are even half true—regardless of the cause—the finances of many of California's coastal cities could soon be underwater.

The Wall Street Journal

By Jay Newman

Feb. 2, 2018

Mr. Newman is a former hedge-fund manager who specialized in sovereign debt.

Copyright © 2024 Bond Case Briefs | bondcasebriefs.com