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Fitch: California Wildfires, Blackouts Highlight Utility Operating Risk

Fitch Ratings-Austin/New York/Chicago-27 August 2020: California wildfires and rolling power outages earlier this month do not have an immediate effect on the credit profiles of the state's investor-owned utilities (IOUs), public-owned utilities (POUs), community choice aggregators (CCAs) and renewable developers, Fitch Ratings says. The occurrence of these two events simultaneously, although unrelated, underscores the challenging utility operating environment in a state prone to natural disasters, which is incorporated in the ratings.

Due to increasingly destructive wildfires triggered by IOU equipment in 2017 and 2018, the three largest California IOUs initiated public safety power shutoffs (PSPS) designed to prevent catastrophic wildfires in 2019. In Fitch's view these outages, in concert with power interruptions driven by heat-related, supply-demand and other issues, diminish customer satisfaction while increasing political risk. A potential decline in ratepayers in those areas where residents and businesses choose not to rebuild, coupled with increased wildfire-related and green economy costs, could pressure utility cash flows in the longer term, absent robust regulatory constructs or other offsetting factors, such as greening the transportation sector and buildings.

Blackouts and wildfires will encourage residential installation of solar-plus-battery storage as utility customers increasingly look for alternative energy sources, reducing demand for utility-provided energy and eroding revenues. Widespread adoption of residential storage would shift load patterns and may obscure the California Independent System Operator's (CAISO) ability to estimate appropriate reserve margins.

Some renewable projects are at risk of unreimbursed curtailment if CAISO directs them to derate for emergencies, such as wildfires, which has not occurred but could erode credit quality if it were to become a persistent issue. If there are increasing periods where power prices jump by many multiples above average pricing, some renewable projects may be able to capitalize on those opportunities and receive a short-term revenue boost.

A record of almost 1.4 million acres has burned across California since last week, leading to the declaration of a state of emergency. The current fires, which were caused by an unusually large number of lightning strikes related to intense thunderstorms and extreme heat, are not expected to expose utilities to third-party liabilities and financial harm. Under the doctrine of inverse condemnation, California utilities are held strictly liable if their equipment is determined to have sparked a wildfire.

The blackouts earlier this month, which occurred primarily in some IOU service areas, were initiated by CAISO, due to an unprecedented heat wave in the Western US and system challenges related to meeting electricity needs with existing resources. The power outages will be investigated by key regulatory agencies with the goal of delivering more reliable power as California transitions to a clean energy economy. The outages are unlike the service interruptions initiated last year by the three large IOUs to decrease wildfire risk. Fitch expects PSPS to be used by IOUs as a tool to

prevent catastrophic wildfires during periods of high weather-related risks. CCAs are affected by CAISO blackouts and PSPS events as their energy supplies are delivered by the IOUs' transmission and distribution systems.

Wholesale electricity prices in California spiked due to the recent energy shortfall. IOUs meet supply needs through a mix of in-house generation and long-term purchase power contracts. When demand is high and IOU supply is insufficient, they may need to purchase higher cost power on the spot market to help meet demand, which could temporarily pressure cash flow until such costs are collected in rates.

Fitch-rated POUs did not experience blackouts earlier this month. The POUs own generation assets and, in some cases, high-voltage transmission lines that permit energy to be imported from other states. Generation assets and transmission capacity provided a physical and financial hedge against the capacity and energy shortages.

POUs had sufficient resources to serve their own loads when energy supply became scarce and market prices spiked. A number of POUs also sold energy into the wholesale market, augmenting revenue when prices rose. Nevertheless, risk exists that any potential solution will impose greater cost and regulatory requirements on the POUs, but there is no short-term credit impact of the blackouts on POUs.