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Investment Brief: California Wildfires' Potential Impact on Municipal Bonds

Here, we address questions we have received from investors about how the blazes might affect municipal credits in the state.

In Brief

- We expect that very few municipal credits in Los Angeles and Ventura Counties will face any long-term negative credit impact from the January 2025 wildfires.
- School districts affected by wildfires have received financial support from Sacramento in the past, while revenue-bond issuers should face limited to no long-term credit impact from the wildfires.
- In assessing the financing of recovery efforts, we would note that in previous disasters, the rebuilding process has historically been supported by a range of solutions including significant federal aid, support from state governments, and funding mechanisms such as increased taxes, higher utility rates, and issuance of additional municipal debt.
- While the potential liabilities, if any, faced by the electric-utility arm of the Los Angeles Department of Water and Power (LADWP) may not be determined for some time, we believe that LADWP has strong cost recovery mechanisms available, with extraordinary support from governmental entities also being possible.

The series of wildfires that broke out in Los Angeles in early January has caused tremendous damage, and our thoughts are with all those affected, their friends and families, and the first responders working to contain the blazes. At times like this, it is difficult to see past the immediate suffering, but investors in California municipal bonds should be reassured that we expect very few municipal credits in Los Angeles and Ventura Counties to face any long-term negative credit impact from the disaster. In addition, investors may take some comfort in the fact that municipal bonds directly support fire prevention and containment efforts—financing the construction of fire stations, the acquisition of fire trucks and emergency service vehicles, and the maintenance of water infrastructure that makes fighting fires possible.

The road to recovery after disasters is often a long and difficult one, but time after time, we have seen impacted communities show resilience following disasters, whether they are hurricanes, ice storms, or wildfires. The rebuilding process has historically been supported by significant federal aid, extraordinary state legislation, and state support, in addition to more traditional routes for raising funds such as through increased taxes, higher utility rates, and issuance of additional municipal debt. Considering all the financial levers available to municipal entities, we view the downside more as the time it will take to determine the solution rather than the actual risk of nonpayment of financial obligations.

Government & School District Impact

As we discussed in a previous article, California's general obligation credit standing remains strong. While concerns about the liabilities created for the state's insurer of last resort, the FAIR Plan, have been well publicized, less frequently noted is that the state is not responsible for making up any

shortfalls that may materialize from claims related to wildfire damage—the burden will be spread across ratepayers all over the state in the form of insurance surcharges and thus will not directly affect the state’s finances.

While the large size and revenue diversity of city and county credits help insulate them from localized emergencies, the state’s school districts, with their reliance on enrollment-linked state revenues and often much smaller size, face a different set of challenges. Fortunately, the state has historically been very quick to step in when disaster strikes.

Case in point: Following the 2018 Camp Fire, the Paradise Unified School District lost nearly half of its enrollment in one year as families were forced to relocate while rebuilding efforts commenced. The state immediately tasked the Fiscal Crisis & Management Assistance Team with identifying a solution, and quickly passed emergency “hold harmless” provisions that granted the district additional funding that was gradually phased out through fiscal 2023. Because of the state’s prompt and effective action, the district’s credit rating remained investment grade, and no negative actions were taken by the rating agencies while the hold harmless provisions phased out.

Two areas that have been significantly affected by the current wildfires are Pacific Palisades and Altadena. Because neither Pacific Palisades nor Altadena are independent municipalities themselves, there are no outstanding general obligation bonds that are backed solely by these areas.

Sector Impact

Beyond tax-backed debt, the municipal bond market also consists of other sectors such as healthcare, higher education, transportation, and utilities. In our analysis, almost all such credits operating in Los Angeles County and Ventura County should face limited to no long-term credit impact from the wildfires due to strong existing creditworthiness or sufficient physical distance from the wildfires, although a few names need to be monitored given proximity to the blazes. There is a very limited number of names and sectors that we would expect to see negative credit impact from the wildfires.

One sector that could be negatively affected would be real estate development deals in the direct path of the wildfires. Known in our market colloquially as “dirt” deals, such issuances are typically secured by special tax assessments on property or revenues derived from incremental assessed value growth within the area where the development took place. Issuances backed by very small acreage face stress if hit by a force majeure event. In our review of the broader California dirt market, we have pinpointed very limited outstanding dirt debt which may see a negative credit impact from the recent fires.

Focus on LADWP

The highest-profile municipal issuer in the headlines is the Los Angeles Department of Water and Power (“LADWP”). The electric arm of LADWP serves much of Los Angeles County including Pacific Palisades. In California, electric utilities are liable for wildfire damage caused by their equipment. It has not been formally determined if LADWP equipment in Pacific Palisades sparked the Palisades Fire, and a formal determination is likely months away, but at least two media outlets have reported that no LADWP equipment was in the immediate vicinity of the ignition point, and that the fire is initially suspected to be caused by humans.

In the meantime, we think it is worth reviewing LADWP’s credit strengths. LADWP is the largest municipal utility in the country and is currently highly rated (following S&P’s downgrade of the debt to ‘A’ on January 14, LADWP is rated either ‘AA’ or ‘A’ by all three major rating agencies). Unlike corporate utilities, LADWP, as a municipal utility, has independent rate-setting authority, which includes the ability to raise rates or issue debt as it sees fit, without any third-party oversight.

Significant wildfire-related liabilities, if any, could be addressed by issuing debt and raising rates, and/or via extraordinary support from the city, county, state, or federal governments. Higher rates would be suboptimal for LADWP ratepayers. However, residential rates are currently 21 cents per kilowatt-hour (kWh), significantly lower than the 32 cents per kWh rate paid by residential customers of Southern California Edison (SCE), the largest electric utility adjacent to LADWP. Therefore, LADWP retains very significant ability to raise rates if needed. We would also note that, per a recent Moody's default study,¹ there have historically not been any municipal electric utility defaults due to weather incidents like hurricanes, wildfires, and other events.

We expect continued headline risk, but we also note that (1) cost recovery mechanisms for LADWP are inherently strong; (2) the cause of the Palisades Fire remains undetermined with initial speculation being that the fires were not sparked by LADWP equipment; and (3) even if LADWP is found liable for significant damages, there is a playbook in place to address such costs in an orderly manner, with extraordinary support from governmental entities also being possible. Nevertheless, it is important to continue to monitor the still-ongoing fire developments and the size of any potential liabilities, which have continued to grow.

The previously mentioned SCE has also been in the headlines, as the large Eaton fire was sparked within its service area. SCE, which has a very limited amount of municipal debt outstanding, is a regulated investor-owned utility that is subject to a different cost recovery process. We would note, though, that SCE has access to a significant, newly formed, \$20 billion-plus wildfire fund available for the three California based investor-owned utilities. Further, the limited number of outstanding SCE municipal bonds are senior secured, meaning that in more stressed scenarios they would likely be senior to any potential unsecured wildfire liabilities.

Looking Ahead

After the fires are contained, public attention will turn to how communities will be rebuilt, how such events can be prevented in the future, and whether there will be an entity or entities that will be deemed financially responsible. We view rebuilding as inevitable given the attractiveness of the affected real estate locations, but questions will remain about the longer-term impacts on demographics and the insurance market. In terms of future prevention, storm hardening and wildfire mitigation protocols will be top of mind as the state finalizes its latest budget in the coming months.

Finally, we reiterate that we expect very low probability for any municipal bond payments to be disrupted, and that almost all municipal credits in California should see little to no credit impact from the recent wildfires. Even those that could see a potential credit impact, like LADWP, have very strong credit fundamentals and a playbook if needed to address very significant costs. We do expect headline risk to remain though, for many months, but not all unfavorable headlines will necessarily mean a negative credit impact.

LORD ABBETT

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January 14, 2025