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S&P Credit FAQ: What Are The Credit Implications Of The Los Angeles County Wildfires?

The recent and still currently active Los Angeles County wildfires pose significant financial and operational risks for U.S. public finance and regulated utility issuers. S&P Global Ratings is closely monitoring the near-term effects and longer-term credit implications of the Palisades, Eaton, Sunset, Hurst, and Kennedy fires. Our analytical views consider how California's strict liability framework, its more frequent and severe physical climate risks, and utilities' and cities' approaches to adaptation and resiliency influence ratings.

The Los Angeles County wildfires could be California's costliest in economic losses. Many U.S. public finance and regulated utility entities we rate—including not-for-profit public power and water and sewer utilities; local governments; and school districts as well as investor-owned utilities—have assets and tax bases in the areas with recent or active fires. The associated substantial destruction could result in infrastructure damage, significant liabilities, and revenue losses from outages and customer dislocations.

Our U.S. public finance and regulated utility analysts answered market participants' questions about credit impacts of these wildfires in a webinar on Friday, Jan. 17, 2025. In this Credit FAQ, we provide comprehensive clarity on the credit implications for California public finance and regulated utility issuers affected by the wildfires.

Key Takeaways

- The growing frequency and severity of climate-related physical risks can affect the credit quality of some entities more than others. Californian utilities' liquidity, insurance, asset adequacy, resilience, and emergency preparedness can face acute credit risks from wildfires—and the potential for wildfire litigation could pose more substantial risks to entities than damage to infrastructure.
- Because utilities have unique exposures and specific mitigation approaches, our ratings are reviewed case-by-case. On Jan. 14, S&P Global Ratings lowered its long-term and underlying ratings on the Los Angeles Department of Water and Power, with both ratings placed on CreditWatch with negative implications, due to our view of heightened risk for both systems. Our current stable outlook on Edison International is predicated on the credit protections afforded to the electric utility through the California Wildfire Fund, which is a fundamental aspect of how we assess credit ratings for all investor-owned utilities in the state. We rate local governments and water and sewer utilities within the wildfire boundaries, and are evaluating potential near-term effects on associated service areas and longer-term implications for underlying infrastructure.
- In our view, the state of California and Los Angeles County's notably strong economic and tax base will support resilience through this disaster. Our Jan. 15 action placing our 'AA' long-term rating on the City of Los Angeles on CreditWatch with negative implications reflects our view that the city's general credit quality could weaken if utilities' credit quality materially weakens further, and acknowledges weakening financial trends existed before this wildfire event.
- Insurers will likely absorb the significant losses from the Los Angeles County fires, including

California's Fair Access to Insurance Requirements plan. We believe our rated primary insurers can weather losses after strong results last year but may see earnings pressure later in 2025.

How does S&P Global Ratings assess overall credit risks associated with wildfires for utilities in California?

Wildfires pose significant credit risk in California due primarily to the associated legal liabilities and physical climate risks.

With California's strict legal framework, wildfire litigation risk is more problematic than the risk of damage to a utility's infrastructure assets. Utilities in the state can be liable for wildfire claims if its facilities were a contributing cause of a wildfire—regardless of negligence. California remains the only western U.S. state that supports this legal interpretation for utilities.

Additionally, physical climate risks are an increasing credit consideration. California experiences extreme wet and dry weather whiplash, increasingly aggressive windstorms (such as the Santa Ana wind phenomenon), and moderate to severe droughts—conditions that create perfect conditions for wildfires. Wildfires are becoming more severe and expansive, spreading quickly as winds carry burning embers into urban neighborhoods that were previously perceived as lower risk.

As these risks increase, many of them caused, at least in part, by climate change, we are reassessing whether utilities' liquidity, insurance, asset adequacy, resilience, and emergency preparedness are insufficient or outdated.

Our view and analysis of wildfire-related credit risks continues to evolve as we learn from such extreme weather events that are increasing in frequency and severity. Given that each utility we rate has both unique exposures and specific approaches to mitigating them, our ratings are reviewed case-by-case. Longer-term credit implications could materialize as we continue to consider the increasing frequency and severity of wildfire events.

What factors influenced S&P Global Ratings' lowering of its ratings on the Los Angeles Department of Water and Power utility?

On Tuesday, Jan. 14, S&P Global Ratings lowered its long-term and underlying ratings on the Los Angeles Department of Water & Power's (LADWP) power and water system by two notches—with the former to 'A' from 'AA-', and the latter to 'AA-' from 'AA+', with both ratings placed on CreditWatch with negative implications.

Our downgrade on the power system bonds reflects the increasing frequency and severity of highly destructive wildfires within LADWP's service territory, and recent spread into more urban areas, which highlights the utility's potential vulnerability to financial liability claims that could eclipse its liquidity and insurance coverage. Such vulnerabilities, alongside the various physical climate risks faced by utilities, and California's strict legal framework, led us to reassess the adequacy of the utilities' reserves and insurance coverage that we incorporated into the previous rating level.

While no determination of cause has been made for these recent wildfires, the department faces wildfire claims from a 2019 fire when its power lines were determined to be the cause of the Getty Fire (resulting in $81 million in claims that were covered by insurance). Claims for the ongoing Palisades Fire could be significantly larger if LADWP is implicated. According to LADWP's wildfire mitigation plan, the utility has in recent years indicated that they consider preemptive de-energization of overhead power lines during threatening conditions to have more significant adverse effects on customer health, safety, and quality of life that outweigh the potential benefits of taking

this action. This is a notable difference in policy compared to most other electric utilities in the state that, in our view, creates credit risk—particularly given LADDP's exposures in high-risk wildfire zones.

If the power system is found liable and receives claims that far exceed its liquidity and insurance, it could potentially face additional downgrades, potentially by multiple notches—depending on the amount of the claims. It could create the possibility of Chapter 9 bankruptcy, which the power system could potentially avoid by issuing debt or a securitization—again, all depending on the size of claims.

While the water and power bonds are each separately secured, the two systems are under the same department, have common management, share a line of credit, and even use the same billing system. This highlights the many interdependencies between systems and prompts consideration of the risks facing municipal enterprises charged with providing essential public services.

The downgrade of the department's water system bonds reflects our view of heightened potential for litigation liabilities alongside escalating costs surrounding the adequacy of existing water system assets, resilience, and emergency preparedness—especially during these events. The lower rating also reflects the potential for contagion risk from the power system, as both systems are part of a singular department featuring a plethora of common interdependencies. As with the power system, these water system exposures have led us to reassess the adequacy of water system liquidity that can act as a resource or buffer for these potential liabilities and costs. The risk of litigation directed at LADWP for water supply mismanagement is already present, as lawsuits have been reported by various media.

We downgraded both the power and water systems by the same number of notches because, in our view, there is heightened risk for both systems. However, their creditworthiness can be different and there is no mechanical link between them.

Our CreditWatch placements reflect our view that, over the next 90 days, there is a 50% probability we could further lower our ratings on both the power system and on the water system. An additional downgrade on the power system could be by multiple notches if the utility infrastructure is identified as a source of ignition, or if there's significant additional damage and customer dislocation. We could lower our rating on the water system if the utilities' management of its operational preparedness is determined to have been deficient, if we believe contagion risks with the power system have increased materially, and/or if measures required to make system improvements will impair financial metrics or rate affordability.

If LADWP is found to have not been liable, we could remove the ratings from CreditWatch and assign a stable outlook. In the event we believe there are other credit risks, there could be additional negative rating actions. But regardless of any determination of liability, our downgrade was based on our belief that LADWP is more exposed to physical climate events, and that its insurance and reserves were inadequate at the prior level.

Why does Edison International have a stable outlook, and how does the California Wildfire Fund support credit quality for investor-owned utilities?

At present, our credit rating on Edison International is 'BBB' with a stable outlook. We are continuing to carefully monitor the risk to Edison and could update our views on the ratings or outlook as the situation develops.

To date, Edison has filed two electric safety incident reports with the California Public Utilities

Commission related to the Eaton and Hurst fires. Edison stated that it filed these reports out of an abundance of caution because the incidents may meet the Commission's technical reporting criteria.

Our primary focus is on the Eaton Fire that the California Department of Forestry and Fire Protection (CAL FIRE) estimates has damaged or destroyed more than 14,000 acres, about 10,500 structures, and is currently about 87% contained. Edison had reported that no interruptions or electrical or operational anomalies were identified until more than one hour after the wildfire's reported ignition time, based on its preliminary electrical circuit information for the energized transmission lines through that area. The company also reaffirmed this analysis in its public comments during subsequent interviews. To date, no fire agency has yet suggested that Edison's electrical facilities were involved in the ignition of the fire or requested the removal and retention of any of Edison's equipment.

Despite the company's assertions, several lawsuits have already been filed against Edison and its subsidiary Southern California Edison Co. Our stable outlook on Edison is predicated on the credit protections afforded to the company through the passage of AB 1054 in 2019, which established and funded a $21 billion Wildfire Fund for California's investor-owned utilities. This fund serves as a material source of liquidity and financial support in the event of a catastrophic wildfire. The California Wildfire Fund clearly differentiates Edison from investor-owned utilities that operate outside of California, underpinning our view of Edison's credit quality, and is the key credit-supportive component for our investment-grade rating.

Another credit supportive aspect of AB 1054 is the establishment of a liability cap that limits the investor-owned utilities' liabilities for catastrophic wildfires. This curbs Edison's exposure to approximately $4 billion—that, if fully funded with debt, would weaken Edison's funds from operations to debt by about 200 basis points. Edison's consolidated funds from operations to debt for the 12 months ending Sept. 30, 2024, was 14.9%, or about 90 basis points above our14% downgrade threshold.

Another important provision of AB 1054 is its revised standard for determining a utility's reasonable conduct, placing the initial burden of proof on the intervenor. Overall, we've consistently stated that we assess these measures in AB 1054 as highly credit-supportive for California's investor-owned utilities because they temper financial exposure to wildfire liability. Under California's interpretation of the legal doctrine of inverse condemnation, a Californian utility can be financially responsible for a wildfire if its facilities were a contributing cause of the fire irrespective of negligence.

However, we will continuously reevaluate Edison's credit risks. Notably, the California Wildfire Fund does not have an automatic replenishing mechanism. As the fund gradually depletes, credit quality would likely weaken. Under AB 1054, when the Wildfire fund is fully depleted, California's investor-owned utilities not only lose the credit benefit of using the fund as a source of liquidity and financial support—but also lose the credit protection of the liability cap. As such, as fund levels decline, this would likely hurt the credit quality of all of California's investor-owned utilities.

The severity of the current wildfire suggests the potential for a more challenging operating environment going forward due to the ongoing effects of climate change. The catastrophic Camp Fire of 2018 and a persistent increase in the frequency of severe wildfires of this scale, may lead us to reassess California's investor-owned utilities' risk exposure and would likely have a negative impact on ratings. As such, we will continue to actively monitor any subsequent developments and their implications for Edison's credit quality.

The mechanics for reimbursement through the California Wildfire Fund can be best explained through the case study of the 2021 Dixie Wildfire that was determined to be caused by PG&E's

equipment. The company has since recorded liabilities of approximately $1.9 billion on its books and has paid out more than $1 billion in third-party claims. The fund has a third-party administrator that reviews all claims. Once the administrator determines that PG&E met its $1 billion deductible, PG&E can seek reimbursement from the Wildfire fund. After all claims are substantially settled, PG&E then undertakes a prudency review with the California Public Utilities Commission (which can typically take between 12-24 months). If the commission finds that PG&E acted prudently, then there would be no requirement for PG&E to reimburse the Wildfire fund.

Alternatively, if the commission determines that PG&E was imprudent or partially imprudent, the utility must reimburse the fund up to its liability cap. The cap is applicable only if the utility has a valid safety certificate, and if the administrator determines that the utility did not act in any manner that showed disregard for the rights and safety of others. For PG&E and Edison, the cap is approximately $4 billion.

In our view, if third-party settlements with Edison reach a significant threshold, Edison would likely follow a similar process. Edison has $1 billion in wildfire-specific insurance, which covers the fund's deductible. Edison also has a state-approved wildfire safety certification and wildfire mitigation plan in place. In assessing the thresholds for potential downgrades of investor-owned utilities, we will look at the key metrics of funds from operations to debt (or FFO, which we define as EBITDA less cash interest and taxes paid). For Edison, we have a downgrade threshold of FFO to debt below 14%.

Prior to the recent Southern California catastrophic wildfires, our base case assumed that Edison's FFO to debt would improve in 2025—incorporating their pending general rate case and recent settlements in the Thomas and Koenigstein fires and the Montecito mudslides that are pending approval with the California Public Utilities Commission.

Comparatively, our downgrade threshold for Sempra is FFO to debt below 15%. Our recent revision of our outlook on Sempra to negative from stable reflects the company's minimal financial cushion relative to its downgrade threshold. Sempra faces both high capital-spending needs and rising operating costs, which pressures its financial measures. Furthermore, Sempra's utilities recently received several rate case orders and after fully incorporating them into our base case, we expect that Sempra's consolidated FFO to debt will likely remain below our downgrade threshold.

Many factors support the California Wildfire Fund's stability, particularly that it depletes very gradually and over a prolonged process. First, third parties' lawsuits against utilities could take substantial time to fully resolve or to ultimately settle. Only after the claims are paid by the utility in an amount that exceeds their wildfire insurance does the utility then file for reimbursement from the fund. Even in the best-case scenario, this process is likely to take several years.

Additionally, the fund is administered by the California Earthquake Authority, which has the right to issue securitization bonds backed by the non-bypassable charge on electric customers' bills. If the authority decides to issue securitization bonds, that would ultimately increase the fund's assets to about $21 billion. To date, the authority has not made the decision to issue the securitization bonds, believing that it's not yet necessary.

Because availability and access to the fund is a fundamental aspect of credit quality for California's investor-owned utilities, a material depletion of the fund could potentially weaken ratings.

What factors may lead S&P Global Ratings to take rating actions in California's water and sewer sector?

We rate several large and small water and sewer utilities within the wildfire boundaries. We are evaluating the potential effects on the associated service areas in the near-term and underlying infrastructure over the longer-term. Additionally, we are assessing their likely impact on affordability and financial performance, especially considering California's limitations regarding rate-raising and cost of service.

Our criteria include an evaluation of both emergency preparedness (the effectiveness of communication; wildfire mitigation; planning, prevention, and response; and system redundancies; among others) and asset adequacy (including whether the assets are sufficient to provide and maintain basic services relative to the known risks and are hardened sufficiently to meet higher risks). This is handled directly through our operational management assessment, which is a critical credit driver and vulnerabilities can cap ratings.

In analyzing financial performance, we assess the costs associated with wildfire recovery in the service area and for system assets. The length of time it takes to rebuild could affect revenue collections, which we model and stress to determine potential consequences. One of the most common operating challenges associated with wildfires in the water and sewer utilities sector is contamination to existing supply—which can increase treatment costs, render reservoirs completely unusable, and can be prolonged for years. Secondly, we assess any reinvestment that will be necessary to harden infrastructure to the levels needed to meet heightened wildfire risks such as these.

Given the magnitude of this catastrophe, the statements made publicly regarding water sufficiency and operational deficiencies, and the governor's request for investigation, we believe it's likely that substantial system improvements will be required, many of which we expect will be costly. Lastly, we assess the exposure to increasing liabilities and litigation that's associated with the adequacy of assets and the response.

The evolving nature of the situation creates uncertainty and lack of clarity on the potential cost associated with the liabilities of litigation. In our view, LADWP faces heightened exposure for litigation, given media reports of legal action alleging mismanagement of supply during the Palisades Fire. While lawsuits don't necessarily mean claims will lead to liability outcomes, we view this risk as elevated.

Against this backdrop, several of these utilities also face challenging water supply issues and regulatory mandates, which compound these pressures and the already rapidly rising cost of service. We believe this could lead to greater repair fatigue or margin compression.

Short-term cost implications and long-term assumptions for future adaptation are the primary credit drivers for the water sector—with an already significant capital plan and associated financial capacity and affordability consequences.

How will insurers absorb losses associated with these wildfires?

Across the U.S., 32 states (including California) utilize the Fair Access to Insurance Requirements plan (FAIR)—which originated from the 1968 Civil Rights Act to aid homeowners facing discrimination in attaining homeowners' insurance to now also providing coverage for properties in disaster- and fire-prone areas where commercial providers are exiting. FAIR plans are authorized by state statute, with premiums paid at the time of annual renewal from policyholders and in some cases from private insurers as a right to provide coverage in the state. (FAIR is not operated by state agencies nor funded within state budgets or taxpayer dollars.)

While we do not rate FAIR plans, we monitor the growth of these plans as anecdotal to rising affordability issues.

According to California's latest FAIR plan reports, the state's total exposure was $458 billion as of September 2024—covering 250,000 dwellings and 8,000 commercial properties, and $1.4 billion in written premiums last year. California's FAIR plan policies cap coverage at $3 million for residential coverage and $20 million for commercial coverage. Considering that the average home value in the Pacific Palisades area was above this coverage capacity, the state FAIR plan has reported $5.89 billion in property value coverage there, as well as more losses from other fires (Altadena FAIR covered properties are valued close to $1 billion). The tremendous devastation in that area is evident, but the total amount of possible claims and losses is yet to be seen. The FAIR plan reportedly has $377 million in cash, and roughly $5.78 billion in reinsurance available to begin to address the coming claims.

Should that not be enough to cover claims, FAIR would raise written premiums on all plan holders and private policyholders and can assess the insurers themselves. FAIR has passed this assessment onto insurance before, most recently during the 1994 Northridge earthquake which saw significant damage in the Los Angeles area. California's insurance regulator has also announced that the first $2 billion beyond what FAIR is able to cover will be split evenly between assessments on insurance companies in the state and policyholders. Companies would contribute in-line with their percentage of the California market they insured in the state over the past two years. For example, if an insurer had 20% market share in California, they would be responsible for 20% of the assessment of the policy and the remaining would be assessed on the policyholders.

If the FAIR plan lacks necessary liquidity or in some way becomes insolvent, there's no obligation for the state of California to help in any financial way. Overall, we're expecting that the FAIR plan will have significant obligations to cover, but the structure of that entity and the design of its provisions to respond will be used to help cover those costs.

In our view, insurance in California will be more costly after these fires. As physical climate risks have increased, the California insurance market has evolved and in recent years we've observed an exodus of commercial insurers. Authorities have made regulatory enhancements in hopes of keeping and luring providers back—allowing insurers to use a catastrophe model to justify premium increases and allowing providers to pass reinsurance costs to policyholders. These provisions alone would likely have prompted some premiums to increase in the state, but the combination of the worsening wildfires and the potential for the FAIR plan to pass on assessments will likely see premiums increase even more.

The significant wildfire losses in the first two weeks this year could rapidly deplete the catastrophe budgets of U.S. primary insurers. This early strain may lead to earnings pressure later in the year, especially if 2025 proves to be above average for catastrophes. However, we believe our rated primary insurers can bear the brunt of the Los Angeles wildfire losses, after strong results in the first nine months of 2024 (and likely for the year), combined with a material reduction in policy coverage in wildfire prone areas in California.

The impact from the wildfires is, in our view, manageable for our rated global reinsurers, with no significant effect on earnings due to the event's magnitude and timing.

What is the status of the credit ratings for the state of California, the city of Los Angeles, and their local governments?

In our view, the state of California and Los Angeles County have a notably strong economic and tax

base, and as such will be resilient through this disaster. We maintain a 'AA-' credit rating with a stable outlook on the state of California, which is slightly below average for U.S. states (with our median rating for the state sector being 'AA+').

Credit attributes we've cited for supporting that rating include California's dependency on volatile capital gains revenues, the frequency of physical climate disasters, and recovery costs, among others—which have recently affected the state's large and complex budget that was submitted in the same period as these wildfires started.

Governor Newsom released a proposed budget on Jan. 10 and now the legislature will begin deliberation. The fiscal 2026 proposal did not have many new programs, and we believe it represents a continuation of current policy. Of note though, related to the fires, this proposal includes doubling the budget for CAL FIRE and hiring 2,400 additional firefighters.

We see the transparency of California's operating data as a credit strength. We're able to check publicly shared monthly revenues and expenditures, annual cash flow estimates, and regular updates to forecasts. When the state revisits the current year and the following year budget expectations in its May Revise, we believe this may be even more informative than normal, considering California will have a clearer picture of the costs associate with the fires and the actions needed for further recovery. At this time, we are not expecting a state rating impact from the Los Angeles County wildfires.

We expect federal funds will cover a significant share of cleanup and recovery costs (with the Biden Administration committing to covering removal costs for six months) as seen with other natural disasters across the U.S. in in recent years. This will alleviate some of the short-term expenditure pressures. State officials have informed us of their efforts to expand staffing in the Fire Zone to help expedite recovery programs and explore other measures to support those facing losses to rebuild as quickly as possible. Governor Gavin Newsom has already asked the state legislature for $2.5 billion for disaster response and rebuilding and repairing schools.

Last week, we placed our 'AA' long-term rating on the City of Los Angeles on CreditWatch with negative implications. While we're not aware at this time of any specific wildfire litigation against the city that is unrelated to its utilities, our recent action reflects our belief that the city's general credit quality could weaken to some degree if the credit quality of the utilities materially weakens further.

Within our holistic analysis of the city, we recognize that LADWP and the city are the same organization, charged with providing services to the same constituency. As such, we believe that the city's general credit is not entirely insulated from any impacts the LADWP may face, given the various aforementioned financial, economic, and governmental interdependencies. Because the LADWP provides essential services to the Los Angeles community, its ability to do so in a manner that is both effective and affordable to the population will play into both long-term economic stability and the government's own fiscal sustainability. Our view on the interconnected nature of the city and its utilities does recognize the city's incentive to support those efforts.

Independent of any financial implications of the fires, our CreditWatch action on Los Angeles also acknowledges weakening financial trends the existed prior to this most recent wildfire event. Regardless of specific litigation filed against the city or its utilities, our credit risk assessment will incorporate its heightened risk exposure to climate events and the potential financial implications.

For local governments, we continue to monitor the associated impacts of the wildfires for issuers with tax-backed securities. Our analysis considers both the tax base and the overall operating profile

of the entity. Across Los Angeles County's affected areas, we anticipate varying degrees of credit impacts—depending on the extent of any assessed value losses or presence of any forms of revenue flexibility. We are closely watching tax increment and special assessment credits that could face acute risk if their taxpayer bases are materially affected. By design, these closed financing structures have relatively narrow taxing boundaries, limited excess liquidity, and may be sensitive to the impacts on the underlying tax base.

We see the potential for certain local governments with smaller tax bases and limited liquidity or reserves to come under credit pressure if they face significant revenue disruptions from reduced assessed values or decreases in local economic activity. In the short-term, we anticipate that affected local governments will lean on reserves to manage this potential period of lost revenue. In the long-term, rebuilding efforts could eventually support revenue growth if we see a recovery in assessed value or a boost in consumption-based taxes. Comparatively, full-service municipal government and school districts will have greater ability to adjust to changing circumstances, whether those are financial or economic.

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