
S&P U.S. Brief: Los Angeles Wildfires And Variable-Rate Municipal Debt

Los Angeles area wildfires threatens utility-backed debt performance. Ongoing Wildfires pose prepayment risks for municipal bonds backed by California-based obligors.

What's Happening

Several wildfires erupted across the greater Los Angeles area on Jan. 7. Although the extent of the damages is still developing, with some figures estimating as high as $150 billion, credit deterioration has already begun. On Jan. 15, we lowered our long-term ratings on 20 municipal bonds issued by the Los Angeles Department of Water and Power, one of the largest variable-rate municipal issuers in the U.S., to 'A' (Power) and 'AA-' (Water) and placed the ratings on CreditWatch with negative implications. S&P Global Ratings currently rates 119 variable-rate demand obligations (VRDOs) and 91 tender option bond (TOB) certificates financing projects located in Los Angeles County and the surrounding area.

Why It Matters

Severe damages could lead to early prepayment of principal and interest. This is due to following factors:

- In VRDOs, severe damages could lead to a number of events, such as extraordinary redemption, that result in prepayment of principal and interest.
- If the physical project is damaged or destroyed, the obligor may receive insurance or condemnation proceeds to pay debtholders. Those funds could be considered part of the obligor's estate and present the risk of clawback in an obligor's bankruptcy. Therefore, we typically see redemptions funded by letter of credit (LOC) funds "to the extent" of receipt of insurance proceeds, thus eliminating the clawback risk. Nineteen of our ratings on the VRDOs and TOBs are supported via self-liquidity by the obligor, which do not benefit from third-party support and exclusively rely on the obligor to ensure principal and interest to the certificateholders.
- For TOB certificates, in lieu of a supporting credit facility, the certificateholders should expect potential rating movement if the repackaged municipal bonds undergo credit stress.
- If the rating on a TOB falls below investment grade or 'BBB-', the TOB trust will unwind and the bonds sold to cover principal, interest, and fees.
- For VRDOs that benefit from a liquidity facility, certificateholders will immediately lose their optional tender rights but not become subject to an immediate payment event.
- For joint and several ratings that benefit from support from both the municipal obligor and a credit facility, we will assess whether the downgrades on either party results in a lower joint and several rating.

What Comes Next

The overall credit impact on U.S. VRDOs and TOBs could be significant. The recent downgrades on the Los Angeles Department of Water and Power will likely have a meaningful impact on the overall performance of U.S. utilities-backed municipal debt. Although these downgrades account for only a small segment of all rated utilities-backed VRDOs and TOBs, not-fo--profit utilities comprise approximately 30% of the total outstanding principal balance. Further, of the 210 ratings exposed to Los Angeles County and the surrounding area, public transportation and not-for-profit health care, which both remain unaffected at this time, account for nearly 45%.

We will continue to monitor developments on the wildfires and the credit deterioration on affected obligors, and their potential impact on variable-rate municipal debt.

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