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**MuniNotes**
*from our Credit Research Team*

**February 2025**

# California wildfires: risk and resilience for muni bonds

*Several major wildfires caused widespread devastation in parts of Southern California in early 2025, with preliminary estimates of damage and economic loss ranging from $250 billion to $275 billion. Insured losses could be as high as $40 billion. The state and federal government, as well as private insurance, will play an important role in mitigating the credit impact on municipal bonds and encouraging rebuilding efforts.*

## HIGHLIGHTS

- **A balanced budget and ample reserves better position the state to manage the aftermath.**
- **The FAIR Plan, California's insurer of last resort, may aid local communities.**
- **Investors have been most concerned about negative credit developments for utilities.**
- **Rating agencies were quick to respond with rating and outlook changes.**
- **We believe municipal obligations that are impacted should remain relatively stable investments.**
- **The FEMA reimbursement process is complex, and the agency faces new challenges.**

## THE STATE OF CALIFORNIA BUDGET IS WELL POSITIONED

The state of California's fiscal position affects its ability to respond to catastrophic events. Favorably, the state is in a strong position due to good fiscal governance. In early January, the governor proposed a balanced budget for fiscal year (FY) 2025–26, reflecting a stronger economy and revenues than the state forecast last year. The state's main operating fund is projected to be down just 1.4% from the prior year's revised budget, or $3.2 billion.

Anticipating budget deficits over a two-year period, the state acted early in June 2024 and solved for a nearly $30 billion deficit through spending cuts, temporary revenue increases, expenditure deferrals, fund shifts and a reserve draw. The state was in a stronger position as a result, and the proposed budget for FY25–26 did not require major changes.

State reserve levels remain strong. The state plans to end FY26 with roughly $17 billion in reserves, or 7.5% of general fund revenues, following a modest draw down. The budget proposes to remove a cap on deposits to the rainy day fund to increase budget resiliency to 20% from 10% of general fund revenues and exclude rainy day deposits from the state appropriations limit. This is considered a positive step toward fiscal governance.

It is worth noting that the budget proposal came out just as the wildfires were unfolding, and adjustments should be expected when a revised budget comes out in May 2025. Nonetheless, California's balanced budget and good reserves better position the state to deal with the aftermath of the devastating Southern California wildfires.

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## LOCAL GOVERNMENTS CAN RECEIVE STATE HELP WITH RECOVERY

The state government can aid local communities' recovery and rebuilding efforts in multiple ways, financially and legislatively. In previous wildfire disasters, the state has provided revenue stability to local governments by backfilling cities' lost property tax revenues and holding school districts' state funding harmless for lost school district enrollment.

Additionally, $2.5 billion has been approved for wildfire cleanup and recovery including evacuations, sheltering survivors and removing hazardous waste. Funds for rebuilding both homes and schools have already been approved. An executive order was signed to expedite debris removal from the Palisades and Eaton fires, suspending certain environmental rules and approval procedures to rebuild faster. The state also retains $94.6 billion in additional liquidity in other funds outside of reserves that could be used to support recovery efforts.

## THE FAIR PLAN IS THE STATE'S FIRE INSURER OF LAST RESORT

Many questions have arisen regarding insurance in the state. Participation in the state's Fair Access to Insurance Requirements (FAIR) Plan for coverage has grown as traditional insurance carriers have exited the California market in recent years and traditional insurance has become cost prohibitive for many homeowners. The FAIR Plan is the state's insurer of last resort when traditional insurance is not available. Importantly, FAIR is authorized by the state but is not a state agency.

As of September 2024, the FAIR Plan's total statewide exposure was $458 billion; the combined Palisades and Eaton fire exposures totaling around $5 billion. Reserves to pay claims as of August 2024 were reported to be $350 million with another $2.5 billion in reinsurance. Through early February, the plan had received more than 3,400 claims from the Palisades fire, and more than 1,300 claims from the Eaton fire. Of these, nearly half were for homes completely destroyed.

Legally, the FAIR Plan can pass along any losses to private insurers that operate in the state through assessments based on insurer market share. California's insurance commissioner recently approved a request to pass along a $1 billion assessment to pay Palisades and Eaton Fire claims.

The assessment on all private property insurance companies in California will allow the FAIR Plan to access its reinsurance, continue operations and ensure claims are paid promptly. Each private insurer has 30 days to pay their respective portion of the $1 billion assessment, and they are allowed to pass along half of the payment onto their own policyholders. This is expected to drive up insurance costs for homeowners across the state. Leaving the state would not relieve private insurers of their obligation to pay the assessment.

This is not the first time the FAIR Plan has passed along losses to its market insurers. Fires in Altadena and Malibu and the Northridge Earthquake in the early 1990s resulted in assessments totaling a combined $260 million. The FAIR plan has already paid claims to policyholders totaling more than $914 million as of 11 February 2025.

Shortly after these fires began, a bill was introduced in the state legislature to allow the FAIR Plan to issue bonds to finance claims and increase liquidity. Although the timing is unknown, the proposed legislation is expected be considered this year. If enacted, new bond proceeds may also be available to increase the FAIR Plan's claims paying capacity.

## WATER DEPARTMENT FACES LEGAL ACTION

Investors have been most concerned about negative credit developments for the Department of Water and Power of the City of Los Angeles (LADWP). LADWP is the largest municipal utility in the United States. The department provides water and power services to a large and diverse service area, consisting almost entirely of the City of Los Angeles and serving approximately 4 million customers. The operations and finances of the Water System are separate from those of the Power System, with bonds of each system separately secured by the respective systems.

Less than a week after the official start of the fire, a group of Pacific Palisades residents and businesses filed a lawsuit against LADWP (Water System), alleging that the city and the utility department mismanaged the water supplies and were unprepared for the fires. The complaint attributes the water supply issue to the nearby Santa Ynez reservoir, which was not operational at the time the flames erupted. LADWP states that the reservoir was out of service to meet safe drinking water regulations.

It is still uncertain whether this lawsuit will result in a successful legal claim, but the risk is heightened, and there could be additional lawsuits. If the utility department were to be found liable, a large legal liability might weigh negatively on the City of Los Angeles and its related enterprises. The department maintains around $205 million of wildfire liability insurance coverage and has another $200+ million in self-insurance funds available. Still, the potential liability relating to the wildfires could well exceed these amounts.

No legal actions have been taken against the power utility and no evidence currently suggests LADWP equipment caused the fires. Legally, both utilities could pass increased costs due to a determined liability on to customers by raising rates. However, the finances of each system are separate, and each can only pass along costs incurred for their own operations. Rate increases are possible, but support from the state should not be ruled out since the utility serves an essential purpose as a water and power provider to a large and densely populated service area. Since the fires began, LADWP water and power bonds have been trading at noticeably wider spreads, around a 40-80 bps increase in yield.

## RATING AGENCIES TAKE CREDIT ACTIONS

Rating agencies were quick to respond to the wildfires with rating and outlook changes. Figure 1 highlights the largest debt issuers that have seen rating action related to the wildfires from the public rating agencies.

### Figure 1: Largest debt issuers to see rating action

| | Par outstanding | Agency | Rating | Outlook | Action |
|---|---|---|---|---|---|
| **Los Angeles Department of Water and Power – Power** | $11.5 B | S&P | AA- | Watch negative | Two-notch downgrade and placed on watch negative |
| | | Moody's | Aa2 | Negative | Outlook revised from stable to negative, rating affirmed |
| | | Fitch | AA- | Watch negative | Placed on watch negative |
| **Los Angeles Department of Water and Power – Water** | $6.5 B | S&P | A | Watch negative | Two-notch downgrade and placed on watch negative |
| | | Moody's | Aa2 | Negative | Outlook revised from stable to negative, rating affirmed |
| | | Fitch | AA | Watch negative | Placed on watch negative |
| **City of Los Angeles (GO and lease revenue bonds)** | $2.5 B | S&P | AA- | Watch negative | Placed on watch negative |
| | | Moody's | Aa2 | Negative | Outlook revised from stable to negative, rating affirmed |
| | | Fitch | AA+ | Watch negative | Placed on watch negative |
| **Los Angeles Wastewater Enterprise** | $2.4 B | Moody's | Aa2 | Negative | Outlook revised from stable to negative, rating affirmed |
| **Los Angeles Solid Waste Program** | $300 M | Moody's | Aa2 | Negative | Outlook revised from stable to negative, rating affirmed |
| | | Fitch | AA | Watch negative | Placed on watch negative |
| **City of Glendale – Electric Utility** | $300 M | S&P | A+ | Negative | Outlook revised from stable to negative, rating affirmed |
| **City of Pasadena – Electric Utility** | $170 M | S&P | AA | Negative | Outlook revised from stable to negative, rating affirmed |

Data source: Moody's Investors Service, Standard & Poor's and Fitch Ratings, January 2025.

## UNIFIED SCHOOL DISTRICT RELOCATES THOUSANDS OF STUDENTS

Los Angeles Unified School District (LAUSD) is one of the nation's largest school systems based on enrollment, providing K-12 education to more than 500,000 students. Charter school enrollment accounts for approximately 20% of the district's total enrollment.

Two LAUSD charter schools (Palisades Charter Elementary and Marquez Charter Elementary) have been largely destroyed by the recent wildfires. The district quickly relocated more than 700 students that attend the two schools to other LAUSD campuses for the remainder of the year. Wildfires also damaged about one-third of the Palisades Charter High School campus. This impacted nearly 3,000 students that have been temporarily placed on virtual learning while school officials continue to search for a temporary campus.

LAUSD plans to set aside $2.2 billion for repairing and rebuilding those schools. The funding will come from the $9 billion in school construction and modernization bonds that voters approved this past November. Also, the district expects cleanup and reconstruction costs to be largely reimbursed by state or federal government. The district has over $11 billion of debt outstanding (GO and COPs). There have been no recent rating actions on LAUSD from a rating agency.

## MOST CREDIT SECTORS ARE EXPECTED TO PROVE RESILIENT

Although the destruction is widespread, Nuveen believes the municipal obligations of the communities and entities impacted by the devastation should remain relatively stable investments. We do not anticipate payment defaults on these bonds. This view is based on our observations of the municipal market following natural disasters both large and small across the country over time.

### General obligation bonds

Bonds issued by local governments (cities/counties/school districts) are generally secured by unlimited property taxes levied on all taxable property. Entities with a large amount of destroyed property could see a dip in assessed values, but debt service levies will then be adjusted upward to ensure sufficient revenue for debt service. For school districts that rely on per-pupil based state aid, the state has historically held school funding harmless in the wake of similar natural disasters. Issuers with weaker reserves and liquidity may experience fiscal stress, but this is not likely to impact repayment of municipal bonds.

### Lease revenue

Lease revenue bonds and certificates of participation are common security structures used in California. These bonds are secured by rental payments for leased properties, subject to appropriation and abatement, which could be compromised if a leased facility is destroyed. However, most have multiple assets leased and issuers cannot simply opt not to appropriate without violating bond covenants. In cases where there is only a single leased asset, rental interruption insurance would likely be available if a facility was damaged or destroyed. Based on our assessment, we have not identified any single site projects that were damaged that would impact lease revenue bondholders.

### Hospitals/health care

This sector is not expected to be impacted. Generally, hospitals in the area are in more urban locations that have not been impacted. We are not aware of any hospitals that have been evacuated or suffered damage thus far. Several clinics and outpatient facilities near the areas impacted by the fires were temporarily closed and some non-emergency services were cut back, but we do not expect bonds in this sector to be negatively impacted.

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### Higher education

No higher education issuers experienced extensive fire damage and operations are not expected to be impacted by a decline in student enrollment for any issuer. Most schools were not in session during the fires. These bonds should not be negatively impacted.

### Charter schools

While many schools closed temporarily due to smoke or location within an evacuation area, few charter schools were damaged by the fires. A couple of affiliated charters of the LAUSD in Pasadena that are fully operated by the district were destroyed. Charter school bondholders have been fortunate and have been generally unscathed by the fires.

### Airports

No significant credit impact on the transportation sector from the wildfires is expected. Airports have remained open and operational and overall travel disruption has been minimal.

### Dedicated tax bonds

Any impact on dedicated tax bonds should be minimal. Los Angeles County Metropolitan Transportation Authority Measure R, Proposition A and Proposition C Sales Tax Revenue Bonds all benefit from a broad and diverse service area (LA County) and have a very high revenue decline tolerance.

### Land-secured bonds

Given the relatively developed nature of the areas impacted by the fires, minimal land secured debt was affected. Typically, special assessment and tax increment financing (TIF) districts are exposed to a higher level of acute risk due to their smaller, more defined tax bases.

Additionally, unlike an unlimited property tax pledge (GO bonds), Mello-Roos special assessment bonds are not able to adjust their tax levy in times of financial stress. Given that most of these bonds are issued to finance new infrastructure in growing communities, a relatively minimal amount of land secured debt was affected by the fires, as the area is much more mature and established.

A few known exceptions include Mello-Roos special assessment districts in Malibu and Altadena, both of which experienced extensive damage from the Palisades and Eaton fires, respectively. While the potential for near-term delinquencies from these impacted communities has significantly increased, a lien on individual parcels offers sound security for bondholders given the relatively high market value of land in desirable locations. This further incentivizes the prompt payment of assessments on behalf of homeowners. If delinquencies were to rise, bondholders also benefit from debt service reserve funds.

## FEMA FUNDING PROCESS FACES POTENTIAL COMPLICATIONS

When the President of the United States makes a major disaster declaration, as occurred for the California wildfires in early January, it opens a wide range of federal programs for emergency response and recovery, including aid from the Federal Emergency Management Agency (FEMA). The declaration allows state and local agencies responding to the fire to apply for a 75% reimbursement of their eligible fire suppression costs through FEMA.

Response and recovery costs are first borne by the individuals or state and local governments and then reimbursed by FEMA. When reimbursements are delayed, state and local governments' cash positions can weaken, leading to budget cuts or cash flow borrowing.

The reimbursement process for governments is complex, and timelines vary. The average turnaround time is one to three years, though some local governments have reported processing times of over six years. Local governments receive funds as sub-recipients of the state, and each disaster declaration and each state can have different requirements or provisions.

*Terminating FEMA altogether is unlikely because it would require congressional action, and Congress has traditionally supported the agency.*

Generally, governments must submit reimbursement applications to FEMA shortly after a disaster. FEMA then reviews the applications, typically the longest part of the reimbursement process. During the review there may be disputes regarding the level of impact, the scope and cost of work, or other documentation, which can affect the amount of funding a state or local government may receive.

Once the terms of the grant are defined, the applicant must sign an agreement to those terms and provide quarterly updates on progress. Grants typically require a local match of 25%, though Congress has the authority to waive or adjust the match. Finally, once the project is complete and FEMA conducts its final reconciliation, the government will be reimbursed.

President Trump has suggested that he would like to fundamentally reform FEMA, or perhaps eliminate the agency, and he issued an executive order establishing a review council for FEMA. Given the typical timeline for FEMA reimbursement, it is possible significant changes may be made affecting the agency, prior to the closeout of projects related to the California wildfires.

Terminating FEMA altogether is unlikely because it would require congressional action, and Congress has traditionally supported the agency. Most recently, in December 2024, Congress showed its support by appropriating an additional $29 billion for the Disaster Relief Fund (DRF), FEMA's main source of funding, after concerns that the fund was running out of money.

It's possible that changes to FEMA may be considered during negotiations for the next round of DRF appropriations. Given the significant damage from both Hurricane Helene and the California wildfires, DRF funds could be depleted before the end of 2025, requiring another supplemental appropriation from Congress.

**For more information, please visit us at nuveen.com.**

## Endnotes

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