

## LOS ANGELES DEPARTMENT OF WATER &amp; POWER

FEBRUARY 2025

**The Latest on Potential Liability**

As the Palisades Fire in Los Angeles County edges closer to complete containment, ramifications for the Los Angeles Department of Water and Power (the “Department”) remain uncertain. To date, there has been no implication that the Department’s Power System infrastructure was responsible for igniting the fire. The investigation into ignition remains ongoing, led by the Bureau of Alcohol, Tobacco and Firearms. Separately, the Department’s Water System has been sued by homeowners claiming the System was unprepared for the wildfire and is therefore responsible for damages, as faulty fire-hydrants and an empty reservoir derailed containment efforts. The lawsuit specifically cites California’s strict “inverse condemnation” liability, the application of which would be somewhat unique for a water utility. The State of California has also opened an investigation into the Water System relative to its preparedness and system functionality as crews battled the blaze.

Since the fires began, Appleton has acknowledged the existence of a “tail risk” associated with potential Department liability, whether through its Power System or Water System. Despite such a risk, our opinion emphasized that the Department had financial resources, insurance coverage, unregulated rate increasing authority and unregulated bonding authority. External support, such as a State loan or a separate mechanism like a securitization program to support funding potential liabilities, was also considered a possibility. We continue to believe that in the event the Department is found liable, these factors would allow the Department to remain a “going concern” that provides the essential services its customers have long relied on.

**What Has Changed?**

Our view of such “tail risk” liability has evolved over the last weeks following internal discussions and productive conversations with our partners and clients. Handicapping the likelihood of being found legally liable is extremely challenging. Attempting to quantify the size of a potential future liability and its financial impact on the Department, or how the market would price that development is equally difficult. Potential additional rating agency downgrades could also exacerbate selling pressure, forcing some investors to exit if certain rating thresholds were crossed.

Given our commitment to high quality municipal bond portfolio management, we recently concluded that the risk (large financial liability) to reward (limited bond price recovery) balance was becoming skewed to the downside. We have also come to appreciate that this situation will not be settled anytime soon. Even if the Department is fully cleared of culpability, that resolution is likely at least a year away. And if the Department were to be found liable, despite possessing tools to manage the financial implications, court proceedings would take an extended amount of time. Holding LAWDP bond issues would realistically also introduce an opportunity cost associated with not being able to reinvest sale proceeds in other municipal entities that lack such event risk.

**A Summary of Our Sell Program**

Since the wildfires broke out on January 7<sup>th</sup>, we have been evaluating market activity in the Department’s bonds as well as other LA-area names. As our investment perspective relative to the Department changed, we implemented a “first phase” of selling on January 23<sup>rd</sup> that reduced account level exposure. Based on our experience, there were active buyers for relatively large amounts of Department bonds. Drawing upon our dealer relationships, we were able to sell many positions at prices that we believed were prudent and in-line with recent trades.

The first group of sales gave us confidence that the market for the Department’s bonds was functioning reasonably well and that an opportunity existed to further reduce client exposure. Given sustained “tail risks”, we decided to exit all of our exposure to the Department.

As of January 31<sup>st</sup>, Appleton clients no longer own Los Angeles Department of Water and Power bonds. We also sold bonds issued by Intermountain Power Agency (UT) and the Southern California Public Power Authority Transmission Project, both of which are joint ventures where the Department is a majority participant and obligated to pay a significant share of operating expenses and debt service.

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A relatively orderly market existed throughout the process of selling the Department's bonds. Credit spreads varied based on maturity, callability, and position size, although spread ranges remained consistently stable. Our Portfolio Management and Trading team was able to execute a sizeable selling program within one week, a testament to our longstanding emphasis on holding liquid positions in client accounts and our strong relationships with the broker-dealer community.

**Tax Loss Harvesting**

While certainly not our primary consideration in deciding to sell, the sale of Department and related entity bonds has been a source of tax loss harvesting for clients previously holding those positions. As an active manager, we are cognizant of opportunities to realize losses for clients, whether derived from duration management or a credit related sale such as this one.

**Other Los Angeles County Issuers:**

Appleton owns other municipal issuers located within Los Angeles County that have revenue or service area exposure to the wildfires. We fully expect short-term challenges associated with cleanup and debris removal, delayed tax revenues, and additional costs to help kickstart rebuilding. However, we are not making any "sell" recommendations for other Appleton-approved names at this time. Strong balance sheets going into the wildfires, expansive tax bases and service areas, revenue diversity, and experienced management teams are characteristics that we believe will support credit quality for other L.A.-area municipal issuers held in Appleton accounts. We appreciate the confidence our clients and business partners have in our team and its investment process and will communicate further updates as warranted.

*Accessibility and communication are important in any environment, although these attributes are especially valuable during uncertain and volatile times. Appleton Partners is committed to sharing our market and portfolio management perspectives as developments unfold. We hope these briefs are helpful and also invite you to reach out to us directly and/or visit [www.appletonpartners.com/Insights](http://www.appletonpartners.com/Insights) for additional commentary and insights.*

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