City and County of Honolulu, Hawaii

Ratings

$52,195,000 Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 1998 .... AA–
$262,496,634 Wastewater System Revenue Bonds (Second Bond Resolution), Junior Series 1998 .... A+

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New Issue Details

The bonds are scheduled to sell on Dec. 9 through negotiation via a syndicate led by PaineWebber Inc.

Purpose: Proceeds of the senior series 1998 bonds will fund the cost of certain additions and improvements to the wastewater system of the city and county, fund the common reserve account to the maximum permitted under the law, and pay costs of issuance. Proceeds of the junior series 1998 bonds will refund the $217.9 million principal amount of general obligation bonds of the city and county issued to fund projects for the wastewater system, fund the junior debt service requirement to the maximum permitted under the law, and pay costs of issuance.

■ Summary

The City and County of Honolulu's wastewater system serves 125,000 separate accounts and 71% of the island of Oahu's 836,000 population. Estimated fiscal 1998 revenues total $115 million. Credit strengths include the essential nature of service provided, favorable rate structure and revenue mix, and sound fiscal policies. Wastewater and combined water/wastewater rates compare favorably with those of other wastewater providers in the nation's major cities. Ten-year forecasts assume manageable annual rate increases. Sound fiscal policies include internal targets for debt service coverage, a three-month operating reserve, and pay-as-you-go financing for 15% of capital expenditures.

Concerns include ongoing funding requirements for the $341.5 million five-year capital improvement plan (CIP) and the $2.3 billion 20-year CIP. A significant portion of both plans is associated with collection system rehabilitation projects, which do not present a major engineering challenge. An additional concern is the city and county's dependence on tourism from Asia and the U.S. Recession conditions in California and Asia in recent years have affected tourism, with a further impact from the higher spending by Asians. However, economic considerations are mitigated by the essential nature of the service provided and rate design — monthly base charges, regardless of usage, are designed to recover a significant amount of system costs.

■ Strengths

- Sound fiscal policies.
- Well designed rate structure, with reasonable rates and manageable increases.
- Strong projected coverage of revenue bond debt.
- Adequate treatment capacity, with no growth-related pressure.
- Favorable revenue mix.

■ Risks

- Ongoing CIP requires frequent but manageable rate increases for the foreseeable future.
- Economy dominated by tourism, which has been stagnant over the past decade.

■ Legal Provisions

Legal provisions are satisfactory and fairly standard for a utility system in the middle of a large capital program. The additional bonds test permits the flexibility to comply with the rate covenant needed to fund a large plan without rate shock. Internal financial targets established by policy strengthen the financial profile, and projected coverage exceeds the targets. The internal targets are 1.60 times (x) senior revenue bond debt service and 1.25x coverage of all revenue bond debt service. Policies also call for a three-month operating reserve.

The rate covenant under the first bond resolution calls for debt service coverage by net revenue of 1.20x. The rate covenant under the second bond resolution calls for debt service coverage by net revenue of 1.10x. A common reserve account under both resolutions is funded to the maximum level permitted by law. The reserves will be cash funded. The additional bonds test for both resolutions requires compliance with the respective rate covenant by either a historical or forward test. If interest is capitalized, the forward test is applied beginning in the period when interest is no longer capitalized.

Service Area

The City and County of Honolulu includes the entire island of Oahu. Oahu is the state's major island. There are only four organized governments for three counties, in addition to the state. Oahu's population is 836,000, which accounts for about 71% of the state's population. The wastewater system serves about 600,000 people and 125,000 customer accounts, with account growth projected at about 0.5% per year in financial forecasts. Several small private companies also provide wastewater service. Current state per capita personal income is $25,686, equal to 102% of the U.S., ranking it 16th. In 1996, Honolulu's per capita personal income was $27,040, 106% of the state and 111% of the U.S.

Hawaii's economy rests on a well developed tourism industry. However, as the seat of state government and the state's trade, finance, communications, and transportation center, Oahu's economy is somewhat broader, although tourism still plays a large role. Most federal establishments, both civilian and military, are on Oahu.

The state's strong and rapid development throughout the 1980s was linked to growing demand for leisure travel within the U.S. and Japan and other Asian countries, particularly South Korea. While tourist arrival patterns from the U.S. mainland have been stable, they have not recovered to levels seen before California's recession. In recent years, economic weakness in Japan and elsewhere in Asia has affected tourist arrivals, with no rapid recovery seen. Moreover, Asian tourism has a greater economic effect on spending, as Japanese tourists spend more per visit than U.S. visitors typically do. The per day, per person spending level dropped from a peak of $350 in 1988 to $280 in 1997 for Japanese visitors; spending rose to $157 from $121 over the same period for visitors from the U.S. mainland.

While declines in Asian tourism and related spending influence the service area economy, the wastewater system's financial performance is somewhat insulated by rate design and the essential nature of the service provided.

Management

The city council is Honolulu's government body and is composed of nine members elected from nine districts, with service limited to two four-year terms. The mayor is the city's chief executive officer, with service also limited to two four-year terms. By charter, the council exercises the city's legislative power, enacts operating and capital budget ordinances, fixes fees and charges for city services with some exceptions, and authorizes the issuance of revenue bonds. Under a 1998 reorganization plan, the Department of Environmental Services oversees the plan, design, and construction of wastewater facilities; manages the system's operation and maintenance (O&M); and complies with and enforces environmental regulations. By ordinance and resolution, the city council requires that wastewater system revenues be kept in a separate fund and that the wastewater program be self-supporting. A separate department, the Board of Water Supply of the City and County, bills customers for water and wastewater services on a combined basis. The customer accounting system is new and Year 2000 compliant. The billing program has had a consistent delinquency rate of less than 0.3%.

The wastewater system appears well managed, as customer receivables are current; is in compliance with permits; and, based on financial forecasts, capital projects designed to comply with the terms of consent decrees entered into by the wastewater system and environmental regulators do not strain financial performance or rates. The refunding of general obligation debt maturing by 2012 with revenue bonds maturing over a 30-year period, while less conservative, is not inconsistent with the operation of a utility with long-lived assets whose useful lives can be extended indefinitely by rebuilding or improving the infrastructure. Moreover, it was a prudent economic decision given the nondiscretionary impact of capital programs and rate shock avoided by extending debt maturities.

Infrastructure/Capital Improvement Program

The wastewater system is divided into eight wastewater basins, with each served by a wastewater treatment plant. Aggregate dry weather design capacity is 144.9 million gallons per day (mgd), well in excess of 1997 flow of 114.8 mgd and slightly below 148.9 mgd expected in 2020. The system's three largest plants treat more than 90% of wastewater flows. The National Pollutant Discharge Elimination System (NPDES) permit or state Department of Health Underground Injection Con-

Financial Summary

($ Mil., Fiscal Years Ending June 30)

	1998*	1999**	2000**	2001**	2002**	2003**	2004**	2005**	2006**	2007**
Growth Assumptions										
ESDU at Start of Year	275,691	277,351	278,661	280,161	281,661	283,161	284,661	286,161	287,661	289,161
New ESDU	1,660	1,310	1,500	1,500	1.500	1,500	1,500	1,500	1,500	1,500
Increase (%)	—	0.6	0.47	0.54	0.54	0.53	0.53	0.53	0.52	0.52
Revenue										
Sewer Service Charge	111.5	111.5	116.2	120.3	125.6	131.0	137.8	144.9	153.5	162.6
System Facility Charge	1.9	1.5	1.8	1.8	1.9	1.9	2.0	2.1	2.1	2.2
Interest on Unrestricted Reserves	0.0	2.5	2.8	2.5	2.9	3.0	3.0	2.8	2.5	2.3
Other Revenue	1.6	0.9	1.0	1.1	1.1	1.2	1.3	1.3	1.4	1.5
Total Revenue	115.0	116.4	121.8	125.7	131.5	137.1	144.1	151.1	159.5	168.6
Expenses	74.1	68.6	71.5	73.7	76.0	78.3	80.8	83.4	86.0	88.8
Net Revenue	40.9	47.8	50.3	52.0	55.5	58.8	63.3	67.7	73.5	79.8
Debt Service										
Senior Revenue Bonds	0.0	0.0	3.2	5.3	10.1	15.2	20.8	27.0	33.3	39.6
Junior Revenue Bonds	0.0	0.0	10.7	10.2	10.2	10.2	10.2	10.2	10.2	10.2
Reimbursable General Obligation	34.3	19.4	12.6	12.5	12.8	13.1	13.0	12.4	11.9	11.6
State Revolving Fund Loans	4.5	5.1	5.2	5.6	5.9	6.3	6.7	7.0	7.4	7.8
Total	38.8	24.5	31.7	33.6	39.0	44.8	50.7	56.6	62.8	69.2
Debt Service Coverage (x)										
Senior Revenue Bonds	N.A.	N.A.	15.16	9.47	5.31	3.74	2.95	2.43	2.14	1.96
Senior and Junior Revenue Bonds	N.A.	N.A.	3.49	3.24	2.64	2.24	1.98	1.76	1.64	1.56
Total All Debt	1.01	1.89	1.53	1.49	1.37	1.27	1.21	1.16	1.14	1.12
Projected Charges										
Monthly Sewer Service Charge	33.65	33.65	34.66	35.70	37.06	38.46	40.23	42.08	44.36	46.75
Increase Over Prior Year (%)	0.0	0.0	3.0	3.0	3.8	3.8	4.6	4.6	5.4	5.4

*Unaudited. **Projected. ESDU – Equivalent single-family dwelling units. N.A. – Not available.

trol permit regulate the discharge of treated wastewater into receiving waters. Seven of the eight plants meet national and state discharge requirements. The state owns the eighth plant, which has not been in compliance consistently. However, this plant is the system's second smallest, as measured by design and current and projected flow. Management is requesting state funds to bring this plant into compliance.

The system has worked with the community, the federal Environmental Protection Agency, and the state Department of Health to develop several consent decrees. The decrees establish milestones for the improvement of the wastewater system. Interim preventive maintenance procedures are to be completed by 2000. Sewer rehabilitation and the infiltration and inflow plan are phased, with completion of a pilot project required by year-end 1998, a final plan targeted for year-end 1999, and ultimate completion by the end of the 20-year CIP. Supplemental environmental projects related to biosolids reuse and beneficial effluent reuse have near-term completion dates. All consent decree activities and associated capital plans were initiated since new management was appointed in 1993 and before the debt restructuring.

The five-year (1998–2002) CIP expenditures total $341.5 million. The 20-year plan (1998–2017) has a total cost of $2.3 billion; 35 collection system projects account for $163 million, or slightly less than one-half of the five-year CIP. Some pipes in the collection system are approaching the end of their useful lives. Major pipelines were put in operation 40–100 years ago, and the underground environment is harsh due to the saline content of the high water table. The deteriorated condition of the system affects overall system performance most during periods of wet weather, when O&M expenditures escalate as a result. The design and construction of 22 wastewater treatment plant projects totaling $78 million account for the next largest component of the five-year plan funded by revenue bond debt and other sources. Proceeds remaining from previously issued and unrefunded general obligation bond debt pay for $84 million of plan projects. About 25% of the five-year capital projects are discretionary, giving the system financial flexibility during the next five years, when the Asian recession is likely to have its greatest effect.

About 84% of 20-year capital projects are nondiscretionary, and about two-thirds of the total relate to collection system improvements. Growth-related projects account for only 17% of 20-year CIP costs. The consulting engineer notes that completion of capital projects as planned should enable the wastewater system to remain in compliance with permit and consent decree requirements. Expenditures over 20 years should eliminate current and projected critical deficiencies, and the 20-year plan is technically sound and conforms to good engineering practice.

■ *Rates/Financial Performance*

By city charter, the city council has the power to set rates so that the wastewater system will remain self-sustaining. The director of environmental services and the mayor recommend a rate increase, subject to approval by city council ordinance. Before enactment, rate ordinances require three readings and a public hearing.

The City and County of Honolulu's residential sewer service charges compare favorably with those of major cities. The annual sewer bill is about $404, based on usage of 10,000 gallons per month. Rates are well designed to withstand the service area's greater sensitivity to economic cycles. The monthly base charge, regardless of usage, is $24.85 and represents about 74% of the average bill of $33.65. Base rates were last increased in 1993 by 30%. Over the next five years, three increases are planned at about the rate of inflation. Thereafter, small to moderate rate increases are required to support rising debt service. By 2007, if rate increases are implemented as planned, the average monthly residential sewer bill will increase to $46.75, about a 39% increase over a 10-year period. While this increase is not insignificant, most major cities with aging infrastructures face similar challenges with respect to the repair of their collection systems.

The wastewater system's revenue mix is favorable. Residential customers account for 71% of sewer system charges. At less than 3%, revenue from the system's top 10 customers does not present any concentration concern or major impact to financial performance from the loss of any one customer. Revenues have been relatively flat since 1993, with the number of new customers added each year just under 1%. Excluding one-time charges (reimbursements to the general fund for refuse disposal charges and legal settlement costs), O&M expenses have grown at the rate of 2.3% per year since 1993. Ten-year financial forecasts show a relatively stable outlook for O&M expenses. Higher revenue requirements and rate increases are driven by the debt service associated with the capital plan. Despite revenue bond issuance of $610 million by 2007, debt service coverage by net revenue is expected to remain above 1.90x for senior revenue bond debt and 1.60x for all revenue debt throughout the 10-year forecast period. Forecasts appear reasonable. Moreover, the financial plan is flexible since a portion will be cash financed, and forecasted rate increases, which are small to moderate, can be modified. Coverage of all debt, including unrefunded general obligation debt and state revolving fund loan repayment, is about 1.10x. About $125 million in general obligation debt will not be refunded by the junior bonds and is the "reimbursable general obligation" line shown in the financial summary table on page 3.

Additional senior bond debt issuance associated with capital plans totals $165 million by 2002, $610 million by 2007, and $1.7 billion by 2017. Amounts financed by 2017 include all senior revenue bond issuance since 1998.

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