City and County of Honolulu, Hawaii

Wastewater System Revenue Bonds
New Issue Report

Ratings

New Issues

Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2012A	AA
Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2012B	AA
Outstanding Debt	
Wastewater System Revenue Bonds, (First Bond Resolution) Senior Series	AA
Wastewater System Revenue Bonds, (Second Bond Resolution) Junior Series	AA–

Rating Outlook

Stable

Related Research

2012 Water and Wastewater Medians (December 2011)
2012 Outlook: Water and Sewer Sector (December 2011)

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New Issue Details

Sale Information: Approximately $133,000,000 Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2012A, and $120,000,000 Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2012B, sold via negotiated sale on Sept. 19.

Security: A senior lien net revenue pledge of the city and county of Honolulu's wastewater system.

Purpose: Proceeds of the 2012A bonds will fund ongoing components of the wastewater capital plan; proceeds of the 2012B bonds will advance refund outstanding bonds for level savings.

Final Maturity: Series 2012A – July 1, 2042; series 2012B – July 1, 2030.

Key Rating Drivers

Revenue Stability: Honolulu provides wastewater service to 82% of the island of Oahu's population. The system has seen limited impact on revenues or delinquency rates from the economic recession.

Large Rate Increases Continue: Substantial rate increases have occurred but appear to have broad political and community support, despite high residential rates on a comparative basis. The city council has approved a package of modest rate increases to occur through fiscal 2017 to support planned capital spending.

Strong Cash Flow Projected: The wastewater system has very strong financial metrics in the past few years resulting from double-digit rate increases implemented in fiscal years 2009–2011 to prepare for increased capital spending through 2020. Cash flow is projected to provide $70 million–$80 million, after debt service is paid, to fund capital.

Debt Service Coverage Targets: Management expects to maintain debt service coverage on senior revenue bonds of at least 2.0x and coverage of all debt over 1.5x, even as annual debt service (ADS) costs escalate substantially.

High Debt and Large CIP: The wastewater system has exceptionally high debt levels, with substantial additional borrowing plans through 2020 to comply with required environmental mandates to address deferred maintenance.

No Relief from Capital Demands: Substantial additional capital needs exist beyond 2020, resulting from the decision by the U.S. Environmental Protection Agency (EPA) to require the wastewater system's two largest treatment plants to move from primary to secondary treatment. Continued rate flexibility will be critical.

Rating History — Senior Series

Rating	Action	Outlook/ Watch	Date
AA	Affirmed	Stable	9/14/12
AA	Affirmed	Stable	10/5/11
AA	Affirmed	Stable	10/15/10
AA	Revised[a]	Stable	4/30/10
AA–	Affirmed	Stable	8/26/09
AA–	Affirmed	Negative	4/14/08
AA–	Affirmed	Negative	7/12/07
AA–	Affirmed	Stable	8/18/06
AA–	Affirmed	Stable	7/7/05
AA–	Affirmed	Stable	6/26/01
AA–	Assigned	—	12/7/98

[a]Reflects revision.

Rating History — Junior Series

Rating	Action	Outlook/ Watch	Date
AA–	Affirmed	Stable	9/14/12
AA–	Affirmed	Stable	10/5/11
AA–	Affirmed	Stable	10/15/10
AA–	Revised[a]	Stable	4/30/10
A+	Affirmed	Stable	8/26/09
A+	Affirmed	Negative	4/14/08
A+	Affirmed	Negative	7/12/07
A+	Affirmed	Stable	8/18/06
A+	Affirmed	Stable	7/7/05
A+	Affirmed	Stable	6/26/01
A+	Assigned	—	12/7/98

[a]Reflects revision.

Related Criteria

U.S. Water and Sewer Revenue Bond Rating Criteria (August 2012)

Revenue-Supported Rating Criteria, (June 2012)

Credit Profile

The ratings primarily reflect the very strong financial position of the system and the proactive steps taken by the political leadership and management team to address many years of delayed spending on system capital infrastructure, including adoption of three multiyear rate packages that extend through fiscal 2017. Financial performance is expected to remain favorable over at least the near to medium term, despite sizable increased leveraging, primarily due to a healthy component of pay-as-you-go in the CIP.

Sand Island and Honouliuli wastewater treatment plants (WWTPs) operate according to expired 301(h) waivers of the federal Clean Water Act, requiring only primary treatment prior to discharging to deep ocean outfalls. In January 2009, the EPA issued final decisions to deny the city's request for renewal of its 301(h) waiver for the two treatment plants. This followed the EPA's tentative decision to deny both waivers in 2007.

A consent decree became effective in December 2010. It was an agreement negotiated by the EPA, Honolulu, the state Department of Health, and four environmental organizations that had litigation pending over Honolulu's noncompliance with the Clean Water Act. As a result of the agreement, ongoing litigation regarding alleged violations of the federal Clean Water Act and permit violations were dismissed. The 2010 consent decree replaced the previous 1995 consent decree and 2007 stipulated order.

The 2010 consent decree outlines a timeline for Honolulu to bring its two wastewater treatment plants up to secondary treatment standards and complete improvements to the collection system that were outlined by the previous consent decree and stipulated order. The city has until 2020 to complete remaining work on its collection system, with an approximate remaining cost of $2.8 billion, in addition to the $1.7 billion already spent toward collection system improvements since 2001.

The city has until 2024 to upgrade the Honouliuli WWTP to secondary treatment and 2035 to upgrade the Sand Island WWTP to secondary. Although a portion of costs related to the treatment plant upgrades is included in the capital spending through 2020, the estimated cost of bringing both WWTPs into compliance with the 2010 consent decree is another $1.7 billion. For additional information on costs, see the Debt Profile on page 4.

While the capital requirements and cost of compliance are substantial, the timeline is longer than originally proposed by the EPA, and the 2010 consent decree brings all regulatory requirements under one document and timeline. This is a positive development since it appeared that the EPA's initial timeline would have potentially diverted capital spending and staff resources away from the much-needed collection system improvements that make up the bulk of the current CIP. However, it is a negative development in that it increases the total capital needs of the system and lengthens the period, during which rates will have to be increased to pay for regulatory required (nondiscretionary) system improvements.

Approved Rate Increases Through 2017

Honolulu raised its rates 175% on a cumulative basis over the six-year period from fiscal years 2006–2011. With the clarity provided by the 2010 consent decree, the package of six annual rate increases approved by city council in June 2011 are more moderate than the rate increases experienced since 2006. Rate increases for the first four years (fiscal 2012 through fiscal 2015) are 4% annually and then increase to 5% and 8% in fiscal 2016 and 2017, respectively. The first two of these six annual rate increases have been implemented. The financial forecast presented by management to Fitch included this level of approved rate increases.

The average monthly residential combined water and wastewater bill is now about $129, or 2.4% of median household income. The high relative combined bill, the pace and scope of the recent rate increases, and the continued high level of capital still needed continue to be credit concerns. These concerns are somewhat mitigated by the demonstrated ability of the city to put rate increases in place to maintain a strong level of cash flow to contribute towards the capital plan and preserve financial margins for bondholders.

Service Area Economy

Honolulu's visitor industry has shown growth in the past two years, following significant declines during the recent recession. Visitor arrivals and days have risen steadily since mid 2009, and 2011 results indicate increases to both average daily room rates and hotel occupancy as compared to 2010 levels. The city's non-tourism economy is also substantial and balances tourism's inherent volatility.

The city is the state's commercial and business center, a regional transportation hub, the state capital, and has a sizable U.S. military presence. More than 70% of Hawaii's population and jobs are in Honolulu. Unemployment rates have consistently remained lower than mainland averages at 5.8% in 2012. Income levels are above the national average, although this is somewhat offset by the island's high cost of living.

The property tax base in Honolulu remained relatively steady until a 7.8% decline in assessed value in fiscal 2011, but fiscal 2012 results show a return to modest growth. Housing starts have continued to rise from their 2008 lows and several major commercial and residential projects, as well as a planned $5.3 billion mass transit system, point towards a recovery in the construction sector.

Operating Profile

Customers

The city operates the wastewater system through the Department of Environmental Services. The department provides sewer services to a population of approximately 780,000, or 82% of the total population of the city and county of Honolulu. Approximately 70% of the wastewater system's revenues come from residential customers, lending stability to the customer base. The remaining customers generally are commercial in nature and include the hotel and tourism industry. Customer growth has been modest over the past five years, averaging less than 1% annually; this trend is expected to continue. Growth projections are modest at 0.3%. The top 10 users only account for 6.5% of revenues.

Sewer System

The wastewater system is divided into eight wastewater basins, each served by a WWTP. The system encompasses more than 600 square miles, with collection and transmission pipes leading into separate WWTPs. Aggregate daily flows averaged 105 millions of gallons per day (mgd) for fiscal 2011, approximately 70% of the 152 mgd combined treatment capacity. The system's two largest plants, Sand Island and Honouliuli, respectively, treat about 80% of the system's wastewater flows.

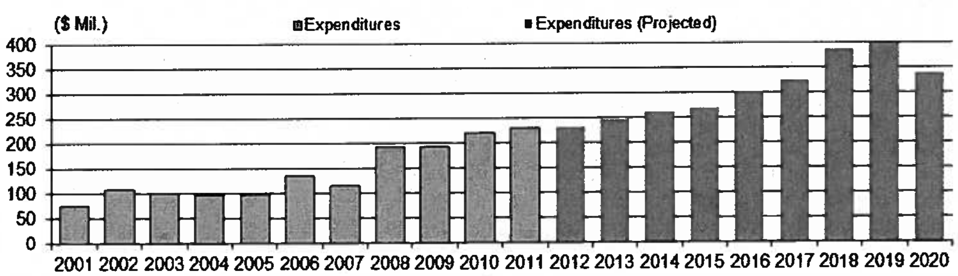
Debt Profile

Substantial Capital Demands

The wastewater system is addressing substantial capital needs. The most immediate capital needs relate to the rehabilitation of an aging collection system, as required by the EPA. More than 80% of the overall $4.9 billion, 20-year CIP (fiscal years 2001–2020) is related to nondiscretionary projects that address safety and public health, protection of the environment, and regulatory compliance. Although many of the CIP projects were established by EPA consent decrees in 1995 and 1998, the city only began to move into the heavy construction phase of the CIP in 2008.

Projected spending for the second half of the CIP (fiscal years 2013–2020) is approximately $2.6 billion, or approximately $250 million–$350 million annually. The wastewater system's five-year CIP is estimated at $1.7 billion and is a subset of the 20-year CIP. The five-year plan will be predominantly funded through revenue bonds and low-cost, state revolving fund loans (total debt funding of 69%).

Capital Improvement Plan Expenditure



The wastewater system generated over $100 million annually in revenues to contribute towards capital spending in fiscals 2010 and 2011. As debt service costs increase over the next few years, free cash flow for capital spending will be an estimated $70 million–$80 million annually through 2017. Fitch considers maintenance of the pay-as-you-go portion of capital funding to be a critical component of the system's remaining financial flexibility. Combined with continued ability to increase rates, the flexibility provided by these two tools helps mitigate the exceptionally high debt levels.

Beginning just prior to 2020, but largely once the collection system improvements have been accomplished, the city will work towards compliance with the new consent decree requirements that require the upgrade of the Honouliuli WWTP to secondary treatment by 2024 and the upgrade of the Sand Island WWTP to secondary treatment by 2035. While the current CIP through 2020 includes some costs associated with the treatment plant upgrades, much of the costs will occur beyond 2020. Very early estimates are in the range of $1.7 billion for the treatment plant refurbishments and upgrades.

High Debt Burden

The system is already highly leveraged and debt levels will climb even further, given the capital needs described above. Outstanding debt (all fixed rate) will increase to about $1.9 billion following this issuance, with another approximately $1.1 billion in debt anticipated in the next five years. Debt per customer is projected to climb from about $11,500 currently to over $17,000 by 2016, compared with Fitch's 'AA' national rating category median for water and wastewater utilities of about $1,615 per customer. Debt to net plant is high at 78% as compared to the 'AA' median of 45%. Honolulu's debt service burden will grow from 29% of revenues in fiscal 2011 to consume an estimated 43% of revenues by 2016.

Legal Covenants

Security

The senior lien bonds are payable from and secured by the net revenues of the wastewater system after payment of operations and maintenance (O&M) expenses. The junior lien bonds are payable from and secured by the net revenues of the system after payment of O&M expenses and senior lien obligations. System facility charges (connection fees) are excluded from the definition of revenues for both securities.

Rate Covenant

The city covenants to set rates and charges sufficient to generate net revenues equal to the greater of the total of 1.0x ADS coverage on senior lien obligations plus the required flow of fund deposits or 1.2x ADS. The rate covenant for junior lien bonds is the greater of 1.0x ADS coverage on junior lien obligations plus all deposits required under the flow of funds or 1.1x ADS on junior lien obligations.

Reserves

The bond resolutions for both the senior and junior lien bonds establish a common debt service reserve for each respective lien to be funded in an amount equal to 1.0x MADS. Although surety bonds are permitted to satisfy the common reserve, a downgrade of the surety providers below the 'AA' rating category requires the city to provide a replacement surety or cash fund the common reserve requirement within 90 days. The series 2010, 2011A, and 2012A bonds have separate reserve funds equal to only 50% of MADS.

Additional Bonds Test

The additional bonds test requires net revenues, by either a historical or forward test, to provide 1.1x MADS. The additional bonds test for junior lien bonds requires net revenues to provide 1.0x MADS.

Taxable Bonds — Federal Subsidy

Amendments to the indenture allow the federal subsidy expected in relation to the Build America Bonds to be treated as an offset to debt service rather than revenue. Fitch's calculation of debt service coverage includes the subsidy as revenue rather than an offset to debt service. In the unlikely event that receipt of the subsidy is delayed, the district is still obligated to pay full debt service from its remaining revenues.

Financial Profile

Rates and Charges

The department must seek city council approval for any rate adjustments. In 2005, the mayor proposed, and the city council adopted, a series of six annual rate increases designed to meet the rising costs associated with the CIP. In 2007, the city council amended and raised the amount of the remaining four rate hikes to absorb the most recent CIP cost increases. Most recently, city council adopted another multiyear package of six annual rate increases, the first of which became effective July 1, 2011 (fiscal 2012) and the second of which became effective July 1, 2012.

Approved Rate Increases

Year Effective	% Increase
2005	25
2006	10
2007	25
2008	18
2009	18
2010	15
2011	15
2012	4
2013	4
2014	4
2015	4
2016	5
2017	8

The average monthly residential sewer bill has risen to approximately $87 in fiscal 2011, which is high compared with that of other utilities. Further annual rate increases beyond those already approved through fiscal 2017 are necessary based on the amount of debt expected to be issued, although they will require approval by future city councils. Current projections indicate the average annual rate hike in the five-year period following the approved increases could be in the range of 4%–5% to fund the existing CIP.

On an affordability scale, the combined water and sewer bill of approximately $129 per month is high at 2.4% of median household income. With the approved rate increases, the combined monthly bill could grow to 3% of median household income at the end of the five-year forecast, with additional rate pressure in later years to fund the upgrades to the treatment plants.

Fitch views the city council's adoption of three multiyear rate packages, and subsequent implementation of the series of rate increases during an economic downturn, as an indication of Honolulu's high level of commitment in addressing its mandated capital improvements and available rate flexibility. The system has not experienced any change in its collection levels or significant community discontent following the rate hikes, as evidenced by the lack of opposition at public meetings. Concern exists that the longevity of the needed rate increases at the system will create rate fatigue but none has been observed to date.

Financial Performance

The system's financial position is strong, with senior lien debt service coverage above 3.0x and total debt service coverage above 1.7x in the past three years, including preliminary results for fiscal 2012. Total debt service coverage includes the department's junior lien bonds, general obligation bonds, and state revolving fund loans. Coverage and liquidity levels continue to be strong as a result of recent rate increases implemented to support debt service that will ramp up over the next several fiscal years. Senior debt service coverage is projected to remain adequate at more than 2.0x through fiscal 2017. Total debt service coverage on all debt obligations is projected to remain above 1.5x through fiscal 2017.

The city's formal policy is to maintain debt service coverage of 1.6x on the senior lien bonds and 1.25x on combined senior and junior lien revenue bonds. However, management anticipates, and the rating reflects, maintenance of 2.0x on the senior bonds and 1.5x total debt service coverage, including system facility charges. This level of coverage enables to the system to generate the healthy cash flow that it anticipates needing to fund a portion of the large capital needs.

Financial Summary

($000, Audited Fiscal Years Ended June 30)

	2007	2008	2009	2010	2011
Balance Sheet					
Unrestricted Cash and Investments	45,746	78,200	63,275	167,200	287,000
Accounts Receivable	23,531	31,818	34,551	41,088	48,596
Other Current Unrestricted Assets	244,085	342,459	285,891	249,489	(48,596)
Current Liabilities Payable from Unrestricted Assets	(65,328)	(81,278)	(89,377)	(99,684)	(113,773)
Net Working Capital	248,034	371,199	294,340	358,093	173,227
Net Fixed Assets	1,616,817	1,699,154	1,873,157	2,048,617	2,191,602
Net Long-Term Debt Outstanding	1,173,635	1,341,478	1,361,308	1,480,867	1,663,731
Operating Statement					
Operating Revenues	160,963	225,104	251,953	308,407	347,038
Non-Operating Revenues	13,996	18,057	3,751	548	4,868
Connection Fees	4,691	5,025	1,555	6,686	3,244
Gross Revenues	179,650	248,186	257,259	316,950	359,248
Operating Expenses (Excluding Depreciation)	(83,773)	(115,058)	(102,595)	(120,884)	(124,810)
Depreciation	(35,311)	(39,362)	(40,682)	(42,281)	(47,321)
Operating Income	60,566	93,766	113,982	153,785	187,117
Net Revenues Available for Debt Service[a]	95,877	133,128	154,664	196,066	234,438
Senior Lien Debt Service Requirements	30,060	34,422	42,281	38,184	58,598
Total Debt Service Requirements	56,690	68,667	104,803	92,048	102,371
Financial Statistics					
Senior Lien Debt Service Coverage (x)	3.19	3.87	3.66	5.13	4.00
Total Debt Service Coverage (x)	1.69	1.94	1.48	2.13	2.29
Days Cash on Hand	199.3	248.1	225.1	504.8	839.3
Days Working Capital	1,080.7	1,177.6	1,047.2	1,081.2	506.6
Debt to Net Plant (%)	73	79	73	72	76
Outstanding Long-Term Debt per Customer ($)	8,265	9,381	9,506	10,320	11,546
Free Cash to Depreciation (%)[b]	111	164	123	246	279

[a]Equals gross revenues less operating expenses. [b]Equals gross revenues, including federal direct subsidy payments, less operating expenses.

Liquidity remains a positive credit factor. Unrestricted reserves are projected at $295 million at fiscal year-end 2012, or 780 days cash on hand. The city's formal policy is to maintain at least three months of operating expenses in reserves, although it is generally in excess of this target. The level of liquidity is likely to come down as the utility enters a period of intense capital spending. It has been built up by the doubling of free cash flow generated by the utility in the past two years.

Projected Financial Summary

($000, Fiscal Years Ending June 30)

	2012	2013	2014	2015	2016	2017
Operating Statement						
Operating Revenues	331,684	345,219	360,275	375,977	395,943	428,296
Non-Operating Revenues	519	520	521	522	523	524
Connection Fees	9,131	9,405	9,686	9,978	10,277	10,586
BABs/RZED Bonds Subsidy[a]	2,176	6,010	5,528	5,528	5,528	5,528
Gross Revenues	343,510	361,154	376,010	392,005	412,271	444,934
Operating Expenses (Excluding Depreciation)	(137,966)	(155,901)	(158,192)	(163,778)	(169,394)	(174,343)
Operating Income	205,544	205,253	217,818	228,227	242,877	270,591
Net Revenues Available for Debt Service[b]	205,544	205,253	217,818	228,227	242,877	270,591
Senior Lien Debt Service Requirements	65,042	76,122	85,842	100,471	117,814	133,884
Total Debt Service Requirements	120,289	134,637	143,367	155,778	173,740	190,495
Financial Statistics						
Senior Lien Debt Service Coverage (x)	3.16	2.70	2.54	2.27	2.06	2.02
Total Debt Service Coverage (x)[c]	1.71	1.52	1.52	1.47	1.40	1.42
Total Debt Service Coverage (x)[d]	1.69	1.48	1.48	1.43	1.37	1.39

BABs – Build America Bonds. RZED – Recovery zone economic development. [a]Equals gross revenues, including federal direct subsidy payments, less operating expenses. [b]Equals gross revenues less operating expenses. [c]Based on Fitch's use of lower interest income assumptions than those used by management forecast, which results in lower than 1.5x coverage target. [d]Excluding BABs/RZED bonds subsidy. Note: Numbers may not add due to rounding.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.