

MOODY'S

INVESTORS SERVICE

New Issue: Moody's assigns Aa2 rating to City and County of Honolulu's Wastewater System Revenue Bonds Senior Series 2012

Global Credit Research - 14 Sep 2012

Outlook is stable

HONOLULU (CITY & COUNTY OF) HI
Sewer Enterprise
HI

Moody's Rating

ISSUE	RATING
Wastewater System Revenue Bonds Senior Series 2012A	Aa2
Sale Amount	\$150,000,000
Expected Sale Date	09/19/12
Rating Description	Revenue: Government Enterprise

Wastewater System Revenue Bonds Senior Series 2012B	Aa2
Sale Amount	\$150,000,000
Expected Sale Date	09/19/12
Rating Description	Revenue: Government Enterprise

Moody's Outlook STA

Opinion

NEW YORK, September 14, 2012 –Moody's Investors Service has assigned a Aa2 rating and stable outlook to the City and County of Honolulu's Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2012A and Senior Series 2012B. At this time, Moody's affirms the Aa2 rating on the system's approximately \$1.17 billion of outstanding senior lien bonds and the Aa3 rating on the system's approximately \$422.6 million of outstanding junior lien bonds. Proceeds will finance a portion of the system's capital improvement program and refund certain maturities of the system's previously-issued debt for annual debt service savings.

RATINGS RATIONALE

The Aa2 senior lien and Aa3 junior lien ratings are based primarily on a trend of solid debt service coverage provided by existing net revenues, a strong management team characterized by conservative budgeting, the city's continued practice of prudent and substantial multi-year rate increases to support its obligations, continuing progress on the system's sizable capital improvement plan which will require substantial borrowing in the coming years, and the sizable economic base served by the wastewater enterprise which continues its gradual recovery.

The stable rating outlook is based on Moody's expectation that the wastewater system will continue to maintain favorable financial performance consistent with the city's conservative financial and debt policies, despite the expectation of substantial future borrowing. Moody's also notes that the system has no exposure to variable rate debt or derivative instruments.

STRENGTHS

- Large, established service area
- Approval of multi-year rate increases generating strong coverage levels

-Prudent financial policies

CHALLENGES

- Substantial capital improvement plan that will keep leverage ratio elevated
- Slow national economic recovery weighs on local tourist-related business
- Uncertainty surrounding sequestration and possible downsizing of military presence

DETAILED CREDIT DISCUSSION

HISTORICALLY STRONG COVERAGE LEVELS EXPECTED TO NARROW OVER TIME GIVEN ADDITIONAL BORROWING PLANS

The city was careful to adopt substantial rate increases in advance of substantial borrowing for its long-term capital program, enabling system revenues to keep pace with growing debt service requirements and provide satisfactory overall coverage. In fiscal 2011, senior lien coverage was down from the prior year as debt service payments increased, but still strong at 4.09 times. Coverage of combined senior and junior lien revenue bonds was also strong at 3.06 times. Including reimbursable general obligation bonds and SRF loans, 2011 coverage of all system obligations was 2.31 times. Fiscal 2012 budgeted results indicate lower coverage levels, but at still sound levels. Coverage of senior lien bonds was budgeted at 3.02 times, while coverage of senior and junior lien revenue bonds combined was 1.97 times and coverage of all system obligations was budgeted at 1.71 times (net of connection fees). Similar to prior years, management is confident actual results will exceed budgeted expectations. Looking forward through 2017 coverage is projected to decline as senior lien and combined senior and junior lien debt service payments nearly double combined with the city's somewhat conservative expectation that operating expenditures will increase rapidly. Coverage levels are projected to remain at satisfactory levels with senior lien coverage estimated to decline to a still sound 2.02 times; combined coverage is projected to be roughly 1.59 times, while coverage of total obligations will be 1.48 times.

Additionally, the city's long-term financial projections indicate that coverage levels will continue to comply with its adopted policy calling for a satisfactory 1.6 times on senior lien bonds and 1.25 times on combined senior and junior lien bonds; including reimbursable general obligation bonds and SRF loans, projected coverage of all system obligations is expected to comfortably exceed the city's target of 1.05 times coverage on all system obligations. At the Aa2 and Aa3 rating levels on the senior and junior lien bonds, respectively, Moody's believes that it will be important for the city to maintain debt service coverage levels in excess of established policy levels.

MANAGEMENT APPROVED ANOTHER ROUND OF MULTI-YEAR RATE INCREASES THROUGH 2017

The city's adoption of substantial multi-year wastewater system rate increases is an important factor in the assigned ratings. As part of his inaugural budget in 2005, the mayor proposed rate increases of 25% in fiscal 2006 and 10% annual increases thereafter through fiscal 2011; in June 2005, the city council passed an ordinance adopting these increases. In June 2007, the city approved another round of rate increases to take effect in 2008 through 2011. As a result, rates were increased by 25% in 2008 (15% higher than originally adopted in 2005) 18% in 2009 and 2010 (8% higher than the rates approved in 2005) and fiscal 2011 rates were increased by 15% (5% higher than previously approved). Even after these sizable increases, wastewater rates are expected to remain comparable to the rates of other major urban systems on the mainland. Positively, management adopted another round of multi-year rate increases through FY 2017; rates increased 4% annually in fiscal 2012 and fiscal 2013 and are projected to increase 4% annually in fiscal 2014 and 2015, followed by a 5% and 8% increase in 2016 and 2017, respectively. Moody's believes that these rate actions represent important achievements in ensuring adequate bondholder security going forward.

CONSENT DECREE PROVIDES GREATER REGULATORY CERTAINTY TO CAPITAL PLAN

The City and County of Honolulu has worked diligently to comply with evolving state and federal regulations on treatment and discharge standards, rehabilitate and expand certain existing facilities and construct new facilities. Significantly, in late 2010 the city, the EPA, the state Department of Health (DOH), and several non-profit environmental groups reached an agreement on a 2010 Consent Decree. The Consent Decree terminated the prior 1995 Consent Decree and the 2007 Stipulated Order and resolved prior lawsuits (2004 and 2006) including city appeals. The 2010 Consent Decree is significant in that it provides certainty on outstanding litigation and the department's long term CIP. The 2010 Consent Decree allows 10 years for completion of work on the collection system, 14 years for the upgrade of the Honouliuli WWTP to secondary treatment, and 25 years, with the

possibility of a three-year extension, for the upgrade of the Sand Island WWTP to secondary treatment. Moody's notes that in March 2012, the Consent Decree was amended with the full agreement of all stakeholders to substitute a construction project after the EPA and DOH agreed the change would result in potential environmental benefits.

Through fiscal 2020 the city is expected to incur \$3.5 billion in capital costs, most of which were already included, planned for, and part of the department's existing CIP. Collection system projects will be the department's top priority through 2020 with treatment projects, including treatment plant replacements and upgrades making up a greater portion of project costs in later years.

To maintain the system's current ratings, Moody's anticipates that the city will continue to raise rates as necessary to maintain satisfactory debt service coverage even if additional borrowing expands beyond currently planned levels to address these regulatory issues.

The system provides wastewater services for approximately 82% of the City and County of Honolulu (general obligation bonds rated Aa1/stable), which encompasses the entire island of Oahu. The customer base is diversified with residential users representing 71% of the system's fiscal 2011 revenues while the ten largest customers accounted for only 6.5% of revenues. The system operates nine wastewater treatment plants serving an area of almost 600 square miles.

Since 1991, EPA, the State of Hawaii, and several environmental groups filed various legal and regulatory actions against the City and County of Honolulu alleging violations of the federal Clean Water Act and several of the permits held by the wastewater department. The 2010 Consent Decree, as mentioned above, addresses all of these actions and allegations and now provides the city with some additional clarity and certainty regarding timeline and compliance requirements while the 2012 amendment reflects a fair degree of flexibility to address future needs. In addition to actions taken to date, the wastewater department has developed capital improvement plans covering periods of five, ten and twenty years, in part to comply with prior legal actions. The long-range capital plan will also address safety and public health, permit compliance, system expansion and reliability issues. Capital appropriations over the 2013-2017 period are estimated to total \$1.7 billion. Approximately \$1.2 billion of funding (including the current issuances) will come from additional system revenue bonds (combined senior and junior lien). As a result, the system's 2011 debt ratio of 60.3% is expected to grow over time, but remain manageable.

SOLID TOURISM AND CONSTRUCTION ACTIVITY EXTENDS HONOLULU'S MODEST ECONOMIC RECOVERY

Honolulu's economic recovery is expected to continue supported in part by recent improvements in the tourism and construction sectors. Visitor arrivals and hotel occupancy percentages had remained somewhat sluggish until improving in 2010 with first half 2012 data indicating solid increases. Unemployment in Honolulu remains favorable and as of June 2012 (on a seasonally adjusted basis), the city's unemployment rate was 6.4%, which remains below the state (7.1%) and nation (8.4%).

Honolulu remains a unique and attractive tourist destination and officials have been successful in niche marketing the island. Moody's also notes projects in renewable energy, the film and television industry, and sustainable agriculture continue to lend support to ongoing diversity in the Honolulu economy alongside traditional economic anchors including the military, health care, and banking sectors.

Real estate has been another important element of Honolulu's economic success. However, between 2007 and 2009 home prices declined, although modestly relative to the rest of the nation. After trending gradually upward home sales and prices dipped slightly in 2011 followed by a solid increase in both metrics through the first half of 2012. Over the medium-term, numerous residential and commercial projects are in various stages of planning and construction and are expected to create jobs and support the local recovery. Despite the moderating influence of many tourism-related service jobs, wealth indicators in Honolulu are favorable with per capita and median family income at 101.9% and 120.1% of the U.S., respectively.

DEBT SERVICE RESERVE REQUIREMENT AT 50% OF MADS; LEGAL PROVISIONS BOLSTERED BY ADOPTION OF FORMAL FINANCIAL POLICIES

Similar to the city's 2010 and 2011 transactions, Moody's notes the Debt Service Reserve (DSR) on the Series 2012A will be equal to 50% of maximum annual debt service on the senior lien, cash funded; the Series 2012B Bonds will be secured at 100% of MADS by the senior lien common reserve fund. Although a slight credit weakness relative to prior DSR requirements (100% of MADS on both liens, cash funded), the lower DSR requirement is mitigated by the city's established practice of segregating 50% of the following year's debt service

obligation in the current year budget. Legal provisions also include covenants to maintain rates and charges sufficient to generate net revenues at least equal to 1.20 times the amount needed to pay debt service on the senior lien bonds and 1.10 times on combined senior and junior lien debt service. A similar covenant is provided for the issuance of additional parity bonds under both liens. The reimbursable general obligation bonds, as well as the debt service on the system's state revolving fund loans, are secured by a lien on net system revenues which is subordinate to the lien created by the junior lien bonds.

Legal provisions are bolstered by the formal adoption of conservative debt and financial operating policies by the city council which require compliance with annual targets of 1.6 times coverage on the senior lien bonds and 1.25 times on first and second lien bonds combined. In addition, the city council resolution incorporates a favorable three-month operating and maintenance reserve fund policy which will serve to insulate the system from unexpected events.

Outlook

The stable rating outlook is based on Moody's expectation that the wastewater system will continue to benefit from approved rate increases and maintain favorable financial performance consistent with the city's financial and debt policies, despite significant future borrowing plans.

WHAT COULD MAKE THE RATING GO UP

- Substantial local economic diversification and improvement in socioeconomic wealth indices
- Sustained financial and debt characteristics consistent with higher-rated entities

WHAT COULD MAKE THE RATING DOWN

- Trend of significantly weakened coverage of annual debt service coverage
- Substantial increase in debt ratio
- Weakened legal provisions

KEY STATISTICS:

Service area population, 2012: 780,000

Operating ratio, 2011: 33.2%

Senior lien debt service coverage, 2011: 4.09 times

Combined senior and junior lien debt service coverage, 2011: 3.06 times

Debt service coverage of all system obligations (including G.O. and SRF loans), 2011: 2.31 times

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published in August 1999. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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