City and County of Honolulu, Hawaii

**Outlook**
The city and county of Honolulu’s credit strength rests in the sound fundamentals of its tourism-based economy, good financial operations and reserves, low debt burden, and strong fiscal management. The island’s tourism base has adapted to a shift to more domestic-based visitors, while the area’s role as the commercial center and state capital and a sizable military presence add stability. Tourism on the island is highly developed and has strong underpinnings, providing continual demand and industry investment. Recent very strong tax base growth has eased financial operations and enabled reserves to increase. The low debt burden reflects the state’s sizable role in financing education facilities. Credit concerns reflect rising labor costs including pensions and retiree health care and vulnerability to decline in the housing market given the recent run-up in residential prices and the decline the county experienced earlier this decade.

**Rating Considerations**
Honolulu is coterminal with the island of Oahu, and the island’s tourism draw is based on sustainable elements such as natural beauty, diverse accommodations and activities, and proximity to sizable North American markets. Tourism activity exhibits volatility typical of the sector, surging in recent years following a long decline. Total visitors surged in 2004 and 2005, with 2005 narrowly exceeding the 2000 peak. However, the number fell about 2% in 2006, and results through August 2007 show stability. The rise follows a precipitous drop in 2001 and relative stability through 2003. Visitors from the U.S. rose faster than international, largely Asian, visitors, as has been the case in most recent years. Domestic visitors now make up about 60% of total visitors.

Other tourism indicators have been strongly positive, with hotel occupancy at 83.1% in 2006, the second highest level in over a decade. The increase is notable given the 27% rise in average hotel room rate since the 1998 peak.

Honolulu’s nontourism economy is substantial and adds balance, as the state’s commercial and business center, state capital, and home of the University of Hawaii. U.S. military also is a major economic element. Honolulu makes up 71% of Hawaii’s population, about 60% of the visitors, and about one-half of the hotel rooms statewide. Employment has risen steadily, and the unemployment rate continues to be well below the national average at 2.3% in 2006.

The real estate market has returned to strong activity, but now could be vulnerable to decline. Assessed value rose 14.6% per year on average since fiscal 2002, following weakness in several prior years. Residential prices have risen considerably, resulting in well-above...
average price-to-income ratios. Building permit activity has been strong, including several sizable hotel/resort/timeshare projects and other commercial development.

Financial operations are sound, relying primarily on property taxes. The general fund ran operating surpluses in five of the past six fiscal years, and unaudited results for fiscal 2007 suggest another strong surplus. The fiscal 2006 general fund balance rose to $98.6 million, a sound 11.6% of spending, about the level held prior to the economic downturn. In addition, the city maintains a reserve for fiscal stability, expected to increase to $10 million in fiscal 2007 and $17.5 million in fiscal 2008. Fitch views the current reserve levels as prudent for a tourism-based economy during a strong economic period.

Honolulu’s strong financial position primarily reflects effective management response to revenue performance, with expenditure growth kept to low levels through organizational restructuring and employee reductions. Management is proactively setting aside funds for retiree health care, a program that is handled at the state level for all government employees. Honolulu will continue to be challenged by sizable increases in pension and retiree health care costs, as well as salary raises, all expenditures controlled by statewide actions, limiting the city’s fiscal autonomy.

**Strengths**
- Tourism-based economy has strong underpinnings, such as physical beauty, public and private infrastructure, and location.
- Role as regional economic center and state capital provides some diversity and stability.
- Financial operations benefit from sound management actions, resulting in preservation of satisfactory reserves.
- Prudent management actions in recent years, including fee increases, organization consolidation, and spending controls.
- Low debt burden (average including state bonds).

**Risks**
- Economic volatility inherent to tourism-based economies.
- Vulnerability to slow assessed value growth, given the prior downturn’s experience.
- Ongoing financial pressures, including labor and pension cost increases.

**Debt**
Honolulu has been a regular general obligation debt issuer, although enhanced liquidity provided by the commercial paper program has resulted in less frequent borrowings. About 59% of the city’s debt matures in the next 10 years. Proceeds from the series 2007A bonds will be used to redeem about $147 million in outstanding commercial paper. The commercial paper was used for various capital projects. Proceeds from the series 2007B and C bonds will be used to advance refund outstanding parity general obligation bonds, with series C as a forward refunding. Net present value savings will depend on market conditions on the sale date.

Honolulu’s overall debt burden is low at $2,429 per capita and 1.3% of market value. The latter figure is well below prior years’ levels, the result of strong assessed value growth. The debt burden is net of general obligation debt paid from the city’s sewer enterprise fund. The low debt burden partially results from the highly centralized nature of Hawaii’s state government. The state finances and performs many functions usually done by local governments, including capital financing for schools. The city has a $250 million commercial paper program, with proceeds used as interim financing for various capital projects.

**Finances**
Honolulu’s financial operations are good and reflect strong fiscal management that responds to economic conditions and recognizes the area’s inherent volatility. Fiscal management has been prudent, utilizing fee increases, restrained expenditure growth, and to a more limited degree, tax rate increases, to keep operating losses low to moderate in amount. As a result, the city has maintained its fund balance at reasonable levels. During weaker economic periods the fund balance has been reduced to levels Fitch views as approaching the minimum level needed to retain the existing high rating. Now that the economy is strong, the fund balance has risen and now is at a level Fitch views as prudent given the vulnerabilities to economic fluctuation and a high real estate market.

Recent financial performance has benefited from strong tax base growth and the city’s prudent actions to restrain expenditure growth. In fact, the tax base growth has been strong enough to enable property tax revenue to continue to rise despite a decrease in the weighted average tax rate in fiscal years 2005 and 2006. Spending has risen as a result of nondiscretionary increases in employee health care
## General Fund Financial Summary

($000, Audited Fiscal Years Ended June 30)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
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<tbody>
<tr>
<td>Taxes</td>
<td>458,116</td>
<td>528,793</td>
<td>621,741</td>
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<td>Intergovernmental</td>
<td>35,584</td>
<td>39,056</td>
<td>43,519</td>
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<td>Licenses and Permits</td>
<td>34,258</td>
<td>35,740</td>
<td>36,219</td>
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<tr>
<td>Other Revenue</td>
<td>94,132</td>
<td>101,458</td>
<td>102,110</td>
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<td><strong>Total Revenues</strong></td>
<td>622,270</td>
<td>705,047</td>
<td>803,589</td>
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<td>Public Safety</td>
<td>229,602</td>
<td>242,108</td>
<td>249,402</td>
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<tr>
<td>General Government</td>
<td>94,690</td>
<td>100,462</td>
<td>105,192</td>
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<tr>
<td>Retirement and Health</td>
<td>85,664</td>
<td>105,307</td>
<td>117,678</td>
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<td>Culture and Recreation</td>
<td>42,917</td>
<td>45,947</td>
<td>49,433</td>
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<td>Other Expenditures</td>
<td>25,270</td>
<td>20,241</td>
<td>22,391</td>
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<tr>
<td><strong>Total Expenditures</strong></td>
<td>478,143</td>
<td>514,085</td>
<td>544,096</td>
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<td>Results</td>
<td>144,127</td>
<td>190,982</td>
<td>259,493</td>
</tr>
<tr>
<td>Transfers In and Other Sources</td>
<td>96,230</td>
<td>97,594</td>
<td>68,149</td>
</tr>
<tr>
<td>Transfers Out and Other Sources</td>
<td>(250,866)</td>
<td>(273,727)</td>
<td>(306,200)</td>
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<tr>
<td><strong>Net Income/(Deficit)</strong></td>
<td>(10,499)</td>
<td>14,849</td>
<td>21,442</td>
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<tr>
<td><strong>Total Fund Balance</strong></td>
<td>62,317</td>
<td>77,166</td>
<td>98,608</td>
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<tr>
<td>Unreserved Fund Balance</td>
<td>41,479</td>
<td>57,364</td>
<td>76,604</td>
</tr>
<tr>
<td>As % of Expenditures and Transfers Out</td>
<td>5.7</td>
<td>7.3</td>
<td>9.0</td>
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Note: Numbers may not add due to rounding.

Costs and pension contributions, as well as salary gains granted through the statewide collective bargaining process, Fiscal discipline and nonpermanent revenue enabled the city to show operating surpluses in three of the past five fiscal years, with a loss occurring in fiscal 2004.

The general fund balance rose to $98.6 million in fiscal 2006, a sound 11.6% of expenditures and transfers out. The unreserved portion also is strong at $76.6 million, or 9.0% of total spending. The city also holds $5 million in the reserve for fiscal stability. While this amount, equaling 1% of general fund expenditures excluding transfers, is below the city's 5% target, unaudited results for fiscal 2007 show it rising to 2%. Also, an increase to $17.5 million or 3% is budgeted for fiscal 2008.

The city’s unaudited financial results for fiscal 2007 suggest another strong year, with the general fund running a small operating surplus, as well as bringing the emergency reserve to $10 million from $5 million. The city expects the unreserved fund balance to rise to about $85 million.

The general fund’s primary revenue source is property taxes, making up 68% of fiscal 2006 revenue and transfers in. Property taxes have experienced extraordinary growth in recent years despite an overall tax rate reduction. Property values have risen substantially, and building activity has been strong, more than offsetting a cumulative 7% reduction in the weighted average tax rate in fiscal years 2005 and 2006. The city has reduced the weighted average tax rate in fiscal years 2007 and 2008 another 7%. Specifically, the tax rate reductions target residential property, with the tax rate for commercial and hotel/resort properties rising. While residential value makes up 84% of the tax base, it generates about 57% of total property tax revenue. The city had raised the tax rate in fiscal 2004 for the first time in four years.

The utility tax is Honolulu’s other local tax source, making up about 3% of total general fund resources. The reliance on property and utility taxes somewhat insulates financial operations from economic volatility. Also, the city’s willingness to raise the tax rate in fiscal 2004 shows fiscal responsibility. Nonetheless, the revenue base remains vulnerable to severe real estate declines, as was experienced in fiscal years 1999–2002.

State-shared transient accommodation tax (TAT) revenue has risen substantially, 35% from fiscal years 2002–2006, reflecting an increase in the number of rooms available, higher occupancy, and rising room rates. This revenue source represents a moderate 5% of general fund resources and is more volatile than other city revenue. In fiscal 2002, Honolulu’s TAT declined 11.3%.
General fund expenditures are dominated by public safety and general government, making up 29% and 12% of general fund expenditures, transfers out, and other uses in fiscal 2006, respectively. Retirement and health benefits also have become a major spending category, rising 44% from fiscal years 2002–2006. Pension costs are expected to continue to rise. The city has little control over retirement costs, contributing the required amount as determined by a statewide employees’ retirement benefit fund. Like labor agreements, pension benefits including retiree health care are negotiated statewide for all state and local government employees.

Recognizing the rising cost of retiree health care (other post-employment benefits [OPEB]) the city took a proactive measure with the fiscal 2008 budget. The city established an OPEB reserve and funded it with $40 million in the fiscal 2008 budget. This amount was determined to be the additional amount the city would have to contribute to fund its liability on an actuarial basis. The total actuarially required contribution was determined to be about $98 million, and the pay-as-you-go cost for fiscal 2008 is budgeted at $53 million. The city expects to maintain this reserve itself and transfer it to the state system if and when liabilities are distributed by participating entity.

A weakness to the city’s financial operations is the statewide labor negotiations, with one set of salaries, benefits, and other adjustments enacted for all state and local government workers within various categories. As a result, labor costs including benefits cannot be tailored to a specific entity’s needs and an important element of fiscal autonomy does not exist. Furthermore, the agreements are not final until approved by the state assembly and each local government board. At this time, a lack of consensus among the various government entities and certain noncounty labor unions has prolonged negotiations.

In general, the city has restrained spending to match revenue gains, the result of strong fiscal control and a broad organizational restructuring that combined departments and eliminated overhead positions. Over several years, the city reduced its employment by about 9% through reorganization, consolidation, and privatization of select services. Nonetheless, future budgets may be challenged to provide for 4%–5% annual salary increases granted under statewide agreements for fiscal years 2008 and 2009. Fitch expects that the city’s previous prudent actions to retain good financial operations will prevail.

The Hawaiian state government assumes several functions that are normally the responsibility of local government, including education, health and welfare, judicial operations, and operation and maintenance of all airports and harbors. Honolulu’s operational responsibilities are limited to functions such as public safety, highways and streets, sanitation, culture and recreation, planning and development, several utilities, and general administrative services.

**Economy**

Honolulu’s economy is experiencing a period of strong performance. It also has diversified somewhat, but remains dominated by a well-developed tourism sector. Diversity comes from the city’s role as the regional commercial, business, and finance center, as well as the state capital and the home of the University of Hawaii. Also, Honolulu contains a strong military presence, which likely will continue given the island’s strategic location. The city’s job base has shown good growth since 2003, following several years of slower gains and decline. Despite economic fluctuation, the unemployment rate remained relatively low and dropped to 2.3% in 2006, below the state’s 2.4% and the national average, 4.6%.

Tourism activity has rebounded from declines following the events of Sept. 11, 2001 and two cyclical declines throughout the 1990s. Total visitors to the island of Oahu reached the 2000 peak in 2005, with a small drop in 2006. Nonetheless, the 4.6 million visitors in 2006 exceeds the 2003 low by 13%. The recently strong figures result from overall positive global economic conditions. In prior years declines have reflected severe dislocation in the Asian economy, weakness in the California economy, the SARS outbreak, and travelers’ security concerns.

Also pointing to a strong economy is Oahu’s hotel industry, where occupancy rose to 83% in 2006 from 71% in 2002 and remained above the state’s 80%. These occupancy rates are above the island’s and the state’s prior peaks in 2000, and is particularly notable given the rise in the average room rate. The average rate now is $156 per night, up 29% from the prior peak, $121 in 2000.

Assessed value gains also show the area’s recent economic strength, benefiting from new construction as well as rising values. Assessed value grew 13.5% per year on average from fiscal years 2001–2008; in each of the past four fiscal years, the annual gain has ranged
from 14.3% (fiscal 2008) to 23.5% (fiscal 2006). Construction activity includes sizable investments by a number of hotel and resort properties, including the addition of time share properties or conversion of hotel rooms to time shares. Fitch believes that the price run-up leaves the city vulnerable to slower gains in the next few years, and possibly declines.

Honolulu’s economy benefits from elements that add diversity and stability: a large military presence; the state capital; the University of Hawaii; and being the business and commercial center of the state. About three-quarters of all state jobs are located in Honolulu. Leisure and trade are the city’s largest employment sectors making up 27% of total employment, followed by government at 20%, professional and business services at 15%, and health care at 10%.

The sizable military presence results from Honolulu’s strategic Pacific location, as well as the historic significance of Pearl Harbor. The U.S. Army, Navy, Air Force, Marine Corps, and Coast Guard all have a presence on Oahu. The U.S. Pacific Fleet’s commander in chief is located at Pearl Harbor, as is the headquarters of the Third Fleet. Pearl Harbor’s tourist appeal is enhanced with the permanent berthing of the battleship USS Missouri. A bridge now connects Pearl Harbor with the Navy’s Ford Island.

The island’s population is rising slowly, up 3.9% since 2000 to 909,863. The city makes up about 71% of the state’s population. Income levels are above the state and national averages. Exceeding the national average partially reflects the high cost of living on the island.