

RESEARCH

City and County of Honolulu; Water/Sewer

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Credit Profile

US\$160.12 mil Wstwater sys rev bnds (sr Series) (First Bond Resolution) ser 2007A due 06/30/2037		
<i>Long Term Rating</i>	AA-/Stable	New
US\$68.975 mil Wstwater sys rev bnds (sr Series) (First Bond Resolution) ser 2007C due 06/30/2022		
<i>Long Term Rating</i>	AA-/Stable	New
US\$8.545 mil Wstwater sys rev bnds (sr Series) (First Bond Resolution) ser 2007B due 06/30/2017		
<i>Long Term Rating</i>	AA-/Stable	New
Honolulu City & Cnty sr In wstwtr (MBIA)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Honolulu City & Cnty wstwtr sys 2nd res (jr) rev bnds ser 1998 & 2003		
<i>Long Term Rating</i>	A+/Stable	Affirmed
Honolulu City & Cnty sr wstwtr (FGIC)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'AA-' rating to the City and County of Honolulu, Hawaii's senior wastewater system revenue bonds series 2007A, B, and C, and affirmed its 'A+' rating to pre-existing junior lien debt. The ratings reflect:

- A diverse and largely residential service area of the wastewater system, serving 74% of the population of Oahu, Hawaii's most populous island (rated 'AA');
- Strong financial performance that has exceeded financial policies adopted by the city council that include a debt service coverage target of no less than 1.6x on senior lien debt and 1.25x on combined junior and senior lien debt;
- Aggressive rate-setting actions in support of capital spending requirements; and
- Good cash reserves, supported by a plan to maintain at least three months of operating expenses in reserve.

The above strengths should enable the department to manage a capital plan that will require \$1.6 billion in financing between 2008 and 2012, and \$2.9 billion before 2017.

The series 2007 A, B and C bonds are secured by a senior lien pledge of net operating revenues of the wastewater enterprise. An estimated \$150 million of the 2007 series is new money, with as much as \$360 million in refunding. On a parity basis with the 2007 senior lien bonds, the Honolulu wastewater system has \$552.2 million in pre-existing debt. Additionally, the wastewater system has \$457.08 million in pre-existing junior lien debt. The lower rating on the junior lien debt reflects the leverage position of the system and considerable additional debt requirements during the next 5 years.

Prior to the issuance of these 2007 bonds, the wastewater enterprise had \$552.2 million in senior lien wastewater revenue debt and \$457.08 million in junior lien wastewater revenue debt. Combined with the new money component of these 2007 senior lien wastewater revenue bonds, there will be a combined

total of \$1.18 billion in wastewater revenue debt. After the issuance of these series 2007 bonds, about \$150 million of which will be new money bonds, an additional \$1.1 billion in revenue bonds are expected to be necessary to complete the \$1.6 billion capital plan between fiscal years 2008 and 2012.

The system's very substantial capital needs necessitate aggressive rate increases. In support of the system's financial requirements, the Honolulu City Council adopted a pre-approved package of rate increases first in 2005 and again in 2007. The second package of rate increases approved in 2007 revised upwards the rate increases from the 2005 rate increase; for example, the rate increase for 2008 went from 10% to 25% and from 10% to 18% in subsequent years. Rate increases will nearly double the typical household's sewer bill, from \$55.31 per month in fiscal year 2008 to \$90 in 2011.

For the \$1.18 billion in wastewater revenue debt (combined junior lien and senior lien) that will be outstanding following the issuance of the 2007 bonds, maximum annual debt service requirements will be \$75 million in fiscal 2013. As future debt issuances occur, however, annual debt costs are expected to rise to \$144 million. With rate increases already adopted, however, and minimal customer growth, net revenues available for debt service should remain adequate. Combined coverage on junior and senior debt is expected to be at least 1.4x, with senior coverage expected to remain above 2.05x.

Outlook

The stable outlook reflects the expectation that the city will be able to afford its very large capital plan by virtue of regular rate increases that should provide adequate revenue to support bonding plans. Critical to rating maintenance will be the timely responsiveness of rate setting actions in the event that additional regulatory improvements, such as an upgrade of treatment to 'secondary' federal standards, are required.

Honolulu Economy Performing Well

With roughly 900,000 residents, or 72% of the state's total population, Honolulu is the center of Hawaii's economy, government, transportation, finance, and education. Tourism accounts for about 25% of the gross state product, and more than 50% of the state's hotel rooms are located in Honolulu. Waikiki, located adjacent to downtown Honolulu, remains the state's most visited destination. Honolulu's tourism market has rebounded strongly along with the rest of the state. The city and island are additionally anchored by the presence of the U.S. military; there are roughly 34,000 active service men and women on the island, and nearly 15% of the island's population is either employed by or a direct dependent of an employee one of the four branches of the armed services. Unemployment has been steadily declining and was 2.3% as of April 2007, near the state level and one of the lowest rates for a U.S. city with a population above 750,000. Effective buying income levels are above the state but average overall, at 105% and 90% of the nation on a household and per capita basis, respectively.

The continued economic rebound on Oahu has been led by a boom in real estate values after an extended period of weakness during the mid- and late-1990s. Since 2001, total taxable market value has risen by a very strong 86% (or nearly 11% per year, on average), to \$146 billion in fiscal 2007, including a very significant 23% and 28% increase in fiscals 2006 and 2007, respectively. Property values are high on a per capita basis, at \$162,000. Single-family homes account for 61% of this valuation, followed by apartments (22%), commercial (7%), industrial (4%), and hotel and resort properties (4%). Historic volatility prior to the recent strong recovery was due primarily to concentration of Japanese capital in the real estate market, which is now diminished, although tourism and second-home investment by domestic "baby-boomers" and retirees remain primary drivers for economic growth. Still, the pace of recent increases will almost certainly moderate, as will the potential for rising concerns about affordability as well as sustainability of currently appreciated market prices

Substantial Capital Needs

The wastewater system is faced with the challenge of upgrading its distribution system, which has been vulnerable to breakages in the past, as well as plant expansions to accommodate customer growth and peaking needs for wet weather events. Historically, Honolulu's main treatment facilities -- the Honouliuli and Sand Island plants -- have operated with a waiver from the Environmental Protection Agency (EPA) that has allowed a lower treatment standard. The Honouliuli waiver was preliminarily denied, and is currently being contested by the city. A decision on the Sand Island waiver is expected in October of 2007. An upgrade to the higher EPA treatment standard would add another \$1.2 billion to the system's capital needs to the \$1.6 billion already required between 2008 and 2012. Most of the financing, 68%, will come

from future revenue bonds.

Departmental Policies Support Financial Stability

The Department of Environmental Services of the City and County of Honolulu was created in 1998 as an enterprise fund to manage the wastewater system. The system serves most of the city and county, except for certain isolated areas that rely on private systems. The system serves more than 600,000 residents, or 71% of the city and county. System capacity is adequate to meet peak demands that can be intense during periods of extended rainfall; the main challenge for the system appears to be related to aging pipes, as evidenced by a breakage and subsequent spillage in March of 2006. With relatively slow growth in the population of Oahu, which is projected to increase 7% during the next 10 years, the system's capacity should be sufficient. Management policies adopted by city council set minimum cash reserve levels and debt service coverage levels, such as a three-month operating reserve. Furthermore, rate-setting is intended to generate sufficient net available revenues to provide a minimum coverage target of 1.6x senior lien debt service and 1.25x junior lien debt service.

Ratings Detail (As Of 13-Jul-2007)

Honolulu City & Cnty Wstwater sys rev bnds (sr Series) (First Bond Resolution) ser 2007ABC

Long Term Rating

AA-/Stable

New Rating

Many issues are enhanced by bond insurance.

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