Revenue
New Issue

City and County of Honolulu, Hawaii

Ratings

New Issues

Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2009A, 2009B, and 2009C	AA–
Wastewater System Revenue Bonds (Second Bond Resolution), Junior Series 2009A	A+

Outstanding Debt

Wastewater System Revenue Bonds (First Bond Resolution), Senior Series	AA–
Wastewater System Revenue Bonds (Second Bond Resolution), Junior Series	A+

Rating Outlook

Stable[a]

[a]Revised from Negative on Aug. 26, 2009.

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New Issue Details

Sale Information: Wastewater System Revenue Bonds (First Bond Resolution) Senior Series 2009A, 2009B, and 2009C, and Wastewater System Revenue Bonds (Second Bond Resolution) Junior Series 2009A, expected Sept. 14–15 via negotiation.
Purpose: Senior series 2009A, 2009B, and 2009C, fund ongoing components of the system's capital plan; a portion of senior series 2009A and junior series 2009A, refund outstanding bonds for savings.
Final Maturity: Senior series 2009A, 2026; senior series 2009B, 2019; senior series 2009C, 2039; junior series 2009A, 2023.

Related Research

- *2009 Median Ratios for Water and Sewer Revenue Bonds — Retail Systems, Jan. 28, 2009*
- *2009 Water and Sewer Outlook, Jan. 12, 2009*

Rating Rationale

- Bondholders are secured by a net revenue pledge of the city and county of Honolulu's wastewater system.
- The city provides wastewater service to 74% of the island of Oahu's population. The system has seen limited impact to revenues or delinquency rates from the current economic recession and a downturn in tourism.
- Two multiyear rate packages have resulted in substantial rate increases through fiscal 2011 but appear to have broad political and community support. A third rate package is anticipated in fiscal 2012 that will include another five years of rate increases.
- High residential rates with continued annual increases are projected in the future.
- The large capital plan has very strong financial metrics in the form of debt service coverage and a healthy pay-as-you-go component.
- The wastewater system has very high debt levels with substantial additional borrowing plans over the medium term to comply with required environmental mandates to address deferred maintenance.
- Substantial additional capital needs may occur as a result of the January 2009 decision by the Environmental Protection Agency (EPA) to require the wastewater system's two largest treatment plants to move from primary to secondary treatment.

Key Rating Drivers

- Continued political and community support will be needed to support rate increases necessary to execute the CIP.
- Maintenance of the system's strong financial position; Fitch Ratings views this as necessary at this rating level, given the size of the capital plan and the increasing debt burden.
- The outcome of the city's appeal to the EPA regarding increased treatment standards at two of its treatment plants, and the required timing of those improvements, could result in significant new capital requirements and rate pressure.

Credit Summary

The revision of the Rating Outlook to Stable from Negative reflects Fitch's belief that the city may be required by the EPA to move to secondary treatment at its two largest treatment plants at some time in the future. However, the timing and costs associated with this upgrade could be long term, near or beyond the final year of the current large capital plan (2019). Furthermore, negotiations and the final agreement regarding the timing of such regulatory upgrades may not occur quickly. The Stable Rating Outlook reflects Fitch's expectation that the third rate package will be adopted and become effective in fiscal 2012 as anticipated and that a change in political administrations or turnover in senior city management will not result in a deviation of momentum in meeting the goals of the current capital plan to address regulatory issues.

The ratings primarily reflect the very strong financial position of the system and the proactive steps taken by the current political leadership and management team to address many years of delayed spending on system capital infrastructure, including adoption of two multiyear rate packages that extend through fiscal 2011. As a result of leadership's guidance, 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 capital plan. Other positive credit considerations include the regional economy, stable residential customer base, and overall community support of the double-digit annual rate increases needed to invest in the system's aging infrastructure. Credit concerns center on the substantial capital needs that have resulted in very high debt levels, high retail rates, and the need to sustain political momentum and community tolerance for future additional rate increases.

System

The city operates the wastewater system through the Department of Environmental Services (the department). The department provides sewer services to a population of approximately 640,000, or 74% of the total population of the city and county of Honolulu. Of this amount, 74% are residential, lending stability to the customer base. The remaining customers generally are commercial in nature, primarily associated with the island of Oahu's 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 downturn in tourism in the past year has not had a significant impact on wastewater revenues.

The wastewater system is divided into eight wastewater basins, each served by a wastewater treatment plant (WWTP). The system encompasses more than 600 square miles, with collection and transmission pipes leading into separate WWTPs. Aggregate daily flows averaged 108 millions of gallons per day (mgd) for fiscal 2009, approximately 71% 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.

A national pollutant discharge elimination system permit or the state Department of Health (DOH) underground injection control permit regulates the discharge of treated wastewater into receiving waters. Most plants treat to the secondary level, but the Sand Island and Honouliuli WWTPs currently 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 was following the EPA's tentative decision to deny both waivers in 2007. If the city is required to convert these two WWTPs to the secondary treatment standard, the capital costs would be substantial; preliminary staff estimates are as high as $1.2 billion. These capital costs are not included in the city's current CIP projections. The city has appealed the decision with the Environmental Appeals Board but the timing of the decision regarding the appeal is uncertain.

Fitch acknowledges that any conversion to secondary treatment would likely occur over an extended timeframe decided through a negotiated process with the EPA. However, Fitch is concerned that the ongoing substantial rate increases needed to support the existing CIP have significantly reduced the system's practical ability (although not legal authority) to raise rates further, including its ability to respond to an event of the magnitude as moving to secondary treatment. Also, the scope of such additional regulatory requirements, depending on the timeline required by the EPA, could potentially divert capital spending

Rating History — Senior Series

Rating	Action	Outlook/ Watch	Date
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

Rating History — Junior Series

Rating	Action	Outlook/ Watch	Date
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

and staff resources away from the much-needed infrastructure investments that currently make up the bulk of the CIP. Given the limited construction resources on the island of Oahu and the large public and private construction programs currently in progress, there may be a limit as to how much additional work the wastewater system can practically accomplish during a given period. As a result, a key credit concern will be the outcome of the appeal and the timing of implementation required to move the plants to secondary treatment, given the scope of the potential escalation in the CIP and its impact on utility operations and the need for additional rate adjustments beyond those contemplated.

Debt and CIP

The wastewater system is a little more than halfway through the 20-year CIP (fiscal years 2000–2019) addressing multiple consent decrees issued by the EPA. More than 80% of the $4.7 billion 20-year CIP 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 2007. As a result, the actual costs of the projects now that construction has begun are much higher than originally estimated. The cost of the 20-year CIP has increased dramatically from a 2005 estimate of $2.1 billion. Projected spending for the second half of the CIP (fiscal years 2010–2019) is approximately $2.95 billion. The wastewater system's five-year capital plan is estimated at $1.6 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 72%). The city has budgeted $18.6 million to cash fund projects in fiscal 2010.

The city has included some additional projects in its CIP resulting from a stipulated order reached with the EPA in March 2007. In March 2006, the rupture of the Beachwalk force main resulted in the release of 48.7 million gallons of untreated wastewater into the Ala Wai Canal in Waikiki and a brief closure of certain beaches in Waikiki. As a result of this event, the city entered into a stipulated order with the EPA, requiring approximately $300 million of improvements on six force mains and one pump station. A portion of these improvements was already included in the long-term CIP, but the timeline has been accelerated by the stipulated order, which requires completion of these projects by 2014.

Although there are some environmental issues resulting from treatment deficiencies, the majority of the wastewater system's capital needs address environmental concerns plaguing the collection and transmission system. The wastewater system's major pipelines were put in operation 40–100 years ago. As a result, some pipes in the collection system are approaching the end of their useful lives. The collection system's diminished condition affects the overall system performance most during periods of wet weather, and O&M expenditures escalate as a result.

The department's debt position is rapidly becoming highly leveraged given the capital needs described above. Outstanding debt (all fixed rate) will increase to about $1.4 billion following this issuance, with another $1.1 billion in debt anticipated in the next five years. Debt per customer is projected to climb from about $9,000 to $15,000, as compared to Fitch's 'AA' rating category median for water and wastewater utilities of about $2,000 per customer.

Rates

The department must seek city council approval for any rate adjustments. In 2005 and 2007, 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, it amended and raised the amount of the remaining four rate hikes to absorb the most recent CIP cost increases. The approved rate increases are as follows:

- July 1, 2005 — 25%.
- July 1, 2006 — 10%.
- July 1, 2007 — 25%.
- July 1, 2008 — 18%.
- July 1, 2009 — 18%.
- July 1, 2010 — 15%.

The average monthly residential sewer bill has risen to approximately $60 in fiscal 2009, which is high compared with that of other utilities. Based on the remaining approved rate hikes, the bill will increase to more than $84 in fiscal 2011. Further annual rate increases beyond those already approved 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 about 11% to fund the existing CIP.

Fitch views the current administration's implementation of the series of rate increases as an indication of its high level of commitment in addressing needed improvements. 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. However, one concern is that a change in political administration at the city and county could alter the high level of importance that has been placed on infrastructure investment by the current mayor. The senior staff position at the department, the director, has experienced a relatively high level of turnover, but this does not appear to have altered the overall direction of the department since the rate increases were implemented and construction began on the capital plan.

Finances

The system's current financial position is strong, with senior lien debt service coverage above 3.0x in fiscal years 2007 and 2008 and total debt service coverage above 1.6x in both years. Total debt service coverage includes the department's junior lien bonds, general obligation bonds, and state revolving fund loans. These coverage levels exclude system facility charges or connection fees, which are not pledged to revenue bondholders. 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 2.5x. Total debt service coverage on all debt obligations is projected to range between 1.1x and 1.8x over the next six fiscal years. 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.

Liquidity remains a positive credit factor even though the city has drawn down its unrestricted cash balances in fiscal 2009. The city was required to deposit $54 million ($10 million in fiscal 2008 and the remaining amount in fiscal 2009) into its debt service reserve fund due to the deterioration in credit quality of certain surety bond providers. Unrestricted reserves at the end of fiscal 2008 were $78 million, or 248 days cash on hand. Unrestricted reserves are projected to decline to $39 million, or 109 days cash on hand in fiscal 2009. Although unfortunate, this depletion in cash is not a credit concern since the department is generating strong cash flow to support capital spending; it expects to replenish the reserves in fiscal 2010. 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.

Financial Summary

($000, Fiscal Years Ending June 30)

	Audited					Unaudited	Projected			
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Balance Sheet										
Unrestricted Cash and Investments	39,500	42,300	46,700	45,746	78,200	38,700	66,900	—	—	—
Accounts Receivable	15,658	15,735	20,875	23,531	31,818	—	—	—	—	—
Other Current Unrestriced Assets	93,939	(9,936)	71,870	244,085	342,459	—	—	—	—	—
Current Liabilities Payable from Unrestricted Assets	(56,276)	(54,492)	(57,039)	(65,328)	(81,278)	—	—	—	—	—
Net Working Capital	**92,821**	**(6,393)**	**82,406**	**248,034**	**371,199**	—	—	—	—	—
Net Fixed Assets	1,384,387	1,450,691	1,513,603	1,616,817	1,699,154	—	—	—	—	—
Net Long-Term Debt Outstanding	800,120	788,715	931,310	1,173,635	1,341,478	1,441,478	—	—	—	—
Operating Statement										
Operating Revenues	111,886	112,746	142,167	160,963	219,907	233,430	276,210	318,510	367,290	412,490
Non-Operating Revenues	1,540	1,590	4,166	13,996	18,057	8,736	536	2,236	3,036	7,436
Gross Revenues	**113,426**	**114,336**	**146,333**	**174,959**	**237,964**	**242,166**	**276,746**	**320,746**	**370,326**	**419,926**
Operating Expenses (Excluding Depreciation)	(94,414)	(74,581)	(82,962)	(83,773)	(115,058)	(129,589)	(136,807)	(143,020)	(148,260)	(153,910)
Depreciation	(30,575)	(30,647)	(31,439)	(35,311)	(39,362)	0	0	0	0	0
Operating Income	**(11,563)**	**9,108**	**31,932**	**55,875**	**83,544**	**112,577**	**139,939**	**177,726**	**222,066**	**266,016**
Net Revenues Available for Debt Service[a]	19,012	39,755	63,371	91,186	122,906	112,577	139,939	177,726	222,066	266,016
Senior Lien Debt Service Requirements	10,641	10,642	12,946	30,060	34,422	42,281	39,248	53,532	74,550	95,578
Total Debt Service Requirements	22,931	33,497	23,792	56,690	68,667	98,483	93,780	109,825	131,773	153,797
Financial Statistics										
Senior Lien Debt Service Coverage (x)	1.8	3.7	4.9	3.0	3.6	2.7	3.6	3.3	3.0	2.8
Total Debt Service Coverage (x)	0.8	1.2	2.7	1.6	1.8	1.1	1.5	1.6	1.7	1.7
Days Cash on Hand	153	207	205	199	248	109	178	—	—	—
Days Working Capital	359	(31)	363	1,081	1,178	—	—	—	—	—
Debt to Net Plant (%)	58	54	62	73	79	—	—	—	—	—
Outstanding Long-Term Debt per Customer ($)	5,595	5,515	6,513	8,207	9,381	10,080	9,887	11,690	13,460	15,192
Operating Margin (%)[b]	16	34	42	48	48	44	50	55	60	63

[a]Equals gross revenues less operating expenses. [b]Equals operating revenues less operating expenses divided by operating revenues. Note: Numbers may not add due to rounding.

Legal Provisions

Security: The senior lien bonds are payable from and secured by the net revenues of the wastewater system after payment of 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 annual debt service (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.

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. These coverage amounts were amended from the previous levels of 1.2x (senior) and 1.1x (junior) in 2006 but will only spring into effect on the junior lien with the issuance of the series 2009A bonds.

Service Area Economy

Honolulu's economy has diversified but remains dominated by a well-developed tourism sector. The worldwide economic downturn reduced travel to the state beginning in 2008, both from domestic and international visitors. Diversity is provided by the city's role as the regional commercial, business, and finance center, as well as its status as the state capital and home to the University of Hawaii. Honolulu has a strong military presence. Recent investments in this sector have created new jobs, both military and civilian, on the island. Investments in this sector will likely continue given the island of Oahu's strategic location. The unemployment rate remained relatively low in 2008 at 3.5%, well below the national average. Income levels are above state and national averages, partially reflecting the high cost of living on the island.