Fitch Rates Honolulu, HI Wastewater System Senior Revs 'AA' & Junior Revs 'AA-'; Outlook Stable

Link to Fitch Ratings' Report(s): City and County of Honolulu, Hawaii

Fitch Ratings-Austin-11 October 2019: Fitch Ratings has assigned the following ratings to the wastewater system revenue bonds of the City and County of Honolulu, HI (the city):

--$202.2 million wastewater system revenue bonds, senior series 2019A first bond resolution 'AA';
--$167.7 million wastewater system revenue bonds, senior series 2019B (refunding) first bond resolution 'AA';
--$20.8 million wastewater system revenue bonds, senior series 2019C (taxable refunding) first bond resolution 'AA'; and
--$22.9 million wastewater system revenue bonds, junior series 2019A (refunding) second bond resolution 'AA-'.

Bond proceeds will be used to fund certain additions and improvements to the city's wastewater system (the system). Additional proceeds will be used to refund certain outstanding bonds previously issued by the city pursuant to the First Bond Resolution and the Second Bond Resolution. These include certain maturities of senior series 2009A, 2009C, 2010B, 2012B and 2015C, as well as junior series 2009A and 2015B. The remaining proceeds pay costs of issuance. The bonds will not have debt service reserve funds. Bonds are expected to price the week of October 21 via negotiated sale.

Fitch also affirms the following ratings on the city's outstanding wastewater system revenue bonds (pre-refunding):

--$1.84 billion in outstanding senior lien revenue bonds at 'AA';
--$307.6 million in outstanding junior lien revenue bonds at 'AA-'.

The Rating Outlook is Stable.

SECURITY

The senior lien bonds are secured by a senior lien on net revenues of the system. The junior lien bonds have a subordinate pledge of net revenues.

KEY RATING DRIVERS

SOLID FINANCIAL PROFILE: The system has maintained a history of strong financial metrics. Fiscal 2018 total debt service coverage (DSC) was a solid 2.0x and days cash on hand (DCOH) were over 3,000, similar to recent results. Financial margins are expected to weaken over the forecast period as the system issues additional debt to fund required environmental mandates related to its federal consent decree (CD), but results are expected to remain sufficient for the rating level.

HIGH DEBT; CONTINUED ESCALATION: The system has high debt on a per customer basis, which will continue to escalate over the long-term. However, overall leverage as measured by debt to funds available for debt service (FADS) is more reasonable.

ONGOING RATE SUPPORT: Substantial rate increases have had broad political and community support despite high residential rates on a comparative basis. The ratings reflect Fitch's expectation that support for future rate increases necessary to maintain adequate financial margins will continue despite recent actions to hold rates steady.

STRONG SERVICE AREA ECONOMY: The system provides wastewater service to around 80% of the island of Oahu's population and 70% of its revenues are provided by a fixed monthly charge. The system has seen limited impact on revenues or delinquency rates from economic cycles. Strong economic conditions on the island should support continued system capital spending.

RATING SENSTIVITIES

FINANCIAL EROSION: Strong margins are supported by a healthy component of pay-as-you-go funding totaling around 30% for the city and county of Honolulu wastewater system's capital plan. This funding source is key to maintaining the current rating, given the magnitude and scope of the system's long-term capital needs. Reduced revenue funding of capital that lowers all-in coverage levels below 1.5x would be expected to result in rating pressure.

RATE PUSHBACK: The ability to sustain political momentum and community tolerance for required additional rate increases is crucial. Rate pressure that impacts the system's financial flexibility could result in lower ratings.

CREDIT PROFILE

The city operates the wastewater system through its Department of Environmental Services. The department provides sewer services to a population of approximately 780,000 people in the city, with which the county is coterminous. Over 70% of the wastewater system's revenues come from fixed base charges, lending stability to pledged revenues. Residential customers provide the majority of system revenues. Customer growth has been modest over the past five years, averaging less than 1% annually; this trend is expected to continue. The customer base is broad and diverse with no concentration concerns.

Honolulu's economy has proven its stability over the long term, with ongoing growth in tourism activity despite periodic downturns. The city also benefits from its position as the state capital and business center, in addition to substantial defense-related investments due to its strategic Pacific location. Unemployment rates have consistently remained lower than mainland averages and personal income levels are relatively high.

SIGNIFICANT CAPITAL DEMANDS

The federal 2010 consent decree, negotiated with the EPA, outlines a timeline for Honolulu to bring its two wastewater treatment plants (WWTP) up to secondary treatment standards and complete improvements to the aging 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.

The city has until 2024 to upgrade the Honouliuli WWTP to secondary treatment and 2035 to upgrade the Sand Island WWTP to secondary. With work related to the collection system coming to a close, the $2.7 billion fiscal 2020-2024 capital improvement program (CIP) focuses predominantly on treatment plant upgrades related to Honouliuli WWTP. The most recent estimated cost of bringing both WWTPs into compliance with the 2010 consent decree totals $3.5 billion, which largely will be funded beyond the current five-year CIP.

DEBT LEVELS VERY HIGH AND INCREASING

Debt levels are exceptionally high on a per customer basis, reflecting the use of bond funding for much of the heavy capital spending to date. Outstanding debt (all fixed rate) totals $2.1 billion, with another approximately $1.9 billion in revenue bonds and state revolving fund loans anticipated to fund the five-year CIP. Consequently, debt per customer is projected to climb from $15,822 currently to over $26,000 by 2024, compared with Fitch's 'AA' category median of $4,596.

A component of capital funding (around 30%) will come from rate revenue and existing cash balances, which provides an important degree of financial flexibility and cushion for bondholders. Fitch considers maintenance of the pay-as-you-go portion of capital funding to be a critical component of the system's financial flexibility, particularly given the decreasing financial flexibility dictated by fixed debt service. All-in debt service was 36% of revenues in fiscal 2018 and is expected to increase to 51% by fiscal 2024.

Despite high levels of debt, leverage (measured as debt to FADS) remains manageable at 7.7x reflecting the system's strong cash balances and strong operating cash flow. As additional debt is issued to fund capital requirements, continued growth in operating cash flow will be necessary to maintain leverage ratios consistent with the current rating.

HISTORICALLY STRONG POLITICAL & COMMUNITY SUPPORT FOR NEEDED RATE INCREASES

Honolulu raised its rates 175% on a cumulative basis over the period from fiscal 2005-2011. With the clarity provided by the 2010 consent decree, the package of six annual rate increases approved by city council in June 2011 were more moderate than the rate increases experienced prior, ranging from 4%-8% annually. Management decided to hold rates flat in fiscal years 2018-2020 due to the system's already high cash balances. Management is expected to seek approval on the next rate package for fiscal 2021 or shortly thereafter.

Despite the recent rate holiday, Fitch continues to believe that the city council's historical adoption of multiyear rate packages, including implementation of a series of rate increases during the last economic downturn, are an indication of Honolulu's high level of commitment to addressing its mandated capital improvements and available rate flexibility. Nevertheless, should delays continue past fiscal 2021 or rates be adopted that are insufficient to maintain strong financial results, credit concerns would likely develop as such events may indicate rate fatigue and/or lack of support by the city council.

STRONG FINANCIALS TO NARROW ON ADDITIONAL LEVERAGE

The system's financial position has remained strong in the last five fiscal years despite debt levels rising nearly 30%. For fiscal 2018, total DSC was a solid 2.0x, which was similar to the three-year average of 2.1x. As of fiscal 2018, the system maintained $1.1 billion in unrestricted cash and investments, equal to a significant 3,029 DCOH and nearly double the amount from fiscal 2014. Free cash flows have also been strong the last five years and have exceeded annual depreciation by a wide margin.

Financial results have benefitted from sizeable rate increases through fiscal 2017. However, with rates being held steady for fiscal 2018-2020, coupled with $1.9 billion in additional issuances, margins are expected to narrow through the fiscal 2024 forecast. Management is currently forecasting total DSC to drop to around 1.3x by fiscal 2024, although the city typically outperforms its projections. Cash balances are also expected to decrease as the system utilizes funds for capital expenditures, but liquidity should remain very strong.

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, the rating reflects the historical DSC of at least 2.0x for senior debt and 1.5x all-in. This level of coverage enables the system to generate the healthy cash flow that it anticipates needing to fund a portion of the large capital needs and limit the amount of additional leveraging.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg.

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In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Lumesis.

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Additional information is available on www.fitchratings.com
Applicable Criteria
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)
U.S. Water and Sewer Rating Criteria (pub. 29 Nov 2018)

Additional Disclosures
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