FitchRatings

**Public Finance**
Tax-Supported
U.S.A

# Honolulu (City & County), Hawaii

## Ratings

| | |
|---|---|
| Long Term Issuer Default Rating | AA+ |

## New Issues

| | |
|---|---|
| $19,685,000 (Honolulu Rail Transit Project) General Obligation Bonds, Series 2020A | AA+ |
| $276,045,000 (Honolulu Rail Transit Project) General Obligation Bonds, Series 2020B | AA+ |

## Outstanding Debt

| | |
|---|---|
| General Obligation Bonds | AA+ |
| General Obligation Refunding Bonds | AA+ |

## Rating Outlook

Stable

## Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (January 2020)

## Related Research

Fitch Rates Honolulu, HI's $296MM 2020 GOs 'AA+'; Affirms IDR at 'AA+' (February 2020)


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## New Issue Summary

**Sale Date:** The series 2020 GO bonds are scheduled to sell via negotiation on February 13, 2020.

**Series:** $19,685,000 GO Bonds, Series 2020A (Honolulu Rail Transit Project); $276,045,000 GO Bonds, Series 2020B (Honolulu Rail Transit Project).

**Purpose:** To finance the capital costs of the rail transit project being constructed by the Honolulu Authority for Rapid Transportation (HART), and to refund the city and county's series 2017H GO floating rate notes.

**Security:** The bonds are backed by the city and county's full faith and credit and supported by an unlimited pledge of ad valorem property tax.

The 'AA+' reflects the city and county's strong revenue framework, low long-term liabilities, and robust operating performance. The rating is constrained by the city and county's elevated fixed carrying costs for debt service and retiree benefits, limiting expenditure flexibility.

**Economic Resource Base:** The combined city and county government includes the entire island of Oahu and a number of small outlying islands. While a significant portion of the city and county's economy is driven by tourism, it is also the state's center for business services, trade, transportation, healthcare, defense, and government. Honolulu is also home to a large military presence that adds a degree of diversification to the economy. The city and county's population of around 980,000 is approximately two-thirds of the statewide total. Median household income is strong at 138% of the national level.

## Key Rating Drivers

**Revenue Framework: 'aaa':** Property taxes account for the majority of general fund revenues, providing a stable revenue source. Fitch expects solid revenue growth, exceeding inflation but below nominal U.S. GDP growth. The city and county has unlimited independent legal ability to raise property tax revenues.

**Expenditure Framework: 'aa':** Based on recent spending practices and continued strong revenue performance, Fitch expects that expenditure increases will be in line with to marginally above revenue growth. While fixed carrying costs for debt service and retiree benefits are elevated, potentially challenging the city and county's ability to reduce expenditures in a downturn, they also reflect the city and county's ongoing commitment to address accrued pension and OPEB liabilities.

**Long-Term Liability Burden: 'aaa':** Long-term liabilities for debt service and pensions are low relative to the tax base and at the low end of the moderate range relative to personal income. While other post-employment benefits (OPEB) liabilities are large and inflexible, statewide reforms to retiree benefits are expected to slow the growth of related liabilities.

**Operating Performance: 'aaa':** Honolulu is well-positioned to address economic challenges as a result of moderate revenue volatility, high ability to raise revenues, and substantial reserves. Financial management is conservative, and budgets are consistently balanced.

## Rating Sensitivities

**Downside Risks Reflect Liability Burden:** The rating could come under downward pressure if the expenditure framework and long-term liability assessments decline. An increase in long-term liabilities to more than 5% of market value or significantly above 10% of personal income could put downward pressure on the long-term liability burden assessment. Further increases in the fixed carrying costs of debt, pension and OPEB liabilities could put downward pressure on the expenditure framework assessment.

**Sustained Progress on Liabilities:** The rating could rise if the city and county's efforts to address pension and OPEB liabilities lead to sustained declines in fixed costs, improving expenditure flexibility, and a liability burden that falls more firmly in the low range. Fitch believes such shifts are unlikely in the near term but could develop with sustained management efforts over a number of years.

## Current Developments

The local economy and tax base continue to perform strongly, supporting the city and county's ongoing strong financial performance. General fund revenues and expenditures have remained in structural balance for the past three fiscal years. The resulting net operating surpluses have allowed the city and county to build up its unrestricted general fund balance and reserve for fiscal stability, even as it worked to increase funding of retiree benefits to actuarially determined levels to address long-term challenges.

## Credit Profile

The city and county's economy has performed strongly in recent years with steady growth in tourism and a continued substantial military presence. Tourism activity is economically cyclical but has proven resilient over the long term, and unemployment rates have been consistently below the U.S. average.

The city and county's economic growth has been bolstered in recent years by substantial new construction activity. Major infrastructure projects include HART's $9.1 billion rail transit project, as well as improvements to the local water and sewer system, the airport, and harbors. There also are significant private investments occurring across Oahu. Large scale hotel development activity is ongoing, reflecting continued growth in visitor arrivals. Overall tax base growth has been strong, with annual increases of between 2% and 10% during fiscal years 2014 to 2020.

### Revenue Framework

Property taxes provide the chief source of general fund support for the city and county. Hawaii counties' power to levy and collect real property taxes is enshrined in the state constitution, which allows each county to adjust its real property tax rates up or down annually with its council's approval. Tax rates are set based on property type, allowing the city and county to limit the tax burden on residents relative to commercial and hotel/resort properties. The general residential property tax rate has remained unchanged since 2011.

Fitch expects the city and county's revenue growth, absent policy actions, to increase above inflation but less rapidly than U.S. GDP, reflecting continued solid gains in taxable assessed values. While revenue gains may be affected by periodic economic shocks, growth has proven solid on average over the long term. Revenue growth was closer to inflation excluding the impact of frequent property tax rate changes.

Honolulu has unlimited legal authority to raise property tax revenues and has regularly adjusted tax rates and property classifications to serve its fiscal needs.

### Expenditure Framework

Honolulu provides a broad range of municipal services. Public safety and general government account for over half of total general fund expenditures. Hawaii provides education as well as health and human services at the state level.

Fitch expects the natural pace of spending growth to be in line with to marginally above expected revenue growth based on the city and county's current spending profile. The recent trend of steady expenditure growth will continue, but ongoing revenue gains are likely to keep pace. Pension and OPEB cost increases are expected to continue to exceed inflation but to grow less quickly than they have in recent years, when contributions surged as Honolulu worked to bring OPEB contributions in line with actuarial requirements.

### Rating History (IDR/GO Bonds)

| Rating | Action | Outlook/ Watch | Date |
|---|---|---|---|
| AA+ | Affirmed | Stable | 2/11/20 |
| AA+ | Revised | Stable | 4/30/10 |
| AA | Affirmed | Stable | 3/20/09 |
| AA | Affirmed | | 10/26/07 |
| AA | Affirmed | Stable | 3/24/04 |
| AA | Assigned | | 3/12/99 |

The city and county's general fund-supported transit system operating costs will increase as the HART rail transit project comes online. Operations and maintenance is expected to cost approximately $39 million in the second half of fiscal 2021 when interim service begins and to grow to approximately $127 million annually (less $40 million of projected annual fare box recovery) upon full service beginning in fiscal 2026. Therefore, the baseline additional cost will be approximately $87 million (over 4% of current governmental spending) from fiscal 2026 onwards, which appears manageable given the city and county's revenue raising flexibility.

Expenditure flexibility is just adequate, reflecting elevated fixed carrying costs, a safety-dominated expenditure profile, and limitations on policymaker control over labor costs. Fixed carrying costs related to debt, pensions, and OPEB consumed almost 32% of total governmental spending in fiscal 2019, which is notably elevated for a U.S. municipality. The elevated fixed carrying costs are caused in part by efforts to address long-term pension and OPEB liabilities. The portion of fixed carrying costs related to pension and OPEB is elevated at 16% of governmental expenditures due to the legislative priority given to reducing pension and OPEB liabilities. The portion of fixed carrying costs related to debt repayment is also above average at almost 16% of governmental expenditures. Fitch expects fixed carrying costs will remain elevated due to anticipated future debt issuances, full funding of actuarially determined annual pension and OPEB contributions, and state-mandated OPEB pre-funding. Honolulu projects that pension and OPEB contribution costs will rise a further 8% in fiscal 2021 before growth stabilizes at around 3% annually from fiscal 2022 onwards.

The city and county's ability to control personnel expenses is somewhat limited by negotiation of contracts at the state level and relatively strong labor protections, including binding arbitration of contract terms for eight bargaining units and the ability to strike for one. However, while state law characterizes arbitration as "final and binding", the city and county can still reject any cost item and force the parties to return to the bargaining table. While the Honolulu has limited ability to set or adjust terms beyond layoffs and/or furloughs, it does have strong control over headcount.

### Long-Term Liability Burden

Long-term liabilities for debt and pensions are low relative to the tax base at approximately 2.5% of market valuation and moderately low at 10% of personal income. Since a material portion of the city and county's resource base is excluded from its total personal income given the high level of tourism-related development, Fitch elevates consideration of the property value metric.

Direct debt of about $2.8 billion makes up half of the long-term liability burden. This excludes certain GO bonds issued on behalf of self-supporting city and county enterprises but includes HART-related GO bonds (in the absence of any revenue history for HART). As a city and county, Honolulu has no overlapping debt, and its debt portfolio is overwhelmingly comprised of fully amortizing, fixed-rate general obligation bonds.

Voter approval is not required to issue debt. Honolulu expects debt issuance to follow historical patterns over the next several years with moderate annual issuance and some continued borrowing on behalf of HART. Fitch does not expect future issuance to increase debt to a degree that would pressure the rating, given the pace of amortization as well as tax base and personal income growth prospects.

Pensions make up the balance of the long-term liability burden. Honolulu participates in the state Employees' Retirement System. Its portion had a 2019 ratio of pension assets to liabilities of about 56% based on an assumed 7% investment return rate and about 49% based on Fitch's standard 6% rate of return assumption. Actuarial contribution rates are determined by statute and adjusted periodically. In recent years the state legislature has lowered assumed investment returns, extended mortality assumptions, and phased in higher employer contribution requirements. While these changes have increased the reported net pension liability and expenses, they have also improved the longer-term sustainability of the pension plan.

The city and county's unfunded OPEB liability is about $1.7 billion as of fiscal 2019, equivalent to 3% of personal income and less than 1% of market valuation, when adjusted for the proportion of unfunded OPEB liabilities supported by enterprises. Honolulu has made notable progress in funding its OPEB program, moving from pay-go to full funding of the annual actuarially required contribution within the span of several years. The total market value of the OPEB trust fund was $594 million as of June 30, 2019. Full funding would be a credit positive but is offset by Hawaii local governments' inability under state statute to change OPEB benefits for current members or accrued OPEB liabilities.

### Rapid Transit Expansion

Proceeds from the series 2020A and 2020B GO bonds will help fund ongoing construction of the HART's $9.1 billion, 20-mile rail transit project. HART was created to construct the rail transit project, the largest infrastructure investment in state history. The project is approximately 54% complete, with interim service expected in late 2020 and full service expected by late 2026. Honolulu is planning to complete the remaining quarter of the project through a public-private partnership. This will complete the project's final 4.1 miles of track in downtown Honolulu, eight stations, and four power substations, plus oversee the completed system's first 30 years of operations and maintenance. The public-private partnership contract will be a joint procurement by the city and county and HART. The request for proposals process has been extended as the parties work through risk assessment costing issues.

The Hawaii State Legislature and the city and county have approved a dedicated general excise tax surcharge and a dedicated TAT that will fund the bulk of the project costs ($7.2 billion) with most construction funded on a pay-go basis, which is unusual for large transit projects. The federal government has also committed to a substantial $1.6 billion contribution via its New Starts program. Project costs have risen significantly to $9.1 billion from initial estimates of $5.1 billion, requiring significant additional funding via extension of the general excise tax surcharge as well as an increase of the TAT.

The city and county's role in the project is substantial, providing a cash flow borrowing capacity via its GO bonds and GO commercial paper issued in anticipation of general excise tax surcharge and TAT revenues, as well as a modest equity contribution funded by GO bonds to be repaid from local property tax revenues. The city and county's exposure to cost overruns has thus far been manageable, including raising the total city and county subsidy to $214 million, just over 2% of the project's construction costs. Of the project's $9.1 billion budget, $130 million represents contingency funds.

### Operating Performance

Honolulu has the highest level of gap-closing capacity. It is expected to manage through downturns while maintaining a high level of fundamental financial flexibility, reflecting strong reserves relative to expected moderate revenue volatility and its high inherent budget flexibility. The city and county's $426 million unrestricted 2019 general fund balance equaled a robust 26% of spending. Fitch expects that policymakers would use a combination of revenue raising measures, reserve spending, and limited expenditure cuts to offset cyclical revenue losses while maintaining reserves consistent with a 'aaa' resilience assessment.

Budget management in times of recovery is strong. Budget management is conservative, and budgets appear structurally balanced. The city and county has used the current economic expansion to position itself well for the next downturn given the growth in unrestricted reserves since the last recession. As previously noted, ongoing increases in pension and OPEB contributions aim to improve ongoing funding of retiree liabilities.

Honolulu maintains a reserve for fiscal stability fund outside of the general fund. It is available for appropriation only in the event of an emergency or certain economic and revenue triggers. Deposits to this reserve fund are made from general fund and highway fund surpluses. The reserve fund is targeted to be between 5% and 8% of expenditures. The reserve fund balance was $121 million in fiscal 2019 and is budgeted to increase to almost $128 million in fiscal 2020.

In an emergency, the city and county could also access the balance of the H-Power account within its solid waste fund (fiscal 2019 ending cash balance of $49 million) to reduce the need for a general fund subsidy of the refuse fund, thereby freeing up general fund moneys for other purposes.

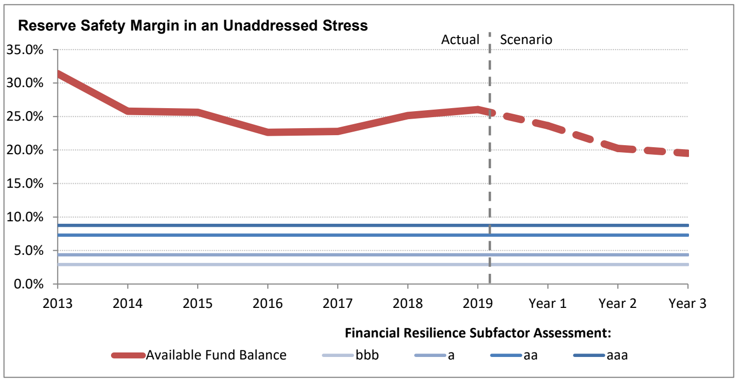
## ESG Considerations

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 Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

## Honolulu (City & County) (HI)

### Scenario Analysis




**Analyst Interpretation of Scenario Results:**

The city and county has the highest level of gap-closing capacity. It is expected to manage through downturns while maintaining a high level of fundamental financial flexibility, reflecting strong reserves relative to expected moderate revenue volatility and its high inherent budget flexibility. The city and county's $426 million unrestricted 2019 general fund balance equaled a robust 26% of spending. Fitch expects that policymakers would use a combination of revenue raising measures, reserve spending, and limited expenditure cuts to offset cyclical revenue losses while maintaining reserves consistent with a 'aaa' resilience assessment.

| Scenario Parameters: | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| GDP Assumption (% Change) | (1.0%) | 0.5% | 2.0% |
| Expenditure Assumption (% Change) | 2.0% | 2.0% | 2.0% |
| Revenue Output (% Change) | (2.9%) | 0.9% | 4.7% |
| Inherent Budget Flexibility | | High | |

| Revenues, Expenditures, and Fund Balance | Actuals | | | | | | | Scenario Output | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | Year 1 | Year 2 | Year 3 |
| Total Revenues | 1,012,408 | 1,039,068 | 1,140,345 | 1,203,597 | 1,285,573 | 1,367,297 | 1,493,311 | 1,449,826 | 1,463,048 | 1,532,353 |
| % Change in Revenues | - | 2.6% | 9.7% | 5.5% | 6.8% | 6.4% | 9.2% | (2.9%) | 0.9% | 4.7% |
| Total Expenditures | 733,510 | 762,755 | 830,195 | 885,055 | 947,713 | 997,137 | 1,068,640 | 1,090,013 | 1,111,813 | 1,134,049 |
| % Change in Expenditures | - | 4.0% | 8.8% | 6.6% | 7.1% | 5.2% | 7.2% | 2.0% | 2.0% | 2.0% |
| Transfers In and Other Sources | 135,950 | 146,729 | 137,372 | 182,247 | 158,670 | 173,272 | 192,766 | 187,153 | 188,859 | 197,806 |
| Transfers Out and Other Uses | 330,684 | 434,975 | 432,795 | 508,890 | 485,659 | 494,558 | 567,008 | 578,348 | 589,915 | 601,713 |
| Net Transfers | (194,734) | (288,246) | (295,423) | (326,643) | (326,989) | (321,286) | (374,242) | (391,196) | (401,056) | (403,908) |
| Bond Proceeds and Other One-Time Uses | - | - | - | - | - | - | - | - | - | - |
| | | | | | | | | | | |
| Net Operating Surplus(+)/Deficit(-) After Transfers | 84,164 | (11,933) | 14,727 | (8,101) | 10,871 | 48,874 | 50,429 | (31,383) | (49,820) | (5,604) |
| Net Operating Surplus(+)/Deficit(-) (% of Expend. and Transfers Out) | 7.9% | (1.0%) | 1.2% | (0.6%) | 0.8% | 3.3% | 3.1% | (1.9%) | (2.9%) | (0.3%) |
| | | | | | | | | | | |
| Unrestricted/Unreserved Fund Balance (General Fund) | 334,022 | 308,849 | 323,576 | 315,475 | 326,346 | 375,220 | 425,649 | 394,266 | 344,446 | 338,842 |
| Other Available Funds (GF + Non-GF) | - | - | - | - | - | - | - | - | - | - |
| Combined Available Funds Balance (GF + Other Available Funds) | 334,022 | 308,849 | 323,576 | 315,475 | 326,346 | 375,220 | 425,649 | 394,266 | 344,446 | 338,842 |
| Combined Available Fund Bal. (% of Expend. and Transfers Out) | 31.4% | 25.8% | 25.6% | 22.6% | 22.8% | 25.2% | 26.0% | 23.6% | 20.2% | 19.5% |

| Reserve Safety Margins | Inherent Budget Flexibility | | | | |
|---|---|---|---|---|---|
| | Minimal | Limited | Midrange | High | Superior |
| *Reserve Safety Margin (aaa)* | 46.6% | 23.3% | 14.6% | 8.7% | 5.8% |
| *Reserve Safety Margin (aa)* | 34.9% | 17.5% | 11.6% | 7.3% | 4.4% |
| *Reserve Safety Margin (a)* | 23.3% | 11.6% | 7.3% | 4.4% | 2.9% |
| *Reserve Safety Margin (bbb)* | 8.7% | 5.8% | 4.4% | 2.9% | 2.0% |

Notes: Scenario analysis represents an unaddressed stress on issuer finances. Fitch's downturn scenario assumes a -1.0% GDP decline in the first year, followed by 0.5% and 2.0% GDP growth in Years 2 and 3, respectively. Expenditures are assumed to grow at a 2.0% rate of inflation. Inherent budget flexibility is the analyst's assessment of the issuer's ability to deal with fiscal stress through tax and spending policy choices, and determines the multiples used to calculate the reserve safety margin. For further details, please see Fitch's US Tax-Supported Rating Criteria.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.