FitchRatings

FITCH RATES HONOLULU, HI WASTEWATER SYSTEM SENIOR REVS 'AA' & JUNIOR REVS 'AA-'; OUTLOOK STABLE

Fitch Ratings-Austin-08 July 2015: Fitch Ratings assigns the following ratings to the wastewater system revenue bonds of the City and County of Honolulu, Hawaii:

--Approximately $176 million (first bond resolution) senior series 2015A rated 'AA';
--Approximately $263 million (first bond resolution) senior series 2015B rated 'AA';
--Approximately $97 million (first bond resolution) senior series 2015C (taxable) rated 'AA';
--Approximately $73 million (second bond resolution) junior series 2015A rated 'AA-'; and
--Approximately $24 million (second bond resolution) junior series 2015B (taxable) rated 'AA-'.

Bond proceeds will be used to fund a portion of the system's capital plan (senior series 2015A), refund outstanding bonds for level savings and pay costs of issuance. The bonds will not have debt service reserve funds. Bonds are expected to price on July 21-22 via negotiated sale.

Fitch also affirms the following ratings on Honolulu's outstanding wastewater system revenue bonds (a portion of which will be refunded by the series 2015 bonds):

--$1.25 billion in outstanding senior lien revenue bonds at 'AA';
--$378.7 million in outstanding junior lien revenue bonds at 'AA-'.

Fitch Ratings has withdrawn the 'AA' rating on Honolulu (wastewater system (first bond resolution) senior series 2007C as the bond was not sold.

The Rating Outlook is Stable.

SECURITY

Senior lien bonds are secured by a senior lien on net revenues of the city and county of Honolulu's wastewater system. The junior lien bonds have a subordinate pledge of net revenues.

KEY RATING DRIVERS

STRONG SERVICE AREA ECONOMY: Honolulu provides wastewater service to 82% of the island of Oahu's population and 70% of the 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.

ROBUST CASH FLOW: The system has strong financial metrics resulting from rate increases implemented to prepare for substantial capital spending. Cash flow funding for 20% of the sizable capital plan should continue to provide a sufficient degree of financial flexibility.

ONGOING RATE SUPPORT: Substantial rate increases have occurred to date with broad political and community support, despite high residential rates on a comparative basis. Continued support for annual future rate increases is key to maintaining adequate financial margins to support the ratings.

HIGH DEBT; CONTINUED ESCALATION: The system has exceptionally high debt levels, which will continue to escalate over the long-term to comply with required environmental mandates in the federal consent decree.

MANAGEMENT COVERAGE TARGETS: Management expects to maintain debt service coverage on senior revenue bonds of over 2.0 times (x) and coverage of all debt over 1.5x, even as annual debt service (ADS) costs escalate. Management's intended adherence to these internal targets is reflected in the ratings.

RATING SENSITIVITIES

REDUCED REVENUE FUNDING FOR CAPITAL: Strong margins are supported by a healthy component of pay-as-you-go funding for the capital plan. This funding is a key driver, given the magnitude and scope of the system's long-term capital needs. Reduced revenue funding of capital that lower coverage levels below 1.5x all-in coverage would result in rating pressure.

LOWER RATE INCREASES: The ability to sustain political momentum and community tolerance for required additional rate increases are key drivers of the ratings. Rate pressure that impacts the system's financial flexibility could result in lower ratings.

CREDIT PROFILE
The city and county of Honolulu (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. Approximately 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. Growth projections are modest at 0.4%. The top 10 users only account for 6.3% of revenues.

CAPITAL DEMANDS ARE SIGNIFICANT

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. Although a small portion of costs related to treatment plant upgrades is included in the estimated $2.3 billion five year capital improvement plan (CIP) in fiscals 2016-2020, the estimated cost of bringing both WWTPs into compliance with the 2010 consent decree is another $1.7 billion, which will take place beyond the five-year CIP.

REVENUE FUNDING OF CAPITAL; DEBT LEVELS REMAIN VERY HIGH
Debt levels are exceptionally high, reflecting the use of bond funding for much of the heavy capital spending to date. Outstanding debt (all fixed rate) totals $1.9 billion, with another approximately $1.6 billion in revenue bonds anticipated to fund the CIP, including the series 2015A bonds. Debt per customer is projected to climb from $13,700 currently to over $22,000 by 2020, compared with Fitch's 'AA' national rating category median for water and wastewater utilities of $1,934 per customer. Debt to net plant is high at 80% as compared to the 'AA' median of 50%.

A component of capital funding (20%) will come from rate revenue, which provides an important degree of financial flexibility and cushion for bondholders. The wastewater system generates $90-$120 million annually in revenues to contribute towards capital spending. The system's free cash/depreciation has been over 150% in the past five years, which exceeds Fitch's median for the rating category of 94%. Fitch considers maintenance of the pay-as-you-go portion of capital funding to be a critical component of the system's remaining financial flexibility, particularly given the decreasing financial flexibility dictated by fixed debt service. All-in debt service was 36% of revenues in fiscal 2014 and is expected to increase to 45% by 2020.

STRONG POLITICAL & COMMUNITY SUPPORT FOR NEEDED RATE INCREASES

City council has adopted multiyear rate packages and continued to implement them during years of economic downturn. Fitch views this practice as an indication of Honolulu's available rate flexibility and high level of commitment in addressing its mandated capital improvements.

Double-digit rate increases implemented in fiscals 2005 - 2011 have been followed by more moderate 4-5% annual rate increases in fiscals 2012-2016. An additional increase of 8% is approved for fiscal 2017. Management expects to design and seek approval on the next six-year rate package prior to fiscal 2018. The last rate package included a full cost of service study.

STRONG COVERAGE MARGINS TO SUPPORT CAPITAL SPENDING

The system's financial position is strong, with senior lien debt service coverage (DSC) above 3.0x and total DSC above 1.6x in the past five years, including actual but unaudited results for fiscal 2014. Total DSC includes the department's junior lien bonds, general obligation bonds, and state revolving fund loans. Management financial projections show senior DSC remaining over 2.0x through fiscal 2019 and total DSC on all debt obligations above 1.5x.

The city's formal policy is to maintain DSC of 1.6x on the senior lien bonds and 1.25x on combined senior and junior lien revenue bonds. However, management anticipates, and the rating reflects, maintenance of at least 2.0x DSC on the senior bonds and 1.5x total DSC, as indicated in management's financial projections. This level of coverage enables to the system to generate the healthy cash flow that it anticipates needing to fund a portion of the large capital needs.

Liquidity remains a positive credit factor. Unrestricted reserves are projected at $419.3 million at fiscal year-end 2014, or 983 days cash on hand. 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. The level of liquidity is likely to come down as the utility increases its capital spending.

Contact:

Primary Analyst
Kathy Masterson
Senior Director
+1-512-215-3730
Fitch Ratings, Inc.
111 Congress Avenue, Suite 2010
Austin, TX 78701

Secondary Analyst
Doug Scott
Managing Director
+1-512-215-3725

Committee Chairperson
Karen Ribble
Senior Director
+1-415-732-5611

Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email: sandro.scenga@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

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

Applicable Criteria
Revenue-Supported Rating Criteria (pub. 16 Jun 2014)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012
U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 31 Jul 2013)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715275