City and County of Honolulu, Hawaii

Wastewater System Revenue Bonds

New Issue Report

Ratings

New Issues

$164,955,000 Wastewater SystemRevenue Bonds (First Bond Resolution), Senior Lien Series 2011A	AA
$67.125 Million Wastewater System Revenue Bonds (First Bond Resolution),Senior Lien Series 2011B	AA

Outstanding Debt

$1,010,000,000 Wastewater System Revenue Bonds, (First Bond Resolution), Senior Series	AA
$435,400,000 Wastewater System Revenue Bonds, (Second Bond Resolution), Junior Series	AA–

Rating Outlook

Stable

Related Research

For information on Build America Bonds, visit www.fitchratings.com/BABs.

2011 Water and Wastewater Medians, Jan. 18, 2011

2011 Outlook: Water and Wastewater Sector, Jan. 18, 2011

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New Issue Details

Sale Information: $165,260,000 Wastewater System Revenue Bonds, Series 2011A, scheduled to sell via negotiated sale during the week of Oct. 10, 2011.

Security: Net revenues of Honolulu's wastewater system.

Purpose: Series 2011A bonds will fund ongoing components of the wastewater capital plan; series 2011B bonds will advance refund outstanding bonds for level savings.

Final Maturity: Series 2011A: July 1, 2042; Series 2011B: July 1, 2022.

Key Rating Drivers

Revenue Stability: The city of Honolulu provides wastewater service to 74% of the island of Oahu's population. The system has seen limited impact on revenues or delinquency rates from the economic recession.

Large Rate Increases: Substantial rate increases have occurred through fiscal 2011 but appear to have broad political and community support, despite high residential rates on a comparative basis. In 2011, the city approved more modest rate increases for six years beginning in fiscal 2012.

Strong Cash Flow Projected: The wastewater system has a healthy pay-as-you-go capital improvement program (CIP), providing for strong debt service coverage of 5.1x in fiscal 2010. The strong margins result from very large rate increases imposed in the past three fiscal years. The healthy cash flow is significantly increasing the cash funding of capital needs in fiscal 2012.

High Debt and Large CIP: The wastewater system has exceptionally high debt levels with substantial additional medium-term borrowing plans to comply with required environmental mandates to address deferred maintenance.

Substantial Long-Term Capital Demands: Substantial additional capital needs exist beyond the current CIP to rehabilitate the aging system. The city has entered into a 2010 consent decree with the EPA to move the wastewater system's two largest treatment plants from primary to secondary treatment at significant cost. Continued rate flexibility will be critical to maintaining historic debt service coverage levels and the current rating level as these upgrades are implemented.

What Could Trigger a Rating Action

Decline in Financial Strength: Fitch Ratings views maintenance of the system's strong financial position as necessary at this rating level, given the size of the CIP and increasing debt burden. Any deterioration in financial margins could result in rating pressure.

Deviation from Regulatory Requirements: Compliance with the terms and timelines required by the new 2010 consent decree is critical to the credit profile.

Rating History — Senior Series

Rating	Action	Outlook/ Watch	Date
AA	Affirmed	Stable	10/05/11
AA	Affirmed	Stable	10/15/10
AA	Revised[a]	Stable	4/30/10
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

[a]Reflects revision.

Rating History — Junior Series

Rating	Action	Outlook/ Watch	Date
AA–	Affirmed	Stable	10/05/11
AA–	Affirmed	Stable	10/15/10
AA–	Revised[a]	Stable	4/30/10
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

[a]Reflects revision.

Related Criteria

Revenue-Supported Rating Criteria, June 20, 2011

Water and Sewer Revenue Bond Rating Guidelines, Aug. 10, 2011

Credit Profile

The ratings primarily reflect the very strong financial position of the system and the proactive steps taken by the political leadership and management team to address many years of delayed spending on system capital infrastructure, including cumulative rate increases totaling 175% between fiscal years 2006 and 2011. As a result, financial performance is expected to remain favorable in the next five years despite sizable increased leveraging. While rate increases in the next few years will be lower than the previous five years, the need to sustain political momentum and community tolerance for future additional rate increases is key to the rating. Following the next five years of capital spending in the range of $250 million–$350 million per year, the system may need to spend even greater amounts annually to begin to comply with additional regulatory mandates to upgrade the treatment plants.

2010 Consent Decree

Sand Island and Honouliuli wastewater treatment plants (WWTPs) have operated 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. Honolulu appealed this decision. In July 2010, agreement on a proposed consent decree was reached by the EPA, Honolulu, the State Department of Health, and four environmental organizations that had litigation pending regarding Honolulu's noncompliance with the Clean Water Act; the decree became effective in December 2010. The 2010 consent decree outlines a timeline for Honolulu to bring the two plants up to secondary treatment standard. It also incorporates the terms and requirements of Honolulu's existing 1994 consent decree and 2007 stipulated order, as well as resolves pending litigation from 2004.

While the capital requirements and cost of compliance are substantial (initial estimates are $1.7 billion for the treatment plant upgrades alone), the timeline is longer than originally proposed by the EPA and the consent decree brings all regulatory requirements under one document and timeline. Fitch views this as a positive development as the EPA's initial timeline could have potentially diverted capital spending and staff resources away from the much needed infrastructure investments that make up the bulk of the current CIP. The consent decree allows 10 years to complete ongoing work on the collection system, 14 years for the upgrade of the Honouliuli WWTP to secondary treatment, and up to 25 years for the upgrade of the Sand Island WWTP to secondary treatment. Honolulu will need to remain in compliance with these timeline requirements.

Approved Rate Increases Through 2017

Honolulu raised its rates 175% on a cumulative basis over the six-year period from fiscal years 2006–2011. With the clarity provided by the 2010 consent decree, the package of six annual rate increases approved by City Council in June 2011 are more moderate than the rate increases experienced since 2006. Rate increases for the next four years (fiscal years 2012 through 2015) will be 4% annually and then increase to 5% and 8% in fiscal 2016 and 2017, respectively. The financial forecast presented by management to Fitch included this level of approved rate increases.

The average monthly residential combined water and wastewater bill is now about $129, or 2.4% of median household income. The high relative combined bill, the pace and scope of the recent rate increases, and the continued high level of capital still needed continue to be credit concerns. These concerns are somewhat mitigated by the demonstrated ability of the city to put rate increases in place to maintain a strong level of cash flow to contribute towards the capital plan and preserve financial margins for bondholders.

Service Area Economy

Honolulu's visitor industry is showing strong growth in 2011, following significant declines during the recent recession. Visitor arrivals and days have risen steadily since mid-2009, and 2011 results to date indicate increases to both average daily room rates and hotel occupancy as compared to 2010 levels. The city's nontourism economy is also substantial and balances tourism's inherent volatility.

The city is the state's commercial and business center, a regional transportation hub, the state capital, and has a sizable U.S. military presence. More than 70% of Hawaii's population and jobs are in Honolulu, and the city receives more than half of all tourist expenditures statewide. Unemployment rates have consistently remained lower than mainland averages and fell to 4.6% in April 2011. Income levels are well above the national average, although this is somewhat offset by the island's high cost of living.

The property tax base in Honolulu remained relatively steady until fiscal 2011's 7.8% decline in assessed value, but fiscal 2012 results show a return to modest growth. Housing starts have continued to rise from their 2008 lows and several major commercial and residential projects, as well as a planned $5.3 billion mass transit system, point towards a recovery in the construction sector.

Operating Profile

Customers

The city operates the wastewater system through the Department of Environmental Services. 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. Approximately 70% of the wastewater system's revenues come from residential customers, 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 top 10 users only account for 6.5% of revenues.

Sewer System

The wastewater system is divided into eight wastewater basins, each served by a WWTP. The system encompasses more than 600 square miles, with collection and transmission pipes leading into separate WWTPs. Aggregate daily flows averaged 105 millions of gallons per day (mgd) for fiscal 2011, approximately 70% 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.

Debt Profile

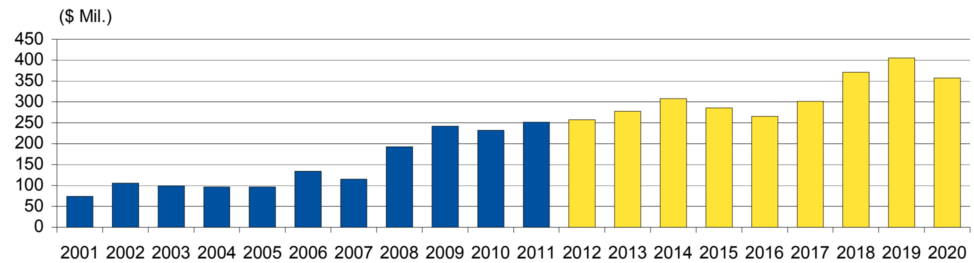
Substantial Capital Demands

The wastewater system is addressing substantial capital needs. The most immediate capital needs relate to the rehabilitation of an aging collection system, as required by the EPA. More than 80% of the overall $5 billion, 20-year CIP (fiscal years 2001–2020) 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 2008.

Projected spending for the second half of the CIP (fiscal years 2012–2020) is approximately $2.8 billion, or approximately $250 million–$350 million annually. The wastewater system's five-year CIP is estimated at $1.4 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 69%).

The wastewater system will generate approximately $100 million annually in revenues to contribute towards capital spending.

Historical and Projected CIP Expenditures



Note: Years 2012–2020 projected.

Beginning just prior to 2020, but largely once the collection system improvements have been accomplished, the city will work towards compliance with the new consent decree requirements that require the upgrade of the Honouliuli WWTP to secondary treatment by 2024 and the upgrade of the Sand Island WWTP to secondary treatment by 2035. While the current CIP through 2020 includes some costs associated with the treatment plant upgrades, much of the costs will occur beyond 2020. Very early estimates are in the range of $1.7 billion for the treatment plan upgrades.

High Debt Burden

The system is already highly leveraged and debt levels will climb even further given the capital needs described above. Outstanding debt (all fixed rate) will increase to about $1.6 billion following this issuance, with another $700 million in debt anticipated in the next five years. Debt per customer is projected to climb from about $11,500 currently to $15,000, compared with Fitch's 'AA' national rating category median for water and wastewater utilities of about $1,500 per customer. Debt to net plant is high at 72% as compared to the 'AA' median of 44%.

Legal Covenants

Security

The senior lien bonds are payable from and secured by the net revenues of the wastewater system after payment of operations and maintenance (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 maximum annual debt service (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. All surety bonds have been replaced by cash reserves. The series 2010 and 2011 bonds have a reserve funded at only 50% of MADS.

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.

Taxable Bonds — Federal Subsidy

Amendments to the indenture allow the federal subsidy expected in relation to the Build America Bonds to be treated as an offset to debt service rather than revenue. Fitch's calculation of debt service coverage includes the subsidy as revenue rather than an offset to debt service. In the unlikely event that receipt of the subsidy is delayed, the district is still obligated to pay full debt service from its remaining revenues.

Financial Profile

Rates and Charges

The department must seek City Council approval for any rate adjustments. In 2005, 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, the City Council amended and raised the amount of the remaining four rate hikes to absorb the most recent CIP cost increases. Most recently, City Council adopted another multiyear package of six annual rate increases, the first of which became effective July 1, 2011 (fiscal 2012).

The average monthly residential sewer bill has risen to approximately $87 in fiscal 2011, which is high compared with that of other utilities. 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 in the range of 4%–5% to fund the existing CIP.

On an affordability scale, the combined water and sewer bill of approximately $129 per month is high at 2.4% of median household income. With the anticipated rate increases, the combined

Approved Rate

Year Effective	% Increase
2005	25
2006	10
2007	25
2008	18
2009	18
2010	15
2011	15
2012	4
2013	4
2014	4
2015	4
2016	5
2017	8

monthly bill could grow to 3% of median household income at the end of the five-year forecast, with additional rate pressure in later years to fund the upgrades to the treatment plants.

Fitch views the City Council's adoption of three multiyear rate packages, and subsequent implementation of the series of rate increases during an economic downturn, as an indication of Honolulu's high level of commitment in addressing its mandated capital improvements and available rate flexibility. 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. Concern exists that the longevity of the needed rate increases at the system will create rate fatigue.

Financial Summary

($000, Audited Fiscal Years Ended June 30)

	2006	2007	2008	2009	2010
Balance Sheet					
Unrestricted Cash and Investments	46,700	45,746	78,200	63,275	167,200
Accounts Receivable	20,875	23,531	31,818	34,551	41,088
Other Current Unrestricted Assets	71,870	244,085	342,459	285,891	249,489
Available Restricted Cash and Investments	—	—	—	—	—
Current Liabilities Payable from Unrestricted Assets	(57,039)	(65,328)	(81,278)	(89,377)	(99,684)
Net Working Capital	**82,406**	**248,034**	**371,199**	**294,340**	**358,093**
Net Fixed Assets	1,513,603	1,616,817	1,699,154	1,873,157	2,048,617
Net Long-Term Debt Outstanding	931,310	1,173,635	1,341,478	1,361,308	1,480,867
Operating Statement					
Operating Revenues	142,167	160,963	225,104	251,953	308,407
Non-Operating Revenues	4,166	13,996	18,057	3,751	548
Connection Fees	—	4,691	5,025	1,555	6,686
Gross Revenues	**146,333**	**179,650**	**248,186**	**257,259**	**315,641**
Operating Expenses (Excluding Depreciation)	(82,962)	(83,773)	(115,058)	(102,595)	(120,884)
Depreciation	(31,439)	(35,311)	(39,362)	(40,682)	(42,281)
Operating Income	31,932	60,566	93,766	113,982	152,476
Net Revenues Available for Debt Service[a]	**63,371**	**95,877**	**133,128**	**154,664**	**194,757**
Senior Lien Debt Service Requirements	12,946	30,060	34,422	42,281	38,184
Total Debt Service Requirements	23,792	56,690	68,667	104,803	92,048
Financial Statistics					
Senior Lien Debt Service Coverage (x)	4.90	3.19	3.87	3.66	5.10
Total Debt Service Coverage (x)	**2.66**	**1.69**	**1.94**	**1.48**	**2.12**
Days Cash on Hand	205	199	248	225	505
Days Working Capital	363	1081	1178	1047	1081
Debt to Net Plant (%)	61.5	72.6	79.0	72.7	72.3
Outstanding Long-Term Debt per Customer ($)	6,559	8,265	9,381	9,506	10,282
Outstanding Long-Term Debt per Capita ($)	1,070	1,349	1,541	1,564	1,679
Free Cash to Depreciation (%)[b]	125.9	110.9	163.8	122.6	242.9

[a]Equals gross revenues, including federal direct subsidy payments, less operating expenses. [b]Equals net revenues available for debt service less operating transfers out, less total debt service, divided by depreciation. Note: Numbers may not add due to rounding.

Financial Performance

The system's financial position is strong, with senior lien debt service coverage above 3.0x and total debt service coverage above 1.5x in the past five years, including unaudited results for fiscal 2011. Total debt service coverage includes the department's junior lien bonds, general obligation bonds, and state revolving fund loans. 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 2.0x through fiscal 2016. Total debt service coverage on all debt obligations is projected to remain above 1.5x. The city's actual performance typically exceeds its projections.

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 current rating anticipates maintenance of 2.0x on the senior bonds and 1.5x total debt service coverage, including system facility charges, which is the level needed to generate approximately $100 million annually to go towards capital spending from cash flow. Maintenance of current debt service coverage levels as the CIP is implemented is critical to the current rating level.

Financial Summary

($000, Fiscal Years Ended June 30)

	Unaudited 2011	2012	2013	2014	2015	2016
Operating Statement						
Operating Revenues	337,705	331,684	364,857	390,734	397,367	418,467
Non-Operating Revenues	185	336	6,979	1,107	11,680	12,379
Connection Fees	3,244	—	—	—	—	—
BABs/RZED Bonds Subsidy[a]	—	2,176	6,010	5,528	5,528	5,528
Gross Revenues	**341,134**	**334,196**	**377,846**	**397,369**	**414,575**	**436,374**
Operating Expenses (Excluding Depreciation)	(113,291)	(137,966)	(147,592)	(153,088)	(158,277)	(163,853)
Depreciation	—	—	—	—	—	—
Operating Income	**227,843**	**196,230**	**230,254**	**244,281**	**256,298**	**272,521**
Net Revenues Available for Debt Service[b]	227,843	196,230	230,254	244,281	256,298	272,521
Senior Lien Debt Service Requirements	49,644	65,042	79,659	94,340	111,120	128,043
Total Debt Service Requirements	103,443	121,427	138,118	151,810	167,140	184,684
Financial Statistics						
Senior Lien Debt Service Coverage (x)	4.59	3.02	2.89	2.59	2.31	2.13
Total Debt Service Coverage (x)	**2.20**	**1.62**	**1.67**	**1.61**	**1.53**	**1.48**
Total Debt Service Coverage Excluding BABs/RZED Bonds Subsidy (x)	**2.20**	**1.60**	**1.62**	**1.57**	**1.50**	**1.45**

[a]Build America Bonds (BABs)/Recovery Zone Economic Development (RZED) Bonds subsidy per the American Recovery and Reinvestment Act (ARRA) of 2009. [b]Equals gross revenues, including federal direct subsidy payments, less operating expenses.

Liquidity remains a positive credit factor. Unrestricted reserves are projected at $270 million at fiscal year-end 2011, or 870 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 enters a period of intense capital spending. It has been built up by the doubling of free cash flow generated by the utility in the last couple of years.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.