FitchRatings

Fitch Rates Honolulu, HI's Wastewater System Sr Revs 'AA' & Jr Revs 'AA-'; Outlook Stable

Fitch Ratings-San Francisco-04 January 2018: Fitch Ratings has assigned the following ratings to the wastewater system revenue bonds of the City and County of Honolulu, HI (the city):

--$218.8 wastewater system revenue bonds, senior series 2018A first bond resolution at 'AA';
--$34.7 wastewater system revenue bonds, senior series 2018B (refunding) first bond resolution at 'AA';
--$42.1 wastewater system revenue bonds, junior series 2018A (taxable refunding) second bond resolution at 'AA-'; and
--$9.1 wastewater system revenue bonds, junior series 2018B (refunding) second bond resolution at 'AA-'.

Bond proceeds will primarily 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 2015C, and junior series 2009A, 2010A 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 January 22 via negotiated sale.

Fitch also affirms the following ratings on the city's outstanding wastewater system revenue bonds (a portion of which will be refunded by the series 2018 bonds):

--$1.56 billion in outstanding senior lien revenue bonds at 'AA';
--$326.2 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

STRONG AND STABLE REVENUE: Honolulu provides wastewater service to 82% 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 continue to support demand and revenue growth.

SIGNIFICANT CAPITAL SPENDING: Honolulu faces significant capital demands under the terms of a federal consent decree, which are reflected in the system's $2.7 billion five-year capital improvement plan (CIP). Cash flow funding for approximately 30% of the sizable capital plan should continue to provide a sufficient degree of financial flexibility, but additional rate increases will be required to support financial performance.

ONGOING RATE SUPPORT: Substantial rate increases have occurred to date with broad political and community support, despite high residential rates on a comparative basis. The current rating reflects Fitch's expectation that support for future rate increases necessary to maintain adequate financial margins will continue.

HIGH DEBT; MANAGEABLE LEVERAGE: The system has high debt levels on a per capita and per customer basis, but debt to free cash available for debt service (FADS) is more moderate. Debt levels are expected to escalate over the long-term to fund required environmental mandates in the federal consent decree, but growing FADS should moderate leverage.

MANAGEMENT COVERAGE TARGETS: Management expects to maintain slightly lower debt service coverage than previously anticipated on senior revenue bonds of over 1.75x and all debt over 1.4x as annual debt service (ADS) costs escalate. However, management's intended adherence to an internal target of 1.5x DSC on an all-in basis 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 city and county of Honolulu wastewater system's 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 lowers 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 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. The top 10 users only account for 7% of revenues.

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 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 portion of costs related to treatment plant upgrades is included in the estimated $2.7 billion five-year capital improvement plan (CIP) in fiscals 2017-2021, most of the current CIP targets collection system improvements. The estimated cost in 2010 dollars of bringing both WWTPs into compliance with the 2010 consent decree totals $1.7 billion, which largely will be funded beyond the current 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 $2.3 billion, with another approximately $1.88 billion in revenue bonds anticipated to fund the five-year CIP. Debt per customer is projected to climb from $15,822 currently to over $25,000 by 2022, compared with Fitch's 'AA' national rating category median for water and wastewater utilities of $1,800 per customer. Debt to net plant is high at 78% as compared to the 'AA' median of 45%.

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. The wastewater system generates $70-$125 million annually in revenues to contribute towards capital spending. The system's free cash/depreciation has been increasing from over 120% in fiscal 2012 to 259% in fiscal 2017, which exceeds Fitch's median for the rating category of 108%. 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 34% of revenues in fiscal 2017 and is expected to increase to 48% by 2022.

Despite high levels of debt, leverage (measured as debt to FADS) remains manageable at 6.8x reflecting the system's strong cash balances and strong operating cash flow. As additional debt is required to fund capital requirements, continued growth in operating cash flow will be necessary maintain leverage ratios consistent with the current rating.

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% to 5% annual rate increases in fiscals 2012 - 2016 and an additional increase of 8% in fiscal 2017. Management decided to hold rates flat in fiscal 2018 due to the system's already high cash balances. Management expects to design and seek approval on a new six-year rate package in the near future. 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) near or above 3.0x and total DSC above 1.6x in the past five years. 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 1.9x through fiscal 2021 and total DSC on all debt obligations above 1.4x. This is slightly lower than previously projected minimums of 2.0x for senior obligation and 1.6x for all obligations. In the out years of the projections, senior DSC is lower at 1.7x and all-in DSC is no lower than 1.4x.

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, the rating reflects maintenance of historical levels of at least 2.0x DSC on the senior bonds and 1.5x total DSC. 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. Should actual DSC fall below these levels, the rating could be pressured.

Liquidity remains a positive credit factor. Unrestricted cash and investments totaled over $1 billion for fiscal 2017, or nearly 3,000 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 cash capital spending.

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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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Applicable Criteria
Rating Criteria for Public Sector Revenue-Supported Debt (pub. 05 Jun 2017) (https://www.fitchratings.com/site/re/898969)
U.S. Water and Sewer Rating Criteria (pub. 30 Nov 2017) (https://www.fitchratings.com/site/re/10010508)

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