Research Update:

Honolulu City And County, Hawaii Series 2025 Senior-Lien Wastewater System Bonds Assigned 'AA+' Rating; Outlook Stable

August 22, 2025

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Overview

- S&P Global Ratings assigned its 'AA+' long-term rating to Honolulu City and County (the department), Hawaii's approximately $221 million series 2025 senior-lien wastewater system revenue bonds.
- S&P Global Ratings also affirmed its 'AA+' rating on the department's outstanding junior and senior wastewater system revenue bonds.
- The outlook is stable.

Rationale

Security

The bonds are limited special obligations payable solely from and secured solely by a net revenue pledge under the department's first bond resolution. The rate covenant is 1.20x, which we consider consistent with the sector's legal provisions. There is a parallel additional bonds test. The department has $2.2 billion in senior-lien bonds outstanding, $201 million of junior-lien bonds outstanding, and $363 million of state revolving fund loans. We rate the two liens on parity, given their similarities in coverage and the limited use of the junior lien, which is not expected to change.

The new issuances include:

- Series 2025 senior-lien new-money bonds, which will finance additions and improvements to the department's wastewater system.

Credit highlights

The rating is supported by the department's extremely strong liquidity, broad and diverse service area, and experienced management team. It also reflects our view of the department's substantial capital needs, a large portion of which are mandated under a consent decree that extends through 2035. Management has exhibited the ability to manage complex capital projects and successfully engage with state and federal stakeholders. The department has approved a change to the rate structure that will shift the structure to a greater reliance on volumetric charges. Further, the department is decoupling the bill from a combined bill with water and wastewater to a stand-alone bill. The new rate structure introduces some forecast uncertainty, but we believe projections are conservative, wastewater consumption is relatively inelastic, and that if revenues underperform due to increased delinquencies or reduced consumption, management will take the necessary actions to increase rates.

The department has completed the first and second phases of its consent decree program without weakening its financial or operational performance, including during periods of extreme economic strain. Phase 1 was the upgrade of the collection system. Phase 2 was the successful secondary treatment upgrade of Honouliuli wastewater treatment plant (WWTP). Phase 3 is the secondary upgrade of Sand Island WWTP, which will be completed in two phases by 2035. The approved rate adjustments are expected to support healthy financial performance despite considerable additional leverage.

The rating further reflects our view of the department’s:

- Service area, which is sizable, with stabilizing economic anchors and strong demographic indicators;
- Sophisticated operational management, which includes innovative and technology-driven asset management, robust climate vulnerability assessments, comprehensive cybersecurity, and long-range financial planning;
- Conservative financial management, with ongoing positive budget variance and comprehensive practices and policies that underpin its strong operating margins, which are expected to decline somewhat, and exceptional liquidity;
- Above-average wastewater rates, which are expected to increase, somewhat mitigated by healthy income levels and smaller distribution of lower-income ratepayers than average; and
- Moderate leverage, which we expect will increase as the department invests in its underlying infrastructure.

Environmental, social, and governance

Environmental factors are a moderately negative consideration in our rating analysis for Honolulu. The island of Oahu is exposed to acute and chronic physical climate risks, including sea-level rise and severe storms, that could lead to future vulnerabilities. In addition, the department has a complex capital plan toward meeting its consent decree requirements and future needs associated with potential climate and regulatory mitigation. We believe strong operational management offsets some of this risk. Furthermore, we view the department's capital planning efforts favorably, as current plans account for both mandated requirements and the potential for future heightened needs. In addition, the city's Office of Climate Change, Sustainability, and Resiliency has established a resilience plan that is regularly updated, along with a climate action plan and long-term disaster and hazard mitigation plans.

In 2018, the city adopted a directive that requires all departments to take action to minimize the effects of climate change and sea-level rise. The directive requires mitigation and adaptation planning to be integrated into capital improvement plans (CIPs), and components of recent capital plans directly address these issues. Social risks are also slightly elevated relative to its peers, given the moderately high rates. However, income levels support the higher rates and its wastewater peers located in sensitive waterways have similarly high rates. Further, management has taken a comprehensive and transparent approach to rate-setting, including a rate study to optimize the rate structure and a five-year minimum rate plan to address the CIP through 2040. The department has also convened a stakeholder advisory group that is leveraged to provide insight on proposed rates, affordability concerns, and rate structure. The department has also made presentations to council, all of which is viewed positively from a governance standpoint.

Outlook

The stable outlook reflects our belief that the department has significant financial capability to support the large capital program. Further, the service area has been resilient through recent economic stress, underscoring the economy's underlying stability.

Downside scenario

If the department underperforms financial projections, causing cash and debt service coverage (DSC) to deteriorate, we could lower the rating. The credit benefits from a positive adjustment for exceptional liquidity, exceeding two years of operations. Given the physical risks and complex capital plan, the liquidity position is a critical driver of the current rating level.

Upside scenario

Given the scope and size of the capital plan (and the regulatory landscape for wastewater), a raised rating is unlikely during the outlook horizon. As the department nears consent decree completion, we could raise the rating if financial metrics remain at current levels.

Credit Opinion

The department provides service to nearly 80% of the population of Oahu, including 149,000 customers. The economy is diverse and includes stable anchors such as the strategically critical military, state and local governments, and higher education. The visitor industry is also an important contributor to the economy, exhibiting resilience through several economic cycles. Domestic travel has fully rebounded to levels that exceed pre-pandemic performance. International travel is improving but more slowly, largely driven by the exchange rate. Visitor arrivals are steadily rising, up more than 100,000 year-to-date. Income levels are high and unemployment is below the national average. Housing prices remain elevated, which could pressure disposable income in the future. There is no meaningful customer concentration.

City council approved a rate package for seven fiscal periods, starting in January 2026. The rate package includes a new structure that shifts the fixed/variable revenue mix (from 73/27 to 40/60). The package also includes an automatic inflation adjustment of 3% annually and a customer assistance program. The rate increases ramp up after two years, to 9% through 2031. We believe the high median household incomes (MHI) support the department's moderately strong market position. Assuming the preliminary rate assumptions, we expect the department's market position will weaken somewhat, reaching 2.25% of MHI in 2029. The current rating accounts for these increases and their influence on affordability as well as the department’s approach toward mitigating these affordability challenges. Further, the bottom quartile of the department’s income distribution is relatively stronger than that of comparable peers. Historically, the department has billed on a combined bill with the board of water, but is transitioning to a stand-alone basis by July 2026. Management does not expect this to influence delinquencies, though there could be more limited enforcement mechanisms, which is currently under negotiation. We will continue to monitor the effects of the new rate structure and collections process on overall financial performance.

The department has sufficient capacity, with design capacity at the plants reaching well beyond average flows. There are nine treatment facilities within the basins; the complexity of operations varies given that some are ocean outfall and others are injection/infiltration. In 2010 (and amended in 2012), the department entered a consent decree program to upgrade the wastewater collection and treatment systems. Phase 1 was for the collection system and was completed in 2022. Phases 2 and 3 include improvements to the two largest treatment plants to integrate secondary treatment. Phase 2 construction at the first plant, Honouliuli, was completed in 2024. Phase 3 includes Sand Island, which is under construction (phase 1 is 88% complete), with expected completion in 2035. The department has generally met all milestones and has been at or under budget, demonstrating strong project execution, especially given the challenging inflationary and construction environment. In addition, the upgrades build in the potential for future regulatory changes, such as nitrogen removal and account for climate-related pressures such as sea-level rise. We view the consent decrees as credit neutral given management's ability to successfully complete project requirements.

The department is committed to renewal and replacement projects and has an asset assessment program in place to prioritize project selection. The department uses lifecycle planning, which we view favorably from a financial predictability and asset management perspective. New technology is being implemented that leverages artificial intelligence for efficiency and optimization. This new technology is expected to save 20% in energy, which, given the trajectory for energy costs, should be a meaningful cost savings. The department participates in state and internal studies and samples perfluoroalkyl and polyfluoroalkyl substances (PFAS/PFOS) in wastewater influent, effluent, and sludges to proactively assess and respond to the implications of potential associated regulations. Reports thus far suggest detected levels are low for effluent and biosolids. Additional capital spending is expected to address treatment for Dieldrin, a pesticide that has since been banned, which will be required under more stringent permit limits at the Kailua Regional Wastewater Treatment Plant. The costs and magnitude of exposure are uncertain but could be material. The increasingly challenging regulations and permit requirements for wastewater, as well as the evolution of technology to address them, is part of the current sector outlook and commensurate with credits throughout the country. We believe management is taking the appropriate steps to address these considerations at existing plants through a pilot study that is slated to begin before year-end. Further, the department has a long lead time (2035) to address these considerations.

The department's climate vulnerability assessment is robust and is done in conjunction with the city and board of water supply. Significant steps are being taken to reduce risks regarding sea-level rise and severe storms, including elevating and relocating facilities as well as hardening assets. Technology upgrades are underway to improve reliability and several projects are planned to reduce fossil fuel use and increase renewable energy production and beneficial recycling. The city follows the National Institute of Standards and Technology (NIST) with respect to cybersecurity and has not had a successful breach. We view the department’s cyber policies as comprehensive, and they include manual shutoff options to address both operational and data-related risks. Succession planning is strong, but the city faces some labor challenges, which it is meeting with intern programs and contracted employment. Labor challenges are not unique to the department and haven't impaired operational capabilities. We view rate planning favorably. Multiyear rate packages are integrated into long-term planning and the new rate structure includes automatic adjustments and a customer assistance program.

The department's financial performance is an area of strength. The rating reflects a positive adjustment for exceptional financial performance, which we believe is sustainable. DSC has averaged 1.7x over the last three years, although these levels could narrow somewhat with the additional debt (which is captured in the current rating). The department outperformed budgetary estimates, with projected 2025 coverage of 2.0x, or over 30 basis points better than forecast, and liquidity reaching $1.4 billion. Delinquencies remain manageable at under 2%, slightly improving from the previous year. DSC reflects all the outstanding obligations, including state revolving fund debt. We expect all-in coverage to remain healthy throughout the forecast period. However, coverage is expected to narrow as the department ramps up the capital spending and operating costs; margins should return to healthy levels thereafter. Ongoing operating surpluses have contributed to robust liquidity of well above 3,000 days of operations. This liquidity provides ample cushion for capital and operating contingencies and is forecast to remain above $1 billion through 2029.

Financial management policies are comprehensive. The department updates its long-range CIP to estimate project costs and timing of expenditures during a 20-year period (currently through 2035). The CIP serves as a tool to inform rate-setting and long-range planning. The department also has coverage policies that exceed legal covenants and reserve guidelines. Debt and investment practices are similarly conservative and follow state guidelines. The department works in conjunction with the city on budget updates and has historically exhibited positive budget variance.

The department is moderately leveraged, with debt-to-capitalization at just more than 50% and the five-year CIP expected to reach $4.2 billion of appropriations. We adjusted the debt score to account for future debt issuances, which are expected to increase leverage. We believe the department has sufficient financial capacity to cover future obligations without weakening overall financial performance. The city has made positive strides in pension funding as well, improving the funding margins year over year and supporting an other postemployment benefits (OPEB) trust.

Ratings List	
New Issue Ratings	
US$218.6 mil wastewtr sys rev bnds sr ser 2025B dtd 09/24/2025 due 07/01/2055	
Long Term Rating	AA+/Stable
Ratings Affirmed	
Water & Sewer	
Honolulu City & Cnty, HI Sewer System	AA+/Stable
Honolulu City & Cnty, HI Sewer System 2nd Lien	AA+/Stable

The ratings appearing below the new issues represent an aggregation of debt issues (ASID) associated with related maturities. The maturities similarly reflect our opinion about the creditworthiness of the U.S. Public Finance obligor's legal pledge for payment of the financial obligation. Nevertheless, these maturities may have different credit ratings than the rating presented next to the ASID depending on whether or not additional legal pledge(s) support the specific maturity's payment obligation, such as credit enhancement, as a result of defeasance, or other factors.