

Revenue
New Issue

City and County of Honolulu, Hawaii

Ratings

New Issue

Wastewater System Revenue Bonds
(First Bond Resolution), Senior
Series 2005A and 2005B AA-

Outstanding Debt

Wastewater System Revenue Bonds
(First Bond Resolution)
Senior Series AA-
Wastewater System Revenue Bonds
(Second Bond Resolution)
Junior Series A+

Rating Outlook Stable

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New Issue Details

Approximately \$150,740,000 Wastewater System Revenue Bonds (First Bond Resolution), consisting of \$134,290,000 Senior Series 2005A and \$16,450,000 Senior Series 2005B, are scheduled to sell during the week of July 18 via negotiations with Citigroup Global Markets Inc. and UBS Financial Services Inc. Dated the date of delivery, bonds maturing on or after July 1, 2015 are subject to optional redemption on July 1, 2015 or any date thereafter at par plus accrued interest to the date fixed for redemption.

Purpose: Bond proceeds will be used to finance certain capital improvements to the system, fund a debt service surety policy, and pay costs of issuance.

■ Outlook

Honolulu's favorable and diverse customer revenue base, sound financial operations and internal policies, and adequate treatment capacity, with little growth-related pressure, have positioned the sewer enterprise satisfactorily, providing for adequate financial flexibility. The system has embarked on a large \$2.1 billion capital improvement plan (CIP), mostly for nondiscretionary purposes related to environmental issues. The system benefits from adequate treatment capacity, with only moderate expansion required through fiscal 2020. Rates are moderate currently and competitive when compared with those for peer systems in Hawaii and the nation. To ensure sufficient revenue growth to meet rapidly rising debt service expenditures, the city recently instituted a series of large annual rate hikes over the next six years.

■ Rating Considerations

The city and county's Department of Environmental Services (the department, or the enterprise) provides wastewater service for the vast majority of the Island of Oahu (City and County of Honolulu). The service area is divided into eight wastewater basins for administrative and planning purposes. Each basin has an accompanying wastewater treatment plant (WWTP). Service is provided to approximately 285,000 equivalent single-family dwelling units (ESDUs), representing a residential population of about 640,000. Of the total accounts, 78% are residential, lending stability to the customer base. Honolulu's tourism-dominated economy exhibits vulnerability but has strong underpinnings.

The system's financial position is sound, with fiscal 2004 liquidity at nearly two years of operating expenditures. Coverage of senior and junior lien obligations for the same period was likewise favorable at 5.0 times (x) and 2.4x, respectively. Rates are moderately high compared with those for income and peer groups. The city council recently adopted the mayor's proposed annual increases, averaging more than 12% annually for fiscal years 2006-2011. The action represents the first rate increase since fiscal 1993 but demonstrates the city's commitment to completion of the CIP and the health of the environment. User concentration is minimal, with the top 10 ratepayers providing only 6% of wastewater sales.

Bond proceeds will be used to finance a portion of the system's near-term capital needs, which are driven by compliance requirements. Financial operations, including the aggressive rate increases, are projected to produce good senior lien debt service coverage of 2.1x by fiscal 2011, the end of the period of approved rate increases. Combined senior and junior lien debt service coverage likewise is projected to be adequate at 1.5x by fiscal 2011.

Credit concerns revolve around the extensive CIP, which is designed primarily to address consent decrees between the system and state and

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federal regulatory bodies. The 20-year, \$2.1 billion CIP, of which the system is in the eighth year, will require the continued fulfillment of certain milestones to meet state and federal requirements. Failure to meet milestones and fulfill requirements may exacerbate environmental issues and present financial liability, which may hinder operational and financial flexibility.

■ Strengths

- Essential service.
- Adequate treatment, with little growth-related pressure.
- Tourism-based service area has strong underpinnings with stable economic fundamentals, including a significant government sector.
- Good projected revenue bond coverage.
- Favorable revenue mix.

■ Risks

- Large and ongoing CIP, requiring aggressive rate increases.
- System must fulfill requirements of state and federal agencies' consent decrees.

■ Legal Provisions

Security: The senior lien bonds are payable from and secured by the net revenues of the 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.

Rate Covenant: The city covenants to set rates and charges sufficient to generate 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 on senior lien obligations plus 1.0x the aggregate requirement on support facility reimbursement obligations. 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 plus 1.0x the aggregate requirement on support facility reimbursement 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 ADS. The common reserve is pledged to bonds designated as benefiting from the common reserve. A separate

debt service reserve may also be established for individual series of senior and junior lien bonds. The current offering will be secured by the senior lien common reserve.

Additional Bonds Test: The additional bonds test for both senior and junior lien bonds requires compliance with the respective rate covenants by either a historical or forward test. If interest is capitalized, the forward test is applied beginning in the period when interest is no longer capitalized.

■ Flow of Funds

All revenues and wastewater system facility charges are deposited into the sewer fund. All wastewater system facility charges are transferred subsequently to the wastewater system facility charge account, and remaining moneys are used to pay O&M and then dispersed in the following order or priority:

- To pay debt service on senior lien obligations.
- To replenish the senior lien common reserve and each separate series reserve on a pro rata basis.
- To maintain adequate working capital and operating reserves.
- To pay debt service on junior lien obligations.
- To replenish the junior lien common reserve and each separate series reserve on a pro rata basis.
- To pay debt service and reserve requirements associated with subordinate lien obligations.
- To pay any reimbursable obligations.
- To fund a renewal and replacement fund equal to the amount provided in the annual budget.
- To repay any moneys drawn from wastewater system facility charges for the payment of debt service on system bonds.
- To fund a rate stabilization account as provided in the annual budget.
- For any lawful purpose.

■ Wastewater System and Environment

Approximately 284,600 ESDUs — roughly 71% of the total population of the city and county — are serviced by the system. Of this amount, 78% are residential. Customer growth has been modest over the past five years, averaging about 1% annually, and continuance of this trend is anticipated.

The wastewater system is divided into eight wastewater basins, each served by a WWTP. The system encompasses more than 500 square miles, with collection and transmission pipes leading into separate WWTPs. Aggregate daily flows averaged

122 million gallons per day (mgd) for fiscal 2004, approximately 80% of the 151 mgd combined treatment capacity. The system's three largest plants treat more than 94% of wastewater flows.

A national pollutant discharge elimination system permit or the state Department of Health Underground Injection Control permit regulates the discharge of treated wastewater into receiving waters. Most plants treat to the secondary level, yet two have 301(h) waivers and meet primary requirements only while also implementing deep ocean outfall. Furthermore, six of the eight plants meet national and state discharge requirements.

The Sand Island WWTP sometimes is out of compliance, as it experiences problems with the 30% biological oxygen demand removal limit, although the WWTP has been in full compliance with all discharge permits since 2003. Some of the capital projects will upgrade the existing processes and fix the problems at this facility. The other plant, the system's eighth, is owned by the state and operated by the department and also has not been in compliance consistently. However, this plant is the system's second smallest, as measured by design and current and projected flow. The state has appropriated funding to bring this plant into compliance and will manage the construction contracts.

Although there are some environmental issues resulting from treatment deficiencies, the majority of the department's capital plan is targeted to address environmental concerns plaguing the collection and transmission system. From fiscal years 1994–1999, the department worked with the community, the federal Environmental Protection Agency (EPA), and the state Department of Health to develop several consent decrees. The most significant consent decree, number 309, resulted from the EPA's filing a lawsuit. This decree established milestones for the improvement of the wastewater system. Interim preventive maintenance procedures started in 1994 and will continue through 2019, the final year of the decree. The sewer rehabilitation and the infiltration and inflow plan are being phased in, with ultimate completion intended by the end of the 20-year decree. Supplemental environmental projects related to biosolids reuse and beneficial effluent reuse have completion dates of 2009 and 2015, respectively.

The department is responsible for the operation, maintenance, compliance monitoring, and facility planning and programming for the wastewater system.

The department is composed of approximately 700 employees in support of the system.

■ Capital Improvement Plan

The fiscal years 1998–2017 CIP has a total cost of \$2.1 billion, which will be funded primarily by revenue bonds. Major pipelines were put in operation 40–100 years ago, and the underground environment is harsh due to the saline content of the high water table. As a result, some pipes in the collection system are approaching the end of their useful lives. The deteriorated condition of the system affects overall system performance most during periods of wet weather, when O&M expenditures escalate as a result. Only 12% of the 20-year CIP costs are discretionary, including improvements for reliability (9%) and preventive improvements (3%). The remaining 88% of the 20-year CIP projects are nondiscretionary, including the required consent decree projects (9%), safety/public health improvement projects (38%), permit or regulatory improvements (21%), and expansion of existing facilities (20%). Expenditures through fiscal 2017 should eliminate current and projected critical deficiencies. Through fiscal 2005, \$739 million had been appropriated toward the 20-year CIP.

Appropriation amounts for the fiscal years 2006–2010 CIP total \$757 million and are part of the projects associated with the 20-year CIP. Funding for the five-year CIP is expected to be derived from state revolving fund loans (6%), internal funds (7%), and parity bonds, including the current offering (86%). Approximately 66% of the fiscal years 2006–2010 CIP expenditures are for the collection system, 27% for the WWTPs, and 7% for project management and equipment, which will support collection system and WWTP expenditures in roughly equal amounts.

Existing debt levels are moderately high at more than \$2,800 per ESDU. In addition, leverage of existing assets is also above average at 58%. With the substantial amount of planned issuances over the next several years, debt levels are anticipated to remain elevated, as annual debt per ESDU associated with the fiscal years 2005–2010 CIP is expected to increase by about \$440 through fiscal 2015.

■ Rates

The power to set rates and charges is maintained by the city council. However, the director of environmental services and mayor recommend a rate increase, which is then subject to approval by city

council. Rates have remained stable yet generated adequate balances to maintain the wastewater system's self-sustaining status. For fiscal 2006, a single family's residential monthly sewer charge is just greater than \$41 per month, relatively high on an affordability basis at 1.1% of median household income and above average compared with those of other major cities and utilities across the U.S. The department's fees are distributed to customers on a combined statement with the water system for the majority of customers. Customers not serviced by Honolulu's Board of Water Supply are billed directly by the department.

Prior to fiscal 2006, base rates were last increased in fiscal 1993 by 30%. Recognizing the need for additional adjustments in light of the system's planned capital expenditures, the mayor proposed, and the council subsequently adopted, six consecutive years of rate increases beginning in fiscal 2006. The adjustments call for a 25% hike effective July 1, 2005 and successive 10% annual hikes thereafter through fiscal 2011. Based on these increases, the average residential bill is expected to exceed \$66 by fiscal 2011, a 61% increase from existing charges. Further escalation of rates is

anticipated through fiscal 2015, although future rate hikes generally are expected to be smaller incremental increases than those adopted recently. While the approved adjustments represent a dramatic increase to user charges, most capital improvements are necessary to meet environmental concerns, and support for the adopted plan reportedly has been overwhelmingly supportive. Successful implementation of the adopted rate increases will remain critical to maintenance of the current rating.

■ Finances

The wastewater system's revenue mix is favorable. Residential customers account for 78% of sewer system charges, with the remaining 22% from nonresidential or commercial and industrial users. Customer concentration is limited, with the top 10 users contributing a reasonable 6% of wastewater revenue sales. The top four users include three state agencies and the University of Hawaii. These four entities total 4% of user charges.

Financial performance over the past five fiscal years has been favorable despite steady user charges. Since

Financial Summary

(\$000, Fiscal Years Ended June 30)

	2000	2001	2002	2003	2004
Balance Sheet					
Cash and Investments	141,478	99,250	168,590	214,178	123,644
Accounts Receivable	16,227	16,406	16,772	16,336	15,658
Other Current Assets	25,848	17,863	12,553	30,481	9,795
Current Liabilities	(29,472)	(34,208)	(41,666)	(47,177)	(56,276)
Net Working Capital	154,081	99,311	156,249	213,818	92,821
Net Fixed Assets	922,899	979,257	1,235,121	1,315,362	1,384,386
Net Long-Term Debt Outstanding	470,854	460,519	606,060	814,988	800,120
Operating Statement					
Operating Revenues	124,860	113,041	113,810	115,747	115,032
Non-Operating Revenues	7,873	7,339	4,780	2,058	1,540
Gross Revenues	132,733	120,380	118,590	117,805	116,572
Operating Expenses (Excluding Depreciation)	(56,834)	(66,959)	(62,755)	(59,995)	(63,336)
Depreciation	(23,295)	(22,025)	(29,983)	(30,290)	(30,575)
Net Operating Transfers In/(Out)	12,167	(6,120)	(46,995)	(59,633)	(31,078)
Net Income/(Loss)	64,771	25,276	(21,143)	(32,113)	(8,417)
Net Revenues Available for Debt Service*	75,899	53,421	55,835	57,810	53,236
Debt Service Requirements	2,788	2,574	6,826	12,710	10,641
Financial Statistics					
Debt Service Coverage (x)	27.2	20.8	8.2	4.5	5.0
Days Cash on Hand	909	541	981	1,303	713
Days of Operating Revenue in Accounts Receivable	47	53	54	52	50
Debt to Net Plant (%)	51	47	49	62	58
Operating Margin (%)**	54	41	45	48	45

*Equals gross revenues less operating expenses. **Equals operating revenues less operating expenses divided by operating revenues.

fiscal 2000, senior lien ADS coverage has ranged from 4.5x–27.2x, and coverage of all debt obligations has ranged from 1.5x–2.0x. While somewhat lower, fiscal 2005 senior ADS is expected to be 3.0x. With the implementation of the adopted rate increases, senior lien coverage is expected to remain a solid 2.1x–4.2x through fiscal 2011. The city has adopted a formal policy of maintaining net revenues of at least 1.6x senior lien ADS and 1.25x coverage on combined senior and junior bonds.

Liquidity remains a credit positive, with the system maintaining 541–1,303 days of operating expenditures in unrestricted cash and investments on hand from fiscal years 2000–2004. Working capital has approximated cash levels during this period, with the exception of fiscal 2004, in which working capital dropped to a still healthy 535 days. The department's formal policy is to maintain at least three months of operations in reserves. Also, the council recently adopted an ordinance not to transfer moneys from the sewer fund to the general fund.

■ Service Area

Honolulu's economy is diversifying somewhat but remains dominated by a well-developed tourism sector that is itself in a transition period. Diversity comes from the city's role as the regional commercial, business, and finance center, as well as the state capital and the home of the University of Hawaii. Also, Honolulu contains a strong military presence, which likely will continue given the

island's strategic location. About three-quarters of all state jobs are located in Honolulu. The city's job base is growing following several years of decline. Despite economic fluctuation, the unemployment rate remains low at 2.9% for 2004 — the lowest in the nation — and compares well with the state's 3.3%.

Honolulu's employment base has been volatile, rising each year from 2000–2003 following several years of small annual declines in the 1990s. Total jobs increased by 1.9% in 2003, led by a rebounding tourism-related sector, with many of the other sectors and subsectors experiencing similar job growth patterns. Since 2000, Honolulu's labor force has grown by a slight 0.8%, which, when coupled with the recent job growth, has resulted in low unemployment levels.

The population grew 4.5% during the 1990s and has risen slowly since then to 899,593. The city makes up about 71% of the state's population. Income levels are above state and national averages. Exceeding the national average partially reflects the high cost of living on the island. Despite the recent and prolonged downturn, per capita income has increased every year since 1990.

For more information on the service area, see "City and County of Honolulu, Hawaii," dated May 17, 2005, available on Fitch's web site at www.fitchratings.com.

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