Revenue
New Issue

City and County of Honolulu, Hawaii

Ratings

New Issues

Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2006A, 2006B, and 2006C	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 $280 million Wastewater System Revenue Bonds (First Bond Resolution), consisting of $196,505,000 senior series 2006A, $27,790,000 senior series 2006B, and $55,455,000 senior series 2006C, are scheduled to sell on Aug. 22 via a negotiated sale through UBS Securities, LLC.

Purpose: Proceeds of the series 2006A bonds will be used to finance a portion of the system's overall capital improvement program. The series 2006B and 2006C bonds will refund existing debt for restructuring and savings.

■ Outlook

Honolulu's stable, primarily residential customer base, sound financial operations, approved annual rate increases through fiscal 2011, and a demonstrated commitment to address the compliance-related capital improvement plan (CIP) have positioned the wastewater system to address mandated improvements while preserving a financial position that Fitch Ratings believes is adequate for the ratings. The City of Honolulu is approximately halfway through a 20-year CIP (1998–2017) to address multiple consent decrees issued by the Environmental Protection Agency (EPA). Approximately 87% of the $2.5 billion CIP 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 is only now beginning to move into a heavy construction phase of the CIP. Key credit drivers over the next few years include the city's ability to execute a ramp-up in spending on its capital plant through effective program management while controlling costs and its stated willingness to implement additional rate hikes, if necessary, to fund potential cost increases in the CIP. The Rating Outlook is Stable. However, negative rating action could be triggered by excessive capital cost increases, significant construction delays, additional EPA mandated requirements, or difficulty implementing approved and projected rate increases.

■ Rating Considerations

The City and County of Honolulu's department of environmental services (the department) provides wastewater for the majority of the Island of Oahu (the city and county). The service area is divided into eight wastewater basins for administrative and planning purposes. Each basin has an accompanying wastewater treatment plant (WWTP). Wastewater service is provided to approximately 289,000 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 unaudited fiscal 2006 senior lien debt service coverage projected at 5.0 times (x) and total debt service coverage projected at 1.8x, including general obligation bonds and state revolving fund loans. However, senior debt service coverage is expected to decline to between 2.65x and 1.81x and total debt service coverage to between 1.06x and 1.09x from fiscal years 2007–2010, as additional debt service requirements become due and approved rate increases are implemented. The city expects to issue approximately $1 billion in new debt over the next 10 years, including the series 2006 bonds, in addition to its outstanding debt of $800 million. In 2005, the city council adopted a series of six annual rate increases designed to meet the rising fixed and operating costs. Further rate hikes beyond fiscal 2011 are likely. Additional rate increases may be needed prior to fiscal 2011 if the scope of the CIP changes. Rates are moderately high compared with those for income and peer groups. Fitch's ongoing credit concerns revolve around the extensive CIP, which is designed primarily to address consent decrees between the system and state and federal regulatory bodies. The mandated components of the CIP 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.

The overall estimated cost of the CIP has increased \$250 million in the past year due to scope changes and construction cost increases as designs have been finalized on various projects. The city is poised to move into a heavy construction phase of the CIP between 2007 and 2009. Fitch anticipates that limited additional cost escalation will occur and that, if necessary, appropriate rate increases may be required to maintain projected financial margins. Of note, the city is engaged in ongoing negotiations with the EPA *(see Sizable Spill section at right)*; however, it is unclear what additional fines or litigation may result.

■ Strengths

- Political commitment to CIP.
- Rate flexibility.
- Adequate treatment capacity.
- Stable base of residential revenues.
- Adequate projected debt service coverage and liquidity levels.

■ Risks

- Large, nondiscretionary CIP susceptible to scope expansion and cost escalation.
- The long-term nature of the mandated capital program, exceeding the typical tenure of elected officials.

■ Recent Developments

Rate Increases Approved

Since Fitch's last review in June 2005, the city has implemented two of the six approved rate increases, including a 25% rate hike effective July 1, 2005 and 10% increase effective July 1, 2006. Additional rate hikes of 10% per year were also approved by the city council and will become effective on July 1 of each of the next four years. Fitch views the current administration's implementation of the series of rate increases as an indication of its high level of commitment to addressing needed improvements. The system has not experienced any change to its collection levels or significant community discontent following the rate increases. Current projections indicate that similarly sized rate hikes will likely be needed after fiscal 2011.

Sizable Spill Prompts EPA Concern

In March 2006, the rupture of a main pipe resulted in the release of 48.7 million gallons of untreated wastewater into the Ala Wai Canal in Waikiki. As a result of this event and other collection system issues, the city is negotiating with the EPA as to the terms of a possible stipulated consent order. The costs that may result from potential penalties or required corrective action are not know at this time. The city is constructing a bypass around the force main as an interim solution, the cost of which is included in the CIP.

■ Legal Provisions

Small changes were made to clarify the master ordinance from 1998 and approved by the city council in August 2006. The changes clarified language regarding the additional bonds test and established a defined assumption for variable-rate debt for purposes of the additional bonds test and rate covenant. The clarifications did not affect the fundamental bondholder protections described below.

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.

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 ADS. The 2006 bonds will include proceeds to fund the reserve requirement. Historically, prior issuances have used surety bonds to fund the requirement.

Additional Bonds Test: The additional bonds test requires net revenues, by either a historical or forward test, to provide 1.2x maximum annual debt service. The additional bonds test for junior lien bonds requires net revenues to provide 1.1x maximum annual debt service.

■ System and Environment

Approximately 289,000 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 less than 1% annually; this trend is expected to continue.

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 112 million gallons per day (mgd) for fiscal 2005, approximately 74% of the 151 mgd combined treatment capacity. The system's three largest plants treat more than 94% of wastewater flows. The city is expanding its largest plant, the Sand Island WWTP.

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 (including Sand Island WWTP) have 301(h) waivers and meet primary requirements only while implementing deep ocean outfall. No changes to these waivers are expected. However, the potential costs of upgrading the two plants to provide secondary treatment, if required in the future, would be considerable.

The Sand Island WWTP (design capacity 86 mgd) is occasionally out of compliance, as it experiences problems with the 30% biological oxygen demand removal limit; however, 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. Another plant, the system's eighth, is owned by the state, operated by the department, and consistently has not been in compliance. 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. The system's 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, and O&M expenditures escalate as a result.

From fiscal years 1994–1999, the department worked with the community, the EPA, and the state department of health to develop several consent decrees. The most significant consent decree, No. 309, resulted from the EPA's filing a lawsuit in May 1995. 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 infiltration and inflow plan are being phased in, with ultimate completion expected 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.

■ Capital Improvement Plan

The city's five-year capital plan is estimated at $933 million. This is a subset of the fiscal years 1998–2017 CIP, which has a total cost of $2.5 billion. The CIP will be funded almost entirely through debt, including revenue bonds (87%) and state revolving fund loans (10%).

Only 13% of the $2.5 billion CIP costs are discretionary, including improvements for reliability (9%) and preventive improvements (3%). The remaining 87% of the 20-year CIP projects is 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, $840 million had been appropriated toward the 20-year CIP.

Financial Summary — Honolulu Wastewater System
($000, Fiscal Years Ending June 30)

	2001	2002	2003	2004	2005	2006*	2007**	2008**	2009**	2010**
Balance Sheet										
Cash and Investments	99,250	168,590	214,178	123,644	23,886	50,616	46,498	51,445	59,701	56,535
Accounts Receivable	16,406	16,772	16,336	15,658	15,735	N.A.	N.A.	N.A.	N.A.	N.A.
Other Current Assets	17,863	12,553	30,481	9,795	8,478	N.A.	N.A.	N.A.	N.A.	N.A.
Current Liabilities	(34,208)	(41,666)	(47,177)	(56,276)	(54,492)	N.A.	N.A.	N.A.	N.A.	N.A.
Net Working Capital	99,311	156,249	213,818	92,821	(6,393)	N.A.	N.A.	N.A.	N.A.	N.A.
Net Fixed Assets	979,257	1,235,121	1,315,362	1,384,386	1,275,779	N.A.	N.A.	N.A.	N.A.	N.A.
Net Long-Term Debt Outstanding	460,519	606,060	814,988	800,120	788,715	N.A.	N.A.	N.A.	N.A.	N.A.
Operating Statement										
Operating Revenues	113,041	113,810	115,747	111,886	115,144	140,834	157,390	173,600	191,490	211,220
Non-Operating Revenues	7,339	4,780	2,058	1,540	1,590	3,306	3,300	7,100	8,000	8,600
Gross Revenues	120,380	118,590	117,805	113,426	116,734	144,140	160,690	180,700	199,490	219,820
Operating Expenses (Excluding Depreciation)	(66,959)	(62,755)	(59,995)	(63,336)	(68,326)	(78,837)	(101,112)	(98,830)	(96,480)	(96,970)
Depreciation	(22,025)	(29,983)	(30,290)	(30,575)	(30,647)	0	0	0	0	0
Operating Income	31,396	25,852	27,520	19,514	17,761	N.A.	N.A.	N.A.	N.A.	N.A.
Net Revenues Available for Debt Service†	53,421	55,835	57,810	50,089	48,408	65,303	59,578	81,870	103,010	122,850
Senior Lien Debt Service Requirements	2,574	6,826	12,710	10,641	10,642	12,947	22,510	34,992	52,987	67,982
Junior Lien and Total Obligations	32,189	22,979	22,602	22,931	33,497	22,986	33,117	33,648	41,212	42,316
Financial Statistics										
Senior Lien Debt Service Coverage (x)	20.75	8.18	4.55	4.71	4.55	5.04	2.65	2.34	1.94	1.81
Coverage of Total Obligations (x)	1.54	1.87	1.64	1.49	1.10	1.82	1.06	1.07	1.08	1.09
Days Cash on Hand	541.02	980.56	1303.02	712.55	127.60	234.34	167.85	190.00	225.86	212.80
Debt to Net Plant (%)	47.03	49.07	61.96	57.80	61.82	N.A.	N.A.	N.A.	N.A.	N.A.
Operating Margin (%)‡	40.77	44.86	48.17	43.39	40.66	44.02	35.76	43.07	49.62	54.09

*Unaudited. **Projected. †Equals gross revenues less operating expenses plus capital contributions; excludes system facility charges. ‡Equals operating revenues less operating expenses divided by operating revenues. N.A. – Not available.

Existing debt levels are moderately high at more than $3,500 per ESDU. In addition, leverage of existing assets is also above average at 62%. With the substantial amount of planned issuances over the next several years, debt levels and leverage ratios are expected to rise.

Rates

The city council has full authority to set rates. However, in practice, the director of environmental services and mayor typically recommend any rate increases, which are then subject to approval by city council. In 2005, the city council approved six consecutive years of rate hikes beginning in fiscal 2006. The first increase, 25% effective July 1, 2005, was received without significant community reaction. The second of the six rate hikes, a 10% increase, became effective July 1, 2006. Based on these rate hikes, the average residential bill is expected to exceed $64 by fiscal 2011, a doubling of the average bill paid prior to the rate increases. Further escalation of rates is anticipated through fiscal 2015, although future rate hikes generally are expected to be incrementally smaller compared with those adopted recently. While the approved adjustments represent a dramatic rise in user charges, most capital improvements are necessary to meet environmental concerns, and support for the adopted plan reportedly has been strong. The city's continued commitment to cost recovery and the successful implementation of adopted and planned rate increases will remain critical to maintenance of the current rating.

Finances

Financial performance over the past five fiscal years has been good. In fiscal 2005, senior debt service coverage exceeded 4.5x and total coverage of all obligations equaled 1.1x, excluding system facility charges. For example, net revenues in fiscal 2005 of $48.4 million exclude $5.3 million in system facility charges that are not legally pledged to bondholders. Strong cash flow generated by rates in previous years was used to build cash reserves and fund sizable transfers to the city's general fund. Only a small amount of the system's capital needs were funded from revenues. Instead, much of the CIP has been and will continue to be debt financed. As a result, the fixed costs associated with debt service will begin to increase substantially, limiting future expense flexibility of the system.

Preliminary unaudited financial results for fiscal 2006, bolstered by a 25% rate increase, came in slightly better than budgeted. Senior lien coverage is projected at 5.0x and total coverage of all obligations at 1.8x. The city adopted an ordinance in 2005 that eliminated transfers from the wastewater system to the general fund. The preservation of excess cash flow within the wastewater system is viewed as a credit strength. 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. Financial performance, based on current CIP assumptions and approved and assumed rate increases, is projected to meet these thresholds.

Liquidity remains a positive credit factor, even though the city has spent some of its reserves. Unrestricted reserves at the end of fiscal 2006 are projected at $50.6 million, or 234 days cash. The city's formal policy is to maintain at least three months of operations in reserves.

■ Service Area

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 only 6% of wastewater revenue sales. The top four users include three state agencies and the University of Hawaii.

Honolulu's economy is diversifying somewhat but remains dominated by a well-developed tourism sector that is 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 home to 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 remained low for 2005 at 2.7%, the lowest in the nation.

The city's and county's population grew 4.5% during the 1990s and has risen slowly since then to 905,266 in 2005. The wastewater service territory accounts for about 71% of the city's and county's population. Income levels are above state and national averages; this partially reflects the high cost of living on the island.