

Revenue
New Issue

City and County of Honolulu, Hawaii

Wastewater System

Ratings

New Issues

Revenue Bonds (First Bond Resolution), Senior Subseries 2010A and 2010B (Taxable Build America Bonds)	AA
Revenue Bonds (Second Bond Resolution), Junior Subseries 2010A	AA-

Outstanding Debt

Revenue Bonds (First Bond Resolution), Senior Series	AA
Revenue Bonds (Second Bond Resolution), Junior Series	AA-

Rating Outlook

Stable

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New Issue Details

Sale Information: Approximately \$26,000,000 Revenue Bonds (First Bond Resolution), Senior Subseries 2010A, and \$177,000,000 Senior Subseries 2010B (Taxable Build America Bonds), as well as \$103,000,000 Revenue Bonds (Second Bond Resolution), Junior Subseries 2010A, expected to price Oct. 25–26, depending on market conditions.

Purpose: Proceeds of the senior series 20010A and 20010B to fund ongoing components of the system's capital plan. Proceeds of the junior series 20010A bonds to refund outstanding bonds for savings.

Final Maturity: Senior series 2010A, 2021. Senior series 2010B, 2041.

Related Research

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

Applicable Criteria

- [Revenue-Supported Rating Criteria, Oct. 8, 2010](#)
- [Water and Sewer Revenue Bond Rating Guidelines, Aug. 6, 2008](#)

Rating Rationale

- 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 current economic recession and a downturn in tourism.
- Two multiyear rate packages have resulted in substantial rate increases through fiscal 2011 but appear to have broad political and community support. The city plans to propose a third rate package that includes another six years of rate increases beginning in fiscal 2012.
- High residential rates with continued annual increases are projected in the future.
- The large capital improvement plan (CIP) has very strong financial metrics in the form of debt service coverage and a healthy pay-as-you-go component.
- The wastewater system has very high debt levels with substantial additional borrowing plans over the medium term to comply with required environmental mandates to address deferred maintenance.
- Substantial additional capital needs exist beyond the current CIP to rehabilitate the aging system, resulting from the decision by the Environmental Protection Agency (EPA) to require the wastewater system's two largest treatment plants to move from primary to secondary treatment. Continued rate flexibility will be critical.

Key Rating Drivers

- The City Council's passage of the next rate package is anticipated for implementation beginning in July 2011. Continued political and community support will be needed to support rate increases necessary to execute the CIP.
- 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.
- Compliance with the terms and timelines required by the new 2010 Consent Decree is critical to the credit profile.

Considerations for Taxable/Recovery Zone Economic Development Bonds Investors

This sector credit profile is provided as background for investors new to the municipal market.

Water and Sewer Utility Revenue Bonds

Municipal water and sewer utilities in the U.S. are enduring natural monopolies that typically have autonomous rate-setting ability and provide highly essential services. The bonds are secured by a pledge of net revenues generated by the water and/or sewer system and typically include structural legal protections such as rate covenants, debt service reserve requirements, and antidilution tests. As such, the sector exhibits extremely strong credit characteristics with minimal defaults. Reflective of this strong performance, the average water and sewer revenue bond rating is 'AA' with 86% at or above 'AA-' and approximately 2% rated 'BBB+' or below. Those with low investment-grade or below-investment-grade ratings generally have substantial capital programs, a high degree of leverage, or weak financial flexibility as reflected in low cash levels, narrow debt service coverage, and/or limited rate-raising flexibility.

For additional information on these ratings, see "Revenue-Supported Rating Criteria," dated Oct. 8, 2010, available on Fitch's Web site at www.fitchratings.com.

Rating History — Senior Series

Rating	Action	Outlook/ Watch	Date
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

^aReflects revision.

Rating History — Junior Series

Rating	Action	Outlook/ Watch	Date
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

^aReflects revision.

Credit Summary

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 adoption of two multiyear rate packages that extend through fiscal 2011. As a result of leadership’s guidance, financial performance is expected to remain favorable over at least the near to medium term, despite sizable increased leveraging, primarily due to a healthy component of pay-as-you-go in the CIP. Other positive credit considerations include the regional economy, stable residential customer base, and overall community support of the double-digit annual rate increases needed to invest in the system’s aging infrastructure. Credit concerns center on the substantial capital needs that have resulted in very high debt levels, high retail rates, and the need to sustain political momentum and community tolerance for future additional rate increases.

Security

Bondholders are secured by a net revenue pledge of the city and county of Honolulu’s wastewater system.

Recent Developments

Regulatory Clarity

Sand Island and Honouliuli wastewater treatment plants (WWTPs) currently operate 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. This was following the EPA’s tentative decision to deny both waivers in 2007. 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 over Honolulu’s non-compliance with the Clean Water Act. The new 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 \$1.2 billion for the treatment plant upgrades alone), the timeline is longer than originally proposed by the EPA, and the new proposed consent decree brings all regulatory requirements under one document and timeline. This is a positive development since it appeared that the EPA’s initial timeline would have potentially diverted capital spending and staff resources away from the much-needed infrastructure investments that currently make up the bulk of the CIP. Given the limited construction resources on the island of Oahu and the large public and private construction programs currently in progress, there may be a limit as to how much additional work the wastewater system can practically accomplish during a given period. The proposed 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. For additional information on costs, see the Debt and Capital Improvement Plan section (*page 3*).

Lower Rate Increases Possible

Honolulu has raised its rates 175% on a cumulative basis over the six-year period from fiscal years 2006–2011. The average monthly residential combined water and wastewater bill is now about \$122, or 2.1% of median household income. Although the last rate increase of the City Council’s proactive six-year rate package just became effective July 1, 2010, the system had been projecting continued double-digit increases for the next five years, given

ongoing uncertainty over the time requirement of moving to secondary treatment. Now, with the consent decree, as discussed above, management anticipates that potential rate increases in the next five years will be more moderate, in the range of 4%–5% annually. Management anticipates taking another six-year rate package to the City Council for approval in the spring of 2011, with the first increase of that package to become effective July 1, 2011. The financial forecast presented by management to Fitch included this level of assumed rate increases.

System

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. Of this amount, 74% are residential, 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 downturn in tourism in the past year has not had a significant impact on wastewater revenues.

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 106 millions of gallons per day (mgd) for fiscal 2010, 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 and Capital Improvement Plan

The wastewater system is addressing substantial capital needs. The primary capital needs relate to the rehabilitation of an aging collection system, as required by the EPA. More than 80% of the overall \$5.4 billion, 20-year CIP (fiscal years 2000–2020) 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 2007. As a result, the actual costs of the projects now that construction has begun are much higher than originally estimated. The cost of the 20-year CIP has increased dramatically from a 2005 estimate of \$2.1 billion. Projected spending for the second half of the CIP (fiscal years 2011–2020) is approximately \$3.65 billion. The wastewater system's five-year CIP is estimated at \$1.5 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 78%).

Upon completion of the collection system needs in roughly 2020, the city will need to 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 2010 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.

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 \$1.2 billion following this issuance, with another \$1.0 billion in debt anticipated in the next five years. Debt per customer is projected to climb from about \$9,500 currently to \$15,000, compared with Fitch's 'AA' rating category median for water and wastewater utilities of about \$2,000 per customer.

Rates

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.

The approved and implemented rate increases were as follows:

- July 1, 2005 — 25%.
- July 1, 2006 — 10%.
- July 1, 2007 — 25%.
- July 1, 2008 — 18%.
- July 1, 2009 — 18%.
- July 1, 2010 — 15%.

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. This is lower than the 11% rate increases anticipated a few years ago.

On an affordability scale, the combined water and sewer bill of approximately \$121 per month is high at 2.1% of median household income. With the anticipated rate increases, the combined 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 in 2005 and 2007, and subsequent implementation of the series of rate increases, as an indication of Honolulu's high level of commitment in addressing needed 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.

Finances

The system's financial position is strong, with senior lien debt service coverage above 3.0x and total debt service coverage above 1.6x in the past five years, including unaudited results for fiscal 2010. 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 2014. Total debt service coverage on all debt obligations is projected to remain above 1.4x through fiscal 2014. Projections for fiscal 2015, show performance declining below these levels, but this is not a rating concern at this time. 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.

Financial Summary

(\$000, Fiscal Years Ended June 30)

	Audited				Unaudited	Projected				
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Balance Sheet										
Unrestricted Cash and Investments	46,700	45,746	78,200	63,275	155,766	226,311	229,355	223,240	208,651	190,690
Accounts Receivable	20,875	23,531	31,818	34,551	—	—	—	—	—	—
Other Current Unrestricted Assets	71,870	244,085	342,459	285,891	(155,766)	(226,311)	(229,355)	(223,240)	(208,651)	(190,690)
Current Liabilities Payable from Unrestricted Assets	(57,039)	(65,328)	(81,278)	(89,377)	—	—	—	—	—	—
Net Working Capital	82,406	248,034	371,199	294,340	—	—	—	—	—	—
Net Fixed Assets	1,513,603	1,616,817	1,699,154	1,873,156	—	—	—	—	—	—
Net Long-Term Debt Outstanding	931,310	1,173,635	1,341,478	1,361,308	—	—	—	—	—	—
Operating Statement										
Operating Revenue	142,167	160,963	225,104	251,953	302,316	328,452	342,709	356,981	372,075	391,056
Non-Operating Revenue	4,166	13,996	18,057	7,080	—	—	—	—	—	—
Connection Fees	—	4,691	5,025	1,555	6,686	8,870	9,131	9,405	9,686	9,978
Gross Revenue	146,333	179,650	248,186	260,588	309,002	337,322	351,840	366,386	381,761	401,034
Operating Expenses (Excluding Depreciation)	(82,962)	(83,773)	(115,058)	(102,594)	(105,128)	(132,853)	(137,660)	(142,049)	(146,595)	(151,303)
Depreciation	(31,439)	(35,311)	(39,362)	(40,682)	—	—	—	—	—	—
Operating Income	31,932	60,566	93,766	117,312	203,874	204,469	214,180	224,337	235,166	249,731
Net Revenue Available for Debt Service^a	63,371	95,877	133,128	157,994	203,874	204,469	214,180	224,337	235,166	249,731
Senior Lien Debt Service Requirements	12,946	30,060	34,422	42,281	38,184	49,644	73,878	92,286	113,433	134,366
Total Debt Service Requirements	23,792	56,690	68,667	93,687	92,048	105,107	131,625	150,649	170,254	189,258
Financial Statistics										
Senior Lien Debt Service Coverage (x)	4.9	3.2	3.9	3.7	5.3	4.1	2.9	2.4	2.1	1.9
Total Debt Service Coverage (x)	2.7	1.7	1.9	1.7	2.2	1.9	1.6	1.5	1.4	1.3
Days Cash on Hand	205	199	248	225	541	622	608	574	520	460
Days Working Capital	363	1,081	1,178	1,047	—	—	—	—	—	—
Debt to Net Plant (%)	62	73	79	73	—	—	—	—	—	—
Outstanding Long-Term Debt per Customer (\$)	6,559	8,265	9,381	9,506	0	9,155	8,985	15,519	15,336	15,151
Operating Margin (%) ^b	42	48	49	59	65	60	60	60	61	61

^aEquals gross revenue less operating expenses. ^bEquals operating revenue less operating expenses divided by operating revenue. Note: Numbers may not add due to rounding.

Liquidity remains a positive credit factor. Unrestricted reserves are projected at \$155 million at fiscal year-end 2010, or 541 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.

Legal Provisions

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. The series 2010 bonds will have a reserve fund unique to this series, 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.

Service Area Economy

Honolulu's economy has diversified but remains dominated by a well-developed tourism sector. The worldwide economic downturn reduced travel to the state beginning in 2008, both from domestic and international visitors. Diversity is provided by the city's role as the regional commercial, business, and finance center, as well as its status as the state capital and home to the University of Hawaii. Honolulu has a strong military presence. Recent investments in this sector have created new jobs, both military and civilian, on the island. Investments in this sector will likely continue given the island of Oahu's strategic location. The unemployment rate remained relatively low in 2008 at 3.5%, well below the national average. Income levels are above state and national averages, partially reflecting the high cost of living on the island.

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