



New Issue: MOODY'S ASSIGNS Aa2 RATING TO HONOLULU WASTEWATER REVENUE BONDS SENIOR LIEN; \$197M OF DEBT AFFECTED

Global Credit Research - 06 Oct 2011

Aa3 RATING AFFIRMED ON JUNIOR LIEN DEBT

Water/Sewer
HI

Moody's Rating

| ISSUE | | RATING |
|------------------------------------------------------------------------------|--------------------------------------|--------|
| Wastewater System Revenue Bonds (First Bond Resolution) Senior Series 2011 A | | Aa2 |
| Sale Amount | \$164,900,000 | |
| Expected Sale Date | 10/13/11 | |
| Rating Description | Senior Lien Wastewater Revenue Bonds | |
| Wastewater System Revenue Bonds (First Bond Resolution) Senior Series 2011B | | Aa2 |
| Sale Amount | \$67,500,000 | |
| Expected Sale Date | 10/13/11 | |
| Rating Description | Senior Lien Wastewater Revenue Bonds | |

Opinion

NEW YORK, Oct 6, 2011 -- Moody's Investors Service has assigned a Aa2 rating and stable outlook to the City and County of Honolulu's Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2011A (\$164.9 million) and Senior Series 2011B (\$67.5 million). At this time, Moody's affirms the Aa2 rating on the system's approximately \$1.01 billion of outstanding senior lien bonds and the Aa3 rating on the system's approximately \$435.4 million of outstanding junior lien bonds. Proceeds from the Senior Subseries 2011A Bonds will finance a portion of the system's capital improvement program. Proceeds from the Senior Series 2011B Bonds will refund certain maturities of the system's previously-issued debt for annual debt service savings.

RATINGS RATIONALE

The Aa2 senior lien and Aa3 junior lien ratings are based primarily on sound debt service coverage provided by existing net revenues, the City's history of prudent and substantial multi-year rate increases to support its obligations, management's recent approval of further rate increases, continuing progress on the system's sizable capital improvement plan which will require additional borrowing in the coming years, and the sizable economic base served by the wastewater enterprise. The stable rating outlook is based on Moody's expectation that the wastewater system will continue to maintain favorable financial performance consistent with the City's conservative financial and debt policies, despite the expectation of substantial future borrowing. Moody's also notes that the system has no exposure to variable rate debt or derivative instruments.

STRENGTHS

- Large, established service area
- Approval of multi-year rate increases generating strong coverage levels
- Prudent financial policies

CHALLENGES

- Substantial capital improvement plan that will keep leverage ratio elevated

-Slow national economic recovery weighs on local tourist-related business

DETAILED CREDIT DISCUSSION

HISTORICALLY STRONG COVERAGE LEVELS EXPECTED TO NARROW OVER TIME GIVEN ADDITIONAL BORROWING PLANS

The City was careful to adopt substantial rate increases in advance of the city's substantial borrowing for its long-term capital program, enabling system revenues to keep pace with growing debt service requirements and provide satisfactory overall coverage. In fiscal 2010, senior lien coverage increased to a strong 5.38 times due to a combination of increased user revenues, reduced expenses and a lower debt service payment in that year. Coverage of senior and junior lien bonds combined was also strong at 3.20 times. Including reimbursable general obligation bonds and SRF loans, 2010 coverage of all system obligations was 2.23 times. Unaudited results for fiscal 2011 indicate sound operations continued as both revenues and expenses outperformed management's conservative budgeting. Coverage of senior lien bonds only was 4.52 times, while coverage of senior and junior lien bonds combined was 2.88 times. Coverage of all system obligations was a sound, unaudited 2.17 times (net of connection fees). Looking forward through 2016 coverage will decline as senior lien and combined senior and junior lien debt service payments nearly triple. Still, coverage levels are projected to remain at satisfactory levels with senior lien coverage estimated to decline to a still sound 2.13 times, combined coverage is projected to be roughly at 1.66 times, while coverage of total obligations will be 1.48 times.

The City's long-term financial projections indicate that coverage levels will continue to comply with its adopted policy calling for a satisfactory 1.6 times on senior lien bonds and 1.25 times on combined senior and junior lien bonds; including reimbursable general obligation bonds and SRF loans, projected coverage of all system obligations is expected to comfortably exceed the City's target of 1.05 times coverage on all system obligations. At the Aa2 and Aa3 rating levels on the senior and junior lien bonds, respectively, Moody's believes that it will be important for the City to maintain debt service coverage levels in excess of established policy levels.

MANAGEMENT APPROVES ANOTHER ROUND OF MULTI-YEAR RATE INCREASES

The City's adoption of substantial multi-year wastewater system rate increases is an important factor in the assigned ratings. As part of his inaugural budget in 2005, the mayor proposed rate increases of 25% in fiscal 2006 and 10% annual increases thereafter through fiscal 2011; in June 2005, the City Council passed an ordinance adopting these increases. In June 2007, the City approved another round of rate increases to take effect in 2008 through 2011. As a result, rates were increased by 25% in 2008 (15% higher than originally adopted in 2005) 18% in 2009 and 2010 (8% higher than the rates approved in 2005) and current fiscal year 2011 rates were increased by 15% (5% higher than previously approved). Even after these sizable increases, wastewater rates are expected to remain comparable to the rates of other major urban systems on the mainland. Positively, management adopted another round of multi-year rate increases through FY 2017; rates are projected to increase 4% annually between fiscal 2012 and 2015, followed by a 5% and 8% increase in 2016 and 2017, respectively. Moody's believes that these rate actions represent important achievements in ensuring adequate bondholder security going forward.

CONSENT DECREE PROVIDES GREATER REGULATORY CERTAINTY TO CAPITAL PLAN

The City and County of Honolulu has worked diligently to comply with evolving state and federal regulations on treatment and discharge standards, rehabilitate and expand certain existing facilities and construct new facilities. Significantly, late last year (2010) the City and County of Honolulu, the EPA, the state Department of Health (DOH), and several non-profit environmental groups reached an agreement on a 2010 Consent Decree. The Consent Decree terminated the prior 1995 Consent Decree and the 2007 Stipulated Order and resolved prior lawsuits (2004 and 2006) including City and County appeals. The 2010 Consent Decree is significant in that it provides certainty on outstanding litigation and the department's long term CIP. The 2010 Consent Decree allows 10 years for completion of work on the collection system, 14 years for the upgrade of the Honouliuli WWTP to secondary treatment, and 25 years, with the possibility of a three-year extension, for the upgrade of the Sand Island WWTP to secondary treatment.

Through fiscal 2020 the City and County is expected to incur \$3.5 billion in capital costs, most of which were already included, planned for, and part of the department's existing CIP. Collection system projects will be the department's top priority through 2020 with treatment projects, including treatment plant replacements and upgrades making up a portion project costs in later years.

To maintain the system's current ratings, Moody's anticipates that the City will continue to raise rates as necessary to maintain satisfactory debt service coverage even if additional borrowing expands beyond currently planned levels to address these regulatory issues.

The system provides wastewater services for approximately 73% of the City and County of Honolulu (general obligation bonds rated Aa1/stable), which encompasses the entire island of Oahu. The customer base is diversified with residential users

representing 71% of the system's fiscal 2010 revenues while the ten largest customers accounted for only 6.3% of revenues. The system operates nine wastewater treatment plants serving an area of almost 600 square miles.

Since 1991, EPA, the State of Hawaii, and several environmental groups have filed various legal and regulatory actions against the City and County of Honolulu alleging violations of the federal Clean Water Act and several of the permits held by the wastewater department. The 2010 Consent Decree, as mentioned above, addresses all of these actions and allegations and now provides the City and County with some additional clarity and certainty regarding timeline and compliance requirements. In addition to actions taken to date, the wastewater department has developed capital improvement plans covering periods of five, ten and twenty years, in part to comply with prior legal actions. The long-range capital plan will also address safety and public health, permit compliance, system expansion and reliability issues. Capital expenditures over the 2012-2016 period are estimated to total \$1.40 billion. Approximately \$968 million of funding will come from additional system revenue bonds (combined senior and junior lien). As a result, the system's 2011 pro-forma debt ratio of 63.0% is expected to grow over time, but remain manageable.

HONOLULU'S ECONOMIC RECOVERY EXPECTED TO STRENGTHEN; UTILITY'S SERVICE AREA REMAINS STABLE

Honolulu's economic recovery is expected to strengthen through the end of the year as job growth leads to growth in consumer-based industries such as retail. Visitor arrivals and hotel occupancy percentages had remained somewhat sluggish until improving in 2010 then were relatively flat through the second quarter of 2011. Unemployment in Honolulu remains favorable at 5.5% (August, 2011) and below the state (6.5%) and nation (9.1%).

Honolulu remains a unique and attractive tourist destination and officials have been successful in niche marketing the island. Moody's also notes projects in renewable energy, the film and television industry, and sustainable agriculture continue to lend support to ongoing diversity in the Honolulu economy alongside traditional economic anchors including the military, health care, and banking sectors.

Real estate has been another important element of Honolulu's economic success. However, between 2007 and 2009 home prices declined, although modestly relative to the rest of the nation. After trending gradually upward, as of May 2011, home sales and prices dipped slightly year-to-date and overall construction has slowed, although only slightly from a year ago. Over the medium-term, numerous residential and commercial projects are in various stages of planning and construction and are expected to create jobs and support the local recovery. Despite the moderating influence of many tourism-related service jobs, wealth indicators in Honolulu are favorable with per capita and median family income at 101.9% and 120.1% of the U.S., respectively.

DEBT SERVICE RESERVE REQUIREMENT WEAKENED TO 50% OF MADS; LEGAL PROVISIONS BOLSTERED BY ADOPTION OF FORMAL FINANCIAL POLICIES

Similar to the city's 2010 transactions, Moody's notes the Debt Service Reserve (DSR) on the Series 2011A Bonds will be equal to 50% of maximum annual debt service on the senior lien, cash funded; the Series 2011B Bonds will be secured by the senior lien common reserve fund. Although a slight credit weakness relative to prior DSR requirements (100% of MADS on both liens, cash funded), the lower DSR requirement is mitigated by the City and County's established practice of segregating 50% of the following year's debt service obligation in the current year budget. Legal provisions also include covenants to maintain rates and charges sufficient to generate net revenues at least equal to 1.20 times the amount needed to pay debt service on the senior lien bonds and 1.10 times on combined senior and junior lien debt service. A similar covenant is provided for the issuance of additional parity bonds under both liens. The reimbursable general obligation bonds, as well as the debt service on the system's state revolving fund loans, are secured by a lien on net system revenues which is subordinate to the lien created by the junior lien bonds.

Legal provisions are bolstered by the formal adoption of conservative debt and financial operating policies by the City Council which require compliance with annual targets of 1.6 times coverage on the senior lien bonds and 1.25 times on first and second lien bonds combined. In addition, the City Council resolution incorporates a favorable three-month operating and maintenance reserve fund policy which will serve to insulate the system from unexpected events.

Outlook

The stable rating outlook is based on Moody's expectation that the wastewater system will continue to benefit from approved rate increases and maintain favorable financial performance consistent with the City's financial and debt policies, despite significant future borrowing plans.

WHAT COULD MAKE THE RATING GO UP

-Substantial local economic diversification and improvement in socioeconomic wealth indices, as well as sustained debt

characteristics consistent with higher-rated entities

WHAT COULD MAKE THE RATING DOWN

-Trend of significantly weakened coverage of annual debt service coverage

-Substantial increase in debt ratio

-Weakened legal provisions

KEY STATISTICS:

Service area population, 2011: 640,000

Operating ratio, 2011: 33.5%

Senior lien debt service coverage, 2011 (unaudited): 5.38 times

Combined senior and junior lien debt service coverage, 2011 (unaudited): 2.88 times

Debt service coverage of all system obligations (including G.O. and SRF loans), 2011 (unaudited): 2.17 times

Peak senior lien debt service (2019) coverage by FY 2011 (unaudited) net revenues: 2.64 times (not including future anticipated bond issues)

Peak senior and junior lien debt service (2019) coverage by FY 2011 (unaudited) net revenues: 1.86 times (not including future anticipated bond issues)

Debt ratio, pro-forma 2011: 63.0%

Net working capital as % of gross revenues, 2010, pro-forma: 128.0%

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published in August 1999. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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Analysts

Dan Steed
Analyst
Public Finance Group
Moody's Investors Service

Matthew A. Jones
Backup Analyst
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA



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