Revenue
New Issue

City and County of Honolulu, Hawaii

Ratings

New Issue

Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2007A, 2007B, and 2007C .... 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 .... Negative
(Changed from Stable on 7/12/07)

Analysts

Kathy Masterson
+1 415 732-5622
kathy.masterson@fitchratings.com

Doug Scott
+1 512 322-5321
douglas.scott@fitchratings.com

New Issue Details

$237,520,000 Wastewater System Revenue Bonds (First Bond Resolution), consisting of $160,120,000 Senior Series 2007A, $8,500,000 Senior Series 2007B, and $68,900,000 Senior Series 2006C, are expected to sell on July 23 via negotiation through UBS Securities, LLC.

Purpose: Proceeds of the senior series 2007A bonds will be used to finance a portion of the city and county of Honolulu wastewater system's overall capital improvement program. The senior series 2007B bonds will be used to refund general obligation bonds maturing in 2008. The senior series 2007C bonds will be used to advance refund existing senior bonds for savings.

■ Outlook

The Negative Rating Outlook reflects the recent rapid escalation in the city and county of Honolulu wastewater system's capital improvement program (CIP) and the likelihood of significant additional mandated capital costs that may be imposed by the U.S. Environmental Protection Agency (EPA). Further capital cost escalation could cause deterioration in the system's financial operations and limit future rate flexibility. To date, Fitch Ratings notes that financial performance is favorable as a result of rate increases adopted in 2005 and 2007 that maintain fiscal margins in light of extensive capital costs. However, a downgrade may result in the event of:

- Sizable further increases in the CIP, including additional regulatory mandates to move to the secondary treatment standard.
- Any erosion in either political or community support for rate increases necessary to execute the CIP.
- Deterioration in the system's strong current and projected financial position.

■ Rating Considerations

Fitch's rating concerns are balanced by the proactive steps taken by the current political leadership and management team to address many years of delayed spending on capital infrastructure, including adoption of two multiyear rate packages that extend through fiscal 2011. Financial results in fiscal 2006 were strong, bolstered by the first round of rate hikes, and near- to medium-term projections indicate continued strong performance as adopted future rate adjustments take effect. To date, the community appears to be supportive of the double-digit annual rate increases needed to invest in the system's aging infrastructure. Additional credit strengths include the strong regional economy and stable residential customer base.

The Honolulu wastewater system faces intense capital-cost pressure stemming from years of deferred investment. The majority of the 10-year, $2.4 billion CIP is driven by mandatory projects outlined in multiple consent decrees with the EPA. The overall cost of the 10-year CIP has increased by $850 million since estimates were provided in 2006, resulting from construction cost escalation, better cost estimates as designs finalize, and additional requirements imposed by a regulatory settlement, as well as a shift in assumptions to a more conservative inflation rate. To support these cost increases, the city passed additional rate increases in June 2007 beyond those already adopted in 2005. As a result, the average annual rate hike over the following four years will rise from 10% to 19%. The Negative Rating Outlook reflects the already large nondiscretionary CIP and cost increases experienced to date. Fitch's concern is that additional EPA-mandated costs or other significant capital cost escalation on top of the existing CIP may begin to erode the system's financial position, given the already high rates and uncertainty over whether ratepayers could or would absorb additional rate increases to fund another large mandate, which could exceed $1 billion.

■ Strengths

- Strong political commitment to the CIP.
- Approved rate increases through fiscal 2011.
- Community support for mandated improvements and approved rate increases.
- Stable residential customer base and limited growth pressure.
- Adequate projected debt service coverage and liquidity levels.

■ Risks

- Large nondiscretionary CIP's susceptibility to scope expansion and cost escalation.
- Long-term nature of the mandated capital program, which exceeds the typical tenure of elected officials and requires long-term community support and tolerance for double-digit rate increases over a number of years.
- High debt burden and rates that will double in the next five fiscal years.

■ Recent Developments

Potential EPA Denial of Existing Waivers

The EPA recently issued a tentative decision to deny the city's request for renewal of its 301(h) waiver for its second largest wastewater treatment plant (WWTP), the Honouliuli WWTP. The EPA has additionally indicated that it expects to deny the city's other 301(h) waiver on Sand Island WWTP, Honolulu's largest WWTP, later in 2007. The waivers exempt the two WWTPs from compliance with the federal Clean Water Act, permitting treatment of effluent to primary standards instead of the more costly secondary treatment. If the city is required to convert these two WWTPs to the secondary treatment standard, the capital costs would be substantial; preliminary staff estimates are as high as $1.2 billion. These capital costs are not included in the city's current CIP projections.

Fitch acknowledges that any conversion to secondary treatment would likely occur over an extended time frame decided through a negotiated process with the EPA. However, Fitch is concerned that the ongoing substantial rate increases needed to support the existing CIP have significantly reduced the system's practical ability (although not legal authority) to raise rates further, including its ability to respond to an event of the magnitude as moving to secondary treatment, if required. Also, the scope of such additional regulatory requirements, depending on the timeline required by the EPA, could potentially divert 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. As a result, a key credit concern over the near term will be the potential denial of the 301(h) waivers or any further escalation in the CIP and its impact on utility operations and the need for additional rate adjustments beyond those contemplated.

Rapid Escalation in CIP Costs

The wastewater system is approximately halfway through a 20-year CIP (fiscal years 1998–2017) to address multiple consent decrees issued by the EPA. Approximately 84% of the $3.7 billion 20-year 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 the heavy construction phase of the CIP. 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 76% from an estimate of $2.1 billion provided two years ago.

In addition to industrywide construction cost increases and the city's completion of the design phase, the city has included some additional projects resulting from a stipulated order reached with the EPA in March 2007. In March 2006, the rupture of the Beachwalk force main resulted in the release of 48.7 million gallons of untreated wastewater into the Ala Wai Canal in Waikiki and a brief closure of certain beaches in Waikiki. As a result of this event, the city entered into a stipulated order with the EPA, requiring approximately $300 million of improvements on six force mains and one pump station. A portion of these improvements were already included in the long-term CIP, but the timeline has been accelerated by the stipulated order.

Additional Rate Increases Approved

In 2005, the City Council adopted a series of six annual rate increases designed to meet the rising costs associated with the CIP. In 2007, it amended and raised the amount of the remaining four rate hikes in order to absorb the most recent CIP cost increases. The approved rate increases are 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 bill has risen to more than $55 in fiscal 2008, which is relatively high compared with that of other utilities. Based on the remaining approved rate hikes, the bill will increase to more than $88 in fiscal 2011. 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 about 11%.

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 in its collection levels or significant community discontent following the rate hikes, as evidenced by the lack of opposition at public meetings.

■ 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). The 2007 bonds will include proceeds to fund the reserve requirement.

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

■ System and Environment

The system provides sewer services to a population of approximately 640,000, or 71% of the total population of the city and county of Honolulu. Of this amount, 77% are residential, lending stability to the customer base. The remaining customers 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.

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 115.8 million gallons per day (mgd) for fiscal 2006, approximately 77% of the 151 mgd combined treatment capacity. The system's two largest plants, Sand Island and Honouliuli, treat about 80% of the system's 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 the system's two largest plants currently operate according to expired 301(h) waivers and only meet primary treatment requirements discharging to deep ocean outfall. As previously noted, the EPA has tentatively denied the renewal of the Honouliuli WWTP waiver and has indicated that it expects to deny the waiver renewal for Sand Island WWTP later in 2007.

Sand Island WWTP (design capacity 86 mgd) occasionally falls out of compliance as it experiences problems with the 30% biological oxygen demand (BOD) removal limit. However, there was no impact on the discharge environment. In addition, the WWTP has been in full compliance with all discharge permits since 2003. Some of the capital projects will upgrade Sand Island WWTP's existing processes and address BOD issues.

■ Capital Improvement Plan

The wastewater system's five-year capital plan is estimated at $1.5 billion and is a subset of the 20-year CIP, which has a total cost of $3.7 billion. The five-year plan will be funded almost entirely through revenue bonds (78%) and low-cost state revolving fund loans (9%).

Although there are some environmental issues resulting from treatment deficiencies, the majority of the wastewater system's capital plan addresses environmental concerns plaguing the collection and transmission system. The wastewater system's major pipelines were put in operation 40–100 years ago. As a result, some pipes in the collection system are approaching the end of their useful lives. The collection system's deteriorated condition affects the overall system performance most during periods of wet weather, and O&M expenditures escalate as a result.

The city has worked with the community, EPA, and state department of health to develop several consent decrees. The most significant consent decree arose from the EPA and state department of health's filing of

Financial Summary

($000, Fiscal Years Ending June 30)

	Audited					Projected				
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Balance Sheet										
Cash and Investments	66,800	50,202	39,583	42,270	46,707	50,984	53,812	61,465	64,457	64,147
Accounts Receivable	16,772	16,336	15,658	15,735	20,875	—	—	—	—	—
Other Current Assets	114,343	194,457	93,856	(9,906)	71,863	—	—	—	—	—
Current Liabilities	(41,666)	(47,177)	(56,276)	(54,492)	(57,039)	—	—	—	—	—
Net Working Capital	156,249	213,818	92,821	(6,393)	82,406	—	—	—	—	—
Net Fixed Assets	1,235,121	1,315,362	1,384,386	1,450,691	1,513,603	—	—	—	—	—
Net Long-Term Debt Outstanding	606,060	814,988	800,120	788,715	931,310	1,271,310	1,441,990	—	—	—
Operating Statement										
Operating Revenues	112,148	111,878	111,886	112,746	142,167	157,390	197,280	233,430	276,210	318,510
Non-Operating Revenues	4,779	2,032	1,540	1,590	4,166	3,300	8,600	8,700	8,600	10,200
Gross Revenues	116,927	113,910	113,426	114,336	146,333	160,690	205,880	242,130	284,810	328,710
Operating Expenses Excluding Depreciation	(62,755)	(59,995)	(63,336)	(68,326)	(75,999)	(101,112)	(123,222)	(134,570)	(136,710)	(141,480)
Depreciation	(29,983)	(30,290)	(30,575)	(30,647)	(31,439)	0	0	0	0	0
Operating Income	24,189	23,625	19,514	15,363	38,895	59,578	82,658	107,560	148,100	187,230
System Facility Charges (SFCs; Connection Fees)	0	3,812	3,077	5,339	8,822	7,880	8,110	8,360	8,610	8,870
Net Revenues Available for Debt Service*	54,172	53,915	50,089	46,010	70,334	59,578	82,658	107,560	148,100	187,230
Senior Lien Debt Service Requirements	6,826	12,710	10,641	10,642	12,946	21,857	34,422	44,889	67,304	91,543
Junior Lien and Total Obligations	22,979	22,602	22,931	33,497	23,792	31,939	38,443	37,704	40,597	43,661
Financial Statistics										
Senior Lien Debt Service Coverage (x)	7.9	4.2	4.7	4.3	5.4	2.7	2.4	2.4	2.2	2.0
Total Debt Service Coverage (x)	1.8	1.5	1.5	1.0	1.9	1.1	1.1	1.3	1.4	1.4
Total Debt Service Coverage Including SFCs (x)	1.8	1.6	1.6	1.2	2.2	1.3	1.2	1.4	1.5	1.5
Days Cash on Hand	389	305	228	226	224	184	159	167	172	165
Days of Operating Revenue in Accounts Receivable	55	53	51	51	54	—	—	—	—	—
Debt to Net Plant (%)	49	62	58	54	62	—	—	—	—	—
Operating Margin (%)**	44	46	43	39	47	36	38	42	51	56

*Equals gross revenues less operating expenses. Excludes SFCs. **Equals operating revenues less operating expenses divided by operating revenues. Note: Numbers may not add due to rounding.

a lawsuit in 1994, which resulted in the 1995 consent decree. This consent decree requires the city to establish a schedule, under which the city shall implement a comprehensive preventive maintenance program and a long-term sewer replacement and rehabilitation program necessary to reduce and prevent spills, implement and enforce its pretreatment program to regulate industrial discharges, and develop and implement an effluent and sludge reuse program. As required by the 1995 consent decree, the long-term sewer replacement and rehabilitation program needs to be completed by Dec. 31, 2019.

Only 16% of the $3.7 billion long-term CIP costs are discretionary, including improvements for reliability (10%) and expansion (6%). The remaining 84% of the 20-year CIP projects are nondiscretionary, including the required consent decree projects (59%), permit or regulatory improvements (19%), safety/public health improvement projects (3%), and nondiscretionary expansion of existing facilities (3%). To date, the city has appropriated $1.3 billion toward the 20-year CIP. Approximately two-thirds of spending for the CIP will occur in the next 10 fiscal years.

■ Finances

The system's current financial position is strong, with fiscal 2006 senior lien debt service coverage of 5.4 times (x) and total debt service coverage of 1.9x, including junior lien bonds, general obligation bonds, and state revolving fund loans. These coverage levels exclude system facility charges, or connection fees, which are not pledged to revenue bondholders. Coverage and liquidity levels were exceptionally strong in fiscal 2006 due to a 25% rate increase 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. Total debt service coverage on all debt obligations is projected to range between 1.1x and 1.4x over the next five fiscal years. The city's formal policy is to maintain 1.6x debt service coverage on the senior lien bonds and 1.25x coverage on all revenue bonds.

Liquidity remains a positive credit factor, even though the city has drawn down some of its cash balances recently. Unrestricted reserves at the end of fiscal 2006 were $46.7 million, or 224 days cash on hand. The city's formal policy is to maintain at least three months of operations in reserves.

The city expects to issue approximately $1.3 billion in new debt over the next five fiscal years, including the series 2007 bonds. As a result, debt per customer, which was a moderate $3,200 in fiscal 2006, is expected to more than double by fiscal 2012 and continue to rise over the remaining 10-year CIP period. Also, total debt service is projected to increase to more than 40% of operating revenues within the next five fiscal years from 25% in fiscal 2006. While debt service coverage is expected to remain strong, the increase in fixed costs as a percentage of the overall cost structure is a long-term credit concern as it limits future financial flexibility, especially in light of reduced affordability for ratepayers.

■ Service Area

Honolulu's economy is diversifying somewhat but remains dominated by a well-developed tourism sector that is in transition. 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 enhances economic diversity. Also, Honolulu has a strong military presence, which likely will continue given the island of Oahu's strategic location. About three-quarters of all state jobs are located in Honolulu. Oahu's job base is growing, following several years of decline. Despite economic fluctuation, the unemployment rate remains low in 2007 at 2.3%, well below the national average.

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