Revenue
New Issue

City and County of Honolulu, Hawaii

Wastewater System

Ratings

New Issue
Wastewater System Revenue Bonds (Second Bond Resolution) Junior, Series 2008A — A+

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

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New Issue Details

Sale Information: Approximately $113,890,000 Wastewater System Revenue Bonds (Second Bond Resolution), Junior Series 2008A, scheduled to price the week of April 21 via negotiation.
Purpose: Current refund the system's outstanding junior series 2003A-2 and 2003B-2, currently in auction-rate mode, and advance refund a portion of the junior series 1998; the system will have no auction-rate securities outstanding after this transaction.
Final Maturity: 2033.

Related Research

- *City and County of Honolulu, Hawaii, Nov. 8, 2007*
- *2008 Median Ratios for Water and Sewer System Revenue Bonds — Retail Systems, Jan. 15, 2008*

Rating Rationale

- The system has maintained a strong historical financial position and projects similar performance at least over the near-to-medium term.
- Proactive political leadership and management are addressing deferred maintenance, including the adoption of two multiyear rate packages that extend through fiscal 2011.
- The regional economy is solid, and there is a stable residential customer base.
- Overall, the community supports the rate packages.
- High system leverage exists with substantial additional borrowing plans over the medium term.
- Substantial additional capital needs may occur if 301(h) secondary treatment waivers are denied by the EPA.
- Customer charges are relatively high and rising.

What Could Trigger a Downgrade?

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

Credit Summary

The Honolulu wastewater system faces intense capital cost pressure stemming from years of deferred investment. The majority of the remaining 20-year $3.9 billion CIP for fiscal years 1998–2017 is driven by mandatory projects outlined in multiple consent decrees with the EPA. The overall cost of the fiscal years 1998–2017 CIP increased by $1.2 billion from fiscal 2006 projections to fiscal 2007 projections, resulting from construction cost escalation, better cost estimates from finalized designs, and additional requirements imposed by a regulatory settlement, as well as shifting in the assumptions to a more conservative inflation rate. To support these cost increases, the city passed substantial additional rate increases in June 2007 beyond those already adopted in 2005. The most recent 2008 update of the 20-year CIP pointed to a moderate 4.8% increase from the 2007 estimate.

Potentially increasing capital costs further, the EPA issued tentative decisions to deny the city's request for a renewal of its 301(h) waivers for the utility's two largest wastewater treatment plants (WWTPs) in 2007; a final ruling by EPA is expected as early as September 2008. The waivers exempt these 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 secondary treatment, the capital costs would be substantial; preliminary

Rating History — Senior Series

Rating	Action	Outlook/ Watch	Date
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

Rating History — Junior Series

Rating	Action	Outlook/ Watch	Date
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

staff estimates are as high as $1.2 billion. These costs have not been included in the city's current CIP projections.

Fitch Ratings acknowledges that any conversion to secondary treatment would likely occur over an extended time frame. However, Fitch remains concerned that the ongoing substantial rate increases needed to support the existing CIP significantly reduce the utility's rate affordability, including its ability to respond to an event of the magnitude of moving to secondary treatment, if required. Also, the scope of such additional regulatory requirements may divert capital spending and resources away from the much needed infrastructure investments that currently comprise the bulk of the CIP, which could be expected to impact the system's strong financial performance. 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 to utility operations and the need for additional rate adjustments beyond those contemplated.

The system's financial position is sound, with fiscal 2007 senior lien debt service coverage of 3.3x and total debt service coverage of 1.8x, including junior lien bonds, general obligation bonds, and state revolving fund loans, well above the city's policy of 1.6x for senior lien bonds and 1.25x for combined senior and junior lien bonds. Senior debt service coverage is projected to remain strong at over 2.2x through fiscal 2013, based on approved rate increases through fiscal 2011 and assumed annual rate increases thereafter. Total debt service coverage on all bonds is projected to range between 1.1x –1.5x.

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 Mayor proposed and the City Council approved another four-year package of supplemental rate hikes to absorb the CIP additions identified through that time. With rate adjustments effective through fiscal 2008 the average monthly residential sewer bill has risen to over $52, which is relatively high in comparison to other utilities. Based on remaining approved rate increases, the bill will increase to over $84 in fiscal 2011; additional rate increases beyond those already approved are likely given the amount of debt to be issued. The passage of such comprehensive rate increases are viewed favorably by Fitch, demonstrating leadership's commitment to necessary repairs of the city's basic infrastructure and completion of the CIP. Also, the lack of public opposition to date points to the community's willingness to absorb substantial cost increases for this purpose.

The city expects to issue approximately $1.4 billion in new debt over the next five years. As a result, debt per customer, which was high at around $4,000 in fiscal 2007, is expected to rise further with future borrowings. Also, total debt service is projected to increase to over 40% of operating revenues within the next five 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.

The system provides wastewater service for the 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 WWTP. Wastewater service is provided to approximately 295,000 equivalent single-family dwelling units, representing a residential population of about 640,000. Of the total accounts, 74% are residential, lending stability to the customer base.

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 MADS.

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 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.

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 105 mgd for fiscal 2007, approximately 69% 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.

A national pollutant discharge elimination system permit or the state Department of Health (DOH) underground injection control permit regulates the discharge of treated wastewater into receiving waters. Most plants treat to the secondary level, yet the Sand Island and Honouliuli 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. 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 has been no impact on the discharge environment. In addition, the WWTP has been in full compliance with all discharge permits since 2003. Some of the city's planned capital projects will upgrade Sand Island WWTP's existing processes and address BOD issues.

In March 2007, the EPA issued a tentative decision to deny the city's request for renewal of its 301(h) waiver for the Honouliuli WWTP. Subsequently, the EPA issued a similar indication for the Sand Island WWTP in December 2007. 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.

Capital Improvement Plan

The wastewater system is a little over halfway through the 20-year CIP (fiscal years 1998–2017) addressing multiple consent decrees issued by the EPA. Over 80% of the $3.9 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 has only recently begun 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 84% from a 2005 estimate of $2.1 billion.

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. The wastewater system's five-year capital plan is estimated at $1.5 billion and is a subset of the 20-year CIP. The five-year plan will be funded almost entirely through revenue bonds and low-cost state revolving fund loans (total of 87% of funding).

Although there are some environmental issues resulting from treatment deficiencies, the majority of the wastewater system's capital needs address 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 DOH to develop several consent decrees. The most significant consent decree arose from the EPA and DOH's filing of a lawsuit in 1994, which resulted in the 1995 consent decree. The consent decree requires the city to establish a schedule under which it will implement a comprehensive preventive maintenance program and a long-term sewer replacement and rehabilitation program. These programs are necessary to reduce and prevent spills, implement and enforce its pretreatment program to regulate industrial discharges, and develop and implement an effluent and sludge re-use program. The rehabilitation program needs to be completed by Dec. 31, 2019.

Rates and Finances

The system's current financial position is strong, with fiscal 2007 senior lien debt service coverage of 3.3x and total debt service coverage of 1.8x, 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 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 2.2x through fiscal 2013. Total debt service coverage on all debt obligations is projected to range between 1.1x–1.5x over the next six fiscal years. 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.

Financial Summary

($000, Audited Fiscal Years Ended June 30)

	2003	2004	2005	2006	2007
Balance Sheet					
Cash and Investments – Core Reserves	50,202	39,583	42,270	46,707	43,774
Net Fixed Assets	1,315,362	1,384,386	1,450,691	1,513,603	1,616,817
Net Long-Term Debt Outstanding	**814,988**	**800,120**	**788,715**	**931,310**	**1,173,635**
Operating Statement					
Operating Revenues	111,878	111,886	112,746	142,167	160,963
Non-Operating Revenues	2,032	1,540	1,590	4,166	13,996
Gross Revenues	**113,910**	**113,426**	**114,336**	**146,333**	**174,959**
Operating Expenses (Excluding Depreciation)	(59,995)	(63,336)	(68,326)	(75,999)	(75,999)
Net Revenues Available for Debt Service	**53,915**	**50,089**	**46,010**	**70,334**	**98,961**
Senior Lien Debt Service Requirements	12,710	10,641	10,642	12,946	30,060
Total Debt Service Requirements	35,312	33,572	44,139	36,738	56,690
Financial Statistics					
Senior Lien Debt Service Coverage (x)	4.2	4.7	4.3	5.4	3.3
Total Debt Service Coverage (x)	1.5	1.5	1.0	1.9	1.8
Days Cash on Hand from Core Reserves	305	228	226	224	210
Days of Operating Revenue in Accounts Receivable	53	51	51	54	53
Debt to Net Plant (%)	62	58	54	62	73
Operating Margin (%)[a]	46	43	39	47	53

[a]Equals operating revenues less operating expenses divided by operating revenues. Note: Numbers may not add due to rounding.

Liquidity remains a positive credit factor, even though the city has drawn down some of its cash balances recently. Unrestricted core reserves at the end of fiscal 2007 were $43.8 million, or 210 days cash on hand. The city's formal policy is to maintain at least three months of operating expenses in reserves.

The city expects to issue approximately $1.4 billion in new debt over the next five fiscal years. As a result, debt per customer, which was a high $4,000 in fiscal 2007, is expected to increase by over 70% by fiscal 2012 and continue to rise through at least fiscal 2017. Also, total debt service is projected to rise to more than 40% of operating revenues within the next couple of fiscal years from 32% in fiscal 2007 and 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.

Financial Projections

($000, Fiscal Years Ending June 30)

	2008	2009	2010	2011	2012	2013
Operating Revenues	197,280	233,430	276,210	318,510	367,290	412,490
Non-Operating Revenues	8,906	8,736	4,936	6,036	7,336	9,636
Gross Revenues	**206,186**	**242,166**	**281,146**	**324,546**	**374,626**	**422,126**
Operating Expenses (Excluding Depreciation)	(123,222)	(130,138)	(130,930)	(135,770)	(140,600)	(145,740)
Net Revenues Available for Debt Service	**82,964**	**112,028**	**150,216**	**188,776**	**234,026**	**276,386**
Senior Lien Debt Service Requirements	34,422	42,281	59,245	81,091	103,740	125,275
Total Debt Service Requirements	72,865	98,483	115,694	137,435	161,470	183,477
Senior Lien Debt Service Coverage (x)	2.4	2.6	2.5	2.3	2.3	2.2
Total Debt Service Coverage (x)	1.1	1.1	1.3	1.4	1.4	1.5

Note: Numbers may not add due to rounding.

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, it amended and raised the amount of the remaining four rate hikes 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 sewer bill has risen to more than $52 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 $84 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 in 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.

Service Area

Honolulu's economy is experiencing a period of strong performance. It has also diversified somewhat, but remains dominated by a well-developed tourism sector. Diversity comes from 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.

Also, Honolulu has a strong military presence, which likely will continue given the island of Oahu's strategic location. The city's job base has shown good growth since 2003, following several years of slower gains and decline. Despite economic fluctuation, the unemployment rate remained relatively low in 2007 at 2.4%, well below the national average. Income levels are above state and national averages, partially reflecting the high cost of living on the island.