



Moody's Investors Service

New Issue: MOODY'S ASSIGNS Aa3 RATING TO HONOLULU WASTEWATER SYSTEM'S SENIOR LIEN REVENUE BONDS

Global Credit Research - 04 Sep 2009

A1 JUNIOR LIEN RATING ALSO ASSIGNED

Water/Sewer
HI

Moody's Rating

ISSUE	RATING
Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2009A	Aa3
Sale Amount	\$36,765,000
Expected Sale Date	09/14/09
Rating Description	Senior Lien Revenue
Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2009B (BABs)	Aa3
Sale Amount	\$15,210,000
Expected Sale Date	09/14/09
Rating Description	Senior Lien Revenue
Wastewater System Revenue Bonds, (First Bond Resolution), Senior Series 2009C (RZEDBs)	Aa3
Sale Amount	\$67,660,000
Expected Sale Date	09/14/09
Rating Description	Senior Lien Revenue
Wastewater System Revenue Bonds (Second Bond Resolution), Junior Series 2009A	A1
Sale Amount	\$128,270,000
Expected Sale Date	09/14/09
Rating Description	Junior Lien Revenue

Opinion

NEW YORK, Sep 4, 2009 -- Moody's Investors Service has assigned an Aa3 rating and stable outlook to the City and County of Honolulu's Wastewater System Revenue Bonds (First Bond Resolution), Senior Series 2009A, Senior Series 2009B (BABs) and Senior Series 2009C (RZEDBs); Moody's has also assigned an A1 rating to the Wastewater System Revenue Bonds (Second Bond Resolution), Junior Series 2009A. The system's Aa3 senior and A1 junior lien ratings carry a stable outlook. At this time, Moody's also affirms the Aa3 rating on the system's approximately \$703.0 million of outstanding senior lien bonds and the A1 rating on the system's approximately \$328.5 million of outstanding junior lien bonds. Proceeds from the Senior Series 2009B and Senior Series 2009C bonds will finance a portion of the system's capital improvement program through 2011. Proceeds from the Senior Series 2009A and Junior Series 2009A will refund outstanding bonds for debt service savings. The Aa3 senior lien and A1 junior lien ratings are based primarily on sound debt service coverage provided by existing revenues, the City's approval of substantial multi-year rate increases to support its obligations, 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.

HISTORICALLY STRONG COVERAGE LEVELS EXPECTED TO NARROW SOMEWHAT GIVEN ADDITIONAL BORROWING PLANS

The City was careful to adopt substantial rate increases in advance of debt issuance, enabling system revenues to keep pace with growing debt service requirements and provide satisfactory overall coverage. In fiscal 2008, first lien coverage was strong at 3.72 times, while coverage of first and second lien bonds combined was a sound 2.33 times. Including reimbursable general obligation bonds and SRF loans, 2008 coverage of all system obligations was 1.87 times, though this total coverage figure is expected to decline to 1.23 times in 2010 (1.14 times net of connection fees) as debt service requirements ramp up from recent borrowings; total coverage stabilizes at 1.50 times or greater in 2011 and beyond as approved rate increases take effect.

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 Aa3 and A1 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.

APPROVED MULTI-YEAR RATE INCREASES

The City's adoption of substantial multi-year wastewater system rate increases in 2005, and again in 2007, 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); 2011 rates will increase 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. Moody's believes that these rate actions represent important achievements in ensuring adequate bondholder security going forward.

LARGE CAPITAL PLAN COULD EXPAND FURTHER GIVEN REGULATORY UNCERTAINTIES

As with all major wastewater treatment systems, the City and County of Honolulu faces evolving state and federal regulations on treatment and discharge standards. The potential for stricter standards in the future adds a measure of uncertainty to the system's future capital needs and additional borrowing plans beyond those currently contemplated by management. For example, in January 2009, the Environmental Protection Agency (EPA) issued final decisions to deny applications for a renewed variance from secondary treatment at the City's Honouliuli and Sand Island wastewater treatment plants. In February and March 2009 the City formally appealed these denials and those appeals are still pending. If renewed variances are denied, the City estimates additional CIP costs of approximately \$400 million for the Honouliuli plant and \$800 million for Sand Island. Though the City is engaged in efforts to reach a settlement on many matters with EPA, Moody's believes that the outcome of these negotiations will likely result in additional capital requirements not currently included in the capital improvement plan. Moody's will monitor the progress of these negotiations and comment as warranted. 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 74% of the island of Oahu's population which includes Honolulu (general obligation bonds rated Aa2/stable). The customer base is diversified with residential users representing 72% of the system's fiscal 2009 revenues while the ten largest customers accounted for only 6.2% 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. Honolulu has entered into four consent decrees in connection with the settlement of these actions which establish a required compliance schedule for project implementation. Among other things, the consent decrees require that Honolulu rehabilitate and

expand certain existing facilities and construct new facilities. 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 the existing consent decrees. The long-range capital program will also address safety and public health, permit compliance, system expansion and reliability issues. Capital expenditures over the 2010-2014 period are estimated to total \$1.6 billion. Approximately \$1.04 billion of funding will come from additional system revenue bonds (combined senior and junior lien) and \$104.9 million from state revolving fund loans. As a result, the system's 2008 debt ratio of 60.0% is expected to grow over time, but remain manageable.

HONOLULU'S ECONOMY SOFTENS; UTILITY'S SERVICE AREA REMAINS STABLE

After several very strong years, Honolulu's economy has softened of late due in part to reduced tourism and a weaker real estate market. The tourism industry began to soften in calendar year 2006 and visitor counts have been stagnant since that time. In addition, real estate activity has slowed and prices have declined somewhat, though the decline has been much less severe than on the mainland. Unemployment in Honolulu, at 6.1% in July 2009, remains favorable compared to 7.2% for the state and 9.7% for the nation.

Nevertheless, Honolulu remains a unique and attractive tourist destination and officials have been successful in niche marketing the island. Moody's notes that airline capacity serving the Hawaii tourism market relies on the health of the financially volatile airline industry. Moody's also notes improving diversity in the Honolulu economy which includes the military, health care, and banking sectors as important contributors. The City's successful efforts to finance light rail development through a general excise tax should help stimulate further housing and business development in west Oahu, especially in the Kapolei and Ko Olina areas. Despite the moderating influence of many tourism-related service jobs, wealth indicators in Honolulu are favorable with per capita and median family income at 107.1% and 149.3% of the U.S., respectively.

STANDARD LEGAL PROVISIONS BOLSTERED BY ADOPTION OF FORMAL FINANCIAL POLICIES

Legal provisions include covenants to maintain a Debt Service Reserve Fund equal to maximum annual debt service on both liens of bonds (currently cash funded) and require the maintenance of 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.

KEY STATISTICS:

Service area population, 2009: 640,000

Operating ratio, 2008: 49.9%

Senior lien debt service coverage, 2008: 3.72x

Combined senior and junior lien debt service coverage, 2008: 2.33x

Debt service coverage of all system obligations (including G.O. and SRF loans), 2008: 1.87x

Peak senior lien debt service coverage by FY 2008 net revenues: 2.28x

Peak senior and junior lien debt service coverage by FY 2008 net revenues: 1.38x

Debt ratio, 2008: 60.0%

Net working capital as % of gross revenues, 2008: 166.5%

The last rating action for the Honolulu Sewer Enterprise, Hawaii was on April 17, 2008 when a Aa3 rating and stable outlook was assigned to the issuer's senior lien bonds and an A1 rating and stable outlook was assigned to the issuer's junior lien bonds.

The principal methodology used in rating the Honolulu Sewer Enterprise's sewer revenue bonds was "Analytical Framework for Water and Sewer System Ratings" published in December 2008 which can be found at www.moody.com in the Credit Policy & Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating the current offering can also be found in the Credit Policy & Methodologies directory.

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