MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa2 to Honolulu, HI's Senior Lien Wastewater Revenue Bonds; outlook is stable

Global Credit Research - 07 Jul 2015

Aa3 assigned to Junior Lien Revenue Bonds

HONOLULU (CITY & COUNTY OF) HI SEWER ENTERPRISE
Sewer Enterprise
HI

Moody's Rating

ISSUE		RATING
Senior Series 2015A First Bond Resolution		Aa2
Sale Amount	$155,320,000	
Expected Sale Date	07/15/15	
Rating Description	Revenue: Government Enterprise	
Senior Series 2015B (Refunding) First Bond Resolution		Aa2
Sale Amount	$251,100,000	
Expected Sale Date	07/15/15	
Rating Description	Revenue: Government Enterprise	
Senior Series 2015C (Taxable Refunding) First Bond Resolution		Aa2
Sale Amount	$99,365,000	
Expected Sale Date	07/15/15	
Rating Description	Revenue: Government Enterprise	
Junior Series 2015A (Refunding) Second Bond Resolution		Aa3
Sale Amount	$76,290,000	
Expected Sale Date	07/15/15	
Rating Description	Revenue: Government Enterprise	
Junior Series 2015B (Taxable Refunding) Second Bond Resolution		Aa3
Sale Amount	$24,550,000	
Expected Sale Date	07/15/15	
Rating Description	Revenue: Government Enterprise	

Moody's Outlook STA

NEW YORK, July 07, 2015 --Moody's Investors Service has assigned a Aa2 rating to the City and County of Honolulu's Wastewater System Revenue Bonds (First Bond Resolution) Senior Series 2015A ($155M), Senior Series 2015B (Refunding) ($251M) and Senior Series 2015C (Taxable Refunding) ($99.4M).

Moody's has also assigned a Aa3 rating to the City and County of Honolulu's Wastewater System Revenue Bonds (Second Bond Resolution) Junior Series 2015A (Refunding) ($76.3M) and Junior Series 2015B (Taxable Refunding) ($24.6M).

At this time, Moody's affirms the Aa2 rating on the system's approximately $1.25 billion of outstanding senior lien bonds and the Aa3 rating on the system's approximately $379 million of outstanding junior lien bonds. The long term ratings carry a stable outlook.

SUMMARY RATINGS RATIONALE

The Aa2 senior lien and Aa3 junior lien ratings are based primarily on the sizable economic base served by the wastewater enterprise and a trend of healthy debt service coverage and liquidity. The rating also incorporates strong management practices including comprehensive fiscal policies, regular rate adjustments and long term planning, and continuing progress on the system's sizable capital improvement plan to address environmental risks which will require substantial borrowing in the coming years.

OUTLOOK

The outlook for the Honolulu Wastewater System is stable. The enterprise continues to navigate a very large capital program in order to comply with a 2010 Consent Decree while maintaining healthy debt service coverage. The stable outlook reflects our view that the system's strong management team will continue to maintain satisfactory debt service coverage and liquidity levels going forward, despite significant future borrowing plans.

WHAT COULD MAKE THE RATING GO UP

- Substantial local economic diversification and improvement in socioeconomic wealth indices

- Sustained reduction in debt ratio

- A stronger additional bonds test or other stronger limitations on leveraging the pledged revenues

WHAT COULD MAKE THE RATING DOWN

- Significant leveraging of net revenues above affordable levels

- Substantial increase in debt ratio

- Weakened legal provisions

STRENGTHS

- Large, established service area; local economy continues to strengthen supported by solid construction activity and tourism

- A long history of regular, independently-set rate increases that maintain financial stability, support a substantial capital program, and provide healthy debt service coverage

- Prudent financial policies

CHALLENGES

- The overall leverage of the system, although debt service coverage remains sound

- Continued compliance with Consent Decree requires substantial borrowing.

RECENT DEVELOPMENTS

Recent developments are incorporated in the Detailed Rating Rationale

DETAILED RATING RATIONALE

REVENUE GENERATING BASE: LARGE, PREDOMINANTLY RESIDENTIAL SERVICE SYSTEM SUPPORTED BY STRONG TOURISM AND CONSTRUCTION ACTIVITY

The system provides wastewater services for approximately 82% of the City and County of Honolulu (general obligation bonds rated Aa1/stable), which encompasses the entire 600 square mile island of Oahu. Honolulu's economy has strengthened somewhat since the beginning of the year and we believe the economy will continue to expand steadily in the near term, supported by a combination of healthy visitor volumes from the US mainland, strong construction activity and employment growth in healthcare, hospitality/leisure and professional services.

Visitor arrivals remain high and hotel occupancy percentages are also near peak levels. The unemployment rate in Honolulu continues to improve: as of March 2015 the City's unemployment rate (3.6%) was still just below the state (3.9%) and although well below the nation (5.6%) that margin has narrowed since last year. Wealth indicators in Honolulu are favorable with median family income at 129.2% of the U.S.

The customer base is diversified with residential accounts representing the largest by type at 94%. However, only 59% of sewer charge revenues came from residential accounts in FY 2014, compared to 71% in fiscal 2011. The change in revenue composition is largely due to the enterprise shifting to monthly base charge resulting in commercial entities providing a higher proportion of sewer service charges.

The ten largest customers accounted for only 6.4% of revenues. Despite the large military presence on the island, nearly all bases provide for their own treatment needs. The system operates nine wastewater treatment plants, the largest of which provides 62 MGD of average daily treatment (compared to 94.5 design capacity) and accounts for about 60% of total system flow. Average daily demand of 105.9 MGD in fiscal 2014 represented a manageable 67% of treatment capacity. The city's flow projections are somewhat conservative and reflect an increase through 2020 reaching about 92% of treatment design capacity. As such, after the city addresses collection system projects through 2020, the CIP will shift toward treatment upgrades to secondary from primary in alignment with the 2010 Consent Decree. Nearly all wastewater effluent is discharged into the ocean and biosolids are managed largely through non-agriculture land application or delivered to the city's H-power waste-to-energy facility.

CONSENT DECREE TO DRIVE LARGE CAPITAL IMPROVEMENT PLAN OVER NEXT QUARTER CENTURY

In late 2010 the city, 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 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. Over the next five years, annual wastewater system capital expenditures are expected to increase gradually totaling approximately $2.0 billion through 2020. As mentioned earlier, collection system projects will be the department's top priority through 2020 with treatment projects, including treatment plant replacements and upgrades making up a greater portion of project costs in later years.

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. A majority of the funding for the next five years will come from additional system revenue bonds, including the current issuances (combined senior and junior lien), as well as system net revenues (26%). As a result, the system's 2014 debt ratio of 57.2% is expected to grow over time, but remain manageable.

Proceeds from the current sale will fund a portion of the construction of a 3-mile gravity sewer tunnel expected to be completed by mid-2018. This project in particular is a result of an amendment to the Consent Decree in March 2012 that substituted a previously approved construction project after the EPA and DOH agreed the change would result in potential environmental benefits.

FINANCIAL OPERATIONS AND POSITION: OPERATIONS REMAIN HEALTHY SUPPORTED BY FORMAL FINANCIAL POLICIES

The system's financial operations are expected to remain sound, supported by proactive management, regular rate increases, as well as debt service and liquidity levels that are guided by formal policies. Senior lien debt service coverage was a solid 3.2 times in fiscal 2013 and revenues increased in 2014 resulting in a similar 3.2 times coverage of senior lien debt service. Total debt service coverage of senior and junior lien debt improved in 2014 to 2.2 times (from 2.1 times). Including reimbursable general obligation bonds and SRF loans, 2014 coverage of all system obligations was 1.9 times. Officials report the system is on track to finish fiscal 2015 above budgeted estimates, including senior lien debt service coverage of 2.7 times, combined senior and junior lien at 1.9 times and coverage of all obligations (including reimbursable general obligation bonds, sate revolving fund loans and USDA bonds) down to 1.6 times.

The city's current conservative forecast calls for senior lien coverage to meet 2.8 times coverage in fiscal 2016, reflective of a 5% rate increase and continuation of the city's focus on expenditure efficiencies which has resulted in nearly no change in expenses over the prior year. Coverage through 2020 is projected to remain slightly below 2.0 times and total coverage is projected to 1.6 times. Including additional issuances over the next five years of between $200 - $300 million we believe coverage levels will decline but still remain above management's coverage policies.

The city was careful to adopt substantial rate increases in advance of substantial borrowing for its long-term capital program, enabling system revenues to keep pace with growing debt service requirements and provide satisfactory overall coverage. 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 city's adoption of substantial multi-year wastewater system rate increases is an important factor in the assigned ratings. After these sizable increases, wastewater rates are above average relative to the rates of other major urban systems on the mainland, although somewhat more affordable relative to household income levels. Positively, management adopted another round of multi-year rate increases of 5% in 2016 and 8% in 2017. Moody's believes that these rate actions represent important achievements in ensuring adequate bondholder security going forward.

Additionally, 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.

Liquidity

The system's liquidity position is strong with 1,162 days cash on hand. Officials project similar levels of liquidity over the near term before reserves decline somewhat around 2020. A relatively small portion of these reserves will be utilized for pay-go financing of capital needs.

DEBT AND OTHER LIABILITIES: ABOVE AVERAGE, BUT STILL MANAGEABLE DEBT RATIO

The system's debt ratio is somewhat elevated at 57.2% and will increase going forward as the system continues to comply with the Consent Decree. Future borrowing projections include annual issuance of between $200 million and $305 million through 2020, although it is likely these are conservative projections. Further, over the next 15 year horizon management intends to utilize an increasing portion of net revenues to fund capital projects.

The Series 2015 transactions will not have a debt service reserve fund requirement. Prior issuances were either secured by a debt service reserve funded at 50% MADS, 100% MADS or no reserve requirement. Although a slight credit weakness, the absence of a debt service reserve requirement is mitigated by the city'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.

Debt Structure

All of the system's debt is fixed rate.

Debt-Related Derivatives

The enterprise is not exposed to derivatives.

Pensions and OPEB

The enterprise system's pension plan is part of the City and County of Honolulu. Honolulu has an average defined-benefit pension burden, based on unfunded liabilities for a multi-employer plan and for its Moody's-estimated share of a cost-sharing plan administered by the state. Reported unfunded liabilities in fiscal 2013 were approximately $1.3 billion, or 60% funded.

Pension costs have pressured the city's budget somewhat in recent years and will likely continue as contributions are budgeted to increase. The city has multiple tools available to address these increased costs, including the legal flexibility to raise revenue or to trim other operating expenses. Reimbursements from the city's self-sufficient enterprises, including the wastewater enterprise totaled $20 million in FY 2013, a somewhat low component of the city's pension liability. Net of these reimbursements, the city's fiscal 2013 contribution was approximately $76.6 million, or 8% of operating revenue.

Moody's fiscal 2013 adjusted net pension liability (ANPL) for the city, under our methodology for adjusting reported pension data, is $2.0 billion (net of self-support), or 2.0 times operating revenues which is high for the rating category. The three-year average of Honolulu's ANPL to Operating Revenues is similar at 2.0 times, while the three-year average of ANPL to full value is average at 1.3%. Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace Honolulu's reported liability information, but to improve comparability with other rated entities.

The city's OPEB liability is sizeable and remains a challenge. As of July 1, 2013 the unfunded OPEB liability was $1.67 billion or 1.6 times fiscal 2014 operating revenues. Together, the city's pension and OPEB liabilities equaled about 1.2% of the city's AV, similar to the city's direct debt burden. Notably, the wastewater enterprise makes up a small component of the city's OPEB liability.

Importantly, in the 2013 legislative session, the state adopted a plan to require phasing in higher annual required contribution (ARC) payments by all counties and the state beginning in fiscal 2015. By fiscal 2019, the payments would reach 100% of the ARC. Honolulu began setting aside amounts to pre-fund its OPEB liability beginning in 2008, and is currently ahead of the required schedule and the 2016 operating budget reflects continued increases in payments which are estimated to equal 79% of its annual OPEB ARC.

Hawaii is the only state that has adopted a plan to fully fund its OPEB ARC payments. While the move is credit positive, it will substantially increase all local government's (including Honolulu) annual fixed costs relative to budget. In fiscal 2013, the city's total payment was $82 million (net of self-support) or about 8% of operating revenue and well above the national median of 1.5%.

By themselves, pension and OPEB costs are above average and will soon grow into a larger portion of the city's budget going forward. In fiscal 2013, pension contributions, debt service and PAYGO costs for OPEB benefits represented 33% of operating expenses.

MANAGEMENT AND GOVERNANCE: FORMAL POLICIES AND CONSERVATIVE BUDGETING

Water and sewer rates are governed by the City and County Council and can be adjusted at any time during the year but generally are approved annually for July 1 implementation. 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.

KEY STATISTICS

Asset Condition (Remaining Useful Life): 45 Years

System Size (O&M in $000s): $155,617

Service Area Wealth (% of US MFI): 129.0%

2014 Senior Lien Annual Debt Service Coverage: 3.2 times

2014 Annual Debt Service Coverage (Total): 1.9 times

Days Cash on Hand: 1,162

Debt to Operating Revenues: 4.75 times

Rate Covenant: 1.2 times senior / 1.1 times combined

Debt Service Reserve Requirement: None

OBLIGOR PROFILE

Honolulu, the capital and principal city of the State of Hawaii was incorporated in 1907 and located on the island of

Oahu. The City and County of Honolulu has an area of 597 square miles and includes the entire island of Oahu. The enterprise system service area is about 82% of the island. As of 2013, Honolulu's population was estimated at 983,429.

LEGAL SECURITY

The senior and junior lien bonds are secured by a first lien and second lien on the net revenues of the city's sewer enterprise.

USE OF PROCEEDS

Proceeds will finance a portion of the system's capital improvement program and refund certain maturities of the system's previously-issued debt for annual debt service savings.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

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