

FITCH RATES HONOLULU, HI WASTEWATER SYSTEM SENIOR REVS 'AA' & JUNIOR REVS 'AA-'; OUTLOOK STABLE

Fitch Ratings-San Francisco-02 August 2016: Fitch Ratings assigns the following ratings to the wastewater system revenue bonds of the City and County of Honolulu, HI (the city):

- Approximately \$213 million (first bond resolution) senior series 2016A 'AA';
- Approximately \$167 million (first bond resolution) senior series 2016B (refunding)'AA';
- Approximately \$17 million (first bond resolution) senior series 2016C (taxable refunding) 'AA';
- Approximately \$25 million (second bond resolution) junior series 2016A (taxable refunding) 'AA-'.

Bond proceeds will be used to fund a portion of the city's wastewater system's (the system) capital plan (senior series 2016A), refund outstanding bonds for level savings and pay costs of issuance. The bonds will not have debt service reserve funds. Bonds are expected to price the week of Aug. 15 via negotiated sale.

Fitch also affirms the following ratings on Honolulu's outstanding wastewater system revenue bonds (a portion of which will be refunded by the series 2016 bonds):

- \$1.39 billion in outstanding senior lien revenue bonds at 'AA';
- \$355.4 million in outstanding junior lien revenue bonds at 'AA-'.

The Rating Outlook is Stable.

SECURITY

Senior lien bonds are secured by a senior lien on net revenues of the system. The junior lien bonds have a subordinate pledge of net revenues.

KEY RATING DRIVERS

STRONG SERVICE AREA ECONOMY: Honolulu provides wastewater service to 82% of the island of Oahu's population and 70% of the revenues are provided by a fixed monthly charge. The system has seen limited impact on revenues or delinquency rates from economic cycles. Strong economic conditions on the island should support continued system capital spending.

ROBUST CASH FLOW: The system has strong financial metrics resulting from rate increases implemented to prepare for substantial capital spending. Cash flow funding for over 30% of the sizable capital plan should continue to provide a sufficient degree of financial flexibility.

ONGOING RATE SUPPORT: Substantial rate increases have occurred to date with broad political and community support, despite high residential rates on a comparative basis. The current rating reflects Fitch's expectation that support for future rate increases necessary to maintain adequate financial margins will continue.

HIGH DEBT; CONTINUED ESCALATION: The system has exceptionally high debt levels, which will continue to escalate over the long-term to comply with required environmental mandates in the federal consent decree.

MANAGEMENT COVERAGE TARGETS: Management expects to maintain debt service coverage on senior revenue bonds of over 2.0x and coverage of all debt over 1.5x, even as annual debt service (ADS) costs escalate. Management's intended adherence to these internal targets is reflected in the ratings.

RATING SENSITIVITIES

REDUCED REVENUE FUNDING FOR CAPITAL: Strong margins are supported by a healthy component of pay-as-you-go funding for the city and county of Honolulu wastewater system's capital plan. This funding is a key driver, given the magnitude and scope of the system's long-term capital needs. Reduced revenue funding of capital that lowers coverage levels below 1.5x all-in coverage would result in rating pressure.

LOWER RATE INCREASES: The ability to sustain political momentum and community tolerance for required additional rate increases are key drivers of the ratings. Rate pressure that impacts the system's financial flexibility could result in lower ratings.

CREDIT PROFILE

The city operates the wastewater system through its Department of Environmental Services. The department provides sewer services to a population of approximately 820,000 people in the city. Approximately 70% of the wastewater system's revenues come from fixed base charges, lending stability to pledged revenues.

Residential customers provide the majority of system revenues. Customer growth has been modest over the past five years, averaging less than 1% annually; this trend is expected to continue. The top 10 users only account for 6% of revenues.

CAPITAL DEMANDS ARE SIGNIFICANT

The federal 2010 consent decree, negotiated with the EPA, outlines a timeline for Honolulu to bring its two wastewater treatment plants (WWTP) up to secondary treatment standards and complete improvements to the aging collection system that were outlined by the previous consent decree and stipulated order. The city has until 2020 to complete remaining work on its collection system.

The city has until 2024 to upgrade the Honouliuli WWTP to secondary treatment and 2035 to upgrade the Sand Island WWTP to secondary. Although a portion of costs related to treatment plant upgrades is included in the estimated \$2.7 billion five year capital improvement plan (CIP) in fiscals 2017-2021, most of the current CIP targets collection system improvements. The estimated cost of bringing both WWTPs into compliance with the 2010 consent decree totals \$1.7 billion, which largely will be funded beyond the current five-year CIP.

REVENUE FUNDING OF CAPITAL; DEBT LEVELS REMAIN VERY HIGH

Debt levels are exceptionally high, reflecting the use of bond funding for much of the heavy capital spending to date. Outstanding debt (all fixed rate) totals \$2 billion, with another approximately \$1.8 billion in revenue bonds anticipated to fund the CIP, including the series 2016A bonds. Debt per customer is projected to climb from \$13,500 currently to over \$23,200 by 2021, compared with Fitch's 'AA' national rating category median for water and wastewater utilities of \$2,308 per customer. Debt to net plant is high at 74% as compared to the 'AA' median of 47%.

A component of capital funding (33%) will come from rate revenue and existing cash balances, which provides an important degree of financial flexibility and cushion for bondholders. The

wastewater system generates \$70-\$125 million annually in revenues to contribute towards capital spending. The system's free cash/depreciation has been over 120% in the past five years, which exceeds Fitch's median for the rating category of 91%. Fitch considers maintenance of the pay-as-you-go portion of capital funding to be a critical component of the system's remaining financial flexibility, particularly given the decreasing financial flexibility dictated by fixed debt service. All-in debt service was 35% of revenues in fiscal 2015 and is expected to increase to 41% by 2021.

STRONG POLITICAL & COMMUNITY SUPPORT FOR NEEDED RATE INCREASES

City council has adopted multiyear rate packages and continued to implement them during years of economic downturn. Fitch views this practice as an indication of Honolulu's available rate flexibility and high level of commitment in addressing its mandated capital improvements.

Double-digit rate increases implemented in fiscals 2005 - 2011 have been followed by more moderate 4-5% annual rate increases in fiscals 2012-2016 and an additional increase of 8% in fiscal 2017. Management expects to design and seek approval on the next six-year rate package prior to fiscal 2018. The last rate package included a full cost of service study.

STRONG COVERAGE MARGINS TO SUPPORT CAPITAL SPENDING

The system's financial position is strong, with senior lien debt service coverage (DSC) near or above 3.0x and total DSC above 1.6x in the past five years. Total DSC includes the department's junior lien bonds, general obligation bonds, and state revolving fund loans. Management financial projections show senior DSC remaining over 2.0x through fiscal 2021 and total DSC on all debt obligations above 1.6x.

The city's formal policy is to maintain DSC of 1.6x on the senior lien bonds and 1.25x on combined senior and junior lien revenue bonds. However, management anticipates, and the rating reflects, maintenance of at least 2.0x DSC on the senior bonds and 1.5x total DSC, as indicated in management's financial projections. This level of coverage enables the system to generate the healthy cash flow that it anticipates needing to fund a portion of the large capital needs.

Liquidity remains a positive credit factor. Unrestricted cash and investments totaled \$766.4 million for fiscal 2015, or over 2,000 days cash on hand. The city's formal policy is to maintain at least three months of operating expenses in reserves, although it is generally in excess of this target. The level of liquidity is likely to come down as the utility increases its capital spending.

Contact:

Primary Analyst
Doug Scott
Managing Director
+1-512-215-3725
Fitch Ratings, Inc.
111 Congress Avenue, Suite 2010
Austin, TX 78701

Secondary Analyst
Shannon Groff
Director
+1-415-732-5628

Committee Chairperson
Dennis Pidherny

Managing Director
+1-212-908-0738

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email:
elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by Bank of America Merrill Lynch (underwriter).

Applicable Criteria

Revenue-Supported Rating Criteria (pub. 16 Jun 2014)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012

U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 03 Sep 2015)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869223

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTP://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](http://fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEBSITE 'WWW.FITCHRATINGS.COM'. PUBLISHED RATINGS, CRITERIA AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE 'CODE OF CONDUCT' SECTION OF THIS SITE. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2016 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable

currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001