



New Issue: MOODY'S ASSIGNS Aa2 RATING AND STABLE OUTLOOK TO HONOLULU WASTEWATER SYSTEM'S SENIOR LIEN REVENUE BONDS

Global Credit Research - 15 Oct 2010

Aa3 JUNIOR LIEN RATING ALSO ASSIGNED

Honolulu (City & County of) HI Sewer Enter.
Water/Sewer
HI

Moody's Rating

ISSUE		RATING
Wastewater System Revenue Bonds (First Bond Resolution) Senior Series 2010, Subseries 2010A Bonds		Aa2
Sale Amount	\$25,915,000	
Expected Sale Date	10/26/10	
Rating Description	Senior Lien Wastewater Revenue Bonds	
Wastewater System Revenue Bonds (First Bond Resolution) Senior Series 2010, Subseries 2010B Build America Bonds (Taxable)		Aa2
Sale Amount	\$177,415,000	
Expected Sale Date	10/26/10	
Rating Description	Senior Lien Wastewater Revenue Bonds	
Wastewater System Revenue Bonds (Second Bond Resolution) Junior Series 2010A		Aa3
Sale Amount	\$102,785,000	
Expected Sale Date	10/26/10	
Rating Description	Junior Lien Wastewater Revenue Bonds	

Opinion

NEW YORK, Oct 15, 2010 -- Moody's Investors Service has assigned a Aa2 rating and stable outlook to the City and County of Honolulu's Wastewater System Revenue Bonds (First Bond Resolution), Senior Subseries 2010A (\$26 million), Senior Subseries 2010B (Taxable BABs) (\$177 million); Moody's has also assigned a Aa3 rating and stable outlook to the Wastewater System Revenue Bonds (Second Bond Resolution), Junior Series 2010A (Tax-Exempt) (\$103 million). At this time, Moody's also affirms the Aa2 rating on the system's approximately \$809.7 million of outstanding senior lien bonds and the Aa3 rating on the system's approximately \$437.3 million of outstanding junior lien bonds. Proceeds from the Senior Subseries 2010A and Senior Subseries 2010B bonds will finance a portion of the system's capital improvement program. Proceeds from the Junior Series 2010A bonds will refund certain maturities of the system's previously issued 1998 bonds for annual debt service savings.

RATINGS RATIONALE

The Aa2 senior lien and Aa3 junior lien ratings are based primarily on sound debt service coverage provided by existing net 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 2009, senior lien coverage declined slightly from the prior year due to increased debt service but remained strong at 3.38 times, while coverage of senior and junior lien bonds combined was a still sound 2.23 times. Including reimbursable general obligation bonds and SRF loans, 2009 coverage of all system obligations was 1.54 times. Unaudited results for fiscal 2010 indicate improved coverage as net revenues benefitted from a combination of prior sewer-charge rate increases and a nearly 8% decline in operating expenses (various legal fees and reduced benefits and materials costs) while annual debt service payments were flat relative to the prior year. The FY10 Unaudited first lien coverage improved to 5.21 times, and coverage of first and second lien bond combined increased to 3.09 times. Coverage of all system obligations also improved to an unaudited 2.23 times (2.16 times net of connection fees). Looking forward through 2015 coverage will decline as senior lien and combined senior and junior lien debt service payments nearly triple. Still, coverage levels are projected to remain at satisfactory levels with senior lien coverage at 1.78 times, combined coverage at 1.41 times and coverage of total obligations at 1.32 times.

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.

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) and current fiscal year 2011 rates were increased 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. Management will adopt another round of rate increases in the third quarter of fiscal 2011; rates are projected to increase 4% annually between fiscal 2012 and 2014 and 5% in 2015. Moody's believes that these rate actions represent important achievements in ensuring adequate bondholder security going forward.

PROPOSED CONSENT DECREE PROVIDES REGULATORY CERTAINTY TO CAPITAL PLAN

The City and County of Honolulu has worked diligently to comply with evolving state and federal regulations on treatment and discharge standards, rehabilitate and expand certain existing facilities and construct new facilities. Significantly, the City and County of Honolulu, the EPA, the state Department of Health (DOH), and several non-profit environmental groups have reached an agreement on a proposed 2010 Consent Decree that would result in the termination of 1995 Consent Decree and the 2007 Stipulated Order and resolve prior lawsuits (2004 and 2006) including City and County appeals. The proposed 2010 Consent Decree has been approved by all parties, lodged with the federal court and the public comment period ended September 15, 2010. The Consent Decree will become effective upon its entry by the federal court. The 2010 Consent Decree is significant in that it provides certainty on outstanding litigation and the department's long term CIP. The proposed 2010 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.

Through fiscal 2020 the City and County is expected to incur \$3.7 billion in capital costs, most of which were already included, planned for, and part of the department's existing CIP. Collection system projects will be the department's top priority through 2020 with treatment projects, including treatment plant replacements and upgrades making up a portion project costs in later years.

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 Aa1/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 6.4% 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. The 2010 Consent Decree, as mentioned above, addresses all of these actions and allegations

and now provides the City and County with some additional clarity and certainty regarding timeline and compliance requirements. 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. Capital expenditures over the 2011-2015 period are estimated to total \$1.42 billion. Approximately \$1.08 billion of funding will come from additional system revenue bonds (combined senior and junior lien). As a result, the system's 2010 pro-forma debt ratio of 66.0% is expected to grow over time, but remain manageable.

HONOLULU'S ECONOMY BEGINS TO RECOVER; UTILITY'S SERVICE AREA REMAINS STABLE

Honolulu's economic recovery is beginning to outpace the nation as construction, house prices and unemployment indicators slowly improve. The tourism industry began to soften in calendar year 2006 and remained relatively stagnant until recent 2010 data suggest year-to-date increases of approximately 6%. Unemployment in Honolulu improved year-to-date to 5.6% (August, 2010) from 6.0% (2009) and remains favorable compared to 6.6% for the state and 9.5% 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.

ADJUSTMENT TO DEBT SERVICE RESERVE REQUIREMENT; LEGAL PROVISIONS BOLSTERED BY ADOPTION OF FORMAL FINANCIAL POLICIES

Moody's notes the Debt Service Reserve (DSR) on the current transactions will be equal to 50% of maximum annual debt service on the senior lien, cash funded. Although a slight credit weakness relative to prior DSR requirements (100% of MADS on both liens, cash funded), this is mitigated by the City and County'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.

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, 2010: 34.2%

Senior lien debt service coverage, 2010 (unaudited): 5.21 times

Combined senior and junior lien debt service coverage, 2010 (unaudited): 3.09 times

Debt service coverage of all system obligations (including G.O. and SRF loans), 2010 (unaudited): 2.23 times

Peak senior lien debt service (2021) coverage by FY 2010 (unaudited) net revenues: 3.16 times (not including future anticipated bond issues)

Peak senior and junior lien debt service (2028) coverage by FY 2010 (unaudited) net revenues: 3.05 times (not including future anticipated bond issues)

Debt ratio, pro-forma 2010: 66.0%

Net working capital as % of gross revenues, 2010, pro-forma: 102.0%

The last rating action for the Honolulu Sewer Enterprise, Hawaii was on September 4, 2009 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. That senior and junior lien ratings were subsequently recalibrated to global scale ratings of Aa2 and Aa3, respectively on May 1, 2010.

The principal methodology used in rating Honolulu (City & County of) HI Sewer Enterprise was Analytical Framework For Water And Sewer System Ratings rating methodology published in August 1999. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found on Moody's website.

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