

RATING ACTION COMMENTARY

# Fitch Rates Honolulu Board of Water Supply, HI Water Revs 'AA+'; Outlook Positive

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Fitch Ratings - San Francisco - 01 Mar 2022: Fitch Ratings has assigned a 'AA+' rating to the following obligations issued by the Honolulu Board of Water Supply, HI (BWS):

--\$75.3 million water system revenue bonds series 2022A (tax-exempt);

--\$54.8 million water system revenue bonds, series 2022B (taxable).

Bond proceeds will be used to fund or reimburse the BWS for certain improvements to the system, refund a portion of BWS' outstanding series 2014A and 2014B (taxable) bonds for interest savings, and pay costs of issuance of the bonds. The bonds are expected to sell via negotiation the week of March 7.

In addition, Fitch has affirmed the 'AA+' rating on the following outstanding obligations (pre-refunding):

--Approximately \$293.3 million water system revenue bonds, series 2012A, 2014A, 2014B (taxable), 2020A, 2020B (taxable), 2021A, and 2021B (taxable).

Fitch has also affirmed BWS's Issuer Default Rating (IDR) of 'AA+'.

The Rating Outlook is Positive.

## **ANALYTICAL CONCLUSION**

The Positive Outlook reflects Fitch's expectations that leverage levels, which historically have been very low, will remain largely consistent with the 'AAA' rating level despite anticipated spending associated with BWS' 30-year water master plan (WMP). Positive rating action could occur within the next couple of years if peak leverage over Fitch's scenario analysis remains around or below 5.0x.

The 'AA+' rating and IDR reflect BWS' leverage in the context of its very strong business profile (revenue defensibility and operating risk), which are both assessed at 'aa'. The strength of BWS' revenue defensibility is rooted in its independent rate-raising ability and very favorable service area demographics. BWS' operating cost burden is very low, and while the life cycle ratio is considered elevated, capital spending has been ramping up in recent years, which should ultimately reduce the age of assets.

BWS' financial profile, assessed at 'aa', reflects currently very low leverage, measured as net adjusted debt to adjusted funds available for debt service, that is expected to rise over Fitch's scenario analysis as BWS continues to implement its WMP, completed in October 2016. For fiscal 2021, the BWS leverage ratio was just 1.7x but it is expected to increase throughout Fitch's scenario analysis and reach nearly 5.0x in the stress case by fiscal 2026.

Impacts from a recent fuel leak from the Navy's Red Hill Bulk Fuel Storage Facility (RHBFSF) are still being evaluated, but BWS has not detected any contamination in its well stations to date and is taking appropriate steps to monitor and mitigate damage. BWS planned in advance for a potential Red Hill contamination event and has been actively monitoring its wells in that area since a 2014 leak. According to the BWS, it has the technical, managerial, and financial expertise to respond to the recent leak and it has thus far not experienced any adverse financial impacts. The BWS is tracking the costs of its actions in response to this incident, but cannot predict the ultimate costs or whether and to what extent it may be reimbursed by the Navy. Fitch's base and stress scenarios do not include any operational or capital spending related to the RHBFSF fuel leak. Such operating and capital costs could be significant and might be borne, at least initially, by BWS. Given actions taken to date and expected future actions of the BWS and federal government, the contamination does not affect the BWS rating or ESG relevance score at this time.

## **CREDIT PROFILE**

BWS provides water service to the entire island of Oahu (city and county of Honolulu) with an estimated residential population of around 975,000. BWS serves approximately 171,300 accounts, over 90% of which are residential, lending stability to the customer base. BWS does not serve the large military installations on the island, since those sites have their own well systems and have permitted pumping amounts from the state.

BWS' water supply is provided by high-quality groundwater aquifers located under the island that require limited treatment. Currently, there is a sustainable yield of 394 million gallons per day (mgd) of available water supply on the island, of which 284 mgd is permitted. BWS's authorized use is 182.6 mgd, which was more than sufficient to meet system sales of 143.4 mgd in fiscal 2021. Water use has been largely flat for the past 10 years given conservation efforts and lower agricultural use, and while the WMP estimates an increase in demand of between 5% and 15% through 2040, it also notes that supplies should be sufficient through at least that period.

### Red Hill Fuel Leak

On Dec. 2, 2021, the U.S. Navy determined that its Red Hill Shaft water source, which is also used by BWS for a portion of its water supply, was contaminated with petroleum due to a Nov. 20 leak from the RHBFSF. As mentioned, BWS has not detected any contamination in its well stations to date. The Navy is in the process of determining the amount of fuel that entered the aquifer, which will determine whether the contamination can be removed. The facility consists of 20 steel-lined underground storage tanks built in the 1940s, which can store up to 250 million gallons of fuel. The tanks are located 100 feet above the groundwater aquifer that the Navy uses to provide water to Pearl Harbor and the BWS also uses to provide water to metropolitan Honolulu.

BWS has increased its testing of five of its well stations located closest to the RHBFSF in response to this incident and indicated it will continue to do so until the situation warrants revising the testing frequency. Further, the BWS's 2018 Long Range Financial Plan (LRFP) developed a scenario for handling a major water source contamination event. In order to prevent any fuel contamination stemming from the December 2021 leak, the BWS shut down the Halawa Shaft pumping station, which delivers 20% of the water delivered to the metropolitan Honolulu water system, and subsequently shut down its Aiea and Halawa Wells. In order to make up for the 20% loss, the BWS is pumping at higher rates from other well stations that also serve metropolitan Honolulu. However, management reports that it is closely monitoring this situation as extended pumping at higher rates can increase water salinity levels and affect both the aquifer and the water pumped. Management further

reports that the situation is stable, but that extended closure of Halawa Shaft could result in mandatory water conservation measures and moratoriums on new water use to prevent the effects of over pumping other well stations.

On Dec. 6, 2021, the Hawaii Department of Health (DOH) issued an Emergency Order (EO) to the Navy to immediately suspend operations, including fuel transfers, at RHBFSF and install a drinking water treatment system at Red Hill Shaft. The order requires that the Navy submit a workplan and implementation schedule within 30 days. The DOH issued a final decision affirming the EO on Jan. 3, 2022; however, the U.S. Department of Justice is challenging the EO in state and federal court.

U.S. Environmental Protection Agency (USEPA) announced on Feb. 4 that it will be conducting an underground storage tank inspection and a Spill Prevention, Control, and Countermeasure (SPCC) and Facility Response Plan (FRP) inspection at Joint Base Pearl Harbor-Hickam the week of Feb. 28, 2022. The focus of the inspections will be on, but not limited to, the underground and aboveground tanks and associated fuel transfer piping, etc.

On Feb. 18, President Biden signed a continuing resolution bill into law that provides \$100 million to the Department of Defense to comply with the DOH order to drain the RHBFSF tanks. The bill provides an additional \$250 million to the military to cover cleanup costs. However, Hawaii's congressional delegation indicated the ultimate cost, and its funding request, will likely be much higher.

After a 27,000-gallon leak of jet fuel in 2014, the Navy entered into an Administrative Order of Consent with the USEPA and DOH to conduct various studies to improve tank inspection, repair, maintenance practices, and understand the condition of the tanks, identify upgrade alternatives, assess the risk of future leaks, determine the area's groundwater flow direction, and remediation of releases. As noted in past reviews, the BWS had repeatedly voiced concerns about the potential of water contamination from the RHBFSF.

## **KEY RATING DRIVERS**

### **Revenue Defensibility 'aa'**

Robust Service Territory, Strong Rate Flexibility

BWS provides an essential service to a large and economically diverse service territory that includes the state capital. Rate flexibility is considered very strong but is slightly lower

when considering wastewater charges for which BWS provides billing service.

### **Operating Risks 'aa'**

Very Low Cost Burden, Elevated Life Cycle to Decline

Operating risk is considered very low given the high quality of groundwater supplies. Asset life is somewhat elevated but should decline as BWS continues to increase capital spending associated with its WMP.

### **Financial Profile 'aa'**

Very Low but Increasing Leverage

BWS' leverage is currently very low but will escalate over the five-year horizon as BWS increases spending related to the WMP. The assessment could improve to 'aaa' within the next couple of years if peak leverage approximates or is below 5.0x in Fitch's scenario analysis. The liquidity profile is very strong, albeit neutral, to the assessment.

### **Asymmetric Additive Risk Considerations**

No asymmetric additive risk considerations affect this rating determination.

### **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Peak and sustained leverage in Fitch's base and stress case that approximates or remains below 5x, provided stability in the revenue defensibility and operating risk assessments.

Factors that could, individually or collectively, lead to negative rating action/downgrade/rating stabilization:

--Sustained leverage in Fitch's base and stress case that approximates or exceeds 7x provided stability in the revenue defensibility and operating risk assessments could lead to a downgrade;

--Sustained leverage in Fitch's base and stress case that exceeds 5.0x provided stability in the revenue defensibility and operating risk assessments could stabilize the rating at the current level;

--Material unanticipated impacts from the Red Hill facility fuel leak that affect the BWS operating risk and/or financial profile assessments.

### **Best/Worst Case Rating Scenario**

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

### **SECURITY**

The bonds are special obligations of BWS payable solely from water system net revenues.

### **Revenue Defensibility**

Revenue defensibility is very strong and assessed at 'aa' with all revenue derived from business lines exhibiting monopolistic characteristics in a service area with demand characteristics and demographic trends deemed to be very favorable. The service area characteristics are very favorable with high income levels and very low historical unemployment.

Customer growth has been essentially flat, with a five-year average CAGR of 0.2%. Area income levels are very high and have consistently been around 140% of the national average. Unemployment has also traditionally been very strong over the last five years at 70% or less the national rate, although unemployment increased significantly as a result of the coronavirus pandemic. Honolulu's unemployment was down to 4.6% in December 2021, but still above the U.S. rate of 3.7%.

While recognizing some cyclicity, Honolulu's economy has demonstrated stability over the long term, with historical ongoing growth in tourism activity despite periodic downturns. The city also benefits from its position as the state capital and business center, in addition to substantial defense-related investments due to its strategic Pacific location.

The board has independent legal ability to increase service rates without external approval and approved a rate package for fiscals 2020 through 2023 intended to support the capital and financing program based off the capital improvement plan (CIP) stemming from the WMP. Rates increased 2% in each of fiscals 2020 and 2021, 4% in fiscal 2022, and will increase an additional 4% in fiscal 2023. BWS is currently conducting a cost-of-service study to establish a five-year rate schedule and expects a slightly higher level of rate increases for fiscal 2024 and beyond.

Currently, monthly user charges equal around \$44 assuming Fitch's standard 7,500 gallons per month of water usage, which Fitch estimates is affordable for over 85% of the population. The level of water charges is very low as a result of the system not having to pay for water supply or expensive treatment processes. However, BWS provides billing services for the city's sewer system, and when water charges are combined with wastewater charges, which are higher, the overall level of affordability for water-related services is slightly lower with about 80% of the population having affordable combined water and sewer bills.

### **Operating Risks**

The operating risk assessment is 'aa', which takes into consideration a very low operating cost burden and an elevated life cycle ratio that is supported by adequate and increasing levels of capital spending. The operating cost burden has historically remained well below Fitch's threshold of \$6,500 per million gallons (mg) of water production for the 'aa' subfactor. The metric is gradually increasing as a result of relatively flat water production and steadily rising costs and stood at \$4,396 per mg in fiscal 2021. Fitch expects unit production cost to remain low for at least the next several years.

The system's life cycle ratio has been above 45% over the last five fiscal years; for fiscal 2021 the life cycle ratio was 47%. However, capital needs have been supported by an increasing level of spending, rising from just 75% of annual depreciation expense to 156% in fiscal 2021. BWS expects to boost spending even further over the next five years, which if achieved, could ultimately lower the life cycle ratio.

Both capital spending and borrowing are set to increase as a result of BWS' LRFP, which reflects priorities included in its 30-year WMP. BWS' fiscal 2022-2026 CIP totals \$951.3 million and focuses on renewal and replacement (R&R) of system assets. The CIP materially increases the pace of pipeline replacement from six miles per year over the last decade to 21 miles per year by fiscal 2028. The CIP also roughly doubles capital spending to around

\$175 million to \$200 million annually from \$90 million-\$100 million in the last two fiscal years.

The LRFPP estimates further increases to approximately \$255 million per year by fiscal 2028 and sustained pipeline replacement investments through fiscal 2047. Over the next five years, management expects to fund approximately \$592.9 million of the CIP from debt sources (approximately 62% of total sources), including the current issuance, while the balance is expected to be derived on a pay-go basis.

## Climate Change Resilience

BWS, in conjunction with the Water Research Foundation, conducted a vulnerability assessment in 2019 relative to climate change and natural disasters. Using the most probable water demand projections through 2040 from the WMP, BWS determined that groundwater supplies would be available even during periods of drought but may be pressured under a high-demand scenario. Including risks associated with climate change, sustainable yield on Oahu would be sufficient to meet projected low-demand but could be pressured in other scenarios. Finally, the assessment found that no groundwater wells, treatment facilities and pump stations were located within the sea level rise exposure areas. However, pipeline exposure to rising sea levels increased from approximately 0.1% at mid-century (1' sea level rise) to around 1% inundation by end of century (3.2' rise).

## Financial Profile

The financial profile is assessed at 'aa'. BWS' leverage ratio was a low 1.7x in fiscal 2021, but increased from 0.5x in the prior year due to an increase in debt and the adjusted net pension liability. The liquidity profile, while robust, is neutral to the assessment. For fiscal 2021, the liquidity cushion ratio equaled 226 days of current cash while coverage of full obligations was 3.0x; Fitch-calculated total debt service coverage for the same period was also 3.0x.

## Fitch Analytical Stress Test (FAST)

The FAST considers the potential trend of key ratios in a base case and a stress case. The stress case is designed to impose a capital cost increase of 10% above expected levels and evaluate potential variability in projected key ratios.

BWS' financial forecast was used to inform the base case, including the implementation of 4% approved rate increases in fiscals 2022 and 2023 and projected revenue increases of



5.0% to 6.0% in each of fiscals 2024 to 2026. It also includes modest spending adjustments -1.0% to 2.5% annually compared to a five-year CAGR of 5.1%. Further, the base case also includes costs related to BWS' \$951.3 million fiscal 2022-2026 CIP along with projected \$592.9 million in debt funding, including the current issuance. However, CIP actual spending has come in at around 70% or less of projections over the last five years. Fitch also assumed receipt of \$9.3 million in annual water system facility charges (WSFCs), equal to the five-year average.

Under the base case, leverage ascends annually throughout the scenario, reaching 4.1x by fiscal 2026. The stress case demonstrates similar results, with leverage rising to around 4.7x by fiscal 2026. The scenarios do not include any operational or capital spending related to the RHBFSF fuel leak. The scenarios support the current rating although the assessment may be changed to 'aaa' over the next couple of years if expectations for leverage in Fitch's scenario analysis generally remain below 5.0x.

### **Sources of Information**

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

### **REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING**

The principal sources of information used in the analysis are described in the Applicable Criteria.

### **ESG Considerations**

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit

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### **RATING ACTIONS**

ENTITY / DEBT ↕	RATING ↕	PRIOR ↕
Honolulu Board of Water Supply (HI)	LT IDR    AA+ Rating Outlook Positive Affirmed	AA+ Rating Outlook Positive
Honolulu Board of Water Supply (HI) /Water Revenues/1 LT	LT    AA+ Rating Outlook Positive Affirmed	AA+ Rating Outlook Positive

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**APPLICABLE CRITERIA**

[U.S. Water and Sewer Rating Criteria \(pub. 18 Mar 2021\) \(including rating assumption sensitivity\)](#)

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 01 Sep 2021\) \(including rating assumption sensitivity\)](#)

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