

FITCH AFFIRMS HONOLULU BD OF WATER SUPPLY, HI WATER REVS AT 'AA+'; OUTLOOK STABLE

Fitch Ratings-Austin-03 November 2016: Fitch Ratings has affirmed its 'AA+' rating on the following bonds issued by the Board of Water Supply City and County of Honolulu, HI (BWS):

--Approximately \$225 million water system revenue bonds, series 2012A, 2014A and 2014B (taxable).

The Rating Outlook is Stable.

SECURITY

The bonds are secured by net revenues of BWS's water system.

KEY RATING DRIVERS

STRONG FINANCIAL POSITION: Financial performance and liquidity are strong. Revenue growth has outpaced expenditures in recent years, driven by annual rate adjustments. Margins are expected to remain robust over the next several years.

AMPLE, HIGH-QUALITY SUPPLY: The system has sufficient groundwater rights to meet its anticipated needs with limited treatment costs and no regulatory issues at present.

RELATIVELY HIGH COMBINED BILL: Annual rate increases will fund almost 100% of the capital program from revenues. While water rates are moderate, the combined bill with higher sewer charges may limit future rate flexibility.

ELEVATED INFRASTRUCTURE AGE: System infrastructure is relatively old compared to other utilities, although operating metrics appear sound. Current investment remains well below annual depreciation but capital spending is expected to accelerate.

STABLE SERVICE AREA: BWS provides water service to the entire island of Oahu. Residential customers provide around 60% of revenues.

RATING SENSITIVITIES

SHIFTS IN FINANCIAL MARGINS: The rating is sensitive to shifts in fundamental credit characteristics, including the strong debt service coverage and liquidity.

GROUNDWATER CONTAMINATION: Contamination of aquifers that threatens the Board of Water Supply's drinking water supplies and leads to significant increases in capital and/or operating costs, particularly resulting from the Navy's Red Hill bulk fuel storage facility (RHBFSF) leaks, could negatively affect credit quality.

CREDIT PROFILE

BWS provides water service to the entire island of Oahu (city and county of Honolulu) with an estimated residential population of around 1 million. BWS serves approximately 174,000 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 permitted pumping amounts from the state. User concentration is moderate, with the top 10 historically making up less than 20% of water revenues. However, the top three users are governmental entities, which help mitigate concentration risk. The largest private user accounts for only 1% of revenues.

STRONG FINANCIAL PERFORMANCE

Financial performance has been strong, with debt service coverage (DSC) of revenue bonds averaging over 4.0x for the past five years. DSC in fiscal 2015 was 6.0x and all-in DSC (including the system's subordinate state revolving fund [SRF] loans) was 5.1x, including connection fee revenues. BWS's financial forecast through fiscal 2020 projects DSC of revenue bonds to remain over 4.5x, which exceeds BWS's own policy target of 1.6x. Total DSC is forecasted to remain above 3.5x.

Liquidity for fiscal 2015 was very high at 666 days cash. Cash balances have climbed steadily in recent years as revenue adjustments from annual rate hikes have outpaced expected increases in operating and capital expenditures. With capital costs rising, cash reserves may be drawn down somewhat over the next several years but should remain robust.

AMPLE HIGH-QUALITY WATER SUPPLY BUT CONTAMINATION CONCERNS

Water supply is provided from groundwater. The groundwater supply is high quality and requires very limited treatment, resulting in a low-cost supply. The water supply is provided by aquifers located under the island, the largest of which is the Pearl Harbor aquifer. Currently, there is a sustainable yield of 407 million gallons per day (mgd) available water supply on the island, of which 294 mgd is permitted. BWS's authorized use is 182.6 mgd, which is sufficient to meet system sales of 142 mgd. Although excess capacity exists, water use has been largely flat for the past 10 years, given conservation efforts and lower agricultural use. Unaccounted-for system water loss is modest at 8%.

In January 2014, one of the fuel tanks at the U.S. Navy's RHBFSF leaked an estimated 27,000 gallons of jet fuel into the aquifer that provides around 25% of the drinking water to metro Honolulu. To date, no contamination has been detected at any of BWS's drinking water wells, although contamination has occurred at one of BWS's monitoring wells. The Navy, along with the Department of Defense's logistics agency, entered into an administrative order of consent with state and federal regulators in 2015 to upgrade the fuel tanks and take steps to address the fuel releases, among other items. BWS is working closely with regulators and the Navy to ensure drinking water supplies are protected. In the event contamination from the RHBFSF spill were to occur at one of BWS's potable wells, BWS has the capacity to meet customer demands from other supply sources on an interim basis, although over the long-term, remediation of the aquifer would be required. Such operating and capital costs could be significant and might be borne, at least initially, by BWS.

INCREASED CAPITAL SPENDING NEEDED

BWS's fiscal 2016-2020 capital improvement program (CIP) totals \$442 million and focuses predominantly on renewal and replacement (R&R) of system assets. The CIP is currently expected to be funded almost entirely from surplus revenues and available reserves, with a small amount (up to \$10 million) in additional SRF loans possible.

Honolulu has an older system, as evidenced by its average age of plant of 20 years, compared to Fitch's median for the 'AA' category of 14 years. Nevertheless, operations appear sound and non-revenue water is relatively low, measuring just 8% for fiscal 2015. The CIP reflects a ramp-up in capital spending to at or around \$80 million annually, as compared to the \$20 million-\$30 million in annual spending since fiscal 2011, which, if sustained, would outpace annual depreciation and

help to address the system's aging infrastructure. However, BWS has been forecasting an intended ramp-up in capital spending during the past few years as well.

BWS recently completed a 30-year water master plan (WMP) and will be revising its CIP estimates over the course of the next year based on the priorities targeted in the WMP. Projected capital expenditures could increase depending on the pace of R&R approved in the revised CIP by the Board of Directors (the board). The level of CIP debt funding could also change at that time. Currently, BWS's debt metrics are relatively low compared to similarly-rated utilities. Fiscal 2015 debt per customer was \$1,865 and debt-to-net plant was a modest 29% compared to Fitch's 'AA' respective medians of \$2,050 and 44%. BWS's debt amortization is relatively quick with 90% repaid in the next 20 years.

RATE FLEXIBILITY DESPITE HIGH COMBINED RATES

In December 2011, the board adopted a five-year package of rate increases that raised rates 9.65% annually through fiscal 2016. All five increases have been implemented; no additional increase was enacted for fiscal 2017. The rate package was adopted to fund increases in operating expenditures and generate up to \$40 million-\$50 million annual cash flow in the later years to support planned capital spending. BWS expects to design its next rate package by the end of calendar 2017 and present it to the board for implementation during fiscal 2018. The expected rate package will support a capital and financing program based off the CIP stemming from the WMP.

Water rates are competitive with other utility systems, even following the most recent rate increases, primarily as a result of the system not having to pay for water supply or expensive treatment processes. However, the combined bill reflects high wastewater charges and is slightly above Fitch's affordability threshold at approximately \$140 per month or 2.1% of median household income. While rates above the affordability threshold can indicate rate sensitivity in the service area, BWS has demonstrated a consistent approach of implementing annual rate increases to fund needed capital investment.

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
Kathy Masterson
Senior Director
+1-512-215-3730

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

Applicable Criteria

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

<https://www.fitchratings.com/site/re/750012>

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

<https://www.fitchratings.com/site/re/869223>

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT 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