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

Fitch Ratings-San Francisco-01 November 2018: Fitch Ratings has affirmed the 'AA+-' rating on the following bonds issued by the Board of Water Supply City and County of Honolulu, HI (BWS):

--Approximately $214.8 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 through fiscal 2016. Margins are expected to remain robust over the next several years with adopted rate increases in fiscals 2020 through 2023.

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. Although there is some concern about potential contamination of aquifers serving BWS's service area resulting from leaks at the Navy's Red Hill bulk fuel storage facility (RHBFSF), none have been detected at any of BWS's drinking water wells to date.

RELATIVELY HIGH COMBINED BILL: An approved five-year rate package will fund about 75% of the five-year capital program from revenues. While water rates are moderate, the combined bill with high sewer charges is slightly above Fitch's affordability threshold and may limit future rate flexibility.

CAPITAL INVESTMENT TO INCREASE: System infrastructure is relatively old compared with other utilities, although operating metrics appear sound. The fiscal 2019-2023 CIP ramps up spending in part to accelerate replacement of ageing pipelines. BWS will increase its debt by about 70% over the next five years with the planned borrowing of $200 million, increasing currently low debt levels to moderate levels. In addition, it anticipates considerable borrowing beyond the five-year horizon.

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

RATING SENSITIVITIES

MATERIAL ESCALACTION IN LEVERAGE: Given the projected long-term ramp up in capital spending and borrowing over the five-year horizon and beyond indicated by the Board of Water Supply's long range financial plan, the debt profile of the system could ultimately become pressured.

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 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 170,000 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 about 18% of water revenues. However, the top three users are governmental entities, which helps 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 at least 6.0x for the past three years. Revenue bond DSC in fiscal 2017 was 6.1x and all-in DSC (including the system's subordinate state revolving fund [SRF] loans) was 5.2x, including connection fee revenues. The BWS budget indicates revenue bond DSC at 4.3x in fiscal 2018; however, this is likely conservative as management indicated operating expenditures are likely to come in lower as the board budgeted fully for all vacant positions. The financial forecast projects DSC of revenue bonds to remain over 5.0x through fiscal 2021 before declining to 3.9x in fiscal 2022 as debt service payments from additional planned borrowing rolls on. Total DSC is forecasted to remain above 3.1x through fiscal 2022, which exceeds BWS's policy target of 1.6x.

Liquidity has increased over the last five years to a very high 963 days cash on hand ($92 million unrestricted and $269 million restricted but available) at fiscal year-end 2017. 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.

INCREASED CAPITAL SPENDING; DEBT

Both capital spending and borrowing are set to increase upon BWS's recent completion of its Long Range Financial Plan, which reflects priorities included in its 30-year water master plan (WMP) completed in October 2016. BWS's fiscal 2019-2023 capital improvement program (CIP) increased significantly to about $762 million from $442 million for the 2016-2020 CIP and focuses on renewal and replacement (R&R) of system assets. Notably, the CIP materially increases the pace of pipeline replacement from six miles per year over about the last decade to 21 miles per year over a 10-year period. The CIP reflects a near doubling of capital spending to around $150 million annually from $80 million in recently years. The LRFP estimates further increases to approximately $255 million per year by fiscal 2028 and sustained pipeline replacement investments through fiscal 2047. Management expects to issue approximately $200 million in revenue bonds (approximately 25% of CIP) to fund capital spending through fiscal 2023, with pay-go comprising the balance. Further, the LRFP indicates annual debt issuance of $105 million-$206 million from fiscal 2024 to 2028. Currently, BWS's debt metrics are relatively low and expected to remain moderate even with the expected $200 million additional debt. Fiscal 2017 debt to net plant of 28% and debt to funds available for debt service of 2.8x are low compared with overall medians of 41% and 5.7x, respectively. Debt per customer of $1,866 will remain in line with medians at about $2,286 through the forecast period. BWS's debt amortization is relatively rapid with all principal repaid within 20 years. However, given the additional level of expected borrowing after fiscal 2023, debt and leverage metrics may be pressured beyond the five-year horizon.

Honolulu's average age of plant of 21 years, compared with Fitch's median for the 'AA' category of 15 years, indicating aging infrastructure. Nevertheless, operations appear sound and non-revenue water is relatively low, measuring just 7.4% for fiscal 2017. Free cash to depreciation has been above 100% for the past four years.

RATE FLEXIBILITY DESPITE HIGH COMBINED RATES
The board recently adopted a five-year rate plan through fiscal 2023. The rate package is intended to support a capital and financing program based off the CIP stemming from the WMP. Rates remained flat in fiscals 2017-2019 and will increase approximately 2.4% in fiscal 2020, 3.2% in fiscal 2021, 6.1% in fiscal 2022 and 5.2% in fiscal 2023 (calculated based on 7,500 gallons usage per month). In December 2011, the board adopted a five-year package of rate increases that raised rates 9.65% annually through fiscal 2016.

Water rates are relatively low at approximately $42.41/month or 0.63% of MHI, given 7,500 gallons of usage 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 2% of MHI affordability threshold at approximately $148 per month or 2.2% of median household income. In addition, this will rise given expected water and wastewater rates hikes over at least the next several years. 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.

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 136.5 mgd in fiscal 2017. Although excess capacity exists, water use has been largely flat for the past 10 years, given conservation efforts and lower agricultural use. The WMP estimates an increase in demand of between 5% and 15% through 2040 and notes sufficient supply through at least that period.

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 some of the monitoring wells located on Navy property. 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. The Navy is reportedly considering several solutions that will need to be submitted to regulatory agencies. 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.

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

A January 2018 district court ruling that dismissed claims regarding payment of Puerto Rico Highways and Transportation Authority debt has raised questions about the scope of protections provided by Chapter 9 of the U.S. bankruptcy code to bonds secured by pledged special revenues. Fitch's rating criteria treat special revenue obligations as independent from the related municipality's general credit quality. The outcome of the litigation could result in modifications to Fitch's approach. For more information, see "What Investors Want to Know: The Impact of the Puerto Rico Ruling on Special Revenue Debt" available at www.fitchratings.com.

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Applicable Criteria
Rating Criteria for Public-Sector, Revenue-Supported Debt (pub. 26 Feb 2018)
https://www.fitchratings.com/site/re/10020113
U.S. Water and Sewer Rating Criteria (pub. 30 Nov 2017)
https://www.fitchratings.com/site/re/10010508