S&P Global
Ratings

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Summary:

Honolulu Board of Water Supply, Hawaii; Water/Sewer

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US$83.8 mil wtr sys rev bnds (taxable) ser 2020B due 07/01/2033		
Long Term Rating	AAA/Stable	New
US$50.45 mil wtr sys rev bnds (tax-exempt) ser 2020A due 07/01/2049		
Long Term Rating	AAA/Stable	New

Rationale

S&P Global Ratings assigned its 'AAA' long-term rating to Board of Water Supply City and County of Honolulu, Hawaii's series 2020A and 2020B bonds. The outlook is stable.

The rating reflects our view of the board's extremely strong enterprise and financial risk profiles. The Board of Water Supply (BWS) serves customers in the broad and diverse Urban Honolulu service area economy, which has very strong income indicators and very low unemployment. Given that the current water bill is only 0.9% of median household effective buying income (MHHEBI), we do not believe planned rate increases through 2023 will pressure affordability above the sector standard. In our opinion, environmental risks for the island are above the sector standard. Climate change risks include sea level rise, changes in precipitation, and a change in demand. However, we believe management has identified operational and financial risks through a recent climate change report and stress scenarios performed in the board's long-range financial plan. Importantly, we believe management has a prudent plan in place to address enterprise-specific risks and has financial cushion to implement the needed rate increases to prepare the system for contingencies. We view positively management's proactive stance in identifying these potential risks, diversifying long-term water supply, and performing vulnerability assessments to identify capital needs to ensure redundancy.

The estimated par amount for the series 2020A is $50.4 million. The proceeds from the series 2020A will be used to fund certain improvements to and extensions of the water system. The estimated par amount for the series 2020B is $83.8 million, and proceeds will be used to refund certain outstanding water system revenue bonds. As of Dec. 31, 2019, the board had about $197 million of outstanding series 2012A, 2014A, and 2014B bonds. In addition, as of the same date, the board had about $84.6 million outstanding of State Revolving Fund loans and $916,000 in notes payable to other lenders. The BWS has no outstanding private or direct placement debt.

The enterprise risk profile reflects our view of BWS':

- Service area in the broad and diverse Urban Honolulu service area economy with very strong income indicators;
- Affordable water system rates given the low county poverty rate and very strong income metrics; and

- Strong operational management assessment, reflected by a robust asset management program, sufficient high-quality groundwater supply, a focus on climate change, watershed management, and diversifying water supply to continue to meet customer demand.

The financial risk profile reflects our view of BWS':

- Extremely strong all-in coverage metrics during the past five years at 4.0x in fiscal 2019, which we expect to decline to about 2.4x, still considered extremely strong, as BWS issues additional debt annually to support 50% of its capital plan from bonds and loans;
- Extremely strong unrestricted cash and investments at about $411 million, equivalent to 950 days of operating expenses for fiscal 2019;
- Large but manageable capital plan at about $757 million during the next five years, with a low debt-to-capitalization ratio of about 22% that we expect to rise given future debt plans; and
- Strong financial management assessment, reflect by robust and transparent financial policies and long-range financial planning that incorporates sensitivity analyses for conservation, growth, natural disaster, water source contamination, climate change, and economic cycles.

The system has a predominantly locally derived revenue base. Local service charges, derived through an autonomous rate-setting process, represent virtually all of the system's revenue. This, coupled with operating expense flexibility, limits exposure to federal revenue.

Net revenue of the water system secures the series 2020A and 2020B bonds. Contributions in-aid-of construction, impact and other similar fees, gifts, and grants do not secure the bonds. BWS has set a rate covenant at the greater of (i) the sum of the aggregate debt service in such fiscal year plus deposits to any debt service reserve fund or (ii) 1.20x maximum aggregate debt service. The additional bonds test is set at 1.2x maximum annual debt service on outstanding and proposed bonds. Furthermore, the series 2020A and 2020B bonds will not have a debt service reserve; however, we view this to be credit neutral given BWS' extremely strong cash position.

Enterprise risk

BWS serves a population of 980,080, or approximately 93% of Oahu's population (excluding military). The service area is anchored by the state capital, which provides over 73,000 jobs, and the military (102,000 jobs); Hawaii-based United States Indo-Pacific Command is responsible for over 50% of global command activity. While tourism is an important sector of the city and county as well as state economies, we believe Honolulu has significant economic diversity, with employment opportunities in finance, higher education, health care, military, tourism, and construction. Honolulu has very strong income indicators at about 127% of the national average. The unemployment rate continues to track below both the state and the national rates, and for December 2019 was 2.1%, compared with the state's 2.3% and nation's 3.4% rates for the same respective time. About 80% of Honolulu consists of permanent homes, and 92.8% of the 170,329 water accounts are residential, providing additional stability to BWS' revenue stream, economic trends and supporting our view that the economy is not driven by the visitor industry. In our opinion, the 10 largest customers are diverse, representing less than 20% of total water sales in 2019, with the leading customer representing only 6.1% of total water sales. The leading three customers are the state of Hawaii, the city and county of Honolulu, and the U.S. government, all of which provide additional stability.

In our opinion, water system rates are affordable given the low county poverty rate and the very strong income indicators. BWS bills its customers monthly, and residential customers are billed under an inverted block rate structure in which the quantity charge per 1,000 gallons increases as consumption moves through each of three usage blocks. Based on BWS' typical residential monthly water usage of 9,000 gallons per month, rates are only 0.9% of Honolulu's MHHEBI, which we consider very affordable and allowing rate revenue-raising flexibility. The county's poverty rate, according to the U.S. Department of Agriculture, is about 8.8%, which we view as low. BWS completed a cost-of-service study in July of 2017 and a long-range financial plan in 2018. After analyzing the cost-of-service study and future capital needs, the board approved the following rate increases annually: 2% (2020-2021) and 4% (2022-2024). The district plans to have another cost-of-service study performed in 2023 and preapprove another multiyear rate increase. After the rate increases, we expect the typical residential bill to rise to about 1.1% of MHHEBI, which we still believe is affordable and allows for future revenue-raising flexibility.

Based on our operational management assessment, we view BWS to be a '1' on a six-point scale with '1' being the strongest. The board has sufficient high-quality groundwater to meet long-term demand and is in the process of diversifying and securing additional raw water to support the potential increase in demand, conservation, climate change, or contamination. In 2019, the sustainable yield, as established by the State Commission on Water Resource Management was revised from 407 million gallons per day (mgd) to 394 mgd, which is sufficient given BWS' average daily production of 136 mgd in 2019. Based on the most probable water demand projections through 2040 noted in the water master plan, groundwater supplies would be available even during drought conditions. However, given the risk associated with climate change, high-demand growth, and a decrease in sustainable yields, BWS plans to diversify water supply through increased recycled water, desalination, new wells, and additional storage, which we view favorably.

BWS is in compliance with all environmental regulations and is taking steps to monitor potential water contamination and compliance with potential changes to the Environmental Protection Agencies (EPA) lead and copper rule. In 2014, about 27,000 gallons of jet fuel leaked from several small holes in an underground storage tank at the U.S. Navy's Red Hill Bulk Fuel Storage Facility. BWS found no signs of contamination in water wells at nearby Halawa Shaft and Moanalua wells, which provide about 25% of the service area's drinking water. The BWS continues to monitor the situation and will take action as appropriate. In addition, the EPA is proposing several revisions to the Lead and Copper Rule that are expected to cause changes to the BWS' capital plan. The BWS will be conducting a study to prepare a Lead Service Lines (LSL) inventory and LSL replacement plan, as well as testing residential and commercial properties including schools and day care facilities to determine the impact of the proposed rule changes. Based on preliminary estimates, about 5% the system's service laterals are unknown materials and about 2% galvanized material service laterals. In our opinion, management is proactively assessing the situation and would make necessary improvements to comply with contamination or more stringent lead and copper rules.

Financial risk

In our opinion, BWS' financials are extremely strong despite planned additional debt and pay-go for capital needs; we expect financials to stay extremely strong. In fiscal 2019, all-in coverage was about 3.7x, which we consider extremely strong. During the past five fiscal years, all-in coverage has remained above 2.5x as the district layered on loan obligations. All-in coverage rose in fiscal 2019 due to the retirement of nearly $25 million of loan obligations. Based on our analysis of management-provided projections, which include rate increases through 2023, a pipeline replacement ramp up to 1% in 10 years, and an operations and maintenance escalation of 3.5%, we expect all-in coverage to remain extremely strong. The projections include about $300 million of bond proceeds and $53 million of loan obligations during the next five years. Based on projections, we expect all-in coverage in fiscal 2024 to be above 2.0x, with a zero percent rate increase assumed in 2024. We understand management plans to have another cost-of-service study performed in 2023, and that management will increase rates as needed to maintain coverage metrics in line with extremely strong historical performance.

BWS' unrestricted cash and investments are extremely strong, and we expect unrestricted cash will remain extremely strong even with the planned pay-go. Based on audited fiscal 2019 financials, total cash was $411 million, equivalent to about 950 days of operating expenses. Total cash has risen since 2015 at about $252 million, equivalent to 600 days of operating expenses. The rise in total cash was driven by a 9.65% rate increase in 2015 and 2016. Management plans to spend between $78 million and $142 million from total cash annually on capital improvements. Despite the planned spend down, we expect unrestricted cash to stay above about $80 million, equivalent to about 180 days of operating expenses. BWS has a planning target of maintaining a working capital reserve of 180 days of operating expenses, which is above the indenture requirements of 45 days of operating expenses. We view positively management's decision to fund its capital plan with 50% debt and 50% cash because management has planned for this by substantially building up cash during the past five years with a plan to use a portion for capital needs.

BWS' debt-to-capitalization ratio is low at about 22%, and the capital plan is large but manageable. BWS' capital improvement plan is about $840 million for 2020-2024, compared to only $278 million of outstanding debt obligations, and BWS plans to fund the capital plan with 50% debt and 50% unrestricted cash and revenue from rate increases. The majority of the capital plan is driven by projects related to potable water projects, new water sources, storage, transmission, and treatment. In addition, about 3% of the capital plan will be used to fund recycled-water projects. The board has a debt-to-asset target at about 50%, and we are using a forward-looking analysis to incorporate the planned future debt obligations. We expect our calculation of debt-to-capitalization ratio to rise during the next five years to a level we consider moderate, but not enough to pressure the rating level.

The district participates in the Retirement System of the State. As of June 30, 2018, the plan was underfunded at about 55%. The district's assumed rate of return at 7% is above our S&P Global Ratings guideline of 6.5%; however, given the district's financial strength, we believe the district would be able to take on higher risk of possible increased annual costs. Although the district has made its full actuarially recommended plan contributions, total plan contributions made last year fell short of not only minimum funding progress but static funding as well. In our opinion, funding contributions need to be increased in order to materially improve funding status. The district's contributions increasing on a level of 3.5% of payroll could increase costs in the future even beyond the expectation if employment growth does not materialize at the same assumed rate.

Based on our financial management assessment, we view BWS to be a '1' on a six-point scale with '1' being the strongest. A score of a strong reflects management's robust financial and capital planning. The board has a 30-year capital plan updated every 10 years, a 10-year capital plan updated every three to five years, and a six-year capital plan updated annually. Additionally, the board annually updates its long-range financial plan and presents budget-to-actuals to the board quarterly. The board has formal investment, liquidity, and debt management policies that are transparent and robust. Furthermore, the board complies with the generally accepted accounting principles and discloses financial plans on BWS' website.

Outlook

The stable outlook reflects the stable, strong, and diverse service area economy that BWS serves. Additionally, the stable outlook reflects our expectation that management will have another cost-of-service study performed and will increase rates as needed to sustain financial metrics in line with historical trends. Further supporting the stable outlook is management's proactive and forward-looking annual updates to financial and capital planning. The outlook includes our forward-looking assessment of BWS' rate affordability, incorporating planned rate increases, in addition to the future planned debt in our financial assessment.

Downside scenario

We could lower the rating if the board's pension funding plans put pressure on the board's financial metrics, if rates are pressured, or if there is a significant increase in the board's environmental liability or capital costs from current expectations. In addition, we could lower the rating if economic disruptions or climate change result in a protracted decline in water sales, although we do not anticipate this occurring over the two-year outlook period.