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Ratings

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Summary:

Honolulu Board of Water Supply, Hawaii; Water/Sewer

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Credit Profile		
US$95.815 mil wtr sys rev bnds ser 2021B due 07/01/2033		
Long Term Rating	AAA/Stable	New
US$47.005 mil wtr sys rev bnds ser 2021A due 07/01/2049		
Long Term Rating	AAA/Stable	New
Honolulu Brd of Wtr Supp wtr sys rev bnds (taxable)		
Long Term Rating	AAA/Stable	Affirmed
Honolulu Brd of Wtr Supp wtr sys rev bnds (tax-exempt)		
Long Term Rating	AAA/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AAA' long-term rating to Board of Water Supply (BWS) City and County of Honolulu, Hawaii's series 2021A and 2021B bonds. At the same time, S&P Global Ratings affirmed its 'AAA' long-term rating on the board's outstanding water system revenue bonds. The outlook is stable.

The estimated par amount for the series 2021A is $47.0 million, with proceeds funding certain improvements to and extensions of the water system. The estimated par amount for the series 2021B is $95.8 million, and proceeds will be used to refund certain outstanding water system revenue bonds. As of Dec. 31, 2020, the board had about $250 million of outstanding principal on the series 2012A, 2014A, 2014B, 2020A, and 2020B bonds. In addition, as of the same date, the board had about $110 million outstanding principal on State Revolving Fund loans. The BWS has no outstanding private or direct placement debt.

Net revenue of the water system secures the series 2021A and 2021B 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 2021A and 2021B bonds will not have a debt service reserve; however, we view this to be credit neutral given BWS' extremely strong cash position.

Credit overview

The BWS serves customers in the broad and diverse Urban Honolulu service area economy. As an island economy, Honolulu is inherently vulnerable to negative effects of certain types of exogenous shock events and has above-average exposure to the tourism industry, resulting in a higher degree of economic pressures stemming from the global COVID-19 pandemic. The effect of the pandemic has had a far greater impact on the underlying economy than past shocks and economic downturns. However, the Honolulu economy has continued to diversify, with 84% of economic activity in nontourism sectors, compared with 67% in 1988. The service area also includes stabilizing institutions such as the state government and federal military, as well as financial, higher education, construction, and health care sectors, which has contributed to relative resiliency during past downturns. Despite past resiliency to shocks such as the Sept. 11 terrorist attacks and the SARS epidemic, the economic impact of the COVID-19 pandemic has been significant throughout Hawaii: Unemployment in Honolulu City and County spiked to 20.8% in April 2020, and visitor arrival for December 2020 dropped 75.2% compared to a year ago, resulting in lower tourism and related economic activity. However, Honolulu County's unemployment has begun to recover at a faster pace than both the state's and neighboring counties', improving to 9.1% for preliminary November 2020.

Although the COVID-19 pandemic has had a significant impact on the underlying economy, the overall financial impact on BWS has been modest. Revenue fell approximately 1.6% between June fiscal year-end 2018 and fiscal 2019, and rose 1.0% from fiscal 2019 to fiscal 2020, given the primarily residential customer base representing 62% of revenue in 2020 and stability of the leading customers. Commercial and industrial customers made up about 38% of fiscal 2020 revenues; however, we do not believe this to be a credit risk given the increase in residential demand has offset the majority of any declines from commercial customers. For the first half of fiscal 2021, nonresidential revenue decreased by 9% but was offset by a 10% increase in residential revenue which resulted in a 3% increase in revenue for the first half of fiscal 2021 compared to fiscal 2020. We understand BWS is restricting expenses to 10% of nondiscretionary budget items to ensure financial stability, which we view favorably. Unrestricted cash and investments at the end of fiscal 2020 were about $446 million, equivalent to 977 days of operating expenses, which we believe to be a sufficient cushion for short-term disruptions.

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.

The enterprise risk profile further reflects our view of BWS':

- Affordable water system rates with a typical monthly bill at just over 1% of median household effective buying income (MHHEBI), when assuming typical monthly water use of 9,000 gallons, 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 4x in fiscal 2020, which we expect to decline to about 2x, 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 $446 million, equivalent to 977 days of operating expenses for fiscal 2020, that we expect to decrease given 50% of the capital plan is pay-go, but we do not expect this figure to drop below an extremely strong figure, with over $300 million and above 600 days of operating expenses;
- Large but manageable capital plan at about $924 million during the next five years, with a low debt-to-capitalization

ratio of about 25% that we expect to rise given future debt plans; and

- Strong financial management assessment, reflect by formalized, investment, liquidity and debt management policies, 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 stable outlook reflects BWS' strong financial position, which we believe can sustain near-term financial impacts related to the pandemic, the diverse economy with stabilizing government institutions and the primarily residential customer base. 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 are management's proactive and forward-looking annual updates to financial and capital planning.

Environmental, social, and governance factors

In our opinion, environmental risks for the island are above the sector standard. Climate change risks include sea level rise, as well as fluctuation in precipitation or demand. However, we believe management has identified and begun to mitigate operational and financial risks through its climate change report and stress scenarios performed in the board's long-range financial plan. Management has identified 0.1% of coastal pipeline it expects will be inundated at high tide by mid-century from one foot of sea level rise and 1.0% by 2100 or sooner. BWS has adopted "One Water," an integrated collaboration among neighboring agencies to address these issues. Current groundwater production is approximately 75% of BWS' permitted use and 35% of the islandwide sustainable yield. BWS is looking at alternative water supplies including groundwater, surface water, recycled and brackish nonpotable water, and desalination. BWS plans to build a desalination plant as a public-private partnership and plans to send out requests for proposal this year. Future capital costs are incorporated in the long-range financial plan. We view this as a credit positive as BWS plans to diversify its long-term water supply reliability.

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 Agency's lead and copper rule. 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.

Regarding social risk, the delinquency rate has increased to 11% and the balance of past due accounts by 44%, representing that rates have become less affordable to a portion of the customer base due to the pandemic. BWS assists customers by establishing a payment plan and referring customers with financial hardship to financial support programs such as Aloha United Way and other charitable organizations. S&P Global Ratings broadly believes that high uncertainty remains about the evolution of the pandemic. While the approval and early administration of a number of vaccines is a positive development, it is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by mid-2021. We use this assumption in assessing the economic and credit implications associated with the pandemic. As the situation evolves, we will update our assumptions and estimates accordingly.

Stable Outlook

Downside scenario

We could lower the rating if BWS' financial metrics decline more than forecast, to levels we no longer consider extremely strong. Deterioration could occur as a result of higher capital costs, a material decline in demand, or increased expenditures related to the board's pension funding plans.

Credit Opinion

In the near term, water system rates may be less affordable to a portion of the customer base, as demonstrated by rising in delinquent accounts and higher unemployment rate due to the pandemic. However, during the next five years, there is room for rate-raising flexibility given the very strong income indicators and below-average county poverty rate. After pre-approved rate increases through 2023, 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. Management plans to undergo another formal rate study and pre-approve another set of multiyear rate increases, which we believe provides more stability to the future revenue stream.

In our opinion, BWS' financials are extremely strong despite the planned additional debt and pay-go for capital needs; we expect financials to stay extremely strong. Based on our analysis of management-provided projections, which assume rate increases of approximately 4% annually through 2025, future debt obligations, and a rise in expenses averaging approximately 1.6% annually, we expect all-in coverage to decline as the board layers on additional debt to fund about 50% of its long-range capital plan. However, even with this decline we expect coverage metrics to remain at 2.0x, which we consider extremely strong. We have additionally performed a stress test assuming a 10% decline in revenues annually, and all-in coverage remains above 1.6x, which supports our view that there is sufficient financial flexibility to deal with any short-term disruptions related to the pandemic, higher delinquencies, future debt and capital costs.

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 our analysis of management provided projections, which assume about 50% of the capital plan will be funded from non-debt sources, cash will decline to $300 million, equivalent to over 600 days of operating expenses through 2025, which we consider extremely strong.

BWS' debt-to-capitalization ratio is low at about 25%, and the capital plan is large but manageable. BWS' capital improvement plan is about $924 million for 2021-2025, compared to only $360 million of outstanding debt obligations. The amount funded from bond proceeds and future state loans is estimated at about $510 million during the next five fiscal years. 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.

BWS participates in the Retirement System of the State. As of June 30, 2020, 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 BWS' financial strength, we believe the BWS 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. BWS' 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.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020