S&P Global Ratings

RatingsDirect®

Summary:

Honolulu Board of Water Supply, Hawaii; Water/Sewer

Primary Credit Analyst:
Alexandra Rozgonyi, Centennial + 1 (303) 721 4824; alexandra.rozgonyi@spglobal.com

Secondary Contact:
Jenny Poree, San Francisco + 1 (415) 371 5044; jenny.poree@spglobal.com

Table Of Contents

Summary:

Honolulu Board of Water Supply, Hawaii; Water/Sewer

Credit Profile		
US$75.32 mil rev bnds ser 2022A dtd 03/23/2022 due 06/01/2051		
Long Term Rating	AAA/Stable	New
US$54.780 mil rev bnds ser 2022B dtd 03/23/2022 due 06/01/2051		
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 2022A and 2022B 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 2022A is $75.3 million, with proceeds funding certain improvements to and extensions of the water system. The estimated par amount for the series 2022B is $54.7 million, and proceeds will be used to refund certain outstanding water system revenue bonds. As of Dec. 31, 2021, the board had about $293 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 $117 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 2022A and 2022B 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 (ADS) in such fiscal year plus deposits to any debt service reserve fund or (ii) 1.20x maximum ADS. The additional bonds test is set at 1.2x maximum ADS on outstanding and proposed bonds. Furthermore, the series 2022A and 2022B bonds will not have a debt service reserve; however, we view this to be credit neutral given BWS' extremely robust cash position.

Credit overview

The rating reflects our view of BWS' transparent, proactive, and forward-looking management, which has resulted in BWS' financial resiliency. Given BWS' history of timely rate increases and robust long-range financial planning, the board's all-in coverage has remained robust at above 2.0x, with over $420 million of unrestricted cash equating to about 870 days of operating expenses. In our opinion, BWS is well positioned to deal with any interim costs related to mitigation efforts and new source water projects due to the U.S. Navy's Red Hill fuel leak in 2021. Both the Navy's Red

Hill Shaft and BWS' Halawa Shaft get their water from the same aquifer. Immediately after the identification of water source contamination with petroleum, BWS shut down the Halawa Shaft, which delivers 20% of the water to the metropolitan Honolulu water system, and soon thereafter took precautionary measures and shut down its Aiea and Halawa wells. To date, no petroleum contamination has been detected in BWS water supply, including in the Halawa Shaft. BWS is testing the five nearest wells weekly in response to the situation.

BWS is pumping at higher rates from its other well stations to make up the 20% loss from shutting down the Halawa Shaft. This could result in a rise in salinity levels, if prolonged, and negatively affect the water being pumped. BWS will continue to monitor the condition of its remaining wells and expects conservation may be necessary during peak use months. The full extent of contamination around Red Hill and the ability to treat the water are uncertain. BWS plans to explore the development of potential additional wells, optimize current wells to increase pumping capacity, and utilize its expected seawater desalination project to augment supply. The total cost is currently unknown but could be significant. It is unclear whether the Navy will fund a portion of the costs. We believe BWS has sufficient rate capacity to increase leverage if needed given current water rates are only about 1% of median household effective buying income (MHHEBI).

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 stable outlook reflects BWS' strong financial position, which we believe can sustain near-term financial impacts, and the diverse economy with stabilizing government institutions and 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

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. Additionally, there is environmental risk related to the Navy's fuel tank leak. If the contamination spreads through the aquifer and affects BWS' water supply or long-term over pumping at current wells, salinity could increase. 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, which include increased conservation and water supply contamination. BWS is testing wells in response to the incident and exploring six potential well sites for future water supply.

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 has been sustained at about 11% since the pandemic, an indication that rates have become less affordable to a portion of the customer base due to the pandemic. BWS has a focus on affordability when setting rates and 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. In addition, BWS received federal assistance to help customers with late payments and plans to participate in the Low-Income Household Water Assistance Program.

Governance factors are stronger than peers given robust long-range financial and capital planning, in addition to robust financial stress-testing and water supply management.

Stable Outlook

Downside scenario

We could lower the rating if financial metrics deteriorate and are sustained at a much weaker level, due either to the acceleration of capital projects related to the fuel leak, significant conservation measures, or increased expenditures due to the board's pension funding plan.

Credit Opinion

Enterprise profile

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 COVID-19 pandemic. 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 the financial, higher education, construction, and health care sectors, which have contributed to relative resiliency during past downturns. Income levels for the service area economy are greater than the national average at 119%, and the unemployment rate has dropped significantly since the peak of 20% in April 2020 to 4.6% for December 2021, which is below the state rate of 4.9%.

In our opinion, water rates are affordable, representing just above 1% of MHHEBI, although we expect affordability will weaken modestly during the next five years because management projects higher rate increases. Management approved a 4% increase for 2022 and 2023 and is in the process of a new rate study. Although the rate study has not been completed, financial forecasts indicate a revenue increase of 5%-6% through 2026. We note the cost-of-service study will take into consideration the effects of the pandemic, the Red Hill fuel leak, and future water demand when developing future rates. Management has a history of working with a rate consultant and approving multiyear rate increases, which we believe provides more stability to future revenue streams.

Our operational management assessment (OMA) includes our analysis of BWS' robust asset management program; sufficient long-term groundwater supply; and a focus on the recent fuel leak, climate change, watershed management, conservation efforts, and diversifying water supply to continue to meet customer demand. Current groundwater production is approximately 78% of BWS' permitted use and only 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 is moving forward with its plan to build a desalination plant as a public-private partnership. We view this as a credit positive as BWS plans to diversify its long-term water supply reliability.

Our OMA also includes our assessment of BWS' cyber security practices and policies that, in our opinion, are robust. We note that there was a cyber security incident, but BWS took immediate action to sever all access to this service. No employee, customer, or financial data was affected. BWS' cyber security program is a layered cyber defense program with technical toolsets, staff education, awareness, proactive threat monitoring, and vulnerability remediation. BWS can isolate systems quickly, reviews third-party providers' potential cybersecurity risks, and requires vendors have cyber practices and policies.

Financial profile

In our opinion, BWS' financials are robust due to rate increases and long-range planning that provides a cushion for challenges related to the fuel leak, climate change, economic cyclicality, and capital needs. Based on our analysis of management-provided projections, we expect all-in coverage will decline as the board layers on additional debt. However, even with this decline, we expect coverage will 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 would worsen to 1.5x, which, if sustained or worsened, could result in rating pressure. However, because a 10% decline in revenues still results in very strong all-in coverage, we believe there is sufficient financial flexibility to deal with any short-term disruptions related to the pandemic, water supply, future debt, and capital costs.

BWS' unrestricted cash and investments are also a credit strength, 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 nondebt sources, cash will decline to $406 million, equivalent to over 800 days of operating expenses, through 2026, which we consider extremely strong. Based on the most recent long-range financial plan, annual pay-go-capital spending ranges from $46 million to $56 million annually.

BWS' pro forma debt-to-capitalization ratio is moderate at about 30%, and the capital plan is large but manageable. BWS' capital improvement plan is about $951 million for 2022-2026, compared to only $410 million of outstanding debt obligations. The amount funded from bond proceeds and future state loans is estimated at about $660 million during the next five fiscal years. We expect our calculation of the debt-to-capitalization ratio will rise during the next five years to a level we consider moderate, but not enough to pressure the rating level.

Our financial management assessment includes our assessment of BWS' robust and transparent financial policies and practices reflected by formalized investment, liquidity, and debt management policies; robust and transparent financial policies; and long-range financial planning. BWS frequently updates its long-range financial plan (LRFP), which incorporates sensitivity analyses. Recently, BWS incorporated the pandemic and aggressive conservation into the LRFP. The plan also has financial stress scenarios for growth, natural disaster, water source contamination, climate change, and economic cycles.

BWS participates in the Retirement System of the State.

As of June 30, 2021, the plan was underfunded at about 57%. The district's assumed rate of return at 7% is above our S&P Global Ratings' guideline of 6%; however, given BWS' financial strength, we believe the BWS would be able to take on higher risk of possible increased annual costs. In our opinion, funding contributions need to be increased in order to materially improve the 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