S&P Global Ratings

RatingsDirect®

Summary:

Honolulu Board of Water Supply, Hawaii; Water/Sewer

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

Secondary Contact:
Jaime Blansit, Englewood + 1 (303) 721 4279; jaime.blansit@spglobal.com

Table Of Contents

Summary:

Honolulu Board of Water Supply, Hawaii; Water/Sewer

Credit Profile		
US$19.0 mil wtr sys rev bnds ser 2023 due 07/01/2052		
Long Term Rating	AAA/Stable	New
Honolulu Brd of Wtr Supp wtr sys rev bnds		
Long Term Rating	AAA/Stable	Affirmed
Honolulu Brd of Wtr Supp wtr sys rev bnds (taxable)		
Long Term Rating	AAA/Stable	Affirmed

Credit Highlights

- S&P Global Ratings assigned its 'AAA' rating to Honolulu Board of Water Supply, Hawaii's anticipated $19 million water system revenue bonds, series 2023.
- At the same time, S&P Global Ratings affirmed its 'AAA' rating on the board's $363 million in outstanding bonds.
- The outlook is stable.

Security

The security is credit neutral and includes a senior lien net revenue pledge, a 1.2x rate covenant, and a parallel additional bonds test. This series does not have a debt reserve fund but other outstanding issues benefit from a common reserve. The lack of a formal debt service reserve fund does not affect our view of the credit given the substantial liquidity in the system.

Credit overview

The 'AAA' rating reflects the board's robust financial metrics and best-in-class management policies and practices, which have allowed it to respond to the Red Hill fuel spill from a position of strength. The board swiftly addressed health and safety concerns and has been successfully advocating on behalf of the rate base to reduce future risks associated with the presence of the fuel tanks. The incident has shifted the board's focus to augmenting supply and furthering source protection. While the ultimate financial cost of the fuel spill is unknown, we believe there is sufficient financial capacity (within the rate base) to support additional leverage or increased costs associated with remediation, if needed. We expect that a substantial portion of the remediation will be funded by the federal government but that there will be costs associated with procuring substitutive supply that will likely be borne by the board's customer base. Further, long-term capital and financial planning efforts support credit stability given the expectation that the board is making necessary investments in infrastructure to meet longer-term climate and supply considerations.

Environmental, social, and governance

Environmental risk is elevated relative to that of peers, while social and governance risk are credit neutral. The island has exposure to physical risks, including severe storms and sea-level rise. Governance, specifically risk management, is extremely robust, mitigating some of this risk. The board conducted a vulnerability assessment that concluded that most essential water utility infrastructure will not be exposed to sea-level rise until mid-century. However, if the sea level rises faster than projected the impact on infrastructure would be far greater. The board has partnered with the city on climate change adaptation legislation, which was adopted in December 2020 and addresses programs related to energy, coastal and water, climate resilience and equity, food security and sustainability, zero waste, pre-disaster multi-hazard mitigation, long-term disaster recovery, climate action, and climate change adaptation. The One Water philosophy is embedded in the water resources planning, including institutionalizing collaboration among city agencies and others, for example, to prioritize coastal infrastructure and elevate streets and private developments to adapt to forecasted sea-level rise. Given the uncertainties associated with climate resiliency, we expect this effort to be ongoing and important to credit stability, given the costs associated with potential hardening or emergency response.

In addition to adaptation and mitigation efforts, the board completed a risk and vulnerability assessment and emergency response plan in accordance with the American Water Infrastructure Act of 2018. Although the assessment concluded that existing infrastructure has significant resilience components already built in, management has identified additional enhancement that is included in the capital plan. The board is also partnering with FEMA to continually improve emergency response. These efforts are expected to mitigate and adapt to higher incidence of hurricanes and severe storms.

Outlook

The underlying economy in Honolulu has proven resilient under several real-life economic stress scenarios, including most recently, COVID-19, which supports credit stability. Further, current financial metrics are healthy and given the board's internal policies related to coverage and liquidity, we believe metrics will remain at or above 'AAA' medians. We expect that margins may soften somewhat given the economic environment and the costs associated with the Red Hill fuel spill, especially as the board balances necessary capital investment with customer affordability. Stability in senior management also supports the current outlook.

Downside scenario

If capital, operating, or deferred maintenance costs result in affordability pressures for the customer base, hindering rate-setting flexibility, it could affect credit stability. If metrics fall below policy levels for consecutive years, it could also pressure the rating. A divergence from the strategic plan or instability in management would also increase downside risks.

Credit Opinion

The utility provides water to approximately one million resident and visitors, and the service area's underlying economy is large and diverse. While the visitor industry is a significant contributor to economic output, the Honolulu service area is diverse, and the visitor industry has demonstrated the ability to rebound following significant disruptions such as 9/11, COVID, SARS, and periods of economic contraction. The utility benefits from strong median household income and low unemployment, which contributes to rate-setting flexibility and low delinquencies. The military presence is a stabilizing factor and we expect that it will result in continued investment and development given the strategic military importance of Oahu. Currently, the primary economic pressures stem from a lack of affordable housing and continued weakness in the international travel market, which has been slow to recover given COVID-19 policies abroad.

The board has ample groundwater water supply for the residential customer base as well as recycled water for commercial and industrial use. The topography is varied and the climate is challenging for optimizing asset life. The asset management practices are well-defined and include metrics to assess effectiveness. The board has an integrated approach to infrastructure and financial stewardship that is demonstrated by the planning documents that guide decision-making. Its Strategic Plan and Water Master Plan (WMP) address current and emerging risks such as climate change, watershed management, and population growth. A condition assessment and hydraulic modeling has also been performed. These documents inform prioritization of preventative maintenance and capital planning. The output is then incorporated into the board's long-range financial plan (LRFP), which assesses the impact of potential risks to the system and whether the board has the financial capacity to respond. We view this approach as highly credit-supportive, improving both asset and financial resiliency.

The board has integrated satellite monitoring and risk-based modeling to reduce leaks and address maintenance needs. Replacing meters and using satellite surveillance has significantly improved efficiency and response. While water loss is slightly above average (15%), management has a plan in place to reduce loss to 8% over a multi-year period. Pipes are also being replaced with higher-grade materials that are expected to be more resilient. Given the above-average exposure to climate risk, we view preventative maintenance and detailed climate planning, through the WMP and One Water project, as important to credit stability. The board uses 33 performance metrics to assess improvement in resource and system performance. We note that it has not met all performance metrics, but that there are detailed plans in place to address infrastructure upgrades and the board is making progress towards meeting these ambitious targets.

Given the recent Red Hill fuel spill as well as the potential presence of emerging contaminants such as PFAS, the board has a heightened focus on source protection and procuring additional supply. The U.S. Navy confirmed two fuel spills in November and December of 2021 at the Red Hill Bulk Fuel Storage Facility. Since both the Red Hill Shaft and the board's Halawa Shaft share an aquifer, the board has shut down the Halawa Shaft (which delivers 20% of Honolulu's water). In the interim, the board has sufficient supply available from pumping at higher rates from other well stations. However, extended pumping at higher rates can degrade both the aquifer and the water pumped. The board is monitoring this risk while assessing other supply options.

Fuel operations have been suspended and a consent order to safely defuel Red Hill is in place. Monitoring the water quality is an ongoing process and additional monitoring is needed to determine the effects of the most recent spill as well as the past spills that continue to contaminate this source of supply. The viability of the supply is currently unknown given the complexity of potential treatment and remediation. Treating the contaminated water may not be feasible nor cost-effective given the different fuel types and quantity present. As such, the board is analyzing various options, including enhanced conservation, new wells, recycled water, or desalination. The cost of alternative supply may be significantly greater than for the current groundwater supply, increasing revenue requirements, but we believe there is sufficient capacity to absorb these costs. We also believe management has been transparent and effective in communicating with the customer base about the nature of the spill and associated costs moving forward, which should support greater ease in associated rate-setting.

The organization is highly effective, with comprehensive policies that address cyber security, emergency planning, and succession planning. Like utilities throughout the country, labor is a challenge for the board due to both retirements and recruiting. This has primarily affected hiring for operations, in particular engineering. Management is addressing these challenges through adjustments to benefits and policies as well as through successful apprenticeship and internship programs that have resulted in relatively low turnover rates of just over 6%. However, the vacancy rate remains high at 25%. Given the complexity of the system and the risks, strong management is critical to credit quality. We will continue to monitor the status of the labor strategy.

The policies and practices associated with rate-setting include all the elements that are deemed strong in our methodology. There are two stakeholder boards, residential and commercial, which promote transparency. There are cost adjusters for energy and regulatory expenses, arguably the two biggest influences of cost escalations given the nature of the system. Finally, management adopts multi-year rate increases that are supported by a third-party cost-of-service study. The planning documents discussed above are integrated into the rate-setting and budgetary process. Rate increases are likely given the inflationary environment, capital needs, and costs associated with the fuel spill. Prior estimates were between 4% and 6% per year, but management reports that increases may be higher. In our view, current rates are affordable relative to income and the poverty rate as well as to those of peers.

Rate-setting practices contribute to the board's very healthy financial performance. Coverage over the past three years has averaged 3.0x, well above the board's 1.7x policy, demonstrating financial resilience even during the pandemic period. Liquidity is also high, with nearly $430 million in unrestricted cash and over two years of total cash, and an additional $230 million that is restricted. Projected coverage and cash are expected to weaken but will stay well above policy targets. Debt levels are relatively moderate, but the capital plan is substantial. Taking into account the almost $1 billion capital plan and the $105 billion Water Infrastructure Finance and Innovation (WIFIA) Act loan, leverage will more than double. While this will require future rate increases, we believe the capital projects are necessary to maintain the integrity of the system and mitigate future risks, which we view favorably. Balancing capital needs with rate affordability may require all-in coverage to dip to levels closer to policy targets in the future but such levels are still expected to be commensurate with the current rating level.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.