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

Fitch Ratings-Austin-03 November 2016: Fitch Ratings has affirmed its 'AA+' rating on the following bonds issued by the Board of Water Supply City and County of Honolulu, HI (BWS):

--Approximately $225 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. Margins are expected to remain robust over the next several years.

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.

RELATIVELY HIGH COMBINED BILL: Annual rate increases will fund almost 100% of the capital program from revenues. While water rates are moderate, the combined bill with higher sewer charges may limit future rate flexibility.

ELEVATED INFRASTRUCTURE AGE: System infrastructure is relatively old compared to other utilities, although operating metrics appear sound. Current investment remains well below annual depreciation but capital spending is expected to accelerate.

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

RATING SENSITIVITIES

SHIFTS IN FINANCIAL MARGINS: The rating is sensitive to shifts in fundamental credit characteristics, including the strong debt service coverage and liquidity.

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 Red Hill bulk fuel storage facility (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 174,000 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 less than 20% of water revenues. However, the top three users are governmental entities, which help mitigates 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 averaging over 4.0x for the past five years. DSC in fiscal 2015 was 6.0x and all-in DSC (including the system's subordinate state revolving fund [SRF] loans) was 5.1x, including connection fee revenues. BWS's financial forecast through fiscal 2020 projects DSC of revenue bonds to remain over 4.5x, which exceeds BWS's own policy target of 1.6x. Total DSC is forecasted to remain above 3.5x.

Liquidity for fiscal 2015 was very high at 666 days cash. 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.

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 142 mgd. Although excess capacity exists, water use has been largely flat for the past 10 years, given conservation efforts and lower agricultural use. Unaccounted-for system water loss is modest at 8%.

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 one of BWS's monitoring wells. 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. 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.

INCREASED CAPITAL SPENDING NEEDED

BWS's fiscal 2016-2020 capital improvement program (CIP) totals $442 million and focuses predominantly on renewal and replacement (R&R) of system assets. The CIP is currently expected to be funded almost entirely from surplus revenues and available reserves, with a small amount (up to $10 million) in additional SRF loans possible.

Honolulu has an older system, as evidenced by its average age of plant of 20 years, compared to Fitch's median for the 'AA' category of 14 years. Nevertheless, operations appear sound and non-revenue water is relatively low, measuring just 8% for fiscal 2015. The CIP reflects a ramp-up in capital spending to at or around $80 million annually, as compared to the $20 million-$30 million in annual spending since fiscal 2011, which, if sustained, would outpace annual depreciation and

help to address the system's aging infrastructure. However, BWS has been forecasting an intended ramp-up in capital spending during the past few years as well.
BWS recently completed a 30-year water master plan (WMP) and will be revising its CIP estimates over the course of the next year based on the priorities targeted in the WMP. Projected capital expenditures could increase depending on the pace of R&R approved in the revised CIP by the Board of Directors (the board). The level of CIP debt funding could also change at that time.
Currently, BWS's debt metrics are relatively low compared to similarly-rated utilities. Fiscal 2015 debt per customer was $1,865 and debt-to-net plant was a modest 29% compared to Fitch's 'AA' respective medians of $2,050 and 44%. BWS's debt amortization is relatively quick with 90% repaid in the next 20 years.

RATE FLEXIBILITY DESPITE HIGH COMBINED RATES
In December 2011, the board adopted a five-year package of rate increases that raised rates 9.65% annually through fiscal 2016. All five increases have been implemented; no additional increase was enacted for fiscal 2017. The rate package was adopted to fund increases in operating expenditures and generate up to $40 million-$50 million annual cash flow in the later years to support planned capital spending. BWS expects to design its next rate package by the end of calendar 2017 and present it to the board for implementation during fiscal 2018. The expected rate package will support a capital and financing program based off the CIP stemming from the WMP.

Water rates are competitive with other utility systems, 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 affordability threshold at approximately $140 per month or 2.1% of median household income. 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.

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Applicable Criteria
Revenue-Supported Rating Criteria (pub. 16 Jun 2014)
https://www.fitchratings.com/site/re/750012
U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 03 Sep 2015)
https://www.fitchratings.com/site/re/869223