

Hawaii; Appropriations; General Obligation

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Credit Profile		
US\$800.0 mil 2011 go bnds ser DZ due 06/30/2032		
<i>Long Term Rating</i>	AA/Stable	New
US\$382.41 mil 2011 go rfdg bnds ser EA due 06/30/2024		
<i>Long Term Rating</i>	AA/Stable	New
US\$56.0 mil 2011 go rfdg bnds ser EC due 06/30/2024		
<i>Long Term Rating</i>	AA/Stable	New
US\$23.0 mil 2011 go rfdg bnds ser ED due 06/30/2024		
<i>Long Term Rating</i>	AA/Stable	New
US\$2.8 mil 2011 go rfdg bnds ser EB due 06/30/2024		
<i>Long Term Rating</i>	AA/Stable	New
Hawaii GO		
<i>Long Term Rating</i>	AA/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'AA' long-term rating to Hawaii's \$800 million series 2011 DZ general obligation (GO) bonds. We also assigned a 'AA' rating to the state's estimated \$467 million of GO refunding bonds issued in four series (2011 EA, EB, EC, and ED). At the same time we affirmed our 'AA' long-term rating and underlying rating (SPUR) on Hawaii's general obligation (GO) bonds and our 'AA-' long-term rating on the state's certificates of participation (COPs). The outlook on all ratings is stable.

The 'AA-' COP rating reflects our view of Hawaii's:

- Annual appropriation risk,
- Covenant to budget and appropriate lease payments for the life of the certificates, and
- General credit characteristics.

The 'AA' GO rating reflects our view of:

- Governor Neil Abercrombie's willingness to implement aggressive solutions, totaling \$1.32 billion, to balance the fiscal 2011-2013 biennial budget in light of a projected budget shortfall that had reached \$1.25 billion for the biennium;
- The state's plans to recapitalize its nearly depleted emergency budget reserve (EBR) and hurricane relief fund (HRF);
- Strong liquidity, particularly when including pooled cash balances available to the general fund for temporary borrowing;
- Management's well-established, proactive budget monitoring practices, including frequent revenue forecast updates from the Council on Revenues (COR), which facilitate prompt identification of potential budget adjustments for budget alignment;
- The governor's executive authority to restrict all executive branch expenditures, such as by cutting spending

midyear without legislative approval or by cutting or delaying education disbursements during the course of a fiscal year;

- Other strong constitutional protections, which require budget balance, that allow for tax increases with legislative approval and give GO bonds first-lien priority before all other disbursements; and
- Stabilization of and modest growth across a number of key economic indicators in the state that should help buoy its tax revenues going forward.

Partly offsetting the above strengths is our view of:

- The state's reliance on tourism from both U.S. and international visitors, including Japan, and declines in tourism-related metrics and revenues, construction spending, and other related economic activity, which have reduced general fund tax revenue growth rates and employment levels;
- A relatively high level of federal funding in the state budget, exposing the state's fiscal performance to revenue loss should the federal government enact significant federal deficit reduction; and
- The low-funded status of the state's retirement system, lack of funding of the state's other postemployment benefits (OPEB) liability, and overall debt ratios considered among the highest of all U.S. states.

All GO bonds are secured by Hawaii's full faith and credit, which the state considers the highest priority in payment according to its constitution. None of the refunding bonds include lengthening of the maturity dates relative to the existing debt to be refunded.

State revenue performance has begun to improve and for the first three months of fiscal 2012, tax collections are outpacing the same period during the past two fiscal years. Tourism, which in large part determines the fate of state tax revenue trends, is also showing signs of modest growth. Even after visitor arrivals increased 8.5% in 2010, however, total visitors continue to trail 2007 levels. After numerous downward revisions to the state revenue forecast going back to March 2008, in April 2011, and again in May 2011, Hawaii's COR projected that revenues would decline 1.6% in fiscal 2011 compared to fiscal 2010 (the prior forecast had been for 0.5% growth). The downward revision incorporated COR's view that the state's economy and revenues would see a drop in economic activity in response to the earthquake in Japan and some other macroeconomic concerns. Actual revenues for fiscal 2011 performed slightly better, down by 0.8% compared to fiscal 2010. This allowed the state to end with a slightly better ending balance of \$126 million in its general fund than had been projected. The ending balance is equal to 2.5% of general fund expenditures, which we consider adequate.

As the end of fiscal 2011 approached, Governor Abercrombie proposed to the legislature closure of the fiscal 2011 gap mainly through the exhaustion of the state's reserves held outside of the general fund, including use of the entire balance of both the Hawaii Hurricane Relief Fund (HHRF; \$121 million balance) and the EBR fund (or "rainy day" fund; \$46 million balance). These alone would cover \$167 million, or 78%, of the \$215 million shortfall. With the somewhat better-than-expected revenue performance mentioned above, the EBR and HHRF balances, as of October 2011, are \$9.7 million and \$21.1 million, respectively.

When Hawaii's EBR and HHRF are added to its ending general fund balance, the total reserves at the end of fiscal 2011 are \$156.8 million, equal to 3.1% of expenditures, which we still consider adequate.

Various measures to close the fiscal 2012 and 2013 budget gaps include the repeal of the state tax deduction, a pension tax, limitations on standardized deductions on tax returns, a suspension of general excise tax exemptions, and the imposition of a 4% general excise tax, a capping of county hotel tax revenues, an increase in rental car daily

surcharges, labor savings, and a reduction in services. The COR projects a robust 14.5% increase in tax revenues in fiscal 2012 compared to fiscal 2011. However, 4.3% of this is attributable to the state's cash management measure at the end of fiscal 2010 whereby tax refunds were paid in early fiscal 2011, thereby artificially depressing net collections in July 2010. Another 5% of the revenue growth is due to the aforementioned tax increases. The remaining 5.3% of the projected growth is from the expected increase in economic activity.

At the end of fiscal 2011, the state-projected ending balance is forecast at \$103.1 million, equal to 1.9% of expenditures, which we view as low. However, part of the state's general fund financial plan includes making \$75 million in contributions to the state's EBR and HHRF which, when combined with existing balances in these funds, brings the projected total reserves to \$208.9 million, which we view as adequate at 3.8% of expenditures.

Hawaii's debt burden of \$5.2 billion of state GO and COP debt is high in our view, as it translates to \$ 3,967 per capita. Compared to other states, Hawaii's debt level stands out as high in part because, in Hawaii, the state assumes numerous functions that, in other states, are performed at the local level.

Based on the analytic factors we evaluate for states, we have assigned Hawaii a composite score of '1.9' on a four-point scale in which '1' is strongest.

Outlook

The stable outlook reflects our view that Hawaii's proactive budget management techniques will result in manageable out-year gaps that state officials will successfully resolve while rebuilding reserves to levels appropriate for the rating. The state's budget management over the 2011-2013 biennium, a period that we believe will be characterized by a challenging and uncertain revenue environment, will be critical to maintaining the rating, particularly in light of what we consider to be optimistic revenue growth assumptions. In our opinion, the state's strong constitutional protections and the governor's executive authority to restrict all executive branch expenditures, such as by cutting spending midyear without legislative approval, provides us with credit comfort at the current rating level. If actual revenue growth is significantly below the state's projections or if the state is unable to further reduce spending, the rating could come under pressure. Upside in the rating is substantially reliant on the state's ability to reduce its debt and retirement liability burden and its reliance on tourism.

Governmental Framework

Hawaii's constitution requires that the state operate on a balanced budget, including on an intra-year basis, as it monitors revenues and expenditures throughout the year and makes necessary adjustments to ensure that general fund expenditures do not exceed current general fund revenues and unencumbered cash balances. There are no constitutional restrictions on the state's ability to raise taxes or other revenues, but property tax authority rests with the counties. Approval of taxes is by simple majority vote of the legislature, and the legislature has broad legal latitude to adjust spending levels. The governor has authority to restrict all executive branch expenditures and to cut spending midyear without legislative approval, such as by cutting or delaying spending on education, but in practice this is politically difficult.

Hawaii is not a voter initiative state, and no vote is required to issue GO bonds or for tax increases. GO bonds in Hawaii have a first-lien status, prior to all other payments, and the issuance of GO bonds must be authorized by a majority vote of the legislature.

Hawaiian state government is highly centralized, and, as such, the level of assistance to local governments is high. The state directly runs the public school system, as well as the university and community college systems. It also administers the public welfare system and operates prisons, harbors, and airport systems. The county functions are primarily property related (police, fire, streets, water, sewer, and parks).

On a four-point scale in which '1' is the strongest, we have assigned a score of '1.7' to Hawaii's governmental framework.

Financial Management

Financial Management Assessment: "Strong"

We consider the state's management practices "strong" under our Financial Management Assessment (FMA) methodology. An FMA of "strong" indicates our view that practices are strong, well embedded, and likely sustainable. Among the highlights of the state's management techniques are statutorily required six-year operating and capital budgets that are updated by the governor and finance staff annually for legislative approval. The COR, an independent body, provides quarterly revenue and expenditure measures and forecasts for inclusion in the biennial budget, budget updates, and the multiyear financial forecast. State finance staff identifies budget variances monthly, and the governor is empowered to curtail expenditures without legislative approval, if required. The finance staff and treasury adhere to an official investment policy, and investment performance is disclosed monthly. There are statutory debt caps, including a calculation to ensure that the total amount of debt service payments required will not cause the state to exceed its debt limit of 18.5% of general fund revenues. State law requires that all state debt begin to amortize principal within five years of issuance, mature within 25 years, and have level principal and interest payments. State law also disallows variable-rate debt or use of swaps or other derivative products. The legislatively created EBR fund provides for a small, controlled emergency fund, but there is no formal or informal target or policy for the size of this reserve or for the state's generally accepted accounting principal unreserved fund balance.

Budget management framework

COR, a seven-member, independent revenue forecasting body, prepares revenue forecasts at least quarterly but also in special sessions when fiscal conditions warrant. The executive branch and legislature are required to consider the council's estimates in the budget process. Should a different forecast be used, this development and the rationale must be publicized.

Spending is controlled through an allotment system, and the Department of Budget and Finance monitors expenditures throughout the year. Budget adjustments are implemented periodically throughout the fiscal year as the state deems necessary. Restrictions can be implemented at any time, but are usually imposed at the beginning of the fiscal year. Adjustments requiring legislative action are handled during the legislative session, which begins shortly after the start of the third quarter; in extraordinary circumstances a special legislative session may be called. The governor has unilateral authority to restrict executive branch spending. Legislative approval is required to authorize spending, to impose new taxes, or to increase existing taxes.

Although the state has demonstrated willingness to provide timely -- and structural -- budget solutions when confronting previously projected budget deficits, the current executive plan from the governor suggests that corrective actions for 2011 will focus mainly on the use of reserves. For fiscals 2012 and 2013, deficit-closing solutions are more structural. Deficits are not carried forward, but soft revenue performance and an expiration of

the previous solutions contribute to a projected shortfall of revenue compared with baseline spending trends, necessitating either adjusted service levels or enhanced revenues for the upcoming biennium.

On a four-point scale in which '1' is the strongest, we have assigned a score of '1' to Hawaii's financial management.

Economy

Hawaii's employment picture is showing signs of tepid growth, and total employment is 1% higher in the third quarter of 2011 than the same period in 2010. This represents the fourth consecutive quarter of improvement using this year-over-year comparison (which we believe gives a better picture because of the tourism-based economy). After two consecutive years of declining unemployment rates (after peaking at 6.8% in 2009), the state's unemployment rate as of the third quarter of 2011 is 6.3%. All job creation is in the private sector as federal, state, and local government employment trends are negative. Despite this, total government jobs are down 3,200 from September 2008 while total jobs in the state are down 20,400 during the same period.

Federal spending plays an important role in Hawaii's economy. Total federal spending equaled 38% of the state's gross domestic product in 2009, the highest in the nation. Historically viewed as a stabilizing source of spending in the economy, the intensifying focus on deficit reduction at the federal level raises the specter that federal spending could be curtailed in the state. However, to the extent U.S. military installations are consolidated globally, Hawaii's location is strategically advantageous. Federal spending and wages and contracts have increased 8.9% and 11.5%, on average each year during the past decade.

Similar to the nation, Hawaii's (population 1.3 million) economic growth decelerated and, in many cases, turned negative in 2008-2010. However, with five state-headquartered banks that originate most of the home mortgages in the state and refrained from heavy subprime lending, Hawaii proved to be considerably less exposed to the subprime lending boom-and-bust cycle that underpinned the national economy. The state reports that Honolulu city and county rates of foreclosures are well below national averages and below those of comparable metropolitan areas around the country.

Hawaii's unemployment, at 6.3% in September 2011, was still well below the national rate of 9.1%, and the state's 2010 rate of 6.6% was the seventh-lowest in the nation. Since 2003, Hawaii's unemployment rate has generally been 2% to 3% below the national rate. Personal income historically has shown steady growth but was virtually flat in 2008 and 2009. Total personal income in the state again began to grow in 2010 and 2011. The state's median household income is strong in our view at 121% of the national average, and per capita personal income is strong in our view, at 2.7% above the national average.

Robust construction activity had spurred job growth during the past several years, but activity has slowed to levels seen in 2003 and 2004. However, unlike many markets, the Hawaii housing market experienced only a moderate housing decline: The median home price in the Oahu market fell just 3% in 2008 and 7.9% in 2009 and rose 3.1% in 2010. Over the longer span of 2006 through 2011 (second quarter), Honolulu's median home prices, having increased 0.3%, held firmer than comparable markets, such as Miami, Fla. (negative 7.7%), Phoenix, Ariz. (negative 9.5%), Las Vegas, Nev. (negative 8.6%), and San Diego, Calif. (negative 1.5%).

Hawaii's economy remains vulnerable to downturns in discretionary spending, especially tourism, an industry that is

still underperforming nationally due to reduced consumer spending, job losses, the recent seismic and tsunami events in Japan, and competitive marketing campaigns from multiple tourism destinations (e.g., Las Vegas). Swings in tourism trends affect excise and income tax collections given that leisure and hospitality is one of the state's leading employment sectors at 17.3%, versus the U.S. average of 9.8%. Visitor arrivals declined 10.9% in 2008 (versus 12.2% for the U.S.) and 4.5% in 2009, but a moderate, 8.7% rebound occurred in 2010. Visitor arrivals rebounded 8.7% in 2010 after a 4.5% decline in 2009 and 10.9% in 2008 (versus 12.2% for the U.S.) Prior to the March 11 earthquake in Sendai, Japan, officials had projected visitor arrivals to grow 4% in 2011, but revised figures indicate growth will be 3%. Japan accounted for 16% of visitor arrivals in the first nine months of 2011 (down from 18% in 2010), whereas the U.S. accounted for 66%, including about 25% from California alone. Occupancy rates dropped off after the earthquake in Japan and were at 74% for the first eight months of 2011, including 81.7% for February 2011 alone, which was above the 2005 peak. Prior to the earthquake, hotel occupancy had rebounded to 70.7% in 2010 after falling to 64.8% in 2009. The average room rate has fluctuated but rose to \$190 for the first eight months of 2011, up from \$174 in 2010 \$177.10 in 2009. Visitor spending rose 16% in 2010 and is forecast to rise 12% in 2011 after a 12.3% decline in 2009.

Population growth during the past 10 years has been robust, with a 12.3% overall growth to 1.36 million people, above the 9.7% rate recorded for the U.S. Since 1997 and through 2010, annual Hawaii GDP growth has averaged 1.63%, somewhat lower than the national 2.21% rate during the same period. Real GDP per capita was 2.74% above the U.S. per capita GDP in 2010.

On a four-point scale in which '1' is strongest, we have assigned a score of '1.5' to Hawaii's economy.

Budgetary Performance

Persistent revenue softness coupled with ascending demands for various social services first eroded and have now nearly depleted the state's reserves. Heavy economic reliance on the service sector -- specifically in the leisure and hospitality areas -- subject a considerable portion of the state's revenues to dependence on discretionary consumer spending and tourism. Although revenues have followed a declining trajectory, ascending social service needs and increasing caseloads have placed upward pressure on spending.

Hawaii's fiscal position is exposed to the potential for revenue loss related to federal deficit reduction, should it be enacted. Of the state's approximately \$11 billion 2012-2013 biennial total budget, roughly \$2 billion, or 18%, is from federal sources.

Part of the state's strategy is to improve employment and construction spending through the maintenance of high levels of capital improvement program (CIP) spending. State capital spending has averaged more than \$1 billion annually since 2007, significantly above spending levels in 2000 through 2006, and management expects this level of expenditure to continue.

Liquidity

General fund cash and investments totaled \$214.7 million in fiscal 2010, or 5.1% of expenditures. General fund cash at the end of fiscal 2010 was higher than at the end of fiscal 2009 (\$173 million), partly because of the state's deferral of tax refunds until after the start of fiscal 2011. These cash balances do not include outside reserve designations. The state reports that as of October 2011, the state's pooled cash balances, which the general fund

may borrow from for cash management purposes, was \$3.02 billion. Furthermore, the state's pooled cash balances have exceeded \$3 billion since at least July 2010. Cash is monitored on a daily basis, with daily reports reflecting the state's investment positions. The state forecasts its liquidity needs on a one-year-forward basis, includes recurring and known expenditures (debt service payments and payroll) in the forecast, and makes investments to provide liquidity on those dates. Annual cash flow is generally predictable, but in the last three years the state has made several downward revisions of forecast revenue growth. The state's disbursements are monitored and managed with greater-than-average scrutiny to provide for positive general fund balances at fiscal year end. But given the recent economic downturn, keeping the general fund balance positive has been challenging. The state has the statutory ability to borrow internally with the approval of the director of finance, but transfers of funds between funds require legislative approval. The state has not done any external borrowing for cash flow purposes; it is permitted to issue GO bonds to fund a deficit, but never has.

Audited financial statements

Audited fiscal 2010 general fund revenues increased 1.4% after a sharp drop in fiscal 2009 of 9.7%. Audited revenues for fiscal 2010 consisted primarily of the general excise and use taxes (51% of revenues) and the individual and corporate income tax (30%). Education expenditures (including kindergarten through grade 12 and higher education) accounted for roughly 52% of expenditures, followed by human services and health-related expenditures, which totaled 27%. The audited ending unreserved fund balance in fiscal 2009 was negative \$211 million, or negative 5% of expenditures, down from negative \$88 million, or 1.8% of expenditures, in 2009. In addition to the effects of the recessionary conditions, which, after several years of softer revenue performance, led to a lower fund balance that dipped into a negative position in fiscal 2010 given the absence of includes several transfers in that had been present in 2009.

The EBR fund, created by the legislature in 1999 and funded with tobacco settlement funds, will receive general fund infusions to recapitalize its position in fiscal 2012 and 2013. The same is true for the HHRF. The state's commitment to replenishing these funds is a departure from earlier plans to allow the reserves to become -- and stay -- depleted. We believe replenishing these funds could contribute to a strengthening of the state's credit quality.

On a four-point scale in which '1' is strongest, we have assigned a score of '1.9' to Hawaii's budgetary performance.

Debt And Liability Profile

Issuance of GO bonds must be authorized by a majority vote of the legislature, and each year the GO Authorization Bill authorizes the aggregate amount of GO bonds that may be issued to finance capital improvement projects. The bill also contains a calculation to ensure that the total amount of debt service payments required will not cause the state to exceed its debt limit of 18.5% of general fund revenues. State law requires that all debt begin to amortize principal within five years of issuance, mature within 25 years, and have level principal and interest payments, It also disallows variable-rate debt or the use of swaps or other derivative products.

Hawaii's debt ratios, as of July 1, 2010, on a per capita and percentage basis were high in our view, with direct state debt exceeding \$ 5.2 billion, or \$ 3,967 per capita, 9.2% of total state personal income, and 7.8% of real state GDP, among the highest of all the U.S. states. As of October 2011, some of the state's GO debt has been paid down, and the balance, prior to the current offering, was \$4.9 billion. Included in Hawaii's overall debt position is \$64 million in COPs. Hawaii's high per capita debt is attributable to the state's assumption of many functions that, in other states, are generally financed by local governments, including education, health, and welfare. Debt levels,

however, rose rapidly during the 1990s, as the state shifted from pay-as-you-go capital spending to GO bonds. However, debt amortization is rapid, with 67% of principal repaid in 10 years and 100% repaid in 20 years. Annual net debt service was moderately high in our view, at 8.5% of general fund expenditures for fiscal 2011, on an unaudited basis.

Other long-term obligations include the state's pension and other post-employment benefits (OPEBs). Pension benefits are administered by the Employees' Retirement System (ERS) of the State of Hawaii, which began operation on Jan. 1, 1926. The system is a cost sharing, multi-employer, defined-benefit pension plan that covers all regular employees of the state and each of its counties, including judges and elected officials. The system covers 111,226 active and retired beneficiaries. The ERS, as of fiscal 2010, had an unfunded actuarial accrued liability (UAAL) of \$7.1 billion and actuarial assets of \$11.3 billion to an actuarial accrued liability of \$18.5 billion, for a funded ratio of 61% -- down from 68.6% in fiscal 2005. The funding level has steadily decreased from a high of more than 95% in fiscal 2000. Although the overall market experienced some recovery, with an 11.5% return in fiscal 2010, the market return from 2009 was negative 18%. The rate of return for the actuarial value was negative 0.42% in 2010, much less than the market return because of the four-year smoothing technique. The state contributed \$527 million to PERS in fiscal 2009 and \$536 million in fiscal 2010. The state paid its annual required contribution (ARC) every year during 2002 through 2010 except for 2007 and 2008, when it paid 95.3% and 95.7% of its ARC, respectively. We viewed the ERS' prior investment return assumption of 8% as somewhat aggressive, but a new law enacted in June 2011 lowers the ERS investment rate return assumption to 7.75%. While this aspect of pension reform would increase the state's actuarial unfunded liability, other state pension reforms are expected to help lower the UAAL. Among these are statutory employer pension contributions and various pension reforms that would increase the retirement age for new employees.

The state completed its valuation of its OPEBs in 2007 for all participants, including counties, which resulted in an \$8.8 billion combined UAAL, which we consider significant. The UAAL rose to an estimated \$14 billion as of 2009. The state funds the annual benefit on a pay-as-you-go basis. The total OPEB liability includes benefits provided to state employees, teachers, and the voluntary employee beneficiary trust. The state has no plans to fund the unfunded portion of the OPEB liability.

Estimated for fiscal 2011, actual long-term debt and pension retirement-benefit liability payments totaled \$920 million, equivalent to 18% of general fund expenditures. If OPEB benefits were funded at ARC, fixed costs, including debt service, would represent 29% of fiscal 2011 general fund expenditures, which we consider high.

The state's GO bonding plans include the issuance of \$2.08 billion in bonds in fiscal 2013 through the end of fiscal 2015. Hawaii's capital plan anticipates \$700 million of GO debt issuance in fiscal 2013.

On a four-point scale in which '1' is the strongest, we have assigned a score of '3.6' to Hawaii's debt and liability profile.

Related Criteria And Research

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007

Ratings Detail (As Of November 8, 2011)

Ratings Detail (As Of November 8, 2011) (cont.)		
Hawaii rfdg GO bnds ser 2008DL & ser 2009DS		
<i>Long Term Rating</i>	AA/Stable	Affirmed
Hawaii COPs ser 2009A		
<i>Long Term Rating</i>	AA-/Stable	Affirmed
Hawaii GO bnds ser 1992BZ		
<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Affirmed
Hawaii GO (wrap of insured) (AMBAC & AGM) (SEC MKT)		
<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Affirmed
Hawaii GO (wrap of insured) (FGIC & AGM) (SEC MKT)		
<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Affirmed
Hawaii GO (MBIA) (National)		
<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Affirmed
Hawaii GO (MBIA) (National) & (AGM)		
<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Affirmed
Hawaii Taxable GO bnds ser 2008DM		
<i>Long Term Rating</i>	AA/Stable	Affirmed
Hawaii Tax Exempt GO		
<i>Long Term Rating</i>	AA/Stable	Affirmed
Hawaii GO		
<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		

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