

MOODY'S

INVESTORS SERVICE

New Issue: Moody's assigns Aa1 ratings to \$380.5 million of Commonwealth of Massachusetts refunding and new money bonds

Global Credit Research - 03 Dec 2012

\$18.6 billion of general obligation debt outstanding; outlook is stable

MASSACHUSETTS (COMMONWEALTH OF)
State Governments (including Puerto Rico and US Territories)
MA

Moody's Rating

ISSUE	RATING
General Obligation Bonds, Consolidated Loan of 2012, Series D	Aa1
Sale Amount	\$150,000,000
Expected Sale Date	12/05/12
Rating Description	General Obligation
General Obligation Refunding Bonds (SIFMA Index Bonds) 2012 Series B	Aa1
Sale Amount	\$230,540,000
Expected Sale Date	12/05/12
Rating Description	General Obligation

Moody's Outlook

Opinion

NEW YORK, December 03, 2012 --Moody's Investors Service has assigned Aa1 ratings to the Commonwealth of Massachusetts' \$230.5 million General Obligation Refunding Bonds (SIFMA Index Bonds) 2012 Series B and \$150 million General Obligation Bonds, Consolidated Loan of 2012, Series D. Proceeds of the 2012 Series B bonds will be used to refund the February 2013 maturities of SIFMA index bonds issued in 2010, 2011 and 2012. Proceeds of the Series D bonds will be used to finance portions of the commonwealth's capital plan, and may be issued in SIFMA index, LIBOR index, or fixed rate mode. The bonds are scheduled to price on December 5.

SUMMARY RATING RATIONALE

The rating reflects the Commonwealth of Massachusetts' strong financial management practices and its demonstrated willingness to balance its budget when necessary through spending cuts, revenue increases and use of reserves; a large education and health care sector that generates high wages and that has helped to mitigate job losses in the current downturn; debt levels that are among the highest in the nation; and relatively low pension funding levels. The outlook is stable

STRENGTHS

- Strong financial management practices, particularly a willingness to promptly identify and close budget gaps through expenditure reductions, revenue increases and prudent use of reserves
- Budget reserves that provide an adequate cushion to another downturn and the commonwealth's demonstrated commitment to maintain them at healthy levels
- An economic base characterized by high wealth and high levels of educational attainment that has provided a degree of stability to the commonwealth's employment situation

CHALLENGES

- Debt ratios that are among the nation's highest and moderate pension funding ratios
- Large health care and other social services costs that drive the budget
- Managing the challenges from federal downsizing during the next several years, which could have a heavy impact on the commonwealth's important healthcare and research sectors

COMMONWEALTH MAINTAINS HEALTHY FINANCIAL POSITION; OCTOBER REVENUES FALL SHORT OF FORECAST

Massachusetts tax revenues increased by 2.9% in fiscal 2012, 0.5% greater than forecast. Total personal income taxes increased by 2.9%, sales taxes by 3.2% and corporate income taxes by 4.1%. The capital gains portion of the personal income tax decreased by 7.6%, an important measure in high wealth Massachusetts. The commonwealth ended fiscal 2012 in June with a \$89 million budgetary basis surplus, and made a net deposit into its rainy day fund, the Stabilization Fund, of \$273 million. That deposit brings the stabilization fund balance to nearly \$1.7 billion, or 7.8% of fiscal 2012 tax revenue, a healthy cushion and a strong reserve position compared to many states. The budgeted fiscal 2013 revenue forecast reflects 4.5% growth compared to fiscal 2012, and budgeted expenditures reflect 3.9% growth over the prior year. Through October, however, collections are \$33 million or 0.5% less than the prior year and 3.8% or \$256 million below forecast. The commonwealth expects to announce budget adjustments soon to close the shortfall, which will likely reflect mostly spending reductions.

ECONOMY SLOWS BUT FUNDAMENTAL MEASURES STILL BETTER THAN NATION

Through the downturn, Massachusetts' economy generally performed more strongly than the nation. More recently, employment growth has slowed to a level slightly below average and the unemployment rate has risen slightly, but is still well below the U.S. average. Massachusetts employment growth was 1.3% in October, well above the pace there in early 2012 but below the U.S. level of 1.5%. The unemployment rate in the commonwealth increased slightly in October to 6.6% but that is still favorable compared to the U.S. average of 7.9%.

The commonwealth continues to be aided by its large education and health sector, which makes up more than 20% of employment. The state also has a large financial activities sector, with a significant mutual fund presence. While the important healthcare sector is partly behind Massachusetts's above-average employment and income performance, future federal downsizing could impact healthcare as well as government research and have a significant impact in Massachusetts. The state is characterized by high wealth and education levels but with slow population and job growth over the longer run. Per capita personal income in 2011 was \$53,621, ranking second among the states

HEAVY TAX-SUPPORTED DEBT LOAD; HIGH PENSION COSTS ALTHOUGH REFORMS WILL PROVIDE LONG-TERM BENEFITS

The commonwealth has a high debt burden, with \$18.8 billion in outstanding general obligation bonds and nearly \$32 billion in total net tax-supported debt. Debt levels have been driven upwards in part by the commonwealth's issuance of bonds to finance projects that in other states would be paid for at the local level. Based on Moody's 2012 state debt medians, the state's debt levels ranked second-highest among the 50 states on both a per-capita basis and as a percentage of personal income, respectively, and is the highest as a percentage of state gross domestic product. The commonwealth's debt per capita was \$4,814, 9.4% of its personal income, and 8.4% of its gross domestic product.

A pension reform enacted by the state last year provides long-term benefits to the state. Based on an updated actuarial valuation released last month, Massachusetts' unfunded pension liability increased to \$23.6 billion and the pension funded declined to 65.1% as of January 1, 2012 as the effect of asset smoothing was realized, down from 71.1% as of January 1, 2011 and 67.5% in 2010. Among the changes, the pension reform measure extended the funding schedule from 2025 to 2040, which reduced the fiscal 2012 contribution from \$2.2 billion to \$1.4 billion (although that was still larger than then fiscal 2011 amount). The negative impact of pushing out the period to fully fund the retirement obligations was partially offset by increasing the retirement age for most state employees; eliminating early retirement subsidies; increasing the period for calculating retirement from an average of three years to five years; and eliminating double-dipping. The measure also prohibits the commonwealth from making less than the annual payment required by the new schedule if investment returns exceed expectations: greater-than-expected gains would be used to shorten the schedule. It further dedicates future tobacco settlement monies to the commonwealth's other post-employment benefits (OPEB) trust fund, starting in phases in fiscal 2013. The

combined ratio of Massachusetts' pension and OPEB actuarially required contributions (ARC) to revenue is 16%, slightly higher than average. Those costs could limit the commonwealth's fiscal flexibility going forward, but the new plan should help to mitigate them in the long run.

CLOSELY MANAGED VARIABLE RATE DEBT AND SWAPS PORTFOLIO

Massachusetts has a total of \$3.5 billion of floating rate debt outstanding, or 11% of its Moody's-calculated net tax supported debt. This includes: just more than \$1 billion of variable rate demand bonds with unremarketed tenders supported by bank liquidity facilities; \$994 million of SIFMA index (\$266 million have maturities within the next twelve months); a \$248 million direct loan; \$401 million of auction rate bonds; \$197 million of CPI index bonds; \$845 million of LIBOR index bonds; and \$289 million of variable rate bonds issued by the University of Massachusetts Building Authority and the Massachusetts Bay Transportation Authority that the commonwealth pledges its full faith and credit to pay if necessary. The commonwealth's variable rate and derivatives portfolio is closely managed and its liquidity facilities and swap agreements contain provisions favorable to the commonwealth and offset its relatively low available cash balances. Liquidity facilities contain a mix of three- and five-year term-out provisions that, considering the strength of Massachusetts' market access should provide ample time to refinance if necessary. Swap counterparties are well-diversified and do not reflect collateral posting requirements on the part of the commonwealth, although the mark-to-market value was a sizeable -\$549.8 million as of October 31, 2012, which limits the commonwealth's ability to refinance the transactions those swaps are associated with. In our analysis, the commonwealth's liquidity (reflecting current cash as well as amounts in the stabilization fund) is sufficient to handle unforeseen circumstances related to its variable rate debt and swaps..

OUTLOOK

The outlook for Massachusetts is stable, reflecting its good reserve levels and efforts to regain structural budget balance. The outlook also reflects our expectation that the commonwealth will continue to take proactive measures to close budget gaps if they emerge and continue its trend of strong financial management. Going forward, heavy reliance on one-time budget solutions, tighter cash margins, unexpectedly severe economic deterioration, or a large increase in tax-supported debt could be credit challenges.

WHAT COULD MAKE THE RATING GO UP

- Continued rebuilding of reserves and establishment of stronger constraints on their use
- Established trend of structural budget balance
- Reduced debt ratios relative to Moody's 50-state median

WHAT COULD MAKE THE RATING GO DOWN

- Protracted structural budget imbalance driven by deeper and/or prolonged economic downturn
- Depletion of Budget Stabilization Fund to inadequate levels
- Increased leveraging of the commonwealth's resources to pay debt service or further erosion in funding ratios
- Narrowed cash flow that strains the commonwealth's liquidity

RATING METHODOLOGY

The principal methodology used in this rating was Moody's State Rating Methodology published in November 2004. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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