



New Issue: MOODY'S ASSIGNS Aa1 RATING TO \$463 MILLION OF MASSACHUSETTS GENERAL OBLIGATION REFUNDING AND NEW MONEY BONDS

Global Credit Research - 17 Jan 2012

\$18.5 BILLION OF G.O. BONDS 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 A (SIFMA Index Bonds)	Aa1
Sale Amount	\$291,815,000
Expected Sale Date	01/18/12
Rating Description	General Obligation
General Obligation Refunding Bonds (SIFMA Index Bonds), 2012 Series A	Aa1
Sale Amount	\$171,240,000
Expected Sale Date	01/18/12
Rating Description	General Obligation

Moody's Outlook N/A

Opinion

NEW YORK, January 17, 2012 --Moody's Investors Service has assigned a Aa1 rating to the Commonwealth of Massachusetts' \$171.2 million General Obligation Refunding Bonds (SIFMA Index Bonds), 2012 Series A and \$291.8 million General Obligation Bonds, Consolidated Loan of 2012, Series A (SIFMA Index Bonds). Proceeds of the refunding bonds will be used to refund the February 1 maturity of SIFMA index bonds issued in 2010 and 2011. A portion of Consolidated Loan 2012 Series A will be used to refund the commonwealth's \$191.2 million outstanding General Obligation Refunding Bonds, 1998 Series A, which are variable rate demand bonds; the new money portion of the issue will be used to help finance the commonwealth's capital plan. The bonds are scheduled to price January 18.

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 during economic downturns, 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 rebuild them to stronger levels, including through a new statutory mechanism to replenish them going forward
- High wealth and high levels of educational attainment
- The presence of large, highly-rated higher education and health care institutions in the Boston area has lent a degree of economic stability and have mitigated some job losses during recessions

CHALLENGES

- Managing expenditure pressures, especially from health care and social services, in a lower revenue environment and amid ongoing economic uncertainty
- Relatively low pension funding levels, and debt ratios that are among the highest in the nation
- Managing the challenges from federal downsizing during the next several years, which could have a heavy impact on the commonwealth's important healthcare sector

DETAILED CREDIT DISCUSSION

TRANSACTION ROLLS PORTION OF PREVIOUSLY ISSUED SIFMA INDEX BONDS; ALSO REFUNDS PORTION OF VRDOs INTO SIFMA STRUCTURE

The refunding bonds and the refunding portion of Consolidated Loan 2012 Series A will bear interest at a rate equal to the SIFMA index plus a spread to be determined at pricing. There is no put feature and thus the bonds do not require external liquidity support. Maturities of the refunding bonds are February 1, 2013 through 2017 and the commonwealth expects to roll each maturity through the issuance of refunding SIFMA index bonds, use of commercial paper, fixed rate bonds or bond anticipation notes. The commonwealth has established a management policy which includes detailed plans for the refinancing. While there is not put risk or exposure to an external bank providing liquidity support, the structure creates rollover risk because of the need to roll the bonds coming due each year; however that risk is mitigated by the commonwealth's demonstrated ability to access the market even during the credit crisis of late 2008, as well as its planning for alternatives and its record of sophisticated debt management. The portion of Consolidated Loan 2012 Series A that refunds the outstanding 1998 Series A variable rate demand bonds mature September 1, 2012 through 2016, matching the amortization of the refunded bonds.

COMMONWEALTH ENDS FISCAL 2011 IN STRONG FINANCIAL POSITION

Massachusetts ended fiscal 2011 with tax collections up 10.6% (nearly \$2 billion) compared to the prior year, and 3.6% greater than forecast. Personal income taxes, which account for 56% of general fund revenue in the high wealth state were especially strong, increasing by 14.5%, growth driven by strong nonwithholding collections. Sales taxes (24% of the total) increased by 6.4% compared to fiscal 2010, and corporate income taxes (11% of the total) were up by 5.1%. All other collections (9% of the total) were up by 5.6%. The commonwealth ended the year with a budgetary basis \$460 million general fund surplus, mostly as the result of the strong nonwithholding collections. On a GAAP-basis, Massachusetts ended fiscal 2011 with a Moody's adjusted available fund balance equal to 12% of operating revenue.

FISCAL 2012 BUDGET REFLECTS SPENDING REDUCTION AND REDUCES RELIANCE ON ONE-TIME RESOURCES; REVENUE FORECAST REVISED UPWARDS

The \$30.6 billion fiscal 2012 budget reduces total state spending by approximately \$666 million, or 2.1%.

It works toward a greater structural balance by reducing the commonwealth's use of one-time resources, which now only reflect 1.5% of the total budget compared to 6.0% in fiscal 2011. Including a supplemental measure passed in October, the budget includes a \$200 million draw from the Budget Stabilization Fund, although as in fiscal 2011 that could be reduced or eliminated later depending on the strength of revenue collections; in 2012 the budget would suspend the transfer into the fund equal to 0.5% of tax revenue. Assuming that the planned draw occurs, the stabilization fund would total \$1.3 billion, or 5.6% of estimated fiscal 2012 revenue.

In October, the fiscal 2012 consensus revenue forecast was revised upwards substantially. While collections had been estimated to increase by only 0.5%, the new forecast calls for 2.4% growth. Preliminary actual collections fiscal year-to-date through December are 2.6% greater than the same period in the prior fiscal year, but slightly below forecast as personal income tax estimated payments declined by 4.6% on a year-over-year basis. The commonwealth updates its consensus revenue forecast four times a year, a strong practice which allows it to quickly make mid-year budget adjustments if necessary. Estimates for fiscal 2013 collections released last week reflect 4.5% growth over the current year, slightly higher than preliminary estimates last fall. Based on the commonwealth's statutory limitation on revenue growth, the personal income tax rate decreased on January 1, 2012 to 5.25% from 5.3%. The current forecasts include that change, which is expected to reduce personal income tax collections by as much as \$56 million in the current fiscal year and by as much as \$117 million in fiscal 2013. Earlier this month, the state supreme court ruled against the commonwealth in a case regarding the provision of immigrant healthcare that is estimated to cost as much as \$50 million in the current fiscal year and \$150 million annually from fiscal 2013 onwards, which the commonwealth will need to dedicate recurring resources toward. The governor's fiscal 2013 budget proposal, which will be released later this month, is expected to address these costs.

FAVORABLE EMPLOYMENT SITUATION CONTINUES

The jobs situation in Massachusetts continues to outperform the nation. Unemployment in the state in November was 7.0% while it was 8.7% nationally. Total nonfarm employment growth was 1.7% compared to one year earlier in Massachusetts, while it was 1.2% for the U.S. 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 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 2010 was \$51,552, ranking second among the states. According to the Census Bureau, the commonwealth had the highest percentage of residents with bachelor's degrees of any state in 2008, which has helped to attract and develop significant high tech and defense contracting sectors. Despite the highly educated population, however, during the last two recessions Massachusetts lost more jobs than the nation and gained fewer during the expansions that followed. Among the commonwealth's economic challenges are high business and housing costs and slow population growth with negative migration trends. Indeed, high costs have pushed some suburban Boston growth into more affordable New Hampshire.

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

The commonwealth has a high debt burden, with \$18.5 billion in outstanding general obligation bonds and \$29 billion in total net tax-supported debt. Debt levels have been driven upwards 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 2010 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. Total net tax-supported debt amounted to 9.2% of total personal income in 2009 compared to the 50-state median of 2.5%.

A pension reform enacted by the state last year provides long-term benefits to the state, if enacted. Based on an updated actuarial valuation released on January 1, 2011, Massachusetts' pension funded ratio had improved to 71.1% from 67.5% in 2010. Among its changes, the plan extends the funding schedule from 2025 to 2040, which reduces the fiscal 2012 contribution from \$2.2 billion to \$1.4 billion (although that is still larger than then fiscal 2011 amount). The negative impact of pushing out the period to fully fund the retirement obligations is 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. Left unchecked, those costs could limit the commonwealth's fiscal flexibility going forward, but the new plan should help to mitigate them.

CLOSELY MANAGED VARIABLE RATE DEBT AND SWAPS PORTFOLIO

Approximately 20% of the commonwealth's general obligation debt is variable rate, largely swapped to fixed rates through cost-of-funds swaps, eliminating basis risk. It has reduced its exposure to external liquidity facility risk through the issuance of SIFMA index bonds, although the need to roll or take out maturities of those bonds creates some market access and liquidity risks. 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. Following the current transaction, the commonwealth will only have one remaining liquidity facility provided by a European bank, reflecting 15.4% of its variable rate demand bond portfolio, although it expects to replace that soon. Considering the strength of its market access, the commonwealth should be able to refinance that debt relatively smoothly if necessary. Swap counterparties are well-diversified and do not reflect collateral posting requirements on the part of the commonwealth. Just more than \$1 billion of the commonwealth's \$3.4 billion total outstanding swap notional amount is with European counterparties, and we similarly think any challenges in that portfolio should be manageable for the commonwealth. As of June 30, the mark-to-market value of Massachusetts' general obligation swaps was -\$369 million.

OUTLOOK

The outlook for Massachusetts is stable, reflecting rebuilding of reserves, improving revenues 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 LONG-TERM 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 LONG-TERM 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

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.moodys.com for a copy of this methodology.

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Analysts

Nicholas Samuels
Lead Analyst
Public Finance Group
Moody's Investors Service

Nicole Johnson
Backup Analyst
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA



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