

New Issue: MOODY'S ASSIGNS Aa1 RATING TO \$490 MILLION OF MASSACHUSETTS G.O. BONDS

Global Credit Research - 20 May 2011

\$17.8 BILLION OF G.O. DEBT OUTSTANDING OUTLOOK IS STABLE

Massachusetts (Commonwealth of)
State
MA

Moody's Rating

ISSUE	RATING
General Obligation Bonds, Consolidated Loan of 2011, Series B	Aa1
Sale Amount	\$485,000,000
Expected Sale Date	05/23/11
Rating Description	General Obligation
General Obligation Bonds, Consolidated Loan of 2011, Series C	Aa1
Sale Amount	\$5,000,000
Expected Sale Date	05/23/11
Rating Description	General Obligation

Opinion

NEW YORK, May 20, 2011 -- Moody's Investors Service has assigned Aa1 ratings to the Commonwealth of Massachusetts' \$485 million General Obligation Bonds, Consolidated Loan of 2011, Series B and \$5 million Series C (Build Mass. Bonds). The Series C bonds will be issued as capital appreciation bonds maturing on February 1, 2014, with interest payable only on that date. Proceeds of the bonds, scheduled to price May 23, will be used to finance capital projects.

SUMMARY RATING RATIONALE

The ratings reflect the commonwealth's demonstrated willingness to cut spending and raise revenues to close budget gaps, a large education and health care sector that generates high wages and that has helped to mitigate job losses in the current downturn, and debt levels that are among the highest in the nation. The outlook is stable.

Credit Strengths:

- Effective financial management during economic downturns, particularly a willingness to promptly identify and close budget gaps through both new revenues and expenditure reductions
- Budget reserves that still provide an adequate cushion, although a reduced one, and a 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

Credit Challenges:

- Managing expenditure pressures, especially from health care and social services, in a lower revenue environment, although collections have begun to improve
- High unemployment persists, although at lower levels than the nation and employment has begun to grow slowly
- Low pension funding levels, and debt ratios that are among the highest in the nation

DETAILED CREDIT DISCUSSION

FISCAL 2011 RECENT DEVELOPMENTS

Through April (ten months of the fiscal year), Massachusetts' fiscal 2011 tax revenue collections are 12.9% greater (\$1.9 billion) than the same period in fiscal 2010, well ahead of the original budget forecast of 2.9% annual growth, and the revised forecast of 6.7% growth, demonstrating continued resilience in the Massachusetts economy. Income tax collections have been particularly strong, increasing 18.5% compared to the same period in the prior year, although that partly reflects changes to the filing deadline that drove April collections upwards; still, withholding collections alone have increased by 6.8% year-to-date and reflect employment growth that while slow, has been ahead of the U.S. rate for nearly a year. Sales tax growth of 7.7% through April in part reflects economic improvement but also last year's increase in the tax rate from 5.0% to 6.25%.

While the enacted \$27.6 billion fiscal 2011 general fund budget included a \$100 million draw on the commonwealth's Budget Stabilization Fund

and the use of \$95 million carried forward from fiscal 2010, amid higher revenue collections and the extension of federal stimulus funds, legislation enacted in October eliminated both. Based on its current balance and the current tax revenue forecast, the stabilization fund equals 3.9% of fiscal 2011 tax revenue. Fiscal 2010 GAAP-basis results show the commonwealth continues to maintain healthy fund balances overall, with an available operating fund balance of nearly \$1.9 billion, or 9.3% of operating revenue.

FISCAL 2012 BUDGET PROPOSAL

The recommended fiscal 2012 budget reflects a 1.8% spending decrease compared to fiscal 2011. The proposal solves for the loss of \$1.5 billion of federal stimulus funds, a \$700 million structural shortfall from use of one-time resources in prior years, and \$500 million of revenues lower than the long-term trend. Spending reductions are broad-based and affect nearly every spending category, including some reductions in local aid. In addition to expenditure cuts, the proposal includes the use of \$385 million of one-time resources, a notable reduction from \$1.8 billion in fiscal 2011 and a demonstration of the commonwealth's efforts to bring the budget into structural balance. Most of that \$385 million reflects a \$200 million transfer from the stabilization fund. After the transfer, the stabilization fund balance would total \$569 million, or 2.8% of forecast fiscal 2012 tax revenue. That cushion is narrow but we expect the commonwealth to begin to rebuild its balance soon: the fund receives a statutorily-required transfer of 0.5% of annual tax revenue (although that was suspended for fiscal 2011), and based on legislation enacted last year, any capital gains collections greater than \$1 billion. However, while a proposed pension reform measure will provide the commonwealth with long-term savings, the 15-year extension of the schedule to eliminate its unfunded liability provides \$800 million in savings in fiscal 2012, also a non-recurring action to provide budgetary relief.

Fiscal 2012 tax revenue is expected to increase by 5.3% compared to fiscal 2011, with 6.0% growth in personal income taxes, 4.6% growth in sales taxes and 5.9% growth in corporate taxes.

BUDGET INCLUDES PENSION REFORM PROPOSAL

A pension reform proposal included in the budget recommendation will provide long-term benefits to the state, if enacted. Based on an updated actuarial valuation released on October 1, Massachusetts' pension funded ratio had improved to 67.5% from 62.7% in 2009, although that is still relatively low. 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). It also increases the retirement age to 67 for most state employees; eliminates early retirement subsidies; increases the period for calculating retirement from an average of three years to five years; and eliminates double-dipping. The proposal also would prohibit 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. The proposal also 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.

EMPLOYMENT CONTINUES SLOW IMPROVEMENT; HIGH WEALTH AND EDUCATIONAL LEVELS CHARACTERIZE THE STATE

Jobs in Massachusetts began to grow again four months before the nation as a whole, and have increased on a year-over-year basis in each of the past 11 months. For both Massachusetts and the U.S., the growth has been slow although it accelerated in March, increasing in both by 1.0%. Similarly, Massachusetts' unemployment rate has been lower than the national average, and was 8.0% in March compared to 8.8% 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. 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

The commonwealth has a high debt burden, with \$17.8 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%.

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 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. As of January 31, the mark-to-market value of Massachusetts' swaps was -\$356 million. The commonwealth also maintains a \$400 million commercial paper program.

For cash flow purposes, the commonwealth issued \$1.2 billion of revenue anticipation notes (RANs) in September 2010 with staggered maturities; the first matured this April, the remaining two mature in May and June.

Outlook

The outlook for Massachusetts is stable, reflecting 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 that Massachusetts

will again rebuild reserves as the economy recovers. Going forward, heavy reliance on one-time budget solutions, tighter cash margins, unexpectedly severe economic deterioration, or a large increase in tax-supported debt would pose credit concerns.

What would make the rating change - UP

- Rapid 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 would make the rating change - 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

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was Moody's State Rating Methodology published in November 2004.

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