Moody's
INVESTORS SERVICE

New Issue: Moody's assigns Aa1 ratings to $1.1 billion of Massachusetts general obligation new money and refunding bonds

Global Credit Research - 21 May 2013

$18.4 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 2013, Series D (Green Bonds)		Aa1
Sale Amount	$100,000,000	
Expected Sale Date	06/04/13	
Rating Description	General Obligation	
General Obligation Refunding Bonds 2013, Series B		Aa1
Sale Amount	$640,260,000	
Expected Sale Date	06/04/13	
Rating Description	General Obligation	
General Obligation Bonds, Consolidated Loan of 2013 Series C		Aa1
Sale Amount	$375,000,000	
Expected Sale Date	06/04/13	
Rating Description	General Obligation	

Moody's Outlook

Opinion

NEW YORK, May 21, 2013 --Moody's Investors Service has assigned Aa1 ratings to the Commonwealth of Massachusetts' $375 million General Obligation Bonds, Consolidated Loan of 2013 Series C; $100 million General Obligation Bonds Consolidated Loan of 2013, Series D (Green Bonds); and $640 million General Obligation Refunding Bonds, 2013 Series B. Proceeds of the bonds, scheduled to price on June 4, will be used to finance the commonwealth's capital plan and to advance refund outstanding general obligation bonds for present value savings without extending final maturities.

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 overall prudent use of reserves

-- Budget reserves that provide an adequate cushion to another downturn and the commonwealth's commitment to maintain them at healthy, although reduced, 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, significant pent up demand to restore spending cuts made during the recession, and spending pressure to increase funding for the statewide transportation system

-- 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 ENDS FISCAL 2012 IN HEALTHY FINANCIAL POSITION, FISCAL 2013 REVENUE FORECAST REVISED DOWNWARDS WHILE YTD COLLECTIONS SHOW SIGNIFICANT APRIL BOOST

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 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 brought 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. On a GAAP basis, the fiscal 2012 ending available fund balance (unassigned fund balance plus available reserves considered available by Moody's in the committed or restricted fund balance) increased to 11.4% of operating revenue from 10.1% in fiscal 2011, also a strong financial position.

The budgeted fiscal 2013 revenue forecast reflected 4.5% growth compared to fiscal 2012, and budgeted expenditures reflect 3.9% growth over the prior year. In December 2012, after cumulative collections fell $540 million short of the budgeted forecast, the commonwealth revised expected revenue growth for the fiscal year downwards to 1.8%. It also approved a variety of measures to close a $540 million budget gap, including expenditure cuts and a $200 million draw from the Stabilization Fund. Fiscal year-to-date through April, however, collections are 5.5% greater than the same period in the prior year and $510 million greater than forecast. The revenue boost is due to strong personal income tax collections as taxpayers sold assets in calendar 2012 ahead of the expiration of federal income tax cuts at the start of 2013, and is similar to current revenue developments in several high income and personal income tax-dependent states. The increased revenue likely reflects one-time gains and such asset sales may mean lower taxable activity in the future. Although it may be one-time revenue, however, taxes on capital gains greater than $1 billion are statutorily deposited into the Stabilization Fund, and the commonwealth estimates that amount could be approximately $100 million.

FISCAL 2014 BUDGET PROPOSALS REFLECT SPENDING INCREASES

The governor, House and Senate are currently debating differing fiscal 2014 budget proposals, expected to be enacted before the June 30 end of the fiscal year. While the governor's proposed budget reflected a 6.9% spending increase, the recently released Senate budget calls for 4.2% greater spending and the House increases it by 3.9%. The spending increases reflect pent-up demand to replace low spending growth from the recession, as well as budget drivers more unique to Massachusetts. While most states finance highways at the statewide level, the commonwealth also finances transit, which has been a significant budget and debt driver for years. Each of the three plans dedicate new revenues to transportation funding of differing amounts. The plans each also all withdraw some funds from the budget reserve, after which the balance is expected to be between 5% and 6% of tax revenues, an adequate cushion. The commonwealth's ability to maintain a healthy reserve and move away from one-time budget balancing measures as the economy improves will remain a focus of our analysis going forward.

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 1.4% in April, about the same as it has been in recent months and slightly below the U.S. level of 1.6%. The unemployment rate in the commonwealth dropped in April to 6.4% compared to the U.S. average of 7.5%.

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, 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 the most current actuarial valuation, 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, combined with the state's high bonded debt 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 bonds; a $248 million floating rate 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 -$510 million as of April 30, 2013, 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, reliance on one-time budget solutions, tighter cash margins, unexpectedly severe economic deterioration, or a large increase in tax-supported debt could pressure the rating at its current level.

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 pension funding ratios

-- Narrowed cash flow that strains the commonwealth's liquidity

The principal methodology used in this rating was US States Rating Methodology published in April 2013. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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