MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa1 to $400M of Massachusetts GO bonds; outlook stable

Global Credit Research - 25 Jul 2014

$19.0 billion of GO debt outstanding

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

Moody's Rating

ISSUE		RATING
General Obligation Bonds Consolidated Loan of 2014, Subseries D-1		Aa1
Sale Amount	$200,000,000	
Expected Sale Date	07/29/14	
Rating Description	General Obligation	
General Obligation Bonds Consolidated Loan of 2014, Subseries D-2		Aa1
Sale Amount	$200,000,000	
Expected Sale Date	07/29/14	
Rating Description	General Obligation	

Moody's Outlook STA

Opinion

NEW YORK, July 25, 2014 --Moody's Investors Service has assigned a Aa1 rating to up to $400 million of the Commonwealth of Massachusetts General Obligation Bonds, Consolidated Loan of 2014, Series D (Multi-Modal Bonds). The initial interest rate will be determined based on the SIFMA Index. The interest rate will increase to an anticipated 9% for any bonds that are not remarketed, converted to another mode, or refunded prior to the scheduled mandatory tender dates in 2016 and 2017. Proceeds of the bonds, scheduled to price on July 29th, will be used for various capital expenditures.

SUMMARY RATING RATIONALE

Massachusetts' Aa1 general obligation rating reflects its 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 helps to bolster employment; debt levels that are among the highest in the nation; and large unfunded pension liabilities. 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 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 large unfunded pension liabilities based on Moody's adjusted figures

-- Large health care and other social services costs that drive the budget and ongoing spending pressure related to 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

DETAILED CREDIT DISCUSSION

FISCAL 2014 REVENUES MET EXPECTATIONS

Despite March and April revenues below estimates, May and June revenues rebounded. The April shortfall was due mainly to lower than expected income tax payments. The Department of Revenue had anticipated that strong revenue collections in early calendar 2013 due to accelerated capital gains realizations would be offset over time. Like many other states, however, the impact was greater than expected in April.

Massachusetts still ended fiscal 2014 in June $169 million, or 0.7%, over the official estimate and 5.6% greater than fiscal 2013 revenues. The larger than expected acceleration of investment activity in fiscal 2013 led to slightly below forecast income tax payments, but this was somewhat offset by a sharp increase in tax settlements and bonus payments. Total personal income tax collections (56% of the fiscal 2014 total) were 2.9% greater than fiscal 2013 and $10 million below than the January 2014 forecast. Taxes on capital gains greater than $1 billion in fiscal years 2011, 2012 and 2013, and greater than $1.023 billion in fiscal 2014 were statutorily deposited into the Stabilization Fund. Sales taxes (24% of total tax collections) fell slightly short of forecast, increasing by 6.4% compared to fiscal 2013 but $5 million less than estimated.

HEALTHY GAAP POSITION REFLECTS GOOD BUT DECLINING STABILIZATION FUND BALANCES

On a GAAP basis, Massachusetts ended fiscal 2013 with an available General Fund balance (unassigned fund balance plus reserves considered available by Moody's in the committed or restricted fund balance) of 13.1%, a healthy cushion following the economic downturn and a good position compared to other states. The commonwealth used $550 million of its rainy day fund, the Budget Stabilization Fund, during fiscal 2013 (in part following downward revenue revisions in December 2012), but it also made $500 million in required deposits. Based on those amounts, the ending fiscal 2013 rainy day fund balance was $1.6 billion, or 7.2% of fiscal 2013 tax collections, a strong cushion itself coming out of the recession. The fiscal 2014 budget reflected a $350 million draw on the fund. The ending fiscal 2014 budget reserve balance is slightly higher at $1.25 billion, or 5.3% of estimated tax revenues but is now expected to drop further to $1.22 billion or 5.0% of estimated taxes based on the fiscal 2015 proposed budget. Those balances are still adequate to deal with unforeseen circumstances but the continued budgeted Stabilization Fund draws also reflect the commonwealth's challenges in getting to structural balance and eliminating the use of one-time resources in the budget.

FISCAL 2015 BUDGET REFLECTS MODEST SPENDING INCREASE

The $36.5 billion adopted fiscal 2015 budget increases spending by 5.9% compared to fiscal 2014. The budget includes $313 million of one-time resources (0.9% of the total budget), less than the prior year and the largest component of which is the planned rainy day fund draw.

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 slightly increased to be in-line with the US average. Massachusetts year-over-year employment growth was 1.46% in June, slightly lower than the US level of 1.83% for the same period. The unemployment rate in the Commonwealth continued to decline to 5.5% for the month of June, lower than the US average of 6.1%, also for June.

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 for 2013 was $56,923, ranking it third highest 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 $19.0 billion in outstanding general obligation bonds and $33.5 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 2014 state debt medians report, the state's debt levels ranked second-highest among the 50 states on a per-capita basis, but dropped to third-highest as a percentage of personal income and as a percentage of state gross domestic product after Hawaii and Connecticut. The commonwealth's debt per capita was $4,999, 9.0% of its personal income, and 8.3% of its gross domestic product.

Based on the commonwealth's fiscal 2012 pension data, we have calculated that its adjusted net pension liability (ANPL) was $62.6 billion or 139.8% of revenues. The 50-state median ANPL to revenues is 63.9%, and Massachusetts ranks seventh highest in this ratio. Our adjustments to reported state pension data include the common 20-year amortization period, as well as an assumed 13-year duration of plan liabilities and a market-based discount rate to value the liabilities, rather than the long-term investment return used in reported figures.

Based on the most current actuarial valuation, Massachusetts' unfunded pension liability increased to $28.3 billion and the pension funded ratio declined to 60.6% as of January 1, 2013 as the effect of asset smoothing was realized, down from 65.1% as of January 1, 2012 and 71.1% in 2011. Massachusetts law requires that the schedule of pension contributions be updated every three years. Just before the fiscal 2015 executive budget was proposed, the governor and legislature agreed to shorten the state's pension amortization schedule and increase its pension contributions by 10% annually through fiscal 2017 and by 7% thereafter until the final amortization payment in fiscal 2036. While pension contributions will rise to 4.7% of the state's budget in fiscal 2015, the agreement means that by fiscal 2018 Massachusetts will make its full actuarial required pension contribution and will reduce its ANPL. The new plan reverses a negative aspect of a pension reform enacted in 2012 that pushed the pension funding horizon to 2040. That reform also increased the retirement age for most state employees; eliminated early retirement subsidies; increased the period for calculating retirement from an average of three years to five years; and eliminated double-dipping. It also prohibits the commonwealth from making less than the annual payment required by the new schedule if investment returns exceed expectations. Additionally, Massachusetts dedicates future tobacco settlement monies to the commonwealth's other post-employment benefits (OPEB) trust fund, phased-in starting 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. The prior pension reform and the increased contributions recently agreed to still result in high fixed costs but will help to reduce Massachusetts' long-term liabilities in the long run.

CLOSELY MANAGED VARIABLE RATE DEBT AND SWAPS PORTFOLIO

Massachusetts has a total of $3.3 billion of floating rate debt outstanding, or 11% of its Moody's-calculated net tax supported debt. This includes: $761 million of variable rate demand bonds with unremarketed tenders supported by bank liquidity facilities; $994 million of SIFMA index bonds ($205 million of which mature within the next year and require take out or refinancing); $445 million of floating rate direct loans; $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 -$330.3 million as of December 31, 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.

The commonwealth plans to increase the amount of its unhedged floating rate debt portfolio over the next several years in an effort to better align asset and liability interest rate risks. The current issue is part of this program. The commonwealth also plans to implement additional risk management controls and oversight to manage the program as it ramps up.

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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