MOODY'S
INVESTORS SERVICE

New Issue: MOODY'S ASSIGNS Aa1 RATING TO COMMONWEALTH OF MASSACHUSETTS $250 MILLION GO BONDS, CONSOLIDATED LOAN OF 2010, SERIES B

Global Credit Research - 16 Jun 2010

COMMONWEALTH HAS TOTAL OF OVER $17 BILLION GO DEBT; OUTLOOK STABLE

State
MA

Moody's Rating

ISSUE	RATING
General Obligation Bonds Consolidated Loan of 2010, Series B	Aa1

Sale Amount	$250,000,000
Expected Sale Date	06/18/10
Rating Description	General Obligation

Opinion

NEW YORK, Jun 16, 2010 -- Moody's Investors Service has assigned a Aa1 rating with a stable outlook to the Commonwealth of Massachusetts' General Obligation Bonds, Consolidated Loan of 2010, Series B. The rating reflects the commonwealth's demonstrated willingness to cut spending and raise revenues to close budget gaps, a large and high-wage education and health care sector that has helped to mitigate job losses in the current downturn, continued cost pressures, and debt levels that are among the highest in the nation. The bonds will mature May 1, 2012-2020, and are expected to sell as early as June 18.

Credit strengths:

* Effective management during economic downturns, with a willingness and ability to promptly identify and close gaps through use of both new revenues and spending reductions

* Strong reserves going into current recession due to rapid reserve replenishment following 2001-02 recession

* High wealth and education levels

* Presence of large, highly-rated higher education and health care institutions in the Boston area add economic stability and have mitigated larger job losses during recessions

Credit challenges:

*Declining tax revenues as a result of recession, however revenues are stabilizing

*Job losses and high unemployment persist, although to a lessening degree in recent months and at a more moderate pace than the nation

*Rising costs related to Medicaid, pensions, healthcare reform as well as OPEB add to long-term budget pressures

*Debt ratios are among the highest in the nation

*Significant use of reserves to close fiscal 2009 budget gap has reduced financial flexibility, although a sizeable reserve still remains

COMMONWEALTH ACTED TO CLOSE FISCAL 2009 GAP WITH BUDGET CUTS, FEDERAL AID, RESERVE DRAWDOWN

As is common with other states, Massachusetts has faced revenue shortfalls during this recession, forcing significant corrective actions. The commonwealth benefited from the sizeable reserves it built up during the 2004-2007 period, and a larger portion of those reserves are still available compared to other large states at this rating level. Massachusetts has generally reacted quickly to identify and correct emerging gaps, using a variety of measures including spending down reserves, revenue increases, expenditure cuts, and use of federal stimulus and other one-time balancing measures.

Gaps totaling more than $3.6 billion (or a sizeable 15% of total operating revenues, excluding federal aid) opened during fiscal 2009 due to poor revenue performance, with the personal income tax off by more than 15%. Early actions by the commonwealth to close those gaps largely focused on spending cuts and a total of more than $1.3 billion in mid-year spending reductions were made. The state also utilized about $1.3 billion of federal stimulus. Additional gaps opened late in the fiscal year, when implementing spending cuts is more difficult, and the state used more than $1.3 billion of a combination of federal stabilization funds and its rainy day fund, drawing the reserve down from $2.1 billion to $841 million at the close of fiscal 2009.

FISCAL 2010 BUDGET INCLUDED SALES TAX INCREASE; REVENUES NOW STABILIZING

Commonwealth policy-makers faced a large gap in formulating the fiscal 2010 budget, which continued to widen as the budget was being developed. The approved budget included a balanced mix of new revenues, spending cuts, use of federal stimulus, as well as use of some reserves and other one-time measures. The commonwealth increased its sales tax from 5.0% to 6.25% effective August 1, which is expected to raise $759 million in the current fiscal year with $900 million annually thereafter; $275 million of this is dedicated to transportation. While fiscal 2010 budget-balancing measures included use of some reserves, a $657 million balance (or about 3.5% of state operating revenues) in the stabilization fund is anticipated at year end. While the reserve is significantly depleted from a peak of $2.3 billion at the close of fiscal 2007, it is still sizeable enough to provide a cushion against future revenue shortfalls or unforeseen spending needs. Total spending for fiscal 2010 is now anticipated to be $30.8 billion, an amount that has essentially been held flat since fiscal 2008.

To date, Massachusetts' fiscal 2010 revenues have stabilized, albeit at a low level. In October 2009, revenue estimates were lowered by $600 million, or 3.2%, and the governor announced corresponding corrective actions including cuts and one-time measures. In January, with revenues having picked up slightly, the revenue estimate was increased by $181 million. Tax revenues through May were 0.4% ($70 million) below the January revised estimate.

LEGISLATURE CONSIDERS PROPOSED FISCAL 2011 BUDGET

The commonwealth's proposed fiscal 2011 budget is now pending in the legislature. The governor's original proposal called for $19.1 billion of tax revenues, up 3.2% from fiscal 2010, which included no new broad tax increases. Spending was proposed to increase by 3.0% and the budget uses $1.4 billion of federal stimulus funds, with a six-month extension of stimulus Federal Medical Assistance Percentage (FMAP) funds assumed and worth $607 million. The budget also proposed a debt restructuring of up to $300 million, which would effectively push principal in 2011 to later years as well as use of $175 million in reserves. The governor has submitted a revision to the legislature, calling for $607 million in cuts if Congress does not approve the FMAP extension. As is the case for most states, Massachusetts will face a challenging fiscal 2012 with the expiration of federal stimulus.

JOB LOSSES SLOW; HIGH WEALTH AND EDUCATION LEVELS CHARACTERIZE STATE

Like the nation, Massachusetts has experienced steep job losses and the commonwealth's April 2010 non-farm employment was 0.9% below April 2009, just below the 1.0% loss nationally. The pace of job losses has ebbed from 2009, when the commonwealth lost 3.6% of jobs year-over year. Unemployment of 9.2% in Massachusetts in April was slightly off the peak of 9.5% in January and February and below the April national rate of 9.9%. The commonwealth has been aided by continued growth in its large education and health sector, which makes up more than 20% of employment and showed 2.1% job growth in April. Massachusetts' two largest private employers are Brigham and Women's Hospital and Massachusetts General Hospital, both part of the Aa2-rated Partners Healthcare System. Other top employers include Harvard University (Aaa), Massachusetts Institute of Technology (Aaa), and Boston University (A2). 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. Per capita personal income in 2009 was $49,875, ranking third 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 this, 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; DEBT AFFORDABILITY STUDY AIDS CAPITAL PLANNING

The commonwealth has a high debt burden, with more than $17.2 billion in outstanding general obligation bonds and $29 billion in total net tax-supported debt. Based on Moody's 2009 state debt medians, the state's debt levels ranked second-highest among the 50 state on both a per-capita basis and as a percentage of personal income, respectively. Total net tax-supported debt amounted to 9.2% of total personal income in 2009, more than three times the 50-state median of 2.5%. The commonwealth recently updated its formal debt affordability study and set a bond issuance cap of $1.5 billion for fiscal 2010.

About one-fifth of the commonwealth's general obligation debt is variable rate, largely swapped to fixed rates through cost-of-funds swaps, eliminating basis risk. In March the commonwealth refunded nearly $540 million of liquidity-backed variable rate debt into SIFMA Index Bonds which do not have liquidity support. The SIFMA bonds mature serially through 2014 and are swapped to fixed rates. The commonwealth's swap portfolio is carefully managed and swap counterparties are well-diversified. Swap legal provisions favor the commonwealth, with potential collateral posting only by the counterparty. As of May 30, the commonwealth's swap agreements had a combined fair market value of approximately -$377 million.

For cash flow purposes, Massachusetts has relied on an $800 million commercial paper (CP) program and revenue anticipation notes (RANs), although in the future the commonwealth intends to use only RANs for cash flow, while using CP for capital purposes. The commonwealth issued $1.2 billion of RANs in September 2009, with a final maturity of June 24, 2010; no commercial paper is currently outstanding. The commonwealth ended fiscal 2009 with an $805 million cash balance, down from $1.2 billion at the end of fiscal 2008. Fiscal 2010 is now expected to end with $860 million, representing an increase of about 7% from the opening balance.

ANNUAL PENSION CONTRIBUTIONS ADD SUBSTANTIAL FIXED COSTS

Annual pension contributions are substantial, and the governor's budget calls for a $1.4 billion contribution in fiscal 2011. The commonwealth dramatically improved pension funding during the 1990s, rising from 29% in 1990 to 85% in 2000. The most recent actuarial valuation, as of January 1, 2009 revealed the funded ratio had fallen from 79% in 2008 to 63%, following significant investment loses. The governor has proposed pension reforms which are estimated to save $2 billion over 30 years. Massachusetts' other post employment benefits (OPEB) liability could add substantial budget pressures in the future, as is also likely in most other states. The January 1, 2009 valuation of the plan shows a $15.3 billion liability, with just $277 million of assets. No funds have been contributed to the trust fund since 2008. The governor has proposed dedicating a small portion of future excess capital gains tax revenues to the OPEB liability and also has proposed reforms to reduce the liability, including raising the retirement age.

Outlook

The outlook for Massachusetts is stable, based on expectations that the commonwealth will continue to quickly react to close emerging budget gaps as a result of weak revenues. The outlook also incorporates Moody's expectation that Massachusetts will again rebuild reserves as the economy recovers. Heavy reliance on one-time budget solutions, tighter cash margins, and failure to plan for the eventual falloff in federal stimulus funds, unexpectedly severe economic deterioration, or a large increase in tax-supported debt would pose a credit concern.

What would make the rating change - UP

*Evidence of economic recovery exceeding that of the nation.

*Rapid rebuilding of reserves.

*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

*Increased leveraging of the commonwealth's resources to pay debt service

*Cash flow narrows further, leading to liquidity strain

*Failure to adopt plan to cover expenditures once federal fiscal stimulus monies are no longer available

PRINCIPAL METHODOLOGY AND MOST RECENT RATING ACTION

The principal methodology used in rating the current issue was Moody's State Rating Methodology, published in November 2004, which can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issue can also be found in the Rating Methodologies sub-directory on Moody's website.

The last rating action with respect to the Commonwealth of Massachusetts was on May 3, 2010 a Aa1 rating was assigned to its Consolidated Loan of 2010, Series A.

Analysts

John Ceffalio
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