Moody's Investors Service

Global Credit Research
New Issue
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New Issue: Massachusetts (Commonwealth of)

MOODY'S ASSIGNS Aa2 RATING TO COMMONWEALTH OF MASSACHUSETTS $538.9 MILLION GO REFUNDING BONDS (SIFMA INDEX BONDS) 2010 SERIES A

Aa2 RATINGS ALSO AFFIRMED ON APPROXIMATELY $17.2 BILLION OUTSTANDING GO DEBT; OUTLOOK STABLE

State
MA

Moody's Rating

ISSUE	RATING
General Obligation Refunding Bonds (SIFMA Index Bonds), 2010 Series A	Aa2

Sale Amount	$538,860,000
Expected Sale Date	03/11/10
Rating Description	General Obligation

Opinion

NEW YORK, Mar 4, 2010 -- Moody's Investors Service has assigned a Aa2 rating to the Commonwealth of Massachusetts' General Obligation Refunding Bonds (SIFMA Index Bonds) 2010 Series A. Concurrently, Moody's has affirmed the Aa2 ratings assigned to approximately $17.2 billion of outstanding Massachusetts general obligation bonds. 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 outlook is stable.

The bonds will mature February 1, 2014 and each maturity will bear interest at a rate based on the SIFMA index.

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

*Steep job losses and rise in unemployment, albeit both 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

TRANSACTION REDUCES EXPOSURE TO VRDBs

The new transaction will refund a 2005 general obligation variable rate demand bond (VRDB) issue. The interest rates on those bonds has been effectively fixed through a swap agreement with Citibank, N.A. (A1, Stable Outlook), where the commonwealth pays a fixed rate and receives a variable rate equivalent to SIFMA. That swap is valued (as of 2/26/2010) at -$42.2 million to the commonwealth. The liquidity for the 2005 bonds-also provided by Citibank, N.A.-expires later this month and the commonwealth has decided not to renew it. Instead, the commonwealth will issue these new bonds that will have no put feature and thus will require no liquidity support. Maturities are February 1, 2011-14 and the bonds will bear an interest rate tied to the SIFMA index, matching the swap to eliminate basis risk. The commonwealth expects to largely roll the maturities, while amortizing at a similar pace to the swap, which terminates in 2028. The rolling of maturities could be accomplished by use of similar SIFMA notes, VRDBs, use of commercial paper capacity, fixed rate bonds, bond anticipation notes, with cash, or a combination of those options. The commonwealth has established a management policy which includes detailed plans for the refinancing.

Moody's considers the transaction, as currently structured, to be a credit positive for the commonwealth. Unlike VRDBs, this transaction has no bank counterparty risk (except for the existing swap) and is not subject to the risk of replacing the liquidity as it expires. The transaction also diversifies the commonwealth's debt portfolio, which prior to this transaction included nearly $2.2 billion of VRDBs. The transaction does create rollover risk as a sizeable payment (now expected to be about $150 million) comes 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.

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. Other fiscal 2010 budget-balancing measures include use of more than $200 million of reserves, which is expected to leave $617 million (or 3% of operating revenues) still available at the close of fiscal 2010. 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.

Massachusetts' year-to-date 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 February were 2.1% below the same period in 2009 despite the sales tax increase, although most of this shortfall occurred during the first quarter of the fiscal year. Through February collections are $34 million above the revised estimate.

GOVERNOR PROPOSES FISCAL 2011 BUDGET

The governor has proposed a budget for fiscal 2010 based on $19.1 billion of tax revenues, up 3.2% from fiscal 2010. Revenues include no new broad tax increases; spending is proposed to increase by 3.0%. The budget uses $1.4 billion of federal stimulus funds, and assumes a six-month extension of stimulus Federal Medical Assistance Percentage (FMAP) funds worth $608 million. Should the additional FMAP aid not be extended by Congress, the governor plans to re-file his budget bill by June 1. The budget also proposes a debt restructuring of up to $300 million, which would effectively push principal in 2011 to later years. While the restructuring would smooth a spike in debt service in 2011, Moody's would consider a restructuring which postpones principal payments to effectively be a deficit financing. The budget also proposes a use of $175 million in reserves, which would leave a $450 million rainy day fund balance. In total, the budget uses an estimated $1.9 billion of one-time funds, less than the $3.1 billion used in 2009 and $2.5 billion in fiscal 2010. As is the case for most states, Massachusetts will face a challenging fiscal 2012 with the expiration of federal stimulus.

JOB LOSSES CONTINUE AT SLOWER PACE THAN NATIONAL AVERAGE

Like the nation, Massachusetts has experienced steep job losses and the commonwealth's December 2009 non-farm employment was 2.1% below December 2008, less severe than the 3.6% loss nationally. Unemployment of 9.3% in Massachusetts in December was the highest since September 1976, but below the national rate of 10%. 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 2.0% job growth in December. 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 2008 was $51,254, 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 8.9% of total personal income in 2008, 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. The 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 January 31, the commonwealth's swap agreements had a combined fair market value of -$338 million.

For cash flow purposes, Massachusetts relies on an $800 million commercial paper program and revenue anticipation notes (RANs). The commonwealth issued $1.2 billion of RANs in September 2009, with a final maturity of June 24, 2010. Approximately $130 million of commercial paper is currently outstanding for capital purposes. Please see Moody's research dated September 11, 2009 for further information on the RAN. 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 expected to end with $786 million.

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.

MOST RECENT RATING ACTION AND PRINCIPAL METHODOLOGY

The last rating action with respect to the Commonwealth of Massachusetts was on November 3, 2009 when a Aa2 rating was assigned to its General Obligation Bonds, Consolidated Loan of 2009 Series E.

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.

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 narrowing, leading to liquidity strain

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

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