STANDARD & POOR'S
RATINGS SERVICES

RatingsDirect®

Massachusetts; General Obligation

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Credit Profile		
US$450.0 mil GO bnds cons ln of 2013 ser A due 04/01/2043		
Long Term Rating	AA+/Stable	New
US$70.0 mil GO bnds cons ln of 2013 ser B (federally taxable) due 04/01/2018		
Long Term Rating	AA+/Stable	New
Massachusetts GO		
Long Term Rating	AA+/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'AA+' rating, and stable outlook, to Massachusetts' $450 million general obligation (GO) bonds consolidated loan of series 2013A and $70 million GO bonds consolidated loan of 2013 series B (federally taxable).

In addition, Standard & Poor's affirmed its 'AA+' rating, and stable outlook, on Massachusetts' existing parity debt.

Factors supporting the 'AA+' rating include what we view as the commonwealth's:

- Strong budget performance, with timely monitoring of revenues and expenditures and swift action when needed to make adjustments, with a focus on structural solutions to budget balance;
- Ongoing progress in improving financial, debt, and budget management, including formalized policies relating to debt affordability as well as multiyear capital investment and financial planning, which are key improvements from a credit standpoint.
- A healthy budget stabilization fund (BSF) balance, which has been key to managing budget volatility. After significant contributions in 2011 and 2012, the expected used of reserves in the current fiscal year and planned reduction under the governor's proposed budget would diminish flexibility in our opinion;
- High wealth and income levels; and
- Deep and diverse economy, that continues to experience steady economic recovery.

Standard & Poor's believes the commonwealth's high debt burden and significant unfunded pension and other postemployment benefit (OPEB) liabilities are offsetting considerations to the current rating. While we view Massachusetts' total postretirement liabilities as relatively high, we believe the commonwealth has been actively managing these liabilities with a focus on cost control and reform in recent years.

We understand that bond proceeds will be used to fund authorized capital projects.

Massachusetts' economy has experienced steady recovery, outpacing national and regional trends by most measures but the pace has slowed in recent months. Through January 2013 the rate increased to 6.7% after falling to 6.0% in June but still remains well below the U.S. rate of 7.9%. Employment growth has been strong relative to other states throughout the recovery. In our view, the commonwealth's economic fundamentals and key anchors, which are centered on higher education, technology, and health care, should contribute to positive economic growth prospects over time. Income growth has also been strong relative to other states with per capita personal income now ranked second in the U.S. behind Connecticut.

Steady economic recovery has contributed to revenue growth but the pace through fiscal 2013 has been variable. After underperforming estimates in certain months at the start of the fiscal year, tax receipts were strong in December and January. Tax collections were 9.2% and 12.2% above fiscal 2012 respectively. We believe that this surge in revenues is due in part to timing issues and taxpayer actions associated with federal tax policy uncertainty at the end of 2012 rather than trend growth. Tax collectionsthrough Feb. 28, 2013, were relatively strong with revenues about $500 million above fiscal 2012 and $332 million above the revised estimate for fiscal 2013. The positive variance is due largely to personal income tax revenue collections including withholding and estimate payments. There have been a range of adjustments to both revenue and expenditure estimates during fiscal 2013. On Dec. 4, 2012, the secretary for administration and finance (A&F) identified a tax revenue shortfall of $540 million for the year. The governor filed legislation with proposed solutions to address the shortfall including the following:

- $225 million in spending reductions across executive branch agencies;
- $20 million in personnel savings;
- $25 million in non-executive branch agencies;
- 1% across the board reductions in unrestricted local aid; and
- $200 million from the budget stabilization fund (BSF). This is in addition to the $350 million already included in the budget.

Based on current estimates, the BSF will be reduced to $1.27 billion from $1.65 billion; about 3.8% of total budgeted expenditures and transfers. The final ending balance could be higher than the current estimate based on capital gains collections and judgment and settlement funds received during the year that could flow to the fund under current law. There have been no budget adjustments relating to federal sequestration but A&F is establishing a task force to assess economic and budget implications.

Based on the analytic factors we evaluate for states, on a scale of '1.0' (strongest) to '4.0' (weakest), we have assigned a composite score of '1.8' to Massachusetts.

Outlook

The stable outlook reflects our expectation that Massachusetts will continue to proactively manage its budget. Management initiatives to formalize long-term financial planning and manage long-term debt and liabilities should allow for better structural alignment of the budget in the future. However, recent and planned withdrawals of the BSF during a period of economic expansion are a credit negative in our view and are a departure from the commonwealth's past funding practice. We believe a lower BSF diminishes flexibility to manage future budget volatility. Credit direction over the two-year outlook horizon will depend on the pace of economic recovery, the funding level of the BSF, and overall structural budget alignment. Standard & Poor's will continue to monitor federal consolidation efforts and will evaluate their effect on the state's finances and officials' response to these revenue reductions.

Government Framework

State finance law requires that the governor submit a balanced budget and the House and Senate each produce a balance budget. The final general appropriation act must also be balanced. If a revenue shortfall is identified, the governor is required by section 9C of Chapter 29 to reduce agency appropriations or recommend a transfer from the BSF. Massachusetts has autonomy to raise taxes and has adjusted its tax structure over time. Medicaid accounts for about one-third of total spending while direct local aid for about 15% of spending. Funding levels for major program areas have been adjusted as needed. Massachusetts voters have approved revenue growth limitations but these have not negatively affected operations or limited flexibility in our view. More significant measures to reduce or eliminate major tax sources have been on the ballot but not approved. We note that the state legislature could amend various measures before they take effect. The commonwealth is authorized to issue GO debt, special obligation debt, and federal grant anticipation notes. There is a statutory limit on debt outstanding and a statutory limitation on debt service appropriations set at 10%. These limitations have not impaired flexibility to manage capital and infrastructure requirements. There is not a statutory priority for funding debt but we understand that the comptroller and other state officials have developed procedures to prioritize payments and debt service is given the highest priority among various payment obligations. Funding for education and municipal assistance is provided. While municipal assistance payments have been reduced over time, funding reductions for education have been limited.

On a scale from '1.0' (strongest) to '4.0' (weakest), Standard & Poor's assigned a '1.5' to the commonwealth's governmental framework.

Budget Performance

The commonwealth's revenue base is diverse, in our view, with income tax (56% of total), sales tax (24%), and corporate tax (8%) comprising the primary tax revenues in fiscal 2012. Spending is heavily weighted toward Medicaid, which accounts for about one-third of total spending while other health and human service spending accounts for another 15% of budgeted expenditures. Local aid is the other significant program area representing about 16% of total spending. Debt and postemployment costs are what we consider a significant 12.6% of spending but have been steady over time. While Massachusetts experienced revenue decline throughout the Great Recession, it made adjustments frequently and included many structural solutions as part of the overall budget balance strategy. In addition to revenue enhancement, we view the expenditure reductions and cost-control measures over the past several years as significant given what we see as high service levels in areas that are usually less flexible such as Medicaid.

Fiscal 2014

On Jan. 14, 2013, the Secretary of Administration and Finance (A&F) and the legislature agreed on the consensus revenue estimate for fiscal 2014. We believe the estimate of $22.3 billion is reasonable and aligned with the current pace of economic growth. This represents growth of 3.9% compared with the current estimate of fiscal 2013 revenues. After the required statutory deposit of capital gains tax revenue to the BSF and transfers of dedicated sales tax revenue, $19.1 billion would be the tax revenue available to fund the fiscal 2014 budget. At the same time, an estimate of potential gross state product was released, which is the benchmark used by the state's Health Policy Commission to establish the commonwealth's health cost growth benchmark. This estimate is now required as part of the health care cost control legislation passed in 2012.

Governor Deval Patrick filed his budget recommendations for fiscal 2014 on January 23rd. Total spending under the plan is estimated at $34.8 billion or 6.9% above fiscal 2013. This increase is well above the 2.9% average growth of spending since 2009 and well above inflation. The governor's plan includes a $550 million increase for education funding aimed at enhancing outcomes. The budget also implements Medicaid expansion under the Affordable Care Act but federal resources and other cost-control initiatives are expected to offset the cost of expansion. Additional transportation reform initiatives are outlined in the budget aimed at eliminating the structural deficits of the Massachusetts Bay Transportation Authority, improving service levels and improving the funding of the regional transportation authorities. The budget also included a recommendation for $13 billion of capital investment in transportation over 10 years but the funding plan for this is uncertain at this time.

The plan includes significant tax policy changes to support the growth in spending that are estimated to provide $791 billion in additional revenue for fiscal 2014 and $1.9 billion when fully annualized. The budget assumes baseline tax revenue growth of $838 million based on the consensus revenue forecast. Despite the significant revenue enhancement and positive baseline revenue growth, the budget is not structurally balanced in our opinion and relies on nearly $1 billion of nonrecurring measures. Under the plan, $400 million will be withdrawn from the BSF, which represents a significant reduction in the reserve balance. In our view, this reverses a trend of enhancing BSF balances that we had viewed positively from a credit standpoint. The commonwealth has historically increased reserve balances in periods of economic recovery, enhancing flexibility in our view. The expected reduction in fiscal 2013 and the proposed reduction in fiscal 2014 would leave the BSF balance at about $1 billion, which is less than half of the $2.3 billion reserve the commonwealth had in advance of the most recent recession. The actual balance could be higher or lower depending on the year end fiscal 2013 balance and certain projected assumptions of capital gains and one time settlements and judgments. A lower reserve translates to less flexibility in our view, given the historical volatility of the revenue base and the uncertainty surrounding potential federal fiscal consolidation. We recognize that the statutory requirement to transfer capital gains in excess of a threshold amount ($1 billion, indexed for inflation) is expected to limit some of the personal income tax volatility in the future and potentially augment the BSF. Included in our assessment of nonrecurring resources is a proposal to issue $400 million in revenue anticipation notes (RANs), which we view as a credit negative. The RAN proceeds would fund current year spending and would be repaid with revenues collected in fiscal years 2015 and 2016.

The most significant tax policy changes include:

- Increasing the personal income tax rate to 6.25% from 5.25%, which is expected to provide $2.56 billion of additional revenue on an annual basis.
- Lower the sales tax rate to 4.5% from 6.25%, which will decrease revenues by $900 million.
- Increase the cigarette tax and smokeless tobacco tax rates providing $166 million of revenue.
- Repeal the sales tax exemption for candy and soda for $53 million of additional revenue.
- A range of changes to corporate income tax that are forecasted to provide an additional $29 million after netting out the benefit for corporations of a lower sales tax rate that the commonwealth estimates to be $470 million.

Fiscal 2012

On a generally accepted accounting principles basis, the commonwealth ended fiscal 2012 with a modest general fund surplus after transfers of $295 million. The unassigned general fund balance was what we consider strong at $1.5 billion or 4.7% of expenditures and transfers. In addition, the committed fund balance was $1.65 billion and represents the BSF. This positive performance was due to stronger-than-forecasted revenues and various structural adjustments to revenues and expenditures. The state has historically maintained a negative unrestricted net asset position that increased to $24.9 billion from $23.1 billion in fiscal 2011. This is a significant shift from the negative $13 billion in fiscal 2009. The sharp increase reflects the comprehensive reform to the transportation system in fiscal 2010. The Massachusetts Department of Transportation (MassDOT) was created and several departments and authorities were merged as part of this structural change. All of the transportation assets have been transferred to MassDOT while the commonwealth is responsible for the debt obligations. This negative position has historically reflected debt issuance by the commonwealth to fund assets that are owned by other political subdivisions. This includes debt issued for various transportation and school construction projects. General fund results on a budgetary basis showed a slight deficit of $113.6 million that was offset by a reduction in the budget stabilization reserve.

On a scale from '1.0' (strongest) to '4.0' (weakest), Standard & Poor's assigned a '1.5' to Massachusetts' budget performance.

Economy

Economic recovery is underway at a steady pace and job growth has been more robust relative to most other states and the U.S.. Unemployment rates have declined at a steady pace due to positive employment trends. Massachusetts has always has always had high income levels but has made gains in this area as well. Per capita personal income stood at $53,471 in 2011, about 129% of the nation. This compares to 125% of the nation in 2010; Massachusetts is now ranked second behind Connecticut. Population has expanded over time at a modest pace with 2012 reaching 6.6 million compared with 6.4 million in 2000 according to the most recent estimate of the U.S. Census Bureau. Growth has outpaced the region since 2007 but continues to lag the nation and we expect this to continue.

The economy has diversified over time and education and health services now make up the primary employment sectors, accounting for 21% of total employment in 2012 according to the commonwealth. This is followed by trade and transport (17%) and professional business services (15%). Cyclical sectors, such as manufacturing and construction, represent only 8% and 3% of employment, respectively. The increasing role of services in the economy reflects growth in research laboratories, computer software, management consulting, other business services, and health care. Higher education anchors, a high level of federal research funding, and venture capital give the commonwealth a leading edge in emerging industries, such as biotechnology, software, communications equipment, and surgical instruments. In addition, its defense-related industries continue to perform well. Massachusetts ranks eighth out of the 50 states by value of federal defense and research contract awards. This part of the economy is likely to be inordinately affected by any federal fiscal consolidation.

On a scale from '1.0' (strongest) to '4.0' (weakest), Standard & Poor's assigned a '1.8' to Massachusetts' economy.

Financial Management

Budget management framework

Once the budget is approved, the Secretary of A&F is required to prepare quarterly updates of both revenues and expenditures and submit them to the legislature. If projected revenues are expected to be insufficient to meet appropriations, the deficiency is certified by A&F and, pursuant to statute (section 9C of Chapter 29), the governor is required to reduce allotments or submit proposals to raise additional revenues or to make appropriations from the BSF to restore balance. Budget adjustments have historically been implemented regularly and on a timely basis. Deficits are not carried forward into future fiscal years. Massachusetts is a voter initiative state. While there have been voter initiatives that limit the overall growth in state tax revenue and a limit on the amount of bonds outstanding and debt service appropriations, these have not substantially altered Massachusetts' ability to manage its budget or fund debt service. While more recent ballot initiatives to reduce or eliminate major tax sources of the state were not approved, the legislature can amend an initiative. The commonwealth provides a relatively high level of service. Adjustments have been made to programs but reductions to areas such as education have been limited.

Financial Management Assessment: 'Strong'

Standard & Poor's maintains a "strong" financial management assessment (FMA) score for Massachusetts. In our framework, an FMA of strong indicates that practices are strong, well embedded, and likely sustainable. Many of the commonwealth's management practices related to debt and financial management are embedded in statute.

Highlights include the following:

- Massachusetts uses internal resources and outside economic forecasting firms to develop a consensus revenue forecast. It has regularly done monthly revenue estimates and quarterly budget reviews. Legislation approved in 2008 requires that revenue reports be submitted semimonthly to the legislature.
- Five-year financial forecasting has been implemented. We understand that it will be updated annually and integrated into the budget process.
- A five-year capital investment plan (CIP) (administrative intent, not binding) is in place that coordinates every facet of debt issuance. Included in the CIP is a detailed debt affordability analysis that is also updated each year.
- There are statutory limits on debt issuance. For direct debt, there is a limit allowing the issue of up to 105% of the previous year's limit ($16.4 billion compared with $14.7 billion outstanding based on the office of A&F estimates). There is also a limit on annual debt service of 10% of the then-current year's budget appropriation. In addition to the aforementioned statutory requirement, the governor's office adheres to an administrative bond cap (debt service capped at 8% of budgeted revenues), which sets the annual limit on debt issuance. The commonwealth targets a 4% net present value savings for refundings. The treasurer's office maintains a swap policy that is comprehensive in our view.
- Massachusetts has a statutorily established BSF that prescribes a mechanism for funding, as well as funding levels. Statute requires the deposit of 100% of consolidated net surplus in any given year into BSF. The statute also provides that the BSF's maximum amount cannot exceed 15% of the current year's revenues. The commonwealth must use any excess above that for tax reduction. A change was made in 2010 to direct capital gain revenues in excess of $1 billion to the fund. Legislation approved in 2012, indexes the capital gains amount to growth in U.S. gross domestic product. The statute also directs 5% of the excess to the state retiree benefits trust fund and the

pension liability fund. We believe this measure has the benefit of enhancing the fund while decreasing budget reliance on this cyclical revenue source. Judgments and settlements in excess of $10 million must also be deposited to the fund.
- The commonwealth has detailed and frequently reviewed investment policies managed through the office of the treasurer. Quarterly cash flow projections are prepared and submitted to the legislature.

On a scale from '1.0' (strongest) to '4.0' (weakest), Standard & Poor's assigned a '1.0' to Massachusetts' financial management.

Debt And Liabilities

By most measures, Massachusetts' debt burden remains high compared with that of other states. The commonwealth has about $18.4 billion of GO debt outstanding. Of this amount, $3.8 billion (20%) is variable rate. All but $900 million of this amount is hedged. The variable-rate portfolio is actively managed by the commonwealth and is governed by a formal policy. In the past several years, the overall portfolio of variable-rate debt has diversified and put risk has been significantly reduced in our opinion. Massachusetts has a range of other debt obligations outstanding, including those issued by state authorities and supported by the statewide sales tax, and contract assistance debt. Including this new issue of bonds, total GO debt debt is $18.9 billion and total tax supported debt is about $31 billion. Debt per capita is high at $4,728 and 8.8% of personal income. On a budgetary basis, debt service was an affordable 6.9% of expenditures in fiscal 2013 based on current estimates of spending. The CIP through 2017 is lower than the previous plan but remains sizable at $16.7 billion. Transportation represents nearly half of program requirements. Planned debt issuance of about $2 billion annually remains within the parameters of the debt affordability policy and bond cap; debt service is below 8% of budgeted revenues. While a debt affordability analysis had been done within A&F, legislation was introduced in 2012 that created a capital and debt affordability committee. The committee includes seven voting members and eight nonvoting members from the legislature, and is charged with formally reviewing the capital investment plan and providing an estimate of debt authorization for the year. This is similar to the current process but is now formalized.

The most recent actuarial valuation of the combined pension indicates weaker funded ratios through Jan. 1, 2012. The aggregate funded ratio declined to 65.1% from 71.1% on Jan. 1, 2011. The unfunded actuarial liability increased to $23.6 billion from $18.6 billion in 2011. The commonwealth attributes the lower funded ratio to recognition of prior-year investment losses and certain adjustments to actuarial assumptions including mortality rates and cost-of-living increases. The funded ratio remains below the average funded ratio for other U.S. states. Massachusetts attributes the decline to prior-year investment performance. The 2012 pension reports included a recommendation to lower the investment return assumption to 8.00% from 8.25% based on an experience study being conducted by the Public Employee Retirement Administration Commission. While this would likely contribute to a higher level of recorded liabilities, we expect that recent reform efforts could lower liabilities over time. Massachusetts also has a $16.3 billion unfunded actuarial accrued OPEB liability, which we consider sizable. The commonwealth established a trust fund to begin to accumulate assets toward the liability and is dedicating tobacco settlement revenues to the trust fund (to be phased in over 10 years) to provide a permanent funding source, which we consider a credit positive. The trust had assets of $360.5 million as of Jan. 1, 2012. Following the release of the OPEB Commission recommendations in 2012, the governor is recommending a range of health reform initiatives to be considered by the legislature. The proposals include increasing the minimum years of service requirement to 20 years from 10, increasing the minimum eligibility age for receiving benefits, and adjusting premium contributions. We view these reforms as positive from a credit standpoint and if approved, believe they would further the commonwealth's progress toward managing its long-term liabilities.

Related Criteria And Research

- U.S. State And Local Government Credit Conditions Forecast, Jan. 17, 2013
- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Financial Management Assessment, June 27, 2006

Ratings Detail (As Of March 18, 2013)		
Massachusetts go 1998B		
Long Term Rating	AA+/Stable	Affirmed
Massachusetts GO rfdg bnds var rate dem bnds ser C dtd 02/20/2001 due 01/01/2021		
Long Term Rating	AA+/A-1+/Stable	Affirmed
Massachusetts GO rfdg (Sifma Index Bnds) ser 2013 A due 02/01/2017		
Long Term Rating	AA+/Stable	Affirmed
Massachusetts GO VRDBs 2000A		
Long Term Rating	AA+/A-1/Stable	Affirmed
Massachusetts GO VRDBs 2000B		
Long Term Rating	AA+/A-1+/Stable	Affirmed
Massachusetts GO VRDBs 2006A		
Long Term Rating	AA+/A-1+/Stable	Affirmed
Massachusetts GO VRDBs 2006B		
Long Term Rating	AA+/A-1/Stable	Affirmed
Massachusetts GO (wrap of insured) (ASSURED GTY & AMBAC) (SEC MKT)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Massachusetts GO (wrap of insured) (FGIC & BHAC) (SEC MKT)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Massachusetts GO (FGIC)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Massachusetts GO (MBIA) (Assured Gty)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Massachusetts GO		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.