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Massachusetts; General Obligation

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Credit Profile		
US$475.0 mil GO bnds cons loan of 2011ser 2011 D due 10/01/2028		
Long Term Rating	AA+/Stable	New

Rationale

Standard & Poor's Ratings Services raised its rating on Massachusetts' general obligation (GO) debt to 'AA+' from 'AA'. The outlook is stable. At the same time, Standard & Poor's assigned its 'AA+' rating to the commonwealth's $475 million GO bonds, consolidated loan of 2011, series D.

The upgrade reflects Massachusetts' ongoing progress in improving financial, debt, and budget management practices, while at the same time implementing cost-control and reform measures associated with its long-term liabilities. The upgrade also reflects the commonwealth's commitment to its stabilization fund. Formalized policies relating to debt affordability, capital investment planning, financial planning, and enhanced funding of the stabilization fund are key improvements from a credit standpoint.

Other factors supporting the 'AA+' rating, in our view, are:

- The commonwealth's relatively strong budget performance through the recent recession, with swift action to restore balance after identifying revenue shortfalls and a focus on structural solutions to budget balance;
- A commitment to maintaining and more recently growing the budget stabilization fund balances, which provide flexibility to manage any budget volatility;
- High wealth and income levels; and
- Deep and diverse economy, which has recovered steadily in the past several months after weakness through the recent recession.

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 its total postretirement liabilities as relatively high, we believe Massachusetts has been actively managing these liabilities.

After declining through the recession, Massachusetts' economy is showing signs of steady recovery. Unemployment rates fell to 7.4% in August according to the Bureau of Labor Statistics, after peaking at 9.0% through most of 2010. The rate remains below the national average of 9.1%, and employment growth has been strong relative to other states, with growth of about 1.0% forecasted for 2011. IHS Global Insight Inc. estimates that Massachusetts' unemployment rate will continue to decline, falling to about 7% in 2014. Job loss through this recession has been less severe than in the 2001 recession and the recession of the early 1990s by what we consider a significant margin. While we believe economic recovery is likely to be slow, Global Insight projects that Massachusetts will lead the region in 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.

Revenue recovery for the state has also been fairly robust, which has contributed to improved budgetary performance and liquidity in our opinion. On a budgetary basis, the commonwealth ended fiscal 2011 with a $460 million surplus, due largely to stronger-than-forecasted revenue performance. Revenues for fiscal 2011 are estimated at $20.5 billion or $723 million above the Jan. 18, 2011, estimate. The governor has filed supplemental budget legislation to allocate the surplus and proposes to deposit $300 million of the surplus to the stabilization fund, $95 million in job-related investments, and $16 million to local governments for natural disaster-related costs. The commonwealth now estimates that the stabilization balance will increase to $1.07 billion if the transfer is approved by the legislature. The balance had already increased relative to forecast following a reversal of a planned drawdown in fiscal 2011, as well as the authorized deposit of 0.5% of fiscal 2011 tax collections in that fiscal year.

The fiscal 2012 budget was approved by the legislature on July 1, 2011 and signed by the governor on July 11. An interim budget was approved in advance of July 1 to start the year. The budget was balanced largely through spending reductions. There were some legislative adjustments to revenue, but there were no broad-based revenue enhancements. The budget significantly reduces its reliance on nonrecurring resources to balance the budget but does include a $200 million draw on the stabilization reserve and a suspension of the statutory contribution (0.5% of total tax revenues or $103.7 million) for fiscal 2012. Revenue performance to date is in line with forecast levels, but there will be a formal evaluation of revenue and expenditure performance in October.

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. Massachusetts has a range of other debt obligations outstanding, including those supported by the statewide sales tax, contract assistance debt, and debt subject to annual appropriation. On a budgetary basis, debt service was an affordable 6.1% of expenditures in fiscal 2011. The capital investment plan and debt affordability analysis through 2016 shows annual debt issuance ranging from $1.75 billion in fiscal 2012 up to $2.25 billion in fiscal 2016. This plan adheres to annual bond cap (debt service as a percent of budgeted revenue within the 8% limit) that is outlined in Massachusetts' annual debt affordability analysis.

The most recent actuarial valuation of the combined pension indicates improved funded ratios through Jan. 1, 2010. The funded ratio improved to 67% from 62% on Jan. 1, 2009. The unfunded actuarial liability is $20 billion, down from $22 billion in 2009. The improved funded ratio was due largely to higher assets reflecting investment performance. The funded ratio remains below average relative to funded ratios for other U.S. states, but recent reform efforts implemented and under consideration currently are expected to lower liabilities. There is also what we consider a sizable amount ($15 billion) of unfunded actuarial OPEB liability (in addition to pay-as-you-go costs). The commonwealth has established a trust fund to begin to accumulate assets toward the liability, which had a balance of $310 million as of June 30, 2010. The 2012 enacted budget provides that 10% of all tobacco settlement payments to the state be dedicated to the trust fund with an additional 10% added each year until the deposit reaches 100% of the payments. This is expected to provide a recurring source of revenue to the trust.

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. While diminished from peak levels, the budget stabilization fund still provides flexibility to manage future budget challenges. Standard & Poor's will continue to monitor the federal consolidation efforts stemming from the Budget Control Act of 2011 and, once these are identified, 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 budget stabilization fund. Massachusetts has autonomy to raise taxes and has adjusted its tax structure over time. Medicaid accounts for about one-third of total spending while primary and secondary education accounts for 10% 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' (strongest) to '4' (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 (55% of total), sales tax (25%), and corporate tax (9%) comprising the primary tax revenues based on fiscal 2011 estimates. 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 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 achieved in the past three years as significant given what we see as high service levels in areas that are usually less flexible such as Medicaid.

Fiscal 2010

On a generally accepted accounting principles basis, the commonwealth ended fiscal 2010 with a slight surplus after transfers of $100 million. The unreserved general fund balance was what we consider strong at $1.8 billion or 6.2% of expenditures and transfers. This positive performance despite tax revenue deterioration is due to federal stimulus funds and structural budget solutions Massachusetts implemented. The sales tax rate was increased to 6.25% from 5.00%, other revenue enhancement measures were implemented a range of spending reductions occurred in most program areas. The state has historically maintained a negative unrestricted net asset position that increased to $22 billion in fiscal 2010, compared with negative $13.3 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. At fiscal year-end, the budget stabilization reserve was $669.8 million or 2.1% of total expenditures. This is down from the peak of $2.3 billion in fiscal 2007. Expenditures in fiscal 2010 were lower than the previous year for the second year in a row.

Fiscal 2011 year-end and fiscal 2012 budget

Fiscal 2011 ended with a $460 million surplus due largely to stronger-than-forecast revenue performance. In early January, the consensus revenue forecast was adjusted for the remainder of fiscal 2011 and developed for fiscal 2012. The consensus tax revenue estimate was $20.5 billion, representing 3.7% growth over the revised fiscal 2011 revenue estimate and 5.3% baseline growth. Stronger-than-forecast monthly revenue growth through January 2011 translated to a higher overall forecast of revenues. Increases in both income tax and sales tax revenues have reflected steady economic recovery. The consensus forecast assumes that income tax increases by 6.0% and retail sales tax increases by 3.7% over fiscal 2011. Capital gains are projected to increase by 15.5%. The enacted budget assumes tax revenues of $20.6 billion reflecting the impact of minor new revenue initiatives offset by a two-day sales tax holiday. The enacted budget for fiscal 2012 addressed the loss of $1.9 billion in nonrecurring resources, including the phase out of federal stimulus funds ($1.5 billion). The budget is balanced with projected tax revenue growth, spending reductions, and what we view as limited use of nonrecurring resources. Nonrecurring revenues included to balance the budget total $448 million; of this nonrecurring amount, $200 million is from the budget stabilization fund. Despite this use of reserves, the fund is expected to retain a balance of more than $897 million (2.8% of total revenues). There are no broad-based revenue measures but rather limited base extensions or maximization proposals. Total spending and transfers of $32.4 billion were included in the enacted budget, which is in line with spending in fiscal 2011. Spending reductions and reform measures were included for many program areas including education and health care. For health care, absent reform and cost control, spending was estimated to be $1 billion higher. Total Medicaid spending is budgeted at $10.3 billion or what we consider a modest 1.5% above fiscal 2011. To offset reductions in local aid funding, municipal health insurance reform was approved by the legislature in an effort to control local government costs. Pension reform legislation under consideration this year is also expected to provide cost savings. State funding for higher education is budgeted to decline to $924 million, a 1.4% reduction from fiscal 2011. The commonwealth's health care reform initiative continues to be funded and the uninsured rate is estimated at 1.9% in 2010. Cost-containment measures for this program were also implemented to control overall health care spending.

The fiscal 2012 budget included a proposal to produce five-year revenue and expenditure forecasts to ensure future structural budget balance. This planning model is now in place and will be integrated into the budget process in the future.

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

Economy

Following recessionary declines in employment, recovery is underway at a steady pace and job growth has been more robust relative to most other states. Before the recent recession, Massachusetts had not recovered to its employment peak in 2001. From an employment standpoint, the economy was much less affected by this recession than it has been in previous downturns. Unemployment rates increased substantially in 2009 and early 2010, but have trended down steadily recent months and at 7.4%, are 1.7% lower than the national rate. Per capita personal income stood at $49,643 in 2010, about 125% of the nation and third behind only Connecticut and New Jersey.

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 2010 according to IHS Global Insight Inc. This is followed by trade and transport (16.9%) and professional business services (14.7%). Cyclical sectors, such as manufacturing and construction, represent only 8.1% and 3.2% 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.

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 Administration and Finance (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 stabilization fund 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 an 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 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 administration and finance 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 budget stabilization fund 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 the rainy-day/stabilization fund. The statute also provides that the stabilization fund'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 (less a distribution to postemployment benefits). We believe this measure has the benefit of enhancing the fund while decreasing budget reliance on this cyclical revenue source.
- 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 relative to other states. The commonwealth has about $18.4 billion of GO debt prior to this issuance; it has a range of other debt obligations outstanding including those supported by the statewide gas tax, sales tax, contract assistance debt, and debt subject to annual appropriation. Total tax-supported debt is about $30 billion. This includes debt of other entities--Massachusetts School Building Authority and Massachusetts Bay Transportation Authority--that is secured by statewide sales tax revenues. While the debt obligations are separately secured, they fund state infrastructure and are paid from state taxes. The commonwealth's higher debt levels are due in part to its funding of education capital projects as well as other infrastructure funding which is done at the local level in other states.

Massachusetts' debt per capita ($4,636), debt relative to personal income (9.3%), and debt to gross state product (9.1%) have always been high relative to other states. Debt service on GO bonds and contract assistance obligations was an affordable 6.1% of budgeted expenditures in fiscal 2011. The commonwealth's CIP through 2015 totals $18 billion, with $9.5 billion of debt projected. This plan adheres to a debt affordability model and an annual bond cap but represents what we consider a significant amount of additional debt. Massachusetts forecasts debt service to be below 8% of revenues through 2015 based on its current forecast of revenues. Transportation accounts for about 55% of total program requirements. An update to the plan is currently underway.

The Public Employee Retirement Administration Commission released its actuarial valuation of the total pension obligation as of Jan. 1, 2010. The unfunded actuarial accrued liability decreased this year to $20 billion compared with $22 billion the previous year. The funded ratio through Jan. 1, 2010, increased modestly in our view to 67% from 62% and the annual required contributions were funded. As part of the fiscal 2012 budget proposal, the governor is extending the period for amortizing the unfunded liability to zero by 15 years--to 2040 from 2025--which will lower current pension costs. Contributions will be above fiscal 2011 levels but about $800 million lower than would have been required under a 15-year amortization. Along with this extension, other reform measures are under consideration. This follows a series of reforms approved in 2009.

Specifically, there are a range of reforms for newly hired employees including increasing the retirement age, limiting certain benefits, and making other adjustments that the administration projects will save the commonwealth $3 billion and local governments $2 billion. The administration also forecasts that a higher retirement age would reduce retiree health costs by $1 billion for the commonwealth and $1 billion for local governments. While it is not clear whether the reform measures will be approved and what the ultimate savings will be, Standard & Poor's believes that Massachusetts' active management of these future cost pressures is important from a credit standpoint.

The commonwealth's accrued other postemployment benefits (OPEB) liability as of October 2010 is $15.2 billion, assuming no prefunding. The State Retiree Benefits Trust Fund was created and received a one-time transfer of resources. The fiscal 2010 audit indicates $310 million of assets. The appropriation for fiscal 2010 was $372 million compared with the annual required contribution of $1.1 billion. While this liability is significant in our view, we believe that Massachusetts has begun to manage this liability as evidenced by the trust fund and other measures. A special commission was created and released a report in July 2008 that recommended the commonwealth develop a strategy to fund the liability. Supplemental budget legislation was passed in 2009 that increased the health care contributions to 20% from 15% for state employees whose retirement is effective on or after Feb. 1, 2010, which should add additional resources to fund future liabilities. A law passed in 2010 requires that 5% of capital gains revenue over $1 billion each year would be transferred to the State Retiree Benefits Trust Fund and be used to address the OPEB liability. As part of the fiscal 2012 budget, the Tobacco Master Settlement Agreement funds will be dedicated to the trust fund on a phased-in basis. Starting in fiscal 2013, 10% would be allocated to the fund and an additional 10% would be allocated each year until 2022.

On a scale from '1.0' (strongest) to '4.0' (weakest), Standard & Poor's assigned a '3.0' to Massachusetts' debt and liability profile.

Related Criteria And Research

USPF Criteria: State Ratings Methodology, Jan. 3, 2011

Ratings Detail (As Of September 20, 2011)		
Massachusetts GO		
Long Term Rating	AA+/Stable	Upgraded
Massachusetts go 1998B		
Long Term Rating	AA+/Stable	Upgraded

Ratings Detail (As Of September 20, 2011) (cont.)		
Massachusetts GO VRDBs 1997B		
Long Term Rating	AA+/A-1+/Stable	Upgraded
Massachusetts GO VRDBs 1998A		
Long Term Rating	AA+/A-1+/Stable	Upgraded
Massachusetts GO VRDBs 2000A		
Long Term Rating	AA+/Stable	Upgraded
Massachusetts GO VRDBs 2000B C		
Long Term Rating	AA+/A-1+/Stable	Upgraded
Massachusetts GO VRDBs 2001B		
Long Term Rating	AA+/A-1+/Stable	Upgraded
Massachusetts GO VRDBs 2006A		
Long Term Rating	AA+/A-1+/Stable	Upgraded
Massachusetts GO VRDBs 2006B		
Long Term Rating	AA+/A-1/Stable	Upgraded
Massachusetts GO (wrap of insured) (ASSURED GTY & AMBAC) (SEC MKT)		
Unenhanced Rating	AA+(SPUR)/Stable	Upgraded
Massachusetts GO (wrap of insured) (FGIC & BHAC) (SEC MKT)		
Unenhanced Rating	AA+(SPUR)/Stable	Upgraded
Massachusetts GO (MBIA) (Assured Gty)		
Unenhanced Rating	AA+(SPUR)/Stable	Upgraded
Massachusetts GO		
Unenhanced Rating	AA+(SPUR)/Stable	Upgraded
Massachusetts GO Rfd		
Unenhanced Rating	AA+(SPUR)/Stable	Upgraded

Many issues are enhanced by bond insurance.