Moody's Investors Service

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

MOODY'S ASSIGNS Aa2 RATING AND STABLE OUTLOOK TO COMMONWEALTH OF MASSACHUSETTS' $300M G.O. BONDS CONSOLIDATED LOAN OF 2009 SERIES B; $250M G.O. BONDS CONSOLIDATED LOAN OF 2009 SERIES C; AND $71.43M G.O. BONDS CONSOLIDATED LOAN OF 2009 SERIES D (TAXABLE)

Aa2 RATING ALSO APPLIES TO APPR0XIMATELY $16 BILLION OF OUTSTANDING G.O. DEBT

State
MA

Moody's Rating

ISSUE		RATING
General Obligation Bonds Consolidated Loan of 2009 Series B		Aa2
Sale Amount	$300,000,000	
Expected Sale Date	05/18/09	
Rating Description	General Obligation	
General Obligation Bonds Consolidated Loan of 2009 Series C		Aa2
Sale Amount	$250,000,000	
Expected Sale Date	05/18/09	
Rating Description	General Obligation	
General Obligation Bonds Consolidated Loan of 2009 Series D (Taxable)		Aa2
Sale Amount	$71,430,000	
Expected Sale Date	05/18/09	
Rating Description	General Obligation	

Opinion

NEW YORK, May 18, 2009 -- Moody's Investors Service has assigned a Aa2 rating and stable outlook to the Commonwealth of Massachusetts' General Obligation Bonds Consolidated Loan of 2009 Series B, General Obligation Bonds Consolidated Loan of 2009 Series C, and General Obligation Bonds Consolidated Loan of 2009 Series D (Taxable). Proceeds will be used for statewide capital projects and to reimburse the commonwealth for projects already in progress. The commonwealth plans to sell the bonds the week of May 18.

Credit strengths are:

*Effective management through period of fiscal strain during 2001-2002 recession.

*Strong reserve levels going into current recession; rapid replenishment of reserves following draws during 2001-2002 recession.

*Healthy revenue growth in recent years due to solid personal income tax gains that offset more modest sales tax performance.

Credit challenges are:

*Sizeable $3.6 billion cumulative budget shortfall for current fiscal year 2009, and even larger $5 billion gap for upcoming fiscal year 2010 as tax revenues plummet

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

*Commonwealth's employment levels were already below 2001 peak levels going into current period of economic declines

*Debt ratios are among highest in the nation and likely to rise if commonwealth lends credit support to related entities such as the Massachusetts Turnpike Authority

SIZEABLE $5 BILLION BUDGET GAP NOW PROJECTED FOR FISCAL YEAR 2010; CURRENT FISCAL YEAR $953 MILLION GAP REMAINS TO BE FILLED

Tax revenues have been hurt by the economic downturn in the commonwealth, as they have been in nearly every other state. Moody's assigned a negative outlook to the U.S. state sector in February 2008 and affirmed that outlook in February 2009. Due to the rapid deterioration in tax revenue performance, the commonwealth took the unusual step of preparing a special consensus forecast this month, outside the normal January and October consensus forecast process. On May 6, the fiscal 2010 tax revenue estimate was reduced by $1.5 billion. As a result, Massachusetts is now facing a substantial budget shortfall of $5 billion in fiscal 2010, up from $3.5 billion only a few months ago. The gap reflects a significant falloff in the revenue forecast to a level that cannot support current service expenses. The state must also address a shortfall of $953 million in its current fiscal year, stemming largely from significant personal income underperformance that emerged in April as tax returns came in well below budgeted levels.

The cumulative budget gap for fiscal 2009 is a sizeable $3.6 billion (including the recent May revision) which represents about 15% of total operating revenues, excluding federal aid. The commonwealth took actions, largely on the spending side, to close a $1.4 billion gap last fall.

The gap-closing plan also incorporated $100 million in savings from a pension funding deferral, a budget balancing action the commonwealth has resorted to in the past, as well as one-time money from a $200 million transfer from the budget stabilization fund (BSF). Actions to close the remaining gap, including those proposed by the governor to address the gap that emerged in April, rely heavily on one-time measures. These include additional draws on the budget stabilization fund (BSF) ($888 million) and $1.2 billion in federal stimulus, Medicaid and stabilization funds. Combined, one-time solutions account for 62% of the fiscal 2009 gap-closing plan. According to the latest estimates, the commonwealth expects to end fiscal 2009 with approximately $766 million in the BSF, down significantly from $2.1 billion the prior year.

As of January, when the budget gap for fiscal 2010 was estimated at $3.5 billion, the governor's proposed plan incorporated one-time solutions to close about $1.3 billion (37%) of the shortfall. At that time additional Medicaid funds under the federal stimulus package were estimated at $711 million. The governor's plan also included another reduction of the BSF ($585 million) although additional draws have already been made to resolve the fiscal 2009 shortfall. The decline would be greater in magnitude than the commonwealth's BSF draw during the 2001-2002 recession. During that period, the BSF fell about 41%, to $641 million from a 2001 peak of $1.7 billion. The planned draws for fiscal 2009 would leave reserves at approximately 33% of the 2008 peak level of $2.3 billion. As a percent of revenues, reserves would still be adequate, at about 4.7% of forecast tax revenues at fiscal year end 2009. However, given the size of the shortfall for fiscal 2010, the commonwealth may resort to further use of the BSF.

The House of Representatives approved a budget for fiscal 2001 that was based on the lower ($3.5 billion) shortfall. The plan includes a sales tax rate increase from 5% to 6.25% which would generate approximately $900 million annually. The Senate Committee on Ways and Means released its budget, relying on the more recent $5 billion gap estimate. Its budget does not include a sales tax increase but would withdraw an additional $314 million from the BSF.

PROPOSAL TO DISMANTLE MASSACHUSETTS TURNPIKE AUTHORITY COULD ADD TO COMMONWEALTH'S ALREADY HIGH DEBT RATIOS

Last fall the governor announced a proposal to dissolve the Massachusetts Turnpike Authority (MTA) including both the Western and Metropolitan Highway Systems (MHS). In October 2008, Moody's downgraded the MTA's MHS senior lien revenue bonds to Baa2 from A3, and the subordinated lien revenue bonds to Baa3 from Baa1. The key reasons for the downgrade were narrowing debt service coverage ratios due to escalating debt service and increased interest costs associated with exercised swaptions, narrowing liquidity and limited access to debt restructuring options in the current market, continued delayed decision-making on toll increases and the potential for traffic and revenue declines in a slowing economy.

According to the governor's plan, the MTA's operations west of Route 128 (Interstate 95), including approximately $200 million in debt of the Western Turnpike system, would be folded into the Massachusetts Highway Department, which is included in the commonwealth's operating budget. The remaining operations, including Route 128, would be merged with the Massachusetts Port Authority (Massport - revenue bonds rated Aa3 with a stable outlook) which runs the Port of Boston, Tobin Bridge and Logan International Airport.

The governor's plan does not identify who will take responsibility for the MTA's MHS debt, which totals approximately $2.2 billion and includes approximately $1.2 billion in senior lien debt and $953 million in subordinate lien debt. The impact of a merger with the MTA on Massport's debt position and credit rating would depend on details worked out. Any potential increase in the commonwealth's direct debt position as a result of absorbing some of the MTA's debt obligations (from the Western Turnpike System) would be reviewed in the context of the commonwealth's already high debt ratios.

DEEPER AND MORE PROLONGED ECONOMIC WEAKNESS LEADING TO REVENUE DETERIORATION WOULD EXACERBATE CHALLENGES

With the national economy now in a major recession, Massachusetts is not alone in facing sharply lower revenue forecasts. However, because Massachusetts is a high-wealth state, fluctuations in personal incomes have a substantial impact on tax receipts. Personal income tax collections make up about 40% of the commonwealth's operating resources. Even with the evident tax revenue recovery in recent years, it took the commonwealth five years for personal income tax receipts to surpass the peak levels of fiscal 2001, underscoring the magnitude of the last recession's impact on financial operations. Downward pressure on revenues was particularly harsh in fiscal 2002, when total tax receipts fell nearly 15%, driven by a 20% drop in personal income tax receipts primarily related to capital gains affected by the stock market decline.

If the economic downturn is more severe or prolonged, the commonwealth's revenue estimates may need to be revised downward even further. As in many states, Massachusetts saw a sharp drop in tax revenues in April. The housing downturn began earlier in Massachusetts than in other parts of the country, with negative effects showing up in weak sales tax performance due to reduced draws on home equity as housing values fell. As in other high-wealth states, Massachusetts remains vulnerable to potential stock market fluctuations that could further erode the capital gains portion of its personal income tax results.

HEALTHCARE COSTS ADD SPENDING PRESSURES

Costs related to the commonwealth's 2007 healthcare reforms initially increased far more rapidly than originally projected. However, 2009 enrollment appears to have leveled off at the prior year's level. As a result, projected expenditures for Commonwealth Care, the subsidized insurance plan, are estimated at $788 million versus $869 million budgeted for fiscal 2009. Even so, funding represents a challenge given the downward revenue revisions for fiscal 2009 and 2010. In addition, the fiscal 2009 budget authorized $453 million for the health safety net trust fund, formerly the uncompensated care pool, a 28% increase over the $353 million budgeted for fiscal 2008. Updated projections indicate that actual costs may be slightly lower by approximately $28 million to $47 million.

ECONOMY IN RECESSION AND HOUSING MARKET WEAKNESS CONTINUES

Massachusetts was among the states hardest hit by the 2001 recession in terms of jobs lost on a percentage basis. At the end of 2008, total non-farm employment was still down from the prior peak by approximately 54,000 jobs, based on annual averages for each year. The state's economy began to slow considerably in 2001, following a prolonged and robust expansion. After three consecutive years of decline, the commonwealth recorded total non-farm job gains in 2005 through 2007, slowing to growth that was just slightly positive (0.2%) in 2008, while national job growth declined by 0.4%. In the first quarter of 2009, the commonwealth's job losses accelerated along with most of the nation. The largest declining sectors in Massachusetts were construction, financial, trade, and manufacturing, which has been shedding jobs since 2000. Service sector job growth has maintained some upward momentum but not enough to offset employment losses in other sectors. In the near term, the commonwealth's economy may be constrained by low housing affordability and negative migration trends. Continuing weakness in the financial markets leading to significant job losses in that sector will likely add strain to the commonwealth's economy.

HEAVY TAX-SUPPORTED DEBT LOAD; DEBT AFFORDABILITY STUDY SHOULD AID CAPITAL PLANNING

The commonwealth has a heavy debt load, with about $16 billion in outstanding general obligation bonds and $29 billion in total net tax-supported debt. The state's debt levels ranked first- and second-highest among the 50 states, on a per-capita basis and as a percentage of personal income, respectively, as reflected in Moody's 2008 State Debt Medians Report. Total net tax-supported debt amounted to 9.8% of total personal income in 2008, over three times the 50-state median of 2.6%. The commonwealth's net tax-supported debt per capita was $4,529, over five times the 50-state median of $889 in 2008. As of December 2008, approximately $4 billion (25%) of the commonwealth's general obligation debt was variable rate, including $2.4 billion of variable rate demand bonds supported by standby liquidity facilities. None of these bonds are insured.

Debt burden increased in recent years in part due to the costs of the central artery/tunnel project and as a result of sizeable issuances for local schools through the Massachusetts School Building Authority (MSBA). The MSBA is authorized to issue up to $10 billion in bonds secured by a dedicated portion (one cent) of the commonwealth's sales tax. Thus far, MSBA has issued almost $4 billion in bonds. With plans for school-related issuance and other capital needs, the commonwealth's debt ratios are expected to remain among the highest in the country.

Massachusetts is an active participant in interest rate swaps in connection with its general obligation bond issuance, with $3.3 billion synthetically fixed via swap agreements associated with general obligation debt.

As of January 30, 2009, the commonwealth's swap agreements had a combined fair market value of negative $360 million, an amount it would owe if the commonwealth's rating is downgraded below Baa3 and the counterparties opt to terminate the agreements. If a termination event is triggered by a counterparty downgrade or bankruptcy filing, the commonwealth has the option to terminate. In the case of the Lehman Brothers bankruptcy filing, the counterparty was replaced without any cost to the commonwealth. The commonwealth has the option of terminating its swaps at any time, and its counterparties do not have such an option. The commonwealth's swaps are conservatively structured on a cost-of-funds basis, which eliminates basis risk.

Massachusetts relies on a $1 billion commercial paper program and revenue anticipation notes (RANs) for cash-flow purposes. In addition to the use of the $1 billion in commercial paper, the commonwealth issued $750 million in RANs in October 2008 and relied on two separate $400 million RAN issuances in fiscal year 2007, both of which were repaid within the fiscal year. The recent addition of RANs to the commonwealth's cash flow management reflects overall growth in the operating budget. The commonwealth's projected ending cash balance at the end of fiscal 2009 is approximately $523 million, considerably tighter than the $1 billion ending cash balance projected in March of this year.

ANNUAL PENSION CONTRIBUTIONS ADD SUBSTANTIAL FIXED COSTS

Annual pension contributions are substantial, at $1.4 billion in fiscal 2008 and $1.46 billion budgeted for fiscal 2009. These amounts satisfy annually required pension contributions. The combined pension funded ratio was 79% as of January 2008 and investment losses of 29% were recently reported for 2008. Massachusetts' other post employment benefits (OPEB) liability could add substantial budget pressures in the future, as is also likely in other states. Assuming no pre-funding of costs, Massachusetts' liability is $15.6 billion. Assuming partial pre-funding, the liability declines to about $11.6 billion with an annual required contribution (ARC) of approximately $981 million. The fiscal 2008 budget created an irrevocable trust fund to begin funding the commonwealth's OPEB liability and $400 million was transferred into the fund at the end of the fiscal year. A similar transfer is not planned for the fiscal 2009 budget. The pay-as-you-go amount for OPEB was $355 million in fiscal 2008 and budgeted at $377 million in fiscal 2009.

MOST RECENT RATING ACTION AND PRINCIPAL METHODOLOGY

The last rating action with respect to the Commonwealth of Massachusetts was on February 17, 2009 when the rating of Aa2 with a stable outlook was assigned to the Commonwealth of Massachusetts General Obligation Bonds Consolidated Loan of 2009 Series A and Refunding Bonds 2009 Series A.

The principal methodology used in rating the current issue was "The State Rating Methodology" which can be found at www.moodys.com in the Credit Policy & Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating this issue can also be found in the Credit Policy & Methodologies directory.

Outlook

The stable outlook incorporates several years of strong income tax revenue trends that offset weak sales tax performance; healthy pre-recession reserve levels that provide some flexibility to weather budget shortfalls over the near term despite planned draws; and employment gains over the past three years. These positive attributes offset concerns regarding rising debt ratios due to large and steady debt issuance by the commonwealth and related entities, as well as the potential extension of credit to struggling issuers such as the turnpike authority. The stable outlook also incorporates Moody's expectation that the commonwealth will continue to take the kind of prompt action demonstrated in the 2001-2002 recession to address any further fiscal strain that may develop. Continued reliance on one-time budget solutions, tighter cash margins, and failure to plan for the eventual falloff in federal stimulus funds would pose a credit concern.

What would make the rating change - UP

*Evidence of improved and sustained economic performance with recovery of jobs lost during recession.

*Maintenance of strong reserve levels.

*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

Analysts

Nicole Johnson
Analyst
Public Finance Group
Moody's Investors Service

Kimberly Lyons
Backup Analyst
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653