New Issue: Massachusetts (Commonwealth of)

MOODY'S ASSIGNS Aa2 RATING AND STABLE OUTLOOK TO COMMONWEALTH OF MASSACHUSETTS' $430.3 MILLION OF G.O. BONDS CONSOLIDATED LOAN OF 2009 SERIES A AND $96.5 MILLION G.O. REFUNDING BONDS 2009 SERIES A

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

State
MA

Moody's Rating

ISSUE		RATING
General Obligation Bonds Consolidated Loan of 2009 Series A		Aa2
Sale Amount	$430,315,000	
Expected Sale Date	02/17/09	
Rating Description	General Obligation	
General Obligation Refunding Bonds 2009 Series A		Aa2
Sale Amount	$96,465,000	
Expected Sale Date	02/17/09	
Rating Description	General Obligation	

Opinion

NEW YORK, Feb 17, 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 A and Refunding Bonds 2008 Series A. Proceeds of the new money series will be used to pay off $325 million of outstanding bond anticipation notes due March 3, 2009, and for statewide capital projects. Proceeds of the refunding bonds will be used to refund the City of Plymouth's certificates of participation, a contract assistance obligation of the commonwealth, for debt service savings of approximately $10 million. Maturities will not be extended.

Credit strengths are:

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

*Strong reserve levels going into current recession; reserves were rapidly replenished following draws during 2001-2002 recession.

*Recent years of healthy revenue growth due to solid personal income tax gains that offset more modest sales tax performance.

Credit challenges are:

*Sizeable budget shortfall of $1.1 billion for current fiscal year 2009, and even larger $3.5 billion gap for upcoming fiscal year 2010 as recession dampens tax performance

*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 $3.5 BILLION BUDGET GAP PROJECTED FOR FISCAL YEAR 2010; CURRENT FISCAL YEAR $1.1 BILLION 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 this February. Massachusetts is facing a sizeable budget shortfall of $3.5 billion in fiscal 2010. 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 $1.1 billion in its current fiscal year, stemming largely from personal income as well as sales tax underperformance.

Last fall, the commonwealth announced a budget shortfall of $1.4 billion for fiscal 2009 due to tax revenues that are estimated to come in under budget by $1.1 billion and expenses that were projected to be $321 million higher than previously expected. That budget deficit was resolved largely on the spending side, using the governor's Section 9C powers to lower spending in agencies under executive control. 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).

The governor's proposed plan to resolve the current $1.1 billion shortfall in the fiscal year 2009 budget includes a combination of $191 million in spending cuts, the largest portion of which would be absorbed by municipalities ($128 million); employee contributions to health care costs ($29 million), and $68 million in additional revenues from tax settlements and the elimination of certain exemptions. However, the solution relies heavily on one-time measures including another draw on the BSF ($327 million) and $533 million in federal stimulus funds for Medicaid. Together, these account for 44% of the fiscal 2009 gap-closing plan.

The governor's proposed plan to resolve the fiscal 2010 projected deficit also relies heavily (about 37%) on one-time solutions. Additional Medicaid funds under the federal stimulus package are estimated at $711 million. The governor's plan also includes another reduction of the BSF ($585 million), which would bring reserves to about $888 million at the end of fiscal 2010. The decline would be similar in magnitude to the commonwealth's BSF draw during the 2001-2002 recession. During that period, the BSF fell about 41%, to $641 million from a 2001peak of $1.7 billion. The planned draw in the latest budget proposal would leave reserves at approximately 38% of the 2007 peak level of $2.3 billion. As a percent of revenues, reserves would still be adequate, at about 4.5% of forecast tax revenues.

The remainder of the governor's budget plan includes expenditure savings of $1.6 billion and approximately $586 million in new revenue. While Chapter 70 funding would be held flat, local aid reductions would save $220 million. The budget plan does include revenue raising options from higher meals and hotel/motel taxes that would replace lost local revenue if adopted by municipalities. Medicaid cost controls, without reducing enrollment, are estimated to save $178 million, and employee healthcare contributions another $60 million. On the revenue side, the budget includes: $148 million from the additional meals and hotel/motel taxes at the state level; $150 million from the elimination of certain sales tax exemptions, and $289 million from other measures such as increases in registry fees, nursing home user rates, an expansion of the bottle bill, and tax revenues from additional auditing.

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 System (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, 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 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 by lawmakers. 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. 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 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 are increasing far more rapidly than initially projected. While this represents success in terms of increased enrollment of previously uninsured residents in healthcare plans, the costs are rising at an unsustainable pace. Projected expenditures for Commonwealth Care, the subsidized insurance plan, were estimated at $869 million for fiscal 2009. This represents a 41% increase over the fiscal 2008 projected expenses ($618 million). In addition, the fiscal 2009 budget included $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. Actual costs were estimated to be substantially higher, at $467 million, in fiscal 2008 due to some one-time payments.

FISCAL 2008 REVENUES CAME IN ABOVE FORECAST

Results for fiscal year 2008 indicate that tax revenues were $1.14 billion above prior-year results, translating into baseline growth of 5.8%. Personal income tax receipts were up 9.5%, more than twice the budgeted increase of 4.3% based on the initial consensus revenue forecast. The revenue over-performance was largely due to increases in income tax receipts: withholding collections ($433 million, up 5%); estimated payments ($389 million, up 18.5%), and income tax payments with returns and extensions ($299 million, up 15.2%). Sales tax collections remained nearly flat, continuing the modest results seen in recent years. The BSF was about $2.1 billion at fiscal year end. This represented a decline of $216 million from the prior year and was essentially the same as the draw originally budgeted ($218 million). Combined reserves remained healthy, at about 11.5% of tax revenues.

ECONOMY MOVES INTO 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 growth during 2005 and 2006, but at paces that trailed the nation's. In 2007, Massachusetts saw job growth of 1%, on par with the national rate, which slowed to 1.1% that year. The commonwealth's year-over-year employment growth was just slightly positive, at 0.2% in 2008, while national job growth declined by 0.4%. The largest declining sectors in Massachusetts were construction, financial, trade, and manufacturing, which has been shedding jobs since 2000. Service sector job growth has remained relatively strong, offsetting 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 turmoil 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 fair market value of negative $360 million, an amount it would owe if the agreements terminated. The commonwealth has the option of terminating its swaps at any time, and its counterparties do not have such an option. Its swaps are conservatively structured on a cost-of-funds basis, which eliminates basis risk.

The commonwealth 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 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.

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 state employee pension plan had a funded ratio of 85% as of January 2007; the teachers' retirement system, for which the commonwealth is also responsible, had a lower funded ratio of 71% as of the same date.

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 currently estimated at $13.3 billion, which translates into an annual required contribution (ARC) of approximately $1.1 billion. The ARC would more than double to $2.8 billion in fiscal 2016 under this valuation. Under a pre-funding assumption, the liability drops to about $7.6 billion with an initial ARC of $703 million. The fiscal 2008 budget created an irrevocable trust fund to begin funding the commonwealth's OPEB liability and $442 million was to have been transferred into the fund by the end of the fiscal year. A similar transfer is not planned for the fiscal 2009 budget. The pay-go amount for OPEB was $355 million in fiscal 2008 and budgeted at $377 million in fiscal 2009.

Outlook

The stable outlook reflects the commonwealth's overall sound financial position bolstered by: several years of strong income tax revenue trends that offset weak sales tax performance; healthy reserve levels that provide 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.

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

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