Moody's Investors Service

New Issue: **MOODY'S ASSIGNS Aa2 RATING TO COMMONWEALTH OF MASSACHUSETTS $500 MILLION GO BONDS CONSOLIDATED LOAN OF 2009, SERIES E**

Global Credit Research - 03 Nov 2009

Aa2 RATINGS ALSO AFFIRMED ON APPROXIMATELY $16.8 BILLION OUTSTANDING GO DEBT; OUTLOOK STABLE

State
MA

Moody's Rating

ISSUE		RATING
General Obligation Bonds, Consolidated Loan of 2009, Series E (Federally Taxable- Build America Bonds- Direct Pay to Issuer)		Aa2
Sale Amount	$500,000,000	
Expected Sale Date	11/09/09	
Rating Description	General Obligation	

Opinion

NEW YORK, Nov 3, 2009 -- Moody's Investors Service has assigned a Aa2 rating to the Commonwealth of Massachusetts' General Obligation Bonds Consolidated Loan of 2009 Series E. The bonds will likely be issued as taxable, direct subsidy Build America Bonds, although depending on market conditions they may be issued as tax-exempt. Proceeds will be used to finance capital projects. The commonwealth plans to sell the bonds as early as the week of November 9. Concurrently, Moody's has affirmed the Aa2 ratings assigned to approximately $16.8 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 some job losses in the current downturn, growing Medicaid and pension costs, and debt levels that are among the highest in the nation. The outlook is stable.

Credit strengths:

* Effective management during strained economic times, 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

COMMONWEALTH ACTED TO CLOSE FISCAL 2009 GAP WITH BUDGET CUTS, FEDERAL AID, RESERVE DRAWDOWN

Tax revenues have declined due to the economic downturn in the commonwealth, as they have been in nearly every other state. 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. Revenues ended the year down 12.5% compared to fiscal 2008, 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 over $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 $766 million at the close of fiscal 2009. Stimulus and use of reserves ultimately accounted for over 60% of the fiscal 2009 gap-closing plan.

FISCAL 2010 BUDGET INCLUDES SALES TAX INCREASE; REVENUES TO DATE BELOW EXPECTATIONS

Commonwealth policy-makers faced an estimated $5 billion gap in formulating the fiscal 2010 budget. The gap was closed through a 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 fiscal 2010 with $900 million annually thereafter; $275 million of this is dedicated to transportation. The sales tax exemption for alcohol was also eliminated, which is expected to raise $79 million in fiscal 2010.

Other fiscal 2010 budget-balancing measures include use of $200 million of reserves, which will leave $571 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 revenues shortfalls or unforeseen spending needs.

As in many states, Massachusetts' year-to-date fiscal 2010 revenues have been disappointing, and on October 15 revenue estimates were lowered by an additional $600 million, or 3.2%. On October 29 the governor announced a plan to close the gap that uses a combination of budget cuts (about half of the proposed new measures), some one-time sources such as a tax amnesty, use of fiscal 2009 surplus, and additional stimulus dollars, bringing the total stimulus dollars in the fiscal 2010 budget to $1.8 billion. Non-union employees will be required to take nine furlough days, and additional cuts of either furloughs or layoffs of union employees has been proposed.

HEALTHCARE COSTS ADD SPENDING PRESSURES

Costs related to the commonwealth's 2007 healthcare reforms have increased more rapidly than originally projected, but spending is expected to drop in fiscal 2010. The decrease, from $805 million in fiscal 2009 to $723 million in fiscal 2010 is due to eliminating eligibility for certain resident aliens (which later was restored through the remainder of fiscal 2010) and through new savings initiatives. As in many states, Medicaid spending has also grown quickly; the $9 billion appropriated for fiscal 2010 is 27% higher than fiscal 2006 spending.

ECONOMY IN RECESSION; UNEMPLOYMENT REMAINS BELOW NATIONAL AVERAGE

Massachusetts is currently in recession, with steep job losses, albeit at a slower rate than the nation. The commonwealth's September 2009 non-farm employment was 3.2% below September 2008, compared to a 4.2% loss nationally. Unemployment spiked to 9.3% in Massachusetts in September, the highest since 1976, but again below the national rate of 9.8%. 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 1.6% job growth in September. 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. Financial activities makes up 6.5% of Massachusetts' jobs and has suffered during the recession, with 5.9% job loses in September over one year prior.

The state is characterized by high wealth and education levels but with slow population and job growth. Per capita personal income in 2008 was $51,253, 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 $16.8 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's net tax-supported debt per capita was $4,323, five times the 50-state median of $865. The commonwealth recently updated its formal debt affordability study and set a bond cap of $1.5 billion for fiscal 2010. The debt affordability policy is designed to keep debt service within 8% of budgeted revenues.

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 and early termination events against the commonwealth only if its rating falls below Baa3. As of October 30, the commonwealth's swap agreements had a combined fair market value of -$363 million.

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), which still has significant issuance capacity. The commonwealth also extended $100 million of contract assistance for Massachusetts Turnpike Authority debt earlier this year to support the authority's debt. The authority was merged into the new Massachusetts Department of Transportation effective November 1. The creation of MassDOT will not immediately increase the commonwealth's debt; however how new MassDOT debt will be secured has not yet been determined.

For cash flow purposes, Massachusetts relies on a $1 billion 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. No commercial paper is currently outstanding. 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 $1.16 billion.

ANNUAL PENSION CONTRIBUTIONS ADD SUBSTANTIAL FIXED COSTS

Annual pension contributions are substantial, at $1.31 billion in fiscal 2009 and $1.37 billion budgeted for fiscal 2010. These amounts satisfy annually required pension contributions, which were reduced by $100 million in March-providing budget relief-when the commonwealth lengthened the amortization period from 2023 to 2025. 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 commonwealth is currently undertaking a major study of pension benefits, which may result in reductions to the pension liability. 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. In fiscal 2008 the commonwealth budget created an irrevocable trust fund to begin funding the commonwealth's OPEB liability and $400 million was transferred into the fund; no additional funds have been transferred since fiscal 2008.

MOST RECENT RATING ACTION AND PRINCIPAL METHODOLOGY

The last rating action with respect to the Commonwealth of Massachusetts was on September 11, 2009 when a MIG 1 rating was assigned to the Commonwealth of Massachusetts General Obligation Notes 2009 Series A, 2009 Series B, and 2009 Series C.

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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