Moody's Investors Service

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

## MOODY'S ASSIGNS Aa2 RATING AND STABLE OUTLOOK TO COMMONWEALTH OF MASSACHUSETTS' G.O. REFUNDING BONDS 2008 SERIES A

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

State
MA

**Moody's Rating**

| ISSUE | RATING |
|---|---|
| General Obligation Refunding Bonds 2008, Series A | Aa2 |

| | |
|---|---|
| **Sale Amount** | $532,105,000 |
| **Expected Sale Date** | 11/17/08 |
| **Rating Description** | General Obligation |

**Opinion**

NEW YORK, Nov 17, 2008 -- Moody's Investors Service has assigned a Aa2 rating and stable outlook to the Commonwealth of Massachusetts $532.105 million General Obligation Refunding Bonds 2008 Series A. Proceeds of the upcoming bond sale will be used to refund outstanding variable rate demand bonds (General Obligation 1998 Series B and Route 3 North Transportation Improvement Association, Inc. Series 2002B) to fixed rate.

Credit strengths are:

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

*Strong reserve levels, rapidly replenished following draws during recession.

*Recent years of healthy revenue growth due to solid personal income tax gains that offset softening in sales tax performance. Credit challenges are:

*$1.4 billion budget gap for fiscal 2009 as economic weakness dampens tax performance

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

*Despite employment gains, commonwealth's jobs remain below pre-recession peak.

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

$1.4 BILLION GAP EMERGES IN FISCAL 2009 BUDGET

Last month the commonwealth announced a budget shortfall of $1.4 billion for fiscal year 2009 due to tax revenues that are estimated to come in under budget by $1.1 billion and expenses that are projected to be $321 million higher than expected. The shortfall represents about 7% of tax revenues and approximately 4% of the commonwealth's total operating budget. It is similar in size to the structural gap that Massachusetts faced going into budget deliberations for both fiscal years 2008 and 2009. The commonwealth's revenue estimates were relatively conservative in recent years and income tax receipts, which make up about 60% of total tax revenues, came in above budget. As a result, Massachusetts was able to rebuild its budget stabilization fund (BSF) through fiscal year 2007. Even though a draw on reserves had been budgeted for fiscal year 2008, the commonwealth needed less than expected due to healthy revenue growth.

The governor's plan to address the budget gap focuses largely on the spending side to save $1.053 billion.

The biggest portion of the spending reductions, approximately $755 million, will be achieved through the governor's Section 9C powers to lower spending in agencies under executive control. Another $146 million would be saved by reducing spending for agencies and independent authorities outside the governor's 9C control. In addition, the commonwealth would save $100 million from a pension funding deferral, a budget balancing action it has resorted to in the past, and $52 million due to a recent pension funding valuation report and revised funding schedule that would be extended from 2023 to 2025.

On the revenue side, the governor's plan includes one-time money from a $200 million transfer from the BSF. This would bring the total BSF draw to approximately $600 million in fiscal year 2009 but leave the balance still healthy at approximately $1.8 billion, about 5% of operating revenues. The governor's plan also incorporates $168 million of additional revenues composed of: $100 million from anticipated judgments and settlements, $55 million in federal grants under the Temporary Assistance for Needy Families program, and $13 million in local revenues from a proposed property tax levy on certain telecommunication equipment. This tax would offset the need for the General Fund to supplement the portion of local aid that is funded from proceeds of the state lottery which has been underperforming.

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

The governor recently announced a proposal to dissolve the Massachusetts Turnpike Authority (MTA) including both the Western and Metropolitan Highway System (MHS). Last month 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, including 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.

## ECONOMIC WEAKNESS LEADING TO REVENUE DETERIORATION COULD ADD MORE BUDGET CHALLENGES

The commonwealth's fiscal 2009 budget was based on a January 2008 consensus tax revenue forecast that assumed a mild and short downturn. With the national economy now verging on a major recession, Massachusetts is not alone in facing sharply lower revenue forecasts. However, as a relatively high wealth state, fluctuations in personal income receipts have a substantial impact on the budget since these revenues 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 year 2001, underscoring the magnitude of the last recession's impact on the commonwealth's 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 and/or prolonged, the commonwealth's revenue estimates may need to be revised downward 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 negatively impact the capital gains portion of its personal income tax results.

## ENACTED FY2009 BUDGET ADDRESSED $1.3 BILLION BUDGET SHORTFALL

Massachusetts faced a $1.3 billion structural gap for fiscal year 2009 representing about 4% of operating revenues. The projected operating deficit was similar in dollar magnitude to the shortfall the commonwealth faced going into the budget process for fiscal year 2008. Gaps in both years underscore continuing pressures on the spending side of the equation, especially related to the cost of healthcare reforms, as well as one-time actions taken to balance prior-year budgets. The adopted budget for fiscal year 2008 relied on the use of about $600 million in one-time reserve transfers from the budget stabilization fund (BSF) and the Healthcare Security Trust Fund (tobacco settlement money) as well as on $180 million carried forward from fiscal year 2007.

The enacted budget for fiscal year 2009 incorporated a combination of revenue enhancements, spending controls, and one-time BSF resources to eliminate the projected gap. On the revenue side, the budget included: 1) $285 million from corporate tax reforms, including closing loopholes followed by tax rate reductions in subsequent years; 2) $157 million from enhanced revenue collections and enforcement measures; and 3) $174 million from a $1 per pack increase in the cigarette tax which will go directly to health care costs. In terms of spending, the budget reflected about $175 million in reduced costs due to flat funding of various agencies and programs and reduced Medicaid costs from certain service changes and efficiencies. As in the prior year, the fiscal 2009 budget again relied on a draw on the BSF ($305 million) and saves $107 million by suspending the statutorily required deposit to the BSF and transferring fiscal 2009 investment earnings to the general fund. As reflected in the budget, combined reserves (reflecting unreserved, undesignated fund plus BSF balances) would be about 5.8% of operating revenues at the end of fiscal year 2009.

## 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 year 2009. This represents a 41% increase over the fiscal year 2008 projected expenses ($618 million). In addition, the fiscal year 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 year 2008. Actual costs are estimated to be substantially higher at $467 million in fiscal year 2008 due to some one-time payments.

## VOTERS DEFEAT BALLOT MEASURE TO ELIMINATE PERSONAL INCOME TAX

On election day, Massachusetts voters turned down by a two to one margin an initiative petition to reduce the state personal income tax beginning January 1, 2009 and then eliminate it entirely beginning January 1, 2010. At approximately 40% of operating revenues, personal income tax receipts make up the commonwealth's largest revenue source. A similar measure was considered in November 2002. It was also defeated then, although it did receive 45% of the vote.

The commonwealth's constitution permits legislation enacted by a voter initiative process, although not for the purpose of appropriations. Initiatives certified by the attorney general for both form and the required number of signatures may be submitted to the legislature for consideration. If the legislature does not enact the measure into law, the initiative may be placed on the ballot for the statewide general election following collection of additional voter signatures. If voters approve the measure, it becomes law 30 days after the election date. However, such initiatives do not constitute constitutional amendments and may therefore be subject to legislative amendment or repeal at any time.

Massachusetts' personal income tax rate was gradually reduced over successive years from 5.85% to 5.3% on January 1, 2002 by an initiative process approved by voters in November 2000. The initiative also mandated a further reduction to 5% in January 2003. In July 2002, the legislature enacted several changes to the income tax and delayed the scheduled rate reduction for at least four years. The commonwealth's income tax receipts plummeted 20% in fiscal year 2002 as the nation entered a recession. Political pressure notwithstanding, action to halt the income tax rate reduction highlights the power of the legislature to change statutory law as needed to restore budgetary balance. Constitutional amendments, which can not be amended by the legislature, require a significantly higher hurdle and longer process to adopt. The process includes gaining 25% of the vote of both legislative houses jointly assembled in constitutional convention in two successive biennial legislative sessions before going to the voters in a general election.

## FISCAL YEAR 2008 REVENUES CAME IN ABOVE FORECAST

Preliminary 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 is 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 is estimated at about $2.2 billion at fiscal year end. While this represents a decline of $88 million from the prior year BSF, the use of reserves was less than originally budgeted ($218 million) and combined reserves still remain satisfactory at about 7.3% of operating revenues.

## ECONOMY SLOWS AS 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 2007, total non-farm employment was still down from the prior peak by approximately 62,000 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. In 2007, the commonwealth saw job growth of 1%, on par with the national rate, which slowed to 1.1% last year. Average monthly year-over-year job gains have slowed to 0.5% through September 2008, although the national pace is essentially flat at 0.1%. Service sector job growth has remained relatively strong, offsetting employment losses in the manufacturing and the construction 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 January 2, 2008, approximately $4.1 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 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. Debt ratios could rise even further as the result of legislation adopted last summer that lends the commonwealth's support, subject to appropriation, to debt that may be issued by the Massachusetts Turnpike Authority (senior lien debt rated A3; subordinate lien debt Baa1). The legislation authorizes the commonwealth to pay debt service, in the event the turnpike authority is unable to, on up to $800 million of variable rate refunding bonds associated with any of the five swaptions the authority entered into with UBS that are exercised by UBS (three have been exercised to date in the notional amount of $334.4 million and the remaining two in the notional amount of $465.6 million could be exercised in September). In addition, the commonwealth may provide full faith and credit support for turnpike authority payment obligations under swap agreements entered into by the turnpike authority if necessary to avoid a termination of such agreements. The authorization for this credit support is only available from October 1, 2008 through January 15, 2009, when the legislature is back in formal sessions. While above average debt ratios are incorporated in Massachusetts' Aa2 rating level, continued leveraging of the commonwealth's resources along with other rising fixed costs could begin to constrain the budget.

The commonwealth has outstanding auction rate securities which is plans to refund with fixed rate general obligation bonds. The auction rate bonds have experienced failed remarketings and higher resets in recent months, although the commonwealth's interest payments have remained within budgeted amounts.

Massachusetts is an active participant in interest rate swaps in connection with its general obligation bond issuance, with $3 billion synthetically fixed via swap agreements. As of June 30, 2007, the commonwealth's swap agreements had a fair market value of negative $3.4 million, an amount it would have owed had the agreements terminated at that time. The commonwealth has the option of terminating its swaps at any time, although its counterparties do not have such an option. Its swaps are conservatively structured on a cost-of-funds basis which eliminates basis point 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 RANs 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 the overall growth in the operating budget.

In July 2007, the commonwealth's administration published a debt affordability study that is intended to guide the state's capital spending program in terms of public infrastructure investment and management of the commonwealth's fiscal resources. The analysis sets up guidelines for an administrative bond cap for annual debt issuance as well as measures of affordability. To that end, the administration will impose a cap that ensures that debt service costs do not exceed 8% of annual budgeted revenues. The commonwealth's 2008 debt affordability study is expected soon.

ANNUAL PENSION CONTRIBUTIONS ADD SUBSTANTIAL FIXED COSTS

Annual pension contributions are substantial at $1.4 billion in fiscal year 2008 and $1.46 billion budgeted for fiscal year 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 year 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 year 2009 budget. The pay-go amount for OPEB was $355 million in fiscal year 2008 and budgeted at $377 million in fiscal year 2009.

**Outlook**

The stable outlook reflects the commonwealth's overall sound financial position bolstered by: recently strong income tax revenue trends that offset weak sales tax performance; healthy reserve levels despite budgeted 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 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 most recent recession to address any 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 slower than expected economic recovery.

*Depletion of Budget Stabilization Fund

*Increased leveraging of the commonwealth's resources to pay debt service

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