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November 5, 2009

Massachusetts; General Obligation

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Table Of Contents

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Massachusetts; General Obligation

Credit Profile		
US$500. mil GO bnds cons loan of 2009 ser E (taxable Build America bnds) due 11/01/2039		
Long Term Rating	AA/Stable	New
Massachusetts GO		
Long Term Rating	AA/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'AA' long-term rating, and stable outlook, to the Commonwealth of Massachusetts' $500 million general obligation (GO) bonds consolidated loan of 2009, series E (federally taxable - Build America Bonds [BABs] - direct pay to issuer).

We also affirmed the 'AA' rating, with a stable outlook, on the parity debt outstanding.

The 'AA' rating on the commonwealth reflects our view of its:

- Strong and conservative budget management practices, with swift action to restore balance after identifying revenue shortfalls in the past year;
- Continued budget stabilization reserve balances despite planned reductions in the current fiscal year, which in our opinion provide flexibility to manage through the current economic climate;
- High wealth and income levels; and
- A deep and diverse economy that has experienced weakness in the past year in line with national trends.

Standard & Poor's believe 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 Massachusetts' total postretirement liabilities as relatively high, we believe the state has been actively managing the liabilities.

Proceeds of this issue will fund various projects in the current capital spending plan. We understand that the bonds could be issued as taxable BABs or traditional tax exempt bonds. If issued as BABs, the federal subsidy is not pledged to the bonds and the final amortization will be a bullet maturity (2039) with mandatory sinking fund payments planned.

The Massachusetts economy continues to decline but the pace has slowed. The unemployment rate increased to 9.3% through September of this year compared with 5.3% in 2008. The rate remains below the national average and the pace of employment decline has slowed while the labor force has been stable. To date, job loss through this recession has been less severe than the 2001 recession and the early 1990s recession by a significant margin. Economic recovery is likely to be slow in our view but IHS Global Insight Inc. projects that Massachusetts will lead the region in recovery. We believe the commonwealth's economic fundamentals and key anchors centered on higher education, technology, and health care should contribute to positive economic growth prospects over time.

In line with most other states, Massachusetts has faced significant budget gaps for fiscals 2009 and 2010 ($8 billion cumulative gap) due largely to declining revenues. Revenues were revised four times through fiscal 2009, which

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significantly lowered the revenue base for fiscal 2010. The enacted fiscal 2010 budget used a balanced mix of revenue enhancement, spending reduction, federal stimulus, and budget reserves to restore balance. The most significant revenue enhancement was an increase in the state sales tax rate to 6.25% from the current rate of 5.00% as well as several base-broadening measures. In total, revenue enhancement is estimated at about $890 billion. Total spending in the enacted budget is $30.5 billion or 0.6% below fiscal 2009 estimated spending. The budget stabilization balance is estimated to be $571 million or 3% of projected revenues for fiscal 2010 following a budgeted withdrawal of $199 million for the year.

As required by statute, the Secretary of Administration and Finance announced on Oct. 15, 2009, that a revenue deficiency of $600 million is expected for fiscal 2010. The governor has submitted a plan to close the gap that relies heavily on spending reductions and some minor revenue enhancements. In addition to the revenue shortfall, potential spending pressures above budgeted levels in Medicaid and other program areas are being managed but we believe these could widen the budget gap if not contained.

In conjunction with the fiscal 2010 budget and sales tax increase, the commonwealth addressed statewide transportation funding issues with $275 million of the sales tax increase dedicated to transportation. These resources were partially aimed at improving the credit profile of the Massachusetts Turnpike Authority (MTA), which faced significant termination costs associated with swap agreements outstanding (see the MTA full analysis published July 27, 2009, on RatingsDirect). About $928 million of the MTA's subordinated debt will be supported by contract assistance payments of the state.

By most measures, Massachusetts' debt burden remains high relative to that of other states. The commonwealth has about $17.3 billion of GO debt (including this issue) and about $26.8 billion of total tax-supported debt. Of this amount, about 80% is fixed rate and the remaining $3 billion is variable rate with a majority of that hedged with interest-rate swaps. 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 about 7% of expenditures in fiscal 2009. The capital investment plan (CIP) through 2014 totals $17 billion, with $10.5 billion of bond issuance projected. This plan adheres to annual bond cap (debt service as a percent of budgeted revenue within the 8% limit) that is outlined in the state's annual debt affordability analysis.

Outlook

The outlook reflects Standard & Poor's view of the commonwealth's proactive approach to managing budget volatility in the past year. Revenue adjustments have been frequent and gap-closing actions have been swift to restored balance. While diminished, we believe the budget stabilization fund retains a balance that will continue to provide flexibility to manage the current fluid revenue environment. These are important credit factors for the state given its dependence on personal income (and related capital gains) tax revenues, which are volatile during economic cycles.

Finances: Active Budget Management Key To Balance

The commonwealth's revenue base is diverse in our view, with income tax (56% of total), sales tax (24%), and corporate tax (8%) comprising the primary tax revenues based on fiscal 2010 estimates. Spending is heavily weighted toward Medicaid, which accounts for about one-third of total spending while other health and human

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service spending accounts for another 16% of budgeted expenditures. Local aid is the other significant program area representing about 17% of total spending. Debt and pension costs are what we consider a significant 11% of spending but have been steady over time. Spending growth was strong through fiscal 2008 but spending declined on a budgetary basis in fiscal 2009 as revenues deteriorated and spending reductions were made to restore balance. Massachusetts projects spending to decline again in fiscal 2010 based on the enacted budget and the mid-year spending cuts that are likely based on the $600 million budget gap. Standard & Poor's views the expenditure restraint as significant given what we see as high service levels in areas that are usually less flexible such as Medicaid. On a generally accepted accounting principles basis, the commonwealth ended fiscal 2008 with a deficit after transfers of $1.7 billion. The unreserved general fund balance was what we consider strong at $3.2 billion or 11.5% of expenditures.

Fiscal 2009

In line with most other states, Massachusetts adjusted its revenue forecast several times throughout fiscal 2009. Tax collections for fiscal 2009 are estimated to be $18.3 billion, or $2.6 billion (12.5%) below fiscal 2008 levels and well below the original forecast. The commonwealth estimates that a majority of the decline ($1.4 billion-$1.6 billion) was due to personal income tax receipts that fell sharply in the second half of the fiscal year. Sales tax revenues were down $218 million or 5.3% from 2008, and corporate taxes were down $450 million or 18% below 2008. To restore balance, the commonwealth identified $1.3 billion of spending reductions, $236 million of revenue enhancements, federal recovery aid, and a drawdown of the budget stabilization reserve by about $1.4 billion. The original budget had assumed a $401 million drawdown of the rainy-day fund. With the additional drawdown in fiscal 2009, the balance at year-end was about $800 million.

Fiscal 2010 budget

Based on the enacted budget, spending in fiscal 2010 will be lower than fiscal 2009 and actually slightly below fiscal 2008 levels. Due to the steady deterioration in revenues through June 2009, the consensus revenue forecast for fiscal 2010 was revised downward and the enacted budget addressed a sizable budget gap through a mix of revenue enhancement, spending reductions, use of federal stimulus, and other reserve funds. The enacted budget for fiscal 2010 includes about $1 billion of revenue enhancements. The most significant revenue measure increased the state sales tax rate to 6.25% from the current rate of 5.00%. Total spending in the enacted budget is $30.5 billion or 0.6% below fiscal 2009 estimated spending. Included in this total is $9 billion of Medicaid spending, which is a 5% growth rate, the lowest in several years. Enrollment is projected to increase by 5%. This level of enrollment growth is consistent with fiscals 2006 and 2007 when economic trends were much stronger. Higher use of Medicaid services has been identified as a potential area of budget pressure. Health care reform continues to be funded in fiscal 2010 with a $723 million contribution to the Commonwealth Care Health Insurance Program. Spending is below 2009 levels, reflecting legislative changes relating to coverage of immigrants and other cost-containment initiatives. Direct local aid is 1.8% above fiscal 2009 levels while most other areas of the budget show declines. Despite spending reductions in a range of program areas, there is a $372 million appropriation to the state retiree benefit trust fund, which is the third consecutive year of funding for the trust for a total of $1.1 billion. Direct local aid for fiscal 2010 increases by 1.8% for fiscal 2010.

Financial Management Assessment: 'Strong'

Standard & Poor's maintains a "strong" Financial Management Assessment (FMA) score for Massachusetts. An FMA of strong indicates that practices are strong, well embedded, and likely sustainable. Many of the

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commonwealth's management practices related to debt and financial management are embedded in statute.

Highlights include the following:

- Massachusetts uses outside economic forecasting firms to forecast revenues and expenditures. The commonwealth 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 revenue forecasts are prepared annually and integrated with its CIP. A five-year CIP (administrative in 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.
- The commonwealth has detailed and frequently reviewed investment policies managed through the office of the treasurer.

Economy: Diversified And Waiting For Recovery

While Massachusetts' economy is deep and diverse in our opinion, it has experienced recessionary declines in line with national trends. Before the current recession, the state had not recovered to its employment peak in 2001. From an employment standpoint, this recession has been less severe than previous downturns. Unemployment rates increased substantially in the past year but appear to be leveling off. Wealth levels are strong in our view. Per capita personal income stood at $50,735 in 2008, about 128% 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 sector, accounting for 19.5% of total employment. This is followed by trade and transport (17.3%) and professional business services (14.8%). Cyclical sectors such as manufacturing and construction represent only 8.7% and 4.2% 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 of the 50 states by value of federal

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defense and research contract awards.

Debt And Liabilities

By most measures, Massachusetts' debt burden remains high relative to other states. The commonwealth has about $17 billion of GO debt; it 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. Total tax supported debt is $26.8 billion. Debt per capita ($4,124) and debt relative to personal income (8.1%) have always been high relative to other states. Budgeted debt service on GO bonds and contract assistance obligations was 6.9% of budgeted expenditures in fiscal 2009. The commonwealth's CIP through 2014 totals $17 billion with $8.9 billion of debt projected. This plan adheres to a debt affordability model and an annual bond cap but represents a significant amount of additional debt in our view. Debt service will remain below 7.7% of revenues through 2014 based on the state's current forecast of revenues.

The Public Employee Retirement Administration Commission released its actuarial valuation of the total pension obligation as of Jan. 1, 2009. The unfunded actuarial accrued liability increases substantially to $22.1 billion from $12.1 billion (state employees and teachers). The funded ratio through Jan. 1, 2009, declined markedly in our view to 62.6% from 78.6%. Pension contributions for fiscal 2010 are $1.4 billion or 4.5% spending; we expect that contributions in fiscal 2011 will be much more significant. Legislation was passed in 2009 to implement various cost-control measures and a pension reform commission has made recommendations for more substantive measures to be evaluated over the next year. The commonwealth's accrued OPEB liability as of December 2008 is $15.637 billion, assuming no prefunding of the liability. If prefunded, the liability is reduced to $11.6 billion. The State Retiree Benefits Trust Fund was created and received a one-time transfer of $400 million in fiscal 2008. A special commission was created and released a report in July 2008 that recommended that a strategy be developed to fund the liability. Three funding sources were identified: tobacco settlement funds, budgetary surpluses, and legislative appropriations. In fiscal 2009, $352 million was transferred to the trust fund. The fiscal 2010 budget directs the comptroller to transfer $372 million into the fund. Supplemental budget legislation was passed in 2009 that increases 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.

Related Research

USPF Criteria: "GO Debt," Oct. 12, 2006

Ratings Detail (As Of November 5, 2009)		
Massachusetts GO cons loan (wrap of insured) (FGIC & BHAC) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Massachusetts GO (wrap of insured) (ASSURED GTY & AMBAC) (SEC MKT)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Massachusetts GO (FGIC)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Massachusetts GO (MBIA) (Assured Gty)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

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Ratings Detail (As Of November 5, 2009) **(cont.)**		
Massachusetts GO (MBIA) (National)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Massachusetts GO		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Massachusetts GO RFD		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Massachusetts GO Rfd		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
University of Massachusetts Bldg Auth, Massachusetts		
Massachusetts		
University of Massachusetts Bldg Auth (Massachusetts) GO (MBIA) (National)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

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