

**New Issue: Rhode Island (State of)**

**MOODY'S ASSIGNS Aa3 RATING AND NEGATIVE OUTLOOK TO STATE OF RHODE ISLAND \$107.4M G.O. CONSOLIDATED DEVELOPMENT LOAN OF 2008, SERIES B, SERIES C (FEDERALLY TAXABLE), AND REFUNDING SERIES D**

**Aa3 RATING AND NEGATIVE OUTLOOK APPLY TO APPROXIMATELY \$997M OUTSTANDING G.O. DEBT**

State  
 RI

**Moody's Rating**

<b>ISSUE</b>	<b>RATING</b>
General Obligation Bonds Capital Development Loan of 2008 Series B	Aa3
<b>Sale Amount</b>	\$88,675,000
<b>Expected Sale Date</b>	12/02/08
<b>Rating Description</b>	General Obligation
General Obligation Bonds Consolidated Development Loan of 2008 (Federally Taxable)	Aa3
<b>Sale Amount</b>	\$8,500,000
<b>Expected Sale Date</b>	12/02/08
<b>Rating Description</b>	General Obligation
General Obligation Bonds Consolidated Capital Development Loan of 2008 Refunding Series D	Aa3
<b>Sale Amount</b>	\$12,035,000
<b>Expected Sale Date</b>	12/02/08
<b>Rating Description</b>	General Obligation

**Opinion**

NEW YORK, Dec 1, 2008 -- Moody's Investors Service has assigned a rating of Aa3 to the State of Rhode Island's \$86.875 million General Obligation Bonds Consolidated Development Loan of 2008 Series B, \$8.5 million 2008 Series C (Federally Taxable), and \$12.035 million 2008 Refunding Series D. The Aa3 rating incorporates the state's modest reserve levels that provide some financial cushion; above average but improving debt ratios; and a history of satisfactory fiscal management including the use of one-time solutions to weather the 2001-2002 recession as many states did. Since fiscal 2007, however, the state has faced continuing revenue under-performance and spending challenges. As a result, Rhode Island has had to address increasingly larger budget gaps at a time when many other states were revising revenue estimates upward and rebuilding reserves as they recovered from the earlier recession. In the past several years, Rhode Island has balanced its budgets with one-time solutions and increased its short term borrowings for cash flow purposes. This raises concerns regarding the state's likelihood of achieving structural budget balance in the near term, especially given the newly identified budget gap of approximately \$357 million (11.5% of general revenues) for fiscal year 2009 and an even larger shortfall projected for fiscal year 2010. As a result, the outlook on the state's credit is negative. Future credit reviews will consider the state's resolution of its latest budget shortfall with a focus on solutions that balance recurring revenues with ongoing expenditures as well as on the state's liquidity position.

The state plans to sell the bonds the week of December 1. Proceeds of the bonds will be used as follows: Series B for various statewide projects, Series C for affordable housing projects, and the refunding Series D to refund the state's general obligation 2000 Series B variable rate debt to fixed rate.

Credit strengths are:

\*Satisfactory fiscal management following revenue weakening during 2001-2002 recession.

\*Budget reserve fund maintained at statutory cap during recession, providing some financial flexibility.

\*Improving debt ratios reflecting debt reduction policies.

Credit challenges are:

\*Consecutive budget gaps for fiscal years 2007, 2008, and 2009 emerge due to revenue underperformance and continuing spending pressures.

\*Past reliance on one-time budget solutions contribute to recurring budget shortfalls.

\*Available reserves remain well below pre-recession peak levels.

\*Increased cash flow borrowing and slim cash margins underscore state's reduced liquidity.

\*Acceleration of job losses and very high unemployment rates undermine Rhode Island's overall economic growth prospects.

#### RECENT REVENUE FORECAST IDENTIFIES SIZEABLE BUDGET GAP FOR CURRENT FISCAL YEAR

The latest projections from the state's November Revenue Estimating Conference (REC) show a budget shortfall of \$357 million in the current year, about 11.5% of general revenues. The estimated gap for fiscal year 2010 is \$351 million (excluding \$111 million in hospital licensing fees that must be renewed annually). The shortfall for fiscal year 2009 emerged after the state resolved a gap of \$383 million (about 11% of general revenues) going into the fiscal year 2009 budget deliberations. The adopted budget relied heavily on reining in spending, which the state has been struggling with for several years. In addition, revenue projections at the time were optimistic in light of recent performance and the state's weak housing environment. The November 2008 REC projects revenue underperformance of approximately \$234 million for fiscal year 2009 and about \$128 million in higher spending despite the state's efforts to reduce its operating costs. Revenue estimates that were revised downward include: personal income taxes (\$113 million), business taxes (\$42 million), sales taxes (\$31 million), and lottery revenues (\$16 million). Increased expenditures include: \$38 million in repayment to the BRF (used to close the fiscal 2008 year-end shortfall); \$37 million for caseload growth in the Department of Human Services; \$19 million due to a change in Medicaid billing methodology for the Department of Children, Youth, and Family; and \$13 million from delays in implementing certain Medicaid reforms.

In the past few years, Rhode Island has faced continuing revenue under-performance and spending challenges resulting in increasingly larger budget gaps. The state employed one-time solutions to resolve its budget gaps in the 2001-2002 recession, using tobacco bond proceeds to balance its budgets in fiscal years 2002 and 2003. In fiscal year 2007, the state relied on \$43 million in residual tobacco bond proceeds, effectively another deficit borrowing, and still needed to draw \$17 million from the state's budget reserve fund (BRF) to close the year. A larger portion (\$124 million) of the 2007 tobacco securitization proceeds were incorporated in the enacted fiscal year 2008 budget and the state again relied on a draw on its BRF to resolve a \$38 million deficit at the end of the fiscal year. In addition, Rhode Island returned to cash flow borrowings of increasingly larger amounts for fiscal years 2007, 2008, and 2009 reflecting the state's reduced available liquidity.

Recurring budget gaps and the state's history of relying on one-time budget solutions raise concern regarding the state's cash margins, which are already slim, and the likelihood of achieving structural budget balance in the near term.

#### RHODE ISLAND FACES \$461 MILLION GAP FOR FISCAL YEAR 2010

As of the November 2008 REC, Rhode Island's fiscal year 2010 projected budget shortfall is \$461 million (assuming \$111 million in hospital licensing fees approved annually). At approximately 19% of General Fund revenues, the gap is sizeable especially given the magnitude of the budget deficit that must now be closed for the current fiscal year. Projections for the next fiscal year reflect modest growth of only 0.6% in total taxes off a now lower base for fiscal year 2009. The forecast assumes job losses through 2009 and essentially flat growth through 2010 although the recovery could be more prolonged. Rhode Island's unemployment rate spiked to 9.3% in October 2008, the highest in the country at nearly two percentage points above the national average of 6.5% the same month.

The governor's proposed budget for fiscal year 2010 will be released in mid-January 2009. The state is also deliberating solutions for its fiscal 2009 shortfall. In the absence of a swift economic recovery, which appears highly unlikely, and/or the identification of additional recurring revenues, significant actions on the spending side will be required to reduce expenditures year over year. Rhode Island has struggled in recent years to contain its rising Medicaid, corrections, and employee costs, although recent workforce reductions have been achieved, and the right-sizing of its budget may take longer.

#### FISCAL YEAR 2007 OPERATING GAP FILLED WITH BOND PROCEEDS; RESERVES DECLINED, REVERSING IMPROVING TREND

Rhode Island used about \$43 million of proceeds from the securitization of residual tobacco settlement revenues to balance the fiscal year 2007 budget. It also drew down its budget reserve account by almost \$17 million, resulting in a slim reserve position of just 2.4% of General Fund revenues, below the state's goal of 3%. The state's unreserved, undesignated balance was essentially depleted, after falling steadily from its pre-recession peak of \$131 million, leaving the state with reduced budgetary flexibility and strained liquidity for subsequent years. After a gap of two years, Rhode Island returned to cash flow borrowing in fiscal year 2007 with a note issuance of \$120 million.

Rhode Island's budget reserve account remained fully funded prior to and through the 2001-2002 recession. This account is funded by limiting annual appropriations to 98% of estimated revenues. Once fully funded, additional revenues are deposited into the state's capital project fund for pay-go financing. In order to maintain the capacity to transfer money to the capital project fund, it is in the state's interest to keep the budget reserve account fully funded. This goal decreases, but does not eliminate, the likelihood that the state would draw on the BRF to resolve potential budget gaps, as it did in fiscal year 2007.

#### STATE DEBT BURDEN SIGNIFICANTLY REDUCED BUT REMAINS ABOVE AVERAGE; TIGHT LIQUIDITY UNDERSCORED BY RETURN TO CASH FLOW BORROWING

Rhode Island's debt burden has dropped considerably over the past ten years although the state's ratios rose last year. Total tax-supported debt for the 2009 median calculation was \$1.87 billion, up only slightly from \$1.8 billion the prior year. Net tax-supported debt was 4.7% of total state personal income, ranking it 13th in the nation, the same as 2007. While still notably higher than Moody's 2008 50-state median of 2.6%, Rhode Island's debt burden remains well below the near 9% level the state experienced in the early 1990s. Rhode Island's debt per capita is also above average at \$1,766 (ranking it 9th), again the same as last year. The 2008 median debt per capita for states is \$889. These improved debt ratios reflect deliberate debt reduction policies, increased pay-as-you-go capital funding, as well as gains in personal income. The state also applied \$295 million of its 2002 tobacco bond proceeds to the defeasance of outstanding general obligation bonds and certificates of participation for debt service savings. Rhode Island will have no variable rate debt outstanding following the issuance of the 2008 Refunding Series D bonds which will be used to take out the Series 2000 General Obligation Bonds that are currently supported by a liquidity facility with Helaba.

Reduced reserve levels are also putting strain on the state's liquidity position. After two years without the need for cash flow borrowing, the state issued \$120 million tax anticipation notes (TANs) in fiscal year 2007. Cash flow borrowings have grown substantially in the past two years with \$220 million issued in fiscal year 2008 and \$350 million in fiscal year 2009 due to further tightening of cash flow margins evident in reduced ending cash balances. The BRF is already incorporated in the state's cash flow statements and thus not available as an additional borrowable resource. The state's alternative liquidity was reduced relative to pre-recession years due to the use of tobacco securitization proceeds in prior years. Rhode Island sold \$90 million in TANs in fiscal 2002, \$150 million in fiscal 2003, and \$200 million in fiscal year 2004. The state ended fiscal year 2001 with combined available reserves of 8.2%. Reserves dropped to only 2.4% of general revenues at the end of fiscal year 2007 before the draw on the BRF was repaid. The BRF was 1.9% of general revenues at the end of fiscal year 2008 (unaudited) reflecting the use of \$38 million in reserves to close the year end budget gap. The unreserved, undesignated general fund balance has essentially been zero for the past two fiscal years, and is likely to remain unfunded in the near term given the size of the state's current budget gap.

#### PENSION FUNDING STATUS REMAINS RELATIVELY LOW

Rhode Island's principal pension plans declined in actuarial funding position following weak financial market returns in 2001 and 2002 captured by five-year smoothed market asset valuation methods. Recently enacted pension reforms should improve the state's pension funding position over time, although these do not apply to all employees. As a result, the state may need to increase its annual pension contributions, an additional expense that would compound the state's spending pressures at a time of rising health care costs. The state employees' pension program had a funding ratio of 57%, based on the June 2007 actuarial valuation. This represents a steady, multi-year decline from a funding level of about 84% as of June 1999. The funding ratio for the teachers' pension program is slightly lower at 55%, also down substantially from June 1999 when the plan had a funding ratio of 82%. Together these plans make up about 86% of the state's pension programs. On a positive note, the annual required contribution is fully funded.

Rhode Island's unfunded liability for other post employment benefit costs (OPEB) is estimated at approximately \$644 million as of June 30, 2005. The amount includes \$580 million for state employees, \$51 million for state police, and about \$9 million for the state's share of teachers OPEB costs. The enacted budget for fiscal year 2008 included about \$27 million in pay-go funding, \$12.7 million less than the annual required contribution.

#### ECONOMY WEAKENS WITH ACCELERATING JOB LOSSES AND SIGNIFICANT HOUSING WEAKNESS

Rhode Island's year-over-year monthly total non farm job losses averaged 2.5% through September 2008, significantly worse than the national pace of negative 0.1% over the same period. The state's manufacturing sector continues a decline that began more than a decade ago. Through 2006, service sector job gains,

particularly in professional and business services, helped Rhode Island maintain positive momentum in total non-farm job growth including through the last recession in 2001-2002. However over the past year almost all sectors have lost jobs with the exception of education and health services which showed modest gains, Foreclosure rates in Rhode Island have been among the highest in the country and will likely limit the state's overall economic growth in the near term. As noted above, Rhode Island's unemployment rate of 9.3% in October is the highest in the nation which had an average rate of 6.5% the same month.

## **Outlook**

Rhode Island's credit outlook is negative reflecting Moody's concerns that the state faces significant hurdles to achieve structural budget balance in the near term given current revenue under-performance, repeated reliance on one-time actions to close recent budget gaps, and persistent spending challenges. Budget uncertainties and reduced reserves also increase the likelihood that Rhode Island's liquidity position will remain narrow. The state's ability to restore structural budget balance and improve its liquidity will be important to future credit analyses.

What would make the rating move - UP

\*Maintenance of stronger reserve levels.

\*Sustained job growth.

\*Restoration and maintenance of structural budget balance.

What could change the rating - DOWN

\*Failure to achieve structural budget balance.

\*Deterioration of state's reserve and balance sheet position.

\*Narrowed liquidity leading to reduced cash flow margins and continuing reliance on cash flow borrowing.

\*Further economic deterioration leading to revenue weakening.

\*Continued reliance on one-time budget solutions.

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