MOODY'S INVESTORS SERVICE

New Issue: MOODY'S ASSIGNS MIG 1 RATING TO $7.8 BILLION STATE OF TEXAS TAX AND REVENUE ANTICIPATIONS NOTES

Global Credit Research - 13 Aug 2010

State
TX

Moody's Rating

ISSUE	RATING
Tax and Revenue Anticipation Notes, Series 2010	MIG 1

Sale Amount	$7,800,000,000
Expected Sale Date	08/24/10
Rating Description	Tax and Revenue Anticipation Notes

Opinion

NEW YORK, Aug 13, 2010 -- Moody's Investors Service has assigned a MIG 1 rating to the State of Texas' $7.8 billion Tax and Revenue Anticipation Notes, Series 2010, scheduled to price on August 24. The note, which matures August 31, 2011, will be issued to manage the mismatch in timing between revenues and large aid payments made to local school districts at the start of the state's fiscal year and is the largest since Texas began its cash flow borrowing program in 1987. The rating reflects the state's projections of a weak General Revenue Fund balance after funds for full note repayment have been segregated but ample alternate liquidity available for the state comptroller to divert to noteholders if necessary. The rating also incorporates strong legal features including note repayment set-asides required to begin five months prior to maturity, the state's strong cash-management procedures and the comptroller's ability to hold back spending in the event of revenue shortfalls. The state's general obligation rating is Aaa with a stable outlook.

LARGE SCHOOL AID PAYMENTS MADE EARLY IN THE STATE'S FISCAL YEAR DRIVES SHORT-TERM BORROWING

Aid payments to local school districts are estimated to total $17.3 billion in fiscal 2011, nearly 23% of general fund expenditures. During the first three months of the state's fiscal year (September-November), 53% of those transfers are made. That timing creates a cash shortfall that drives the need for large short-term borrowings: 55% of Texas' general fund revenue is generated by the sales tax which is historically weakest during the first quarter and September itself is usually the weakest single month for collections. The state also makes 25% of the transfers in the fiscal year's last quarter. The mismatch between the early schedule of school aid payments and revenues creates cash pressure early in the state's fiscal year. The state expects its deepest daily cash shortfall to occur on December 13, 2010, when the mismatch between revenues and expenditures will equal -$10.8 billion; that amount is larger than the current issue, and the state plans to cover the difference through internal borrowing.

To manage its cash flow needs, the state has issued a tax and revenue anticipation note (TRAN) every year since 1987. The upcoming note issuance reflects the largest since Texas began its short-term borrowing program and in part reflects the strain that the flow of school aid transfers can have on the state's overall cash position, particularly during an economic downturn and weak revenue performance. It also indicates the challenge the state will face in its next biennial budget. The state's rainy day fund has robust balances and is an important source of alternative liquidity for the state's cash flow notes. With weak operating cash balances expected to continue through the biennium, drawing down the rainy day fund could limit the state's ability to effectively use short-term borrowing in fiscal 2012 and 2013 absent significant changes in the its expenditures or revenues.

REVENUE PERFORMANCE AMID THE ECONOMIC DOWNTURN CONTINUES TO SQUEEZE STATE FINANCES, EVEN AS SALES TAX SHOWS IMPROVEMENT

While Texas has historically forecasted revenues conservatively, the effects of the economic downturn on tax collections have been greater than original estimates. The Texas economy rebounded strongly following the early 2000s recession and as the state grew and the energy sector surged, revenues performed strongly. Between fiscal 2004 and fiscal 2008, the sales tax alone increased annually by 7.9%, 5.8%, 12.0%, 10.9%, and 6.6%, respectively, significantly greater than estimated. Amid the current economic downturn, however, the sales tax fell well below forecast, with fiscal 2009 collections declining by 2.7% compared to an estimated increase of 2.2%. Current year collections have dropped by 7.2% year-to-date through July compared to the original estimate of a 0.5% increase, although, more positively, the sales tax has grown in each of the past four months by an average of 1.5%. Based on its cash flow forecast, the state expects fiscal 2011 sales tax revenue to increase by 3.9% compared to the current year, reasonable considering how far collections have fallen and recent positive trends. However, while Texas is expected to be an above-average performer compared to the nation going forward, a slower recovery or fall back into recession could blunt revenue growth.

PRIOR SEGREGATION AND LOOK AHEAD PROVISIONS PROVIDE STRONG NOTEHOLDER SECURITY

The legal structure of the notes is governed by strong provisions outlined in the state comptroller's note order, as well as the comptroller's strong cash management powers outlined in statute. The note order provides for the set-aside of funds to repay the Series 2010 TRAN monthly starting in March 2011, five months prior to the August 31 maturity date. By July 31, 2011, 75% of the funds for note repayment are required to be set-aide, and 100% of note principal is required to be segregated by August 24, 2011, seven days prior to maturity. A look-ahead provision also provides the state with strong incentive to closely monitor its cash flows and make adjustments if needed: after each principal set-aside, if the remaining funds needed to pay the note at maturity is more than 80% of the revenue forecast for the rest of the fiscal year the comptroller is required to make additional deposits from any available resource, including by diverting the next revenues received in the general revenue fund.

STATE FORECASTS WEAK GENERAL REVENUE FUND CASH BALANCES: BORROWABLE RESOURCES PROVIDE SUFFICIENT

ALTERNATIVE LIQUIDITY

Texas' general fund cash position has weakened as the state's revenues have continued to decline. The comptroller estimates that the August 31, 2010 unrestricted general fund ending cash balance will be -$2.1 billion after repayment of the TRAN issued to benefit the current fiscal year, or $975 million when including restricted general revenue accounts. That compares to the original forecast of a $2.1 billion unrestricted and $5.3 billion consolidated ending cash balance, respectively. For fiscal 2011, the weak cash position is forecast to continue. Following repayment of the Series 2010 TRAN, the state estimates a fiscal year-end unrestricted general fund ending balance of -$4.5 billion and -$1.3 billion on a consolidated basis, or -6.0% of revenue.

A key source of alternative liquidity is the state's rainy day fund, the Economic Stabilization Fund, which is estimated to end the current fiscal year with a balance of $7.7 billion and to end fiscal 2011 with a balance of $8.2 billion. The fund is available to use to help repay the TRAN if necessary on every day except the last day of the biennium, the same day the Series 2010 note matures. Because of that, but including approximately $1.5 billion of other alternative resources (a variety of smaller state funds and monies in a tobacco endowment account), the fiscal year-end cash balance is only 0.2% of revenue. The cash buffer is much stronger on August 24, however, the day 100% of note repayment funds is required to be segregated, because the Economic Stabilization Fund is still an available resource. The August 24 forecasted general ending cash balance is -6.3% of revenue, but 10.9% when including all alternative liquidity. In the context of the Texas' tight cash flows, the legal structure of the note repayment mechanism and the comptroller's strong legal controls over cash management are particularly key elements of the short-term rating. We expect that the state will take all actions necessary to ensure that the set-asides are made in full and that funds for full principal repayment are segregated in advance of note maturity as required.

MOST RECENT RATING ACTION AND PRINCIPAL METHODOLOGY

The last rating action with respect to the State of Texas was on June 11, 2010, when Aaa ratings were assigned to the state's General Obligation Refunding Bonds, Series 2010A and 2010B, issued through the Texas Public Finance Authority.

The principal methodology used in assigning the rating was "Short-Term Cash Flow Notes," published in May 2007, and available on 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 issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Analysts

Nicholas Samuels
Analyst
Public Finance Group
Moody's Investors Service

Maria Coritsidis
Backup Analyst
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service
250 Greenwich Street
New York, NY 10007
USA