FitchRatings

FITCH DOWNGRADES MINNESOTA GOS TO 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-07 July 2011: Fitch Ratings has downgraded the rating on approximately $5.7 billion in state of Minnesota general obligation (GO) bonds to 'AA+' from 'AAA'.

In addition, Fitch has downgraded the rating on the state's school district credit enhancement program, which is linked to the GO rating, to 'AA' from 'AA+'.

The Rating Outlook is Stable.

RATING RATIONALE:
--The downgrade reflects the state's reliance on non-recurring gap-closing measures over the course of the recession, the difficulties in reaching consensus on a plan to address the resulting large budget gap for the biennium that began on July 1, the likelihood that the final budget agreement will again include non-recurring solutions, and an increasingly contentious budgeting environment in the state in recent years. Fitch believes that as a result Minnesota's financial posture is no longer consistent with an 'AAA' rating.
--Minnesota's economy is balanced, closely resembling the nation's. Employment is recovering in line with the U.S., and the state's unemployment rate is well below the national average. Personal income per capita is the 13th highest of the states at 106% of the U.S. average.
--The state's debt position is strong, with a debt burden that is on the low end of the moderate range at about 2.7% of personal income and rapid amortization. The state has conservative debt policies.
--Minnesota's revenue structure is subject to volatility, and finances are pressured by a large responsibility for local units.

KEY RATING DRIVERS:
--The Stable Outlook at the 'AA+' rating level reflects Fitch's expectation that the state ultimately will implement budget balancing solutions for the current biennium that include a mix of recurring and non-recurring measures; rebuild its reserve position and repay deferrals to school districts as economic and revenue conditions improve, albeit at a slower pace than in the past due to the extent of the deferrals; and continue its strong debt profile and practices.

CREDIT SUMMARY:
Minnesota experienced significant weakness in economic and revenue performance in the biennium that ended on June 30, 2011. Large budget gaps were resolved primarily through non-recurring measures, most significantly payment deferrals to school districts and use of federal stimulus funds. As a result, the state faces a large budget gap for the current fiscal 2012-2013 biennium despite a trend of economic and revenue improvement and carries a sizable general fund GAAP deficit that will continue until the deferrals are repaid.

The gap to be addressed for the fiscal 2012-2013 biennium, which began on July 1, totals $5 billion including full repayment of the $1.4 billion in school aid payment shifts employed to balance the last biennial budget, and $3.6 billion assuming that such payments are made only as surplus funds become available, as has been the state's practice in past downturns and as required by law. The governor and legislature have been unable to reach a budget agreement to address the gap, and the non-essential portion of the state government has been shut down since the start of the fiscal year.

The governor and legislature now appear to be about $1.4 billion apart. This is the gap that remains after factoring in the spending cuts to which both sides have agreed as well as an agreement that the existing $1.4 billion in payment shifts mentioned above will not be repaid as part of the enacted budget. It has been reported that in an attempt to avert a shutdown last week both sides agreed to a further $700 million payment deferral to schools, with the legislature proposing to address the remaining gap through a securitization of future tobacco settlement revenue and the governor instead proposing an income tax on high earners.

While negotiations continue, it is impossible to know at this point when a budget agreement will be reached or the shape that the final agreement will take. However, it appears likely that the outcome will continue the use of non-recurring balancing tools and that deferred payment obligations will continue to be a drag on the state's finances.

As noted above, Minnesota's credit remains fundamentally strong. The state has a history following downturns of rebuilding reserves and repaying the deferrals to school districts that have regularly been used as a budget balancing tool for the state. However, Fitch notes that the payment deferrals relied upon in the recent downturn have been larger than those of the past and that the context of budget decisionmaking has become increasingly contentious over time. Taken together, Fitch believes that these factors result in a fiscal posture that is more consistent with a 'AA+' rating.

For more information on the State of Minnesota, please see Fitch Research dated Sept. 2, 2010, available at 'www.fitchratings.com'.

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Additional information is available at 'www.fitchratings.com'.
Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria', dated Aug. 16, 2010;
--'U.S. State Government Tax-Supported Rating Criteria', dated Oct. 8, 2010.

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Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=548605
U.S. State Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=564546

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