

MOODY'S ASSIGNS MIG 1 RATING TO THE CITY OF SOMERVILLE'S (MA) \$12.86 MILLION BANS

Aa3 LONG-TERM RATING AFFECTS APPROXIMATELY \$67.9 MILLION OF OUTSTANDING GO DEBT

Moody's Investors Service has assigned a MIG 1 rating to the City of Somerville's (MA) \$12.86 million Bond Anticipation Notes (dated February 20, 2009 and payable February 19, 2010). Concurrently, Moody's has affirmed the Aa3 long-term rating on approximately \$67.9 million of the city's outstanding general obligation debt. Security is provided by the city's general obligation limited tax pledge as debt service has not been exempted from the levy limits of Proposition 2 ½. Assignment of the MIG 1 rating incorporates the city's strong credit profile and 12-month maturity of the current note. The Aa3 rating reflects the city's sizeable tax base within the Greater Boston (GO rated Aa1/stable outlook) economy and maintenance of healthy reserve levels while incorporating a resident wealth profile that lags commonwealth medians as well as an above-average debt position.

Proceeds of the current issue will renew a like amount of maturing bond anticipation notes issued primarily for energy conservation projects, school construction and water projects, with lesser amounts funding various recreational facilities. The outstanding notes mature February 20, 2009.

MARKET ACCESS

The current note issue meets Moody's standards for the MIG 1 rating as defined in the recently-updated methodology (please refer to our October 2008 publication "Temporary Criteria Change for Bond Anticipation Note Ratings Due to Municipal Market Disruption"). The MIG 1 rating incorporates the city's long-term credit characteristics and history of market access. The February 2010 maturity date of the current issue exceeds the nine-month standard, temporarily adopted due to recent market disruptions that have prevented more historical levels of market access. However, Moody's notes that access to short-term municipal credit markets remains uncertain due to widespread market disruption, which could impact market access.

Somerville has demonstrated a satisfactory history of access to the capital markets. The city received three bids on its most recent note sale dated December 30, 2008, six bids on its sale dated June 30, 2008, and five bids on its sale dated February 20, 2008.

DIVERSE TAX BASE WITH COMMERCIAL REDEVELOPMENT POTENTIAL; RESIDENTIAL GROWTH MODERATING

After experiencing two consecutive declines, property value reductions are expected to continue through calendar year 2009. However the \$9.6 billion equalized value base is expected to benefit from ongoing commercial redevelopment activity related to Somerville's favorable location and management's commitment to attracting new business. Consequently, while residential values continue to contract, several of these new commercial development projects are expected to soften the overall assessment declines. Falling residential values resulted in a modest 1.8% reduction to assessed value as of January 1, 2008 followed by a 2.1% decline as of January 1, 2009. Long-term, however, Moody's believes the city's convenient location and planned transit improvements favorably position the city for growth. Equalized values grew an average of 9.5% annually over the last six years which, coupled with stronger growth rates in the first three quarters of the decade, have increased a robust 14.6% incorporating both significant market appreciation and new growth. Consequently, the city's equalized value has more than tripled to over \$9.6 billion from \$3.17 billion in 1998 primarily driven by condominium conversions of rental units, new commercial development and ongoing market value appreciation.

To capitalize on Somerville's desirable location and to facilitate future growth, city management has embarked on an ambitious economic development plan, including commissioning various feasibility studies to identify potential projects, rezoning initiatives to facilitate investment and pursuit of state and federal grant funds. The principal driver for future growth is the 145-acre Assembly Square Project, including two million square feet of office space, over 2,000 housing units, and a 500,000-square-foot IKEA. Previously delayed due to zoning litigation, site work has begun and management expects construction to commence in the summer of 2009. The city is also pursuing several new hotels and is working to rezone areas of the city to allow for greater density. Longer term plans to add two subway stops within city limits would unlock additional land for redevelopment. The city has secured \$15 million in developer support and \$25 million of federal earmarks for one of these projects; however construction remains several years out.

Portions of Tufts University (revenue bonds rated Aa2/stable outlook) lie within the city and the university's presence provides economic stability as well as significant employment opportunities. Although a tax-exempt entity, the city benefits from annual payments-in-lieu of taxes of \$125,000 and affordable rental rates of university-owned property utilized for city operations. The city's sizeable student population (about 14% of total population according to the 2000 census), drawn from Tufts, as well as nearby Harvard (rated Aaa/stable outlook) and MIT (rated Aaa/stable outlook), partially depresses the city's income indices, expressed by median family income and per capita income at 83% and 91%, respectively, of commonwealth medians.

HEALTHY FINANCIAL OPERATIONS SUPPORTED BY CONSERVATIVE BUDGETING

Moody's believes Somerville's conservative budgeting approach and strong financial management will be integral to the city's financial stability over the next several years, given slowing revenues and forthcoming reductions in state aid. Audited fiscal 2007 financial statements show a fifth consecutive operating surplus which raised undesignated general fund balance to \$14.3 million, or a healthy 8.4% of revenues. The total \$29.2 million general fund balance (a strong 17.1% of revenues) includes a \$9.6 million reserve for employee benefits as city maintains employee contributions for its self-funded health insurance program within the general fund. As these balances are not available for general operations, Moody's views Somerville's unreserved fund balance as more accurately reflecting the city's financial position. The 2007 operating surplus was primarily generated from conservative revenue estimates, particularly of tax liens, investment earnings and \$5.6 million of expenditure savings including approximately \$1.1 million of savings derived from lower than expected employee health insurance claims.

Additionally, the city applied developer payments of \$2 million to the city's Assembly Square Stabilization Fund, while \$2.5 million of free cash was transferred into the Capital Stabilization Fund, boosting that fund's balance to approximately \$2.8 million. Aggregate stabilization funds closed with a \$4.8 million balance, up from \$400,000 in 2006, bringing available reserves (comprised of unreserved fund balance plus stabilization funds) to a healthy \$22.6 million or 13.1% of revenues. While approximately \$2 million of this balance was earmarked in fiscal 2007 (with an additional \$1 million earmarked in fiscal 2008) to offset debt service related to renovations of city buildings and parks over the next five to six years, Moody's believes the city's policy of applying a minimum of \$1.5 million but up to one-third of annual free cash balances to the Capital Stabilization Fund will ensure maintenance of an adequate financial cushion.

In keeping with conservative budgeting practices, in fiscal 2008 management reduced budgetary assumptions of economically sensitive revenues, and continued to cautiously budget expenditures. Unaudited results indicate a sixth consecutive surplus, resulting in a modest increase to general fund balance and a \$2.8 million increase to stabilization funds, raising that reserve to over \$7.6 million. Certified free cash balances topped \$10.2 million, a record level for the city. Officials are planning to apply approximately \$3 million of this free cash to establish a revenue stabilization fund or "rainy day" fund, providing a financial bridge during this economic downturn. Any use of these funds is yet undetermined, however Moody's anticipates the city will continue to prudently manage its overall reserve levels. The adopted fiscal 2009 budget included an overall expenditure increase of 5% and included the use of \$3.5 million of free cash. Through December 31 management reports modest favorable variances in both revenues and expenditures. Despite the governor's recent announcement of current year aid reductions, which will cost Somerville \$2.9 million of revenue, management remains confident that efforts to contain costs and recent reductions in fuel costs will be sufficient to cover this revenue shortfall without draws on free cash. For fiscal 2010, Somerville faces an additional \$2.1 million reduction, and the city is exploring various revenue augmentation and cost saving measures including potential increases in parking rates, overtime controls and slower hiring. To offset the cost of these reductions, the governor has proposed revenue augmentation measures including a local option meals tax, elimination of a property tax loophole for telecommunication infrastructure and increases in the hotel tax, which if passed would yield an estimated \$1.2 million annually for the City of Somerville. Going forward, Moody's expects the weaker economy will continue to cause budgetary tightening. Having exhausted its levy capacity, Somerville will need to look to alternate sources to augment revenues or pursue expenditure reductions in order to remain structurally balanced as employee salary and benefit costs continue to rise. To the extent that the city relies on a rainy day reserve over the next few years, Moody's will monitor the city's active management of overall reserve levels and the ability to maintain sufficient financial flexibility.

DEBT POSITION EXPECTED TO REMAIN MANAGEABLE

Moody's believes that the city's debt position will remain manageable given anticipated school construction assistance and rapid retirement of outstanding debt. Somerville's direct debt burden is a modest 1.0 % of equalized valuation, however overall debt burden is above average at 3.2% due to significant overlapping obligations attributable to the Massachusetts Water Resources Authority (senior lien debt rated Aa2/stable outlook) and the Massachusetts Bay Transportation Authority (Aa2/stable outlook). After adjusting for 90% commonwealth school construction reimbursement, this number falls to a more favorable 2.8%. Debt service payments accounted for a manageable 4.4% of general fund expenditures in fiscal 2008. Amortization of outstanding debt is rapid with 81.2% of principal repaid within ten years. Future debt plans consist of permanently financing \$7.7 million of bond anticipation notes in 2010 and replacing or

extensively renovating a fire damaged school. The extent of the school construction or reconstruction will certainly drive the total cost, however \$12 million of received insurance payments and Massachusetts School Building Authority grants (MSBA revenue bonds rated Aa2/stable outlook) are expected to balance the effect on the city's debt burden. The city solely issues fixed rate debt and has no exposure to derivative products.

KEY STATISTICS:

2007 population (estimate): 74,405 (-4% since 2000 census)

2009/2010 Equalized Valuation: \$9.6 billion

Average Annual Equalized Value growth (2003-2009): 9.5%

2009/2010 Equalized Value per capita: \$128,590

Per Capita Income: \$23,628 (91% of commonwealth median, 110% of nation)

Median Family Income: \$51,243 (83% of commonwealth median, 102% of nation)

FY07 General Fund balance: \$29.2 million (16.9% of General Fund revenues)

FY07 Unreserved Undesignated General fund balance: \$14.3 million (8.3% of General Fund revenues)

FY07 Stabilization Fund balance: \$4.8 million (2.8% of General Fund revenues)

FY08 General Fund balance (unaudited, non-GAAP): \$30.9 million

FY08 Unreserved Undesignated General Fund balance (unaudited, non-GAAP): \$14.4 million

FY08 Stabilization Fund balance (unaudited, non-GAAP): \$7.6 million

Overall debt burden: 3.2% (2.8% adjusted for state building aid)

Payout of principal (10 years): 81.2%

Long-term GOLT debt outstanding: \$67.9 million

RATING METHODOLOGY USED AND LAST RATING ACTION TAKEN

The principal methodology used in rating the City of Somerville's Bond Anticipation Notes was "Bond Anticipation Note and Other Short-Term Capital Financings" which can be found at www.moodys.com in the Credit Policy & Methodologies directory, in the Index of Special Reports - U.S. Public Finance. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Credit Policy & Methodologies directory.

The last rating action was on January 14, 2009 when a Aa3 was assigned to the city's general obligation limited tax bonds.