FITCH UPGRADES THE STATE OF TENNESSEE'S $1.1B OUTSTANDING GOS TO 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-17 October 2006: Fitch upgrades its rating on the State of Tennessee's (the state) outstanding $1.1 billion general obligation bonds (GOs) to 'AA+' from 'AA'. The rating upgrade largely reflects a return to structural balance that owes in part to an improving economy, a permanent revenue increase, and a restructuring of TennCare, the state's Medicaid-expansion healthcare delivery program. The state's consistently low debt level is also a principal factor underpinning the state's rating. Financial management has been habitually conservative and allowed the state to overcome a structural deficit that plagued state operations for several years. The state is exposed to economic cyclicality as the economy has above average manufacturing concentration. The Rating Outlook is Stable.

The state's debt -- which is used infrequently, amortizes rapidly, and represents a very low burden on resources -- is well-protected by security provisions. Several taxes, including a portion of the gas tax, are pledged to debt service, and their yield is the basis for a debt limit that consistently remains less than one-third used. Net tax-supported debt of just under $1.4 billion equates to only 0.7% of 2005 personal income. Debt is now below the 2000 level, due both to the rapid amortization schedule and to reduced bond issuances during a period of stringent financial operations earlier this decade.

A drawback to the state's financial position is its heavy reliance on the sales tax, which was unable to keep pace with state spending needs, primarily TennCare's rising costs that averaged double-digit increases for several fiscal years. Yet, recent reform of TennCare is expected to bring significant cost-savings and the sales tax was raised in 2002. The state has shown fiscal restraint when challenged by significant structural gaps and consistently balanced its financial operations. The state's budgetary reserve has ended at record highs since fiscal 2003, including the unaudited fiscal 2006 reserve balance of $325 million, or 3.1% of revenues. The fiscal 2007 budget calls for a deposit to the reserve, expected to bring its balance to $497 million or nearly 5% of revenues, and is built upon conservative revenue growth assumptions of 3% and spending growth of 5.6%, with state appropriations for TennCare essentially held flat to fiscal 2006 levels. The state has met the full actuarially required employer contribution to its pension system each year since 1972 and enjoys pension funding ratios of 99.9%.

Tennessee's economy has been cyclically vulnerable, as manufacturing is important to the state's economy. Following growth in each year from 1992 to 2000, employment dropped 2001 through 2003 more than 1.5 times the U.S. loss. The economy then improved with job gains of 1.6% in 2004 and 0.5% in 2005, compared to the national rates of 1.1% and 1.5%, respectively. Tennessee is experiencing major change in its employment base. Apparel and textiles jobs have given way to transportation equipment as the largest manufacturing employment group, accounting for 15% of manufacturing in 2005. Meanwhile, the professional and business services sector grew nearly 90% from 1990-2005, providing over 11% of the state's jobs in 2005, up from 7.5% in 1990. August 2006 employment was up 1.2% from a year ago, comparing favorably to the 1.3% U.S. growth rate. Tennessee's per capita income growth outpaced the U.S. at 4.4% versus 4.2% in 2005 and the state ranks 36th by this measure among the other states.

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