

Auckland City Council

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Major Rating Factors

Strengths:

- Solid cash operating surpluses
- New Zealand's largest economic hub
- Strong system support

Weaknesses:

- Increasing need to deliver capital expenditure
- Increasing debt

Issuer Credit Rating

AA-/Stable/A-1+

Rationale

The ratings on Auckland City Council reflect our opinion of the pending amalgamated council's credit profile. The Crown has announced its intention to merge Auckland City Council and seven other New Zealand local governments in the Auckland region into one, new, single authority called the Auckland Council (with effect from Nov. 1, 2010). All powers, assets, and liabilities of the existing councils will be transferred to the newly constituted council, and therefore Auckland City Council's credit quality will reflect that of the newly established Auckland Council. In our assessment, the credit quality of the merged Auckland Council will be weaker than that of Auckland City Council.

The ratings on the future Auckland Council are likely to be supported by strong cash-operating surplus, a strong system of support, and a large local economy. Auckland Council's need to deliver large infrastructure projects and the resulting increase in debt will offset these strengths.

Standard & Poor's expectation is that the new Auckland Council will continue to record solid cash-operating surpluses at the consolidated level. However, we would also expect to see small accrual operating deficits (after Standard & Poor's adjustments) and a deteriorating overall cash (after capital expenditure) position. The size of the overall cash deficits is dependant on the level of delivery of the capital-expenditure program.

New Zealand local governments benefit from strong systemic support. The New Zealand local government system promotes a strong management culture and fiscal discipline among New Zealand councils. This provides a source of credit strength and allows them to support higher debt burdens than some of their international peers at the same rating level. Given the importance of Auckland to New Zealand as a whole, we expect that the central government's support for the new council will be slightly stronger than other New Zealand councils around the country.

Auckland's economy provides further support to the rating. The greater Auckland region is the financial and economic hub of New Zealand, and represents the single-largest regional economy in New Zealand, accounting for roughly one-third of the nation's GDP growth.

The new Auckland Council's debt will be higher than any individual council's within the group, as each of Auckland's individual councils is forecasting significant increases in debt-funded capital expenditure. Standard & Poor's believes that the sum of internal and external capacity constraints is likely to lead to lower-than-forecast capital expenditure; however, the Auckland Council's debt will increase and is more likely to be consistent with an 'AA-' rating over the short-to-medium term.

Short-term credit factors

The short-term rating on Auckland City Council is 'A-1+'. Auckland City Council's liquidity is very strong, and sufficient to mitigate the potential of a liquidity crisis in the short term. At the core-council level, short-term debt maturing in the next 12 months of NZ\$25 million (at June 30, 2009) is supported by cash holdings and cash equivalents of around NZ\$24 million. The availability of NZ\$100 million in undrawn committed bank facilities further supports the council's liquidity. In regards to the Auckland Council, its liquidity will be supported by existing facilities that have more than half their credit available. Auckland Council's liquidity will be further supported by the substantial financial assets held by the Auckland Regional Council.

Outlook

The stable outlook reflects our expectation that the merged council's credit quality will remain consistent with an 'AA-' rating over the medium term. The Auckland Council rating could be reviewed either up or down depending on the policies of the newly merged council and the consolidated forecasts it produces once the new council begins operating on Nov. 1, 2010. Factors that may affect the merged council's credit rating include the delivery of savings measures, the sale of assets, additional contributions from central government and/or their "takeover" of existing capital-expenditure projects and ratings policies.

Peer Comparison

Auckland City Council's current strengths relative to its domestic and international peers include its strong cash operating balance and its historically low debt. Offsetting these strengths is its weaker overall balance due to its heavy capital-expenditure requirements having resulted in a significant increase in debt. While Auckland City Council's credit metrics appear stronger than similarly rated entities, its rating reflects the contingent liability associated with the guarantee of Watercare's debt, as well as the upcoming merger with the other Auckland local governments.

On balance, Auckland City Council's fiscal performance is slightly stronger than its similarly rated domestic peers, Dunedin City Council (AA-), Hutt City Council (AA), and Greater Wellington (AA-). (See table 1). Auckland City Council's operating cash balances as a percentage of operating revenue are the strongest of its domestic peers. Both its accrual operating position and overall cash position have continued to weaken over the past year, as its capital-expenditure program is increasingly debt-funded. Over the medium term, Auckland Council's debt position is likely to be the weakest of its domestic peers as it implements its capital-expenditure strategy. The ratio of net debt to operating revenue is likely to peak between 100% and 140%, which is considerably more than higher-rated Hutt City Council.

Auckland City Council's rating reflects the upcoming merger with seven other local authorities. With most councils in the Auckland region having forecast large capital-expenditure programs in their respective long-term council community plans (LTCCPs), we expect the amalgamated council to record significant increases in debt levels, modest (Standard & Poor's adjusted) accrual deficits and significant overall cash deficits.

The rating on Auckland City Council reflects the council's guarantee of Watercare's debt. Despite having stronger finances and similar debt to higher-rated Hutt, Auckland's rating is lower, reflecting the council's guarantee of the financial obligations of Watercare, Auckland's bulk water supplier. With the merger of the councils, Watercare will be consolidated into the new council, thereby continuing to weigh on the new entity's rating. Nevertheless, the risk associated with Watercare and Auckland City Council's water retailer, Metrowater, is considerably less when compared with Dunedin's Council-controlled trading organisations, which include an electricity company.

Auckland City Council compares well against its international peers. Based on similar ratings, the Canadian cities of Oxford and Laval and the French city of Cannes are good international peers for Auckland City Council.

Reflecting its revenue flexibility, Auckland City Council has a strong cash operating (as a percentage of operating revenue) position relative to its international peers. Auckland City Council's revenue autonomy is stronger than its Canadian and French peers', as Auckland City Council is less reliant on transfers from the central government. However, Auckland City Council's decision to constrain rates increases to the council's cost of inflation is expected to result in a weaker cash-operating position. Reflecting its high capital-expenditure, Auckland City Council's overall cash balance is weaker than its international peers'. Standard & Poor's expects that the merged Auckland Council will have a similar financial profile; however, this would not necessarily continue to constrain rates.

Table 1

Comparative Financial Profile—Actual (core) 2008							
	Auckland City Council	Cannes (City Of)	Dunedin (City Council)	Greater Wellington (Regional Council)	Hutt (City Council)	Laval (City Of)	Oxford (County Of)
Issuer credit rating (LC)	AA-/Stable/A-1+	AA-/Stable/--	AA-/Stable/A-1+	AA-/Stable/A-1+	AA/Stable/A-1+	AA-/Stable/--	AA-/Stable/--
Three-year averages, using actual results only							
Accrual operating balance (% of operating revenue)	(3.3)	N.A	(8.9)	(0.2)	(0.8)	N.A	N.A
Operating balance (% of operating revenues)	29.7	9.1	13.2	4.0	20.4	25.9*	20.4*
Balance after capital expenditures (% of total revenues)	(9.1)	(15.0)	(10.9)	(4.9)	0.0	5.7*	(3.2)*
Capital expenditures (% of total expenditures)	42.6	27.2	33.9	9.2	28.0	26.3*	32.5*
2008 (mil. NZD)							
Total revenues	649.8	578.5	175.2	178.6	130.5	967.1*	178.5*
Direct debt (at year-end)	322.2	710.1	112.0	67.0	81.3	888.6*	60.3*
Direct debt (% of operating revenues)	57.2	130.9	82.4	37.8	66.6	97.7*	38.3*
Net financial liabilities (% of conso oper rev)	53.4	132.0	39.9	27.7	66.6	99.4*	(9.6)*
Interest (% of operating revenues)	3.7	5.3	4.3	2.3	5.3	6.9*	1.3*

*Figures for 2007. N.A.--Not available.

Economy

Auckland's economy provides modest support to the rating. In the short term, the performance of the council's local economy is not an important factor with regard to credit quality. However, over the long term, the economic structure will influence the credit rating because it affects the revenue and expense pressures placed on the council as well as their ability to attract future ratepayers.

The greater Auckland area, located in the northern part of the north island of New Zealand, has a population of more than 1.4 million. Auckland is the financial and economic hub of New Zealand, and represents the single largest regional economy in New Zealand, accounting for around one-third of national GDP.

Finance and insurance, property services, business services, communication services, and manufacturing feature strongly in Auckland's regional economy. Despite its expanding population, the Auckland region's economic performance has been weaker than New Zealand's as a whole. Real GDP per capita growth (annual average) over the 10 years to 2008 was 1.6% (compared with 2% for New Zealand).

The region's population growth continues to be above New Zealand as a whole. Latest population projections suggest that the Auckland region will continue to grow at 1.6% per year until 2016, increasing the supply of labor to the region. On the flip side, population growth will exert further pressure on the city's core infrastructure.

System Support and Predictability

The New Zealand local government system promotes a strong management culture and fiscal discipline among New Zealand councils, thereby providing a source of credit strength. LTCCPs are required every three years, and must provide financial forecasts that span 10 years. These forecasts are integrated with the council's Annual Plan. The production of LTCCPs promotes a full review of the council's priorities and includes a review of funding and financial policies. The 10-year forecasts are audited by Audit New Zealand.

Other strengths of the New Zealand system that support the rating include:

- Strict financial and non-financial reporting requirements;
- Balanced budgets that include meeting the cost of depreciation or providing the rationale for not doing so;
- Clear revenue and expenditure responsibilities between local and national governments, with an adequate level of taxation powers; and
- Willingness from the Crown to provide emergency support.

Given the size and importance of the new Auckland Council to New Zealand, Standard & Poor's expects the central government will take a special interest in the region.

Management Capacity

Standard & Poor's expects the Auckland Council's rating to be supported by sound management capacity. The Crown's legislative environment, which promotes a culture of planning, transparency, and consultation, ensures a strong management culture will develop within the new council. Further, the new council will be able to draw on expertise from both the merging councils and from the private sector.

Capital spending is expected to continue to lag budget despite the merger. Given the size of the merged council's capital-expenditure program, Standard & Poor's expects that the Auckland Council's challenging capital-expenditure program will be confined by internal (i.e. its ability to physically manage the projects and gain relevant approvals) and external (i.e. its ability to attract workers and resources) capacity constraints. However, the

merger of the region's councils will encourage greater coordination, thereby reducing some of these constraints.

Elections are due in October 2010. At this stage, there are no clear candidates for mayor, although some alliances reflecting the central government parties are forming. Policies of the newly elected council and their implementation will be a key ratings factor in the future. More will be known in the lead up to the 2010 election, with a better indication of the new council's future direction in 2011 when the amalgamated council releases its annual plan.

Fiscal Flexibility

The Auckland Council is likely to continue to enjoy moderate fiscal flexibility. While rates revenue can be easily modified, if the new council adopts a similar policy to Auckland City Council of confining rates increases to the council's rate of inflation, it is likely to affect the council's fiscal flexibility. The ability to delay capital expenditure means that there is some flexibility on the expenditure side, but Auckland has significant and pressing infrastructure needs so it cannot delay some projects indefinitely.

As a general rule, New Zealand local governments do not receive substantial operating grants and subsidies from the Crown. Although grants, subsidies, and financial contributions from other forms of government can diversify a council's revenue base, it can also restrict a council's financial flexibility as they are usually for specific purposes.

The new Auckland Council's core services are expected to be limited to those areas generally provided by local government, such as road maintenance, street cleaning, water supply, wastewater, stormwater, refuse collection and disposal, and sport and recreational facilities. The council is unlikely to perform any significant welfare functions, which can be linked to economic cycles and are highly volatile, nor will it be responsible for the high growth health, education, or justice sectors, therefore offering some support to the rating.

Pressures on existing infrastructure and demand for new infrastructure assets, due to strong population growth, have resulted in capital expenditure being a substantial proportion of all expenditure for the merging councils. At fiscal 2009, Auckland City Council only had capital expenditure of around 32% of total budgetary expenditure, and is projecting an increase to 40% in fiscal 2010. While it is difficult to determine the exact level of capital expenditure for the newly merged council, its percentage of total expenditure is likely to remain high, reflecting the infrastructure needs of the broader region. Like other New Zealand councils, the new Auckland Council is likely to be hindered by internal and external capacity constraints in delivering a large capital-expenditure program, therefore providing it with some flexibility.

CCTO ownership

The amalgamated council is likely to have several CCTOs, some of which will add some additional risk to the council's overall credit quality. Standard & Poor's views several of the Auckland Council's proposed businesses as high investment grade and low risk because the majority of their incomes are from fees and charges.

Budgetary Performance

The amalgamated council's budgetary performance is expected to be slightly weaker than Auckland City Council's; however, it is largely dependent on the decisions made post-amalgamation. While Auckland City Council's accrual operating position is expected to strengthen in fiscal 2010, both its cash operating and overall balance positions are forecast to weaken slightly, partly reflecting both the council's decision to constrain rates and its increasing capital-expenditure program.

Standard & Poor's makes some accounting adjustments to New Zealand local government's finances so that its analysis is consistent with that of other rated local governments. Specifically, the major adjustments made relate to the exclusion of developer contributions and capital grants from both operating revenue and cash flow from operating activities. Standard & Poor's considers the inclusion of developer contributions and vested assets as a key risk to fiscal outcomes being achieved primarily because of the uncertainty around whether they are received as projected.

Auckland Council's budgetary performance (after Standard & Poor's adjustments) is likely to provide support to the rating, with consolidated results generally stronger than individual councils'. While the Auckland Council is likely to record an accrual operating deficit, it is also likely to continue to record strong cash operating surpluses over the short-to-medium term.

Reflecting the increase in each of the individual council's capital-expenditure program, Auckland Council's overall cash position after capital expenditure (as a percentage of operating revenue) is likely to be in deficit over the short-to-medium term. The size of the deficits will be dependant on the ability of the amalgamated council to deliver its substantial capital-expenditure program. Standard & Poor's expectation is that Auckland Council will not be able to meet its capital-expenditure forecasts, thus reducing the size of the after-capital deficits.

Liquidity and Debt Management

Auckland City Council's liquidity is very strong, and sufficient to mitigate the potential of a liquidity crisis in the short term. At the core-council level, short-term debt maturing in the next 12 months of NZ\$25 million (at June 30, 2009) is supported by cash holdings and cash equivalents of around NZ\$24 million. The availability of NZ\$100 million in undrawn committed bank facilities further supports the council's liquidity. In regards to the Auckland Council, its liquidity will be supported by existing facilities that have more than half their credit available. Auckland Council's liquidity will be further supported by the substantial financial assets held by the Auckland Regional Council.

With the establishment of the integrated treasury group, the Auckland region's councils are ensuring that liquidity and debt management remain prudent in the lead up to the amalgamation. The councils are integrating existing treasury functions to manage funding and interest rate risk and to ensure that investors have greater certainty. A transitional treasury policy and operating protocols have been developed and approved by the Auckland Transition Authority.

There is some concentration of debt maturing in the first three years of the Auckland Council; however, it is unlikely to put pressure on the rating. It is not unusual for New Zealand councils to "front-end" their LTCCPs, particularly given the internal and external capacity constraints that councils experience in delivering capital expenditure. While 18% of the amalgamated council's debt is maturing before Nov. 1, 2010, new borrowings during this period are likely to be less than forecast and managed through the use of a prudent liquidity policy including large committed facilities.

Debt burden

Standard & Poor's expects the debt levels of the amalgamated council to be consistent with an 'AA-' rating. While Auckland City Council's debt levels are forecast to remain consistent with a higher rating, the consolidated forecasts for the amalgamated council are forecast to peak at 160% of operating revenue. Standard & Poor's expectation is that under spends will result in debt peaking between 100%-140%, a level consistent with an 'AA-' rating. The level of debt recorded by the new council will be dependant on a number of factors, including forecast revenues of both the council and its newly formed CCTOs, and its ability to deliver its sizable capital-expenditure program.

Given the internal and external capacity constraints facing the new Auckland Council, it is unlikely that the new council will be able to reach its forecast capital-expenditure levels. Standard & Poor's has observed that New Zealand local governments under-spend on capital expenditure in the range of 20% to 60%. Given the size of the proposed capital-expenditure program, Standard & Poor's expects that the amalgamated council will not reach its debt targets in the short-to-medium term. However, there is ongoing pressure on Auckland to deliver infrastructure, particularly given its role as the economic hub of New Zealand as well as host city for the 2011 Rugby World Cup.

Contingent and other liabilities

Currently, Auckland City Council's guarantee of Watercare's financial obligations is a significant contingent liability for the council. Total contingent liabilities at June 30, 2009, were NZ\$897 million, with NZ\$574 million attributed to the guarantee of Watercare's debt, offset by back-to-back arrangements covering NZ\$335 million of this contingent liability. While Auckland City Council only owns 41.6% of Watercare, with the remaining ownership distributed between the other councils within the Auckland region, it is the primary obligor and therefore the size of the contingent liability significantly affects the council's rating. With the amalgamation of the councils (and owners) and Watercare's transfer to a water CCTO, Watercare will not be a contingent liability for the new council. Rather, it will be considered as part of the council's consolidated accounts, which will have the asset backing and rating ability ascribed to the existing councils to offset this liability.

Auckland City Council's other non-debt and contingent liabilities are small, and support credit quality.

Approximately NZ\$295 million of the NZ\$897 million relate to legal claims against Auckland City Council, including weathertightness ("leaky house") claims. Provisions have been established to cover potential liabilities arising from these claims. These provisions are based on legal and actuarial advice regarding Auckland City Council's anticipated liability, and also the history of payments made to date. The weathertightness claims are a significant issue for Auckland City Council, currently accounting for 42% of the nationally active Weathertight Homes Resolution Services (WHRS) claims. As Auckland City Council accounted for 77% of the weathertightness contingent liability figures reported by the amalgamating councils at June 30, 2009, the proportion of weathertightness contingent liabilities to the new council's resources will reduce significantly, whilst active WHRS claims will not increase proportionally.

Auckland City Council, Consolidated Council					
Mil. NZ\$	Year- ended June 30				
	2009	2008	2007	2006	2005
OPERATING RESULTS (MIL.)					
Rates	420.2	394.1	374.6	344.6	307.5
Fees, fines and user charges	116.2	283.0	264.8	244.2	247.4
Interest received	18.7	14.3	18.3	24.1	15.9
Other operating revenue	200.3	27.2	22.4	7.0	16.1
Total operating revenue	755.3	718.6	680.1	619.9	586.9
Interest expense	27.6	20.8	9.6	8.4	12.6
Depreciation	165.5	144.5	132.3	122.9	113.3
Other operating expenditure	625.0	594.1	553.1	498.7	433.9
Total operating expenditure	818.2	759.4	695.0	630.1	559.9
Operating balance (accrual)	(62.8)	(40.8)	(14.9)	(10.1)	27.0
+ Depreciation	165.5	144.5	132.3	122.9	113.3
+ Other adjustments	22.4	89.3	64.2	90.5	35.6
#NAME?	125.1	192.9	181.6	203.2	176.0
+ Asset sales	8.6	0.0	0.7	0.9	12.6

Auckland City Council, Consolidated Council (cont.)					
+ Other capital receipts (payments)	116.2	72.3	73.2	(22.0)	18.4
- Capital expenditure	387.7	408.2	362.2	216.3	192.8
- Net equity investment (policy)	0.0	0.0	0.0	(16.8)	(0.5)
Overall balance	(137.8)	(142.9)	(106.6)	(17.4)	14.7
FINANCIAL PERFORMANCE INDICATORS					
Operating revenue growth (%)	5.1	5.7	9.7	5.6	6.9
Operating expenditure growth (%)	7.7	9.3	10.3	12.5	9.3
Accrual operating balance/operating revenue (%)	(8.3)	(5.7)	(2.2)	(1.6)	4.6
Cash operating balance/operating revenue (%)	16.6	26.8	26.7	32.8	30.0
Overall balance/operating revenue (%)	(18.2)	(19.9)	(15.7)	(2.8)	2.5
Gross interest expense/operating revenue (%)	3.7	2.9	1.4	1.4	2.2
Adjusted net interest expense/operating revenue (%)*	1.7	1.5	(1.0)	(2.4)	(0.4)
Adjusted cash operating balance net interest cover (x)*	10.6	19.8	(25.9)	(13.1)	(73.6)
Capital expenditure/total budgetary expenditure (%)	32.2	35.0	34.3	25.6	25.6
BALANCE SHEET (MIL.)					
Cash and liquid investments	80.4	41.5	53.4	239.4	245.9
Other non-current assets	80.9	88.3	57.7	43.6	86.6
Non-current assets	10,682.4	10,452.6	9,623.0	8,788.7	7,989.7
Total assets	10,843.7	10,582.4	9,734.2	9,071.7	8,322.1
Current loans	24.9	118.9	76.8	135.0	98.9
Current employee and other provisions	48.7	52.8	51.8	38.0	21.7
Other current liabilities	156.9	178.1	149.8	138.6	161.3
Non-current loans	474.1	203.3	58.3	55.9	80.9
Non-current employee and other provisions	230.4	187.3	117.5	81.2	44.2
Other noncurrent liabilities	283.2	247.6	262.3	229.7	1.8
Net worth	9,625.6	9,594.5	9,017.6	8,393.4	7,913.2
Total net worth & liabilities	10,843.7	10,582.4	9,734.2	9,071.7	8,322.1
MEMORANDUM ITEMS					
Gross debt	498.9	322.2	135.0	190.8	179.8
Net debt	418.5	280.7	81.6	(48.6)	(66.0)
Present value of operating lease obligations	27.1	58.6	24.8	11.6	8.6
Contingent liabilities	897.0	975.0	273.0	220.2	83.6
FINANCIAL POSITION INDICATORS					
Debt obligations					
Gross debt/operating revenue (%)	66.1	44.8	19.9	30.8	30.6
Net debt/operating revenue (%)	55.4	39.1	12.0	(7.8)	(11.2)
Adjusted net debt/operating revenue (%)*	59.0	47.2	15.6	(6.0)	(9.8)
Gross debt/cash surplus payback (years)	4.0	1.7	0.7	0.9	1.0
Adjusted net debt/cash surplus payback (years)*	3.6	1.8	0.6	(0.2)	(0.3)
Gross debt/capita (\$)	1,138.9	735.5	309.4	442.9	412.8
Net debt/capita (\$)	955.4	640.8	186.9	(112.8)	(151.5)

Auckland City Council, Consolidated Council (cont.)**Non-debt obligations**

Employee and other provisions/operating revenue (%)	37.0	33.4	24.9	19.2	11.2
Contingent liabilities/operating revenue (%)	118.8	135.7	40.1	35.5	14.2

Net worth indicators

Net worth/total assets (%)	88.8	90.7	92.6	92.5	95.1
Change in net worth (%)	0.3	6.4	7.4	6.1	17.2

*Adjusted for imputed interest and debt burden of lease obligations.

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Ratings Detail (As Of December 21, 2009)***Auckland City Council**

Issuer Credit Rating	AA-/Stable/A-1+
Commercial Paper	
<i>Local Currency</i>	A-1+
Senior Secured (5 Issues)	AA-
Senior Unsecured (6 Issues)	AA-

Issuer Credit Ratings History

15-Dec-2009	AA-/Stable/A-1+
30-Apr-2009	AA/Negative/A-1+
24-Jul-2008	AA/Stable/A-1+
13-May-2008	AA+/Watch Neg/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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