

**Credit Opinion: Johannesburg, City of**

**Johannesburg, City of**

South Africa

**Ratings**

Category	Moody's Rating
Outlook	Stable
NSR Issuer Rating -Dom Curr	Aa2.za

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**Key Indicators**

**Johannesburg, City of**

	2004	2005	2006	2007	[1]2008
Net Direct and Guaranteed Debt/Operating Revenue (%)	46.1	41.0	43.0	39.6	51.1
Interest Payments/Operating Revenue (%)	4.8	5.2	5.7	5.6	5.2
Gross Operating Balance/Operating Revenue (%)	4.8	12.9	9.5	12.7	1.9
Cash Financing Surplus (Requirement)/Total Revenue (%)	-7.9	6.6	-5.8	-3.5	-13.4
Intergovernmental Transfer/Operating Revenue (%)	15.9	16.8	19.8	15.8	16.6
Real GDP (% change) [2]	3.2	5.5	5.4	5.1	n/a
GDP per capita as % of National Average	160.1	162.2	161.1	n/a	n/a

[1] Figures for 2008 are unaudited [2] GDP at Provincial level

**Opinion**

**SUMMARY RATING RATIONALE**

The City of Johannesburg's Aa2.za national scale long-term issuer and debt ratings with stable outlook reflects, on the global rating scale, a Baseline Credit Assessment (BCA) of 7 on a scale of 1-21 (in which 1 represents the lowest credit risk) and a moderate likelihood that the South African Government (local currency A2, stable) would act to prevent a default by the municipality.

Johannesburg's BCA of 7 reflects the city's strong operating performance over recent years, manageable debt burden and sound liquidity. Furthermore, the rating is supported by a very deep and diverse local economy, which has the status of being the business capital and main financial and economic centre of South Africa. The BCA also takes account of the challenges associated with the service and infrastructure backlogs, in spite of recent progresses, and the exposure of the municipal budget to volatile credit and economic conditions, due to the inherent characteristics of the local economy.

**Credit Strengths**

Credit strengths for the City of Johannesburg include:

Strong financial performance in recent years, although recent deterioration

Manageable debt burden that should remain relatively stable

Strong and diversified economic base coupled with a broad tax base

Sound liquidity profile

### **Credit Challenges**

Credit challenges for the City of Johannesburg include:

Service backlogs that remain huge in spite of progress made

High maintenance and refurbishment expenditure of the ageing infrastructure over the medium term

Volatile credit and economic conditions that could lead to a weakening of the tax collection rate

### **Rating Outlook**

Johannesburg's rating outlook is stable, based on the expectation that the municipality will maintain a prudent financial policy framework. Notwithstanding a recent increase, debt burden is expected to remain at a manageable level.

### **What Could Change the Rating - Up**

Johannesburg's rating could improve if the financial profile of the city improves, supported by revenue growth. This should be underpinned by capital investment in revenue generating assets and the reduction in the challenges surrounding infrastructure backlogs.

### **What Could Change the Rating - Down**

Johannesburg's Aa2.za rating could come under pressure if market conditions or weakened fiscal discipline result in higher debt levels and lower tax collection that adversely impact its financial profile.

### **DETAILED RATING CONSIDERATIONS**

The rating assigned to Johannesburg reflects the application of Moody's Joint Default Analysis (JDA) rating methodology for regional and local governments (RLGs). In accordance with this methodology, Moody's first establishes the BCA for the municipality and then considers the likelihood of support coming from the national government to avoid a default by the jurisdiction, should this extreme situation ever occur.

### **Baseline Credit Assessment**

Johannesburg's BCA of 7 reflects the following factors:

Operating Environment - Johannesburg operates in a developing country that is characterised by moderate to low GDP per capita, relatively low GDP volatility and a moderate ranking on the World Bank's Government Effectiveness Index. These characteristics suggest a low level of systemic risk, as reflected in the A2 local currency rating assigned to the national government.

South Africa held its first democratic election in April 1994, at which point in time the African National Congress (ANC) became the overwhelmingly dominant political party.

The government's focus on macroeconomic stability has paid dividends over the past few years, with GDP growth reaching 5% in 2005 (a 21-year high) and maintaining a steady pace during 2006 and 2007. However, the robust economic growth and strong domestic demand coupled with high fuel prices have fanned inflationary pressures. In August 2008, the headline consumer price inflation rose to 13.6%, but inflation pressures are starting to ease. Since December 2005, the South African Reserve Bank has raised interest rates by 550 basis points (50 basis points at a time), pushing the prime overdraft rate to 15.5% in June 2008.

Notwithstanding the country's political transformation and socio-economic progress, South Africa presents a multitude of challenges that still need to be addressed, including: wide income disparities; significantly high levels of unemployment; low skill levels; poverty; and HIV/Aids. The government has launched a major public infrastructure investment programme in roads, rail, ports and power to address developing infrastructure shortfalls and in preparation for the 2010 World Cup that will be held in South Africa.

Institutional Framework - The institutional framework, which encompasses the arrangements determining intergovernmental relations and jurisdictional powers and responsibilities, features moderate financial predictability and stability. Since 1994, the local government system in South Africa has been significantly restructured and

transformed in an effort to improve the coverage and quality of public service delivery to the majority of the population. The country is divided into three interdependent but distinctive spheres of government: national; provincial (nine provinces); and local government (283 municipalities).

A key element of the system restructuring was the demarcation process in 2000 that entailed new municipal boundaries. The intention was to ensure economically viable and financially sustainable municipalities with the capacity to efficiently deliver services to communities. Under the old system, many municipalities were not financially viable as they lacked a sufficient tax base. Accordingly, larger and more equitable entities were created and the number of municipalities was reduced to 283 from 843. They are grouped into six metropolitan municipalities (metros, Category A), 230 local municipalities (Category B) and 47 district municipalities (Category C).

The provincial governments, assisted by the National Treasury, are responsible for municipal oversight regarding the approval and monitoring of budgets.

Metropolitan and local municipalities have localised, defined powers and functions that include delivering basic services and municipal infrastructures, such as water provision, electricity distribution, refuse removal, sanitation, storm water management, municipal roads, cemeteries, fire fighting services and municipal healthcare. District municipalities' primary role is to facilitate, fund and execute infrastructure development in the local municipalities under their jurisdiction. Other services vary and can include water provision, fire fighting, safety and security, and economic development.

Spending responsibilities and revenue structures of South African municipalities are difficult to alter due to a consolidated legal framework, with the entities enjoying the discretion to set the level of rates for taxes and service charges. This allows for a moderate level of own-source revenue flexibility. Revenues of the metropolitan and local municipalities are primarily from property taxes, service charges that include electricity and water sales, refuse and sewerage charges, and other minor services, as well as transfers from the national government. The majority of metros and local municipalities receive 5-20% of their revenue through transfers, with some of the smaller municipalities receiving up to 50% of their revenue through grants. Flexibility is enhanced by the fact that there are no legal constraints on increasing revenue, although the National Treasury sets guidelines to keep increases in line with inflation. Revenues of district municipalities are more rigid than those of the metros and local municipalities, as they are strongly dependent on national government transfers.

Operating expenses of metros and local municipalities are considered largely inflexible, with 80-85% of the cash costs being non-discretionary or fixed. The operating expenditure items mainly comprise bulk water and electricity purchases, employee costs, bad debt charges, general expenses, and repairs and maintenance of fixed assets. The large-scale infrastructure backlogs, coupled with deferred maintenance on existing assets, have resulted in growing capital expenditure budgets and financing requirements. The central government's objective to improve services has resulted in increased grant funding to all levels of municipalities. However, capacity problems are a serious obstacle in fulfilling these plans. Grant allocations have consistently been under-spent as a result of major skills shortages. In addition, the existing infrastructure system is ageing and the maintenance of it has been neglected since 1994. Maintenance expenditure is considered too low since almost all municipalities have deferred some portion of maintenance based on technical quality assessments of the state of their assets. This ultimately results in the deferment of maintenance expenses, with consequently higher costs in future years and deterioration in the quality of service delivery. District municipalities are mainly responsible for the funding of infrastructure development.

The combination of fiscal transfers and own-source revenues of most metros and local municipalities is not sufficient to provide the comprehensive range of services required. However, in spite of these pressures, the debt burdens of the municipalities have remained moderate. The highest debt levels are present at the metro level, as these governments have sufficiently diverse and strong economic bases to sustain these higher levels.

**Economic Fundamentals - Johannesburg** is classified as a Category A local metropolitan municipality based on its size, economic diversity and service responsibilities. It is one of only six cities in South Africa with this status. There are approximately 4 million people living in the city which covers an area of 1,626 km<sup>2</sup>. However, the population is growing rapidly due to the general migration of people from outlying areas into the large centres in South Africa. Reflecting the importance of the local economy at the national level, Johannesburg is the corporate headquarters for more than 70% of South African companies and its GDP per capita is approximately 60% above the national average. These factors continue to support economic growth and stimulate job creation.

While Johannesburg has its origins in gold mining, it has developed into the business capital of South Africa. The city is home to most of the corporate headquarters and the largest listed companies in South Africa. The Gauteng province in which Johannesburg is situated is the most prominent business hub in South Africa, contributing more than 33% of the country's GDP; its GDP per capita is more than 60% above the national average. Notwithstanding the city's economic dynamism supports job creation, its unemployment rate remains high, at 30% (although lower than the national average) and the migration of people to the city is aggravating the situation.

Johannesburg enjoys a good level of infrastructure that is well developed. However, some portions of the infrastructure, such as water and sewer lines, are ageing. Additionally, electrical installations and distribution networks need replacement at a huge cost over the short-to-medium term. Infrastructure and housing backlogs are prevalent, which adds to the spending pressures of the city.

However, in spite of these pressures, the debt burdens of the municipalities in South Africa have remained moderate. The highest debt levels are present at the metropolitan level, which has sufficiently diverse and strong economic bases to sustain these higher levels.

**Financial Position and Performance** - The City of Johannesburg has shown strong financial performance in recent years, as illustrated by the growth in revenue and the control of expenditure. The 2008 operating balance declined to 1.9% compared with 12.7% for 2007. Contributing to the weaker performance is the operating loss realised by City Power (the electricity utility) of ZAR14.6 million. This loss was caused by higher maintenance costs following the problems associated with the load shedding implemented by Eskom in January 2008.

With revenue of ZAR18 billion (US\$2 billion) in fiscal 2008, Johannesburg remains the largest South African city measured by revenue. The city recorded an average annual growth rate of 13.9% over the last five years. Own-source revenues, represented by property taxes, water and electricity sales and other service charges, account for approximately 76% of total revenue and have been growing at some 8.3% per annum over the past five years; 2008 growth was pedestrian at only 3%. In 2008, government grants comprise 24% of total revenue and consist of operating grants of ZAR2.7 billion, an increase of 8% from 2007, and capital grants of ZAR1.6 billion. The operating grant is primarily the equitable share grant that grew by 8% and reflects the central government's strategy to allocate larger amounts to local government. The capital grants include ZAR1.1 billion earmarked for the 2010 Soccer World Cup Stadium, but this will diminish as the construction of the stadium nears completion.

Operating expenditure increased at an annual pace of 11.5% over the past five years, resulting in positive operating balances during this period. Employee costs are well contained at 26% of operating expenses, but asset maintenance costs of ZAR400 million remain low even though they have increased by 55% from the previous year. However, the deferment of maintenance expenditures will result in higher maintenance or replacement costs at a later stage.

**Debt Profile** - At June 2008, the outstanding debt of Johannesburg totaled ZAR8.3 billion, an increase of ZAR2.1 billion from the previous year. The increase has raised the debt-to-operating revenue ratio (excluding capital grants) to 51.1% from 39.6% in the prior year. Johannesburg's currently high debt-to-revenue ratio - which is the second-highest among South African metros - exposes the municipal budget to the high and volatile interest rate environment of South Africa. Nonetheless, debt servicing remains manageable, with interest charges of ZAR846 million or 5% of operating expenses.

The capital budget for the next three years to 2011 amounts to ZAR14 billion, of which ZAR5.2 will be spent in FY2009. The main focus of the capital expenditure is on electricity and water provision, the 2010 World Cup Stadium and transportation in preparation for the World Cup. The capital expenditures for the next three years are expected to be funded from additional borrowings of ZAR7.5 billion, own-cash resources of ZAR700 million and grants and transfers from the national and provincial governments of ZAR5.8 billion. In spite of the ambitious capital expenditure budget, the debt-to-operating income ratio is expected to remain flat at roughly 50% by 2011, which is manageable for the city given its growing revenue base and diversified local economy.

Johannesburg's debt policy has traditionally been cautious, with a large portion of debt at fixed interest rates. The debt repayment schedule does not represent a credit issue thanks to a smooth amortisation profile. At the 30 June 2008 FYE, the city had invested ZAR2.6 billion in a ring-fenced account for the repayment of the long-term liabilities. Furthermore, the city has maintained healthy cash surpluses during FY2008. At FYE2008, the non-sinking fund investments and cash resources stood at ZAR1.7 billion, of which ZAR1.2 billion represented unspent conditional grants earmarked for capital expenditure programmes. The tax collection rate improved to 98% from 93.7% in 2007, which supported the strong operating cash flows of the city. However, the international credit crisis and decline in economic activity are expected to affect the tax collections over the next 18 months as the average South African consumer is under financial stress; this could affect the city's ability to pay its municipal accounts.

**Governance and Management Factors** - Johannesburg's rating reflects sound financial management and budget planning, with financial results close to original estimates. Investment policies are normally adequate to reduce investment risk to low levels.

The city consistently provides annual financial statements, including balance sheets, income statements and cash flow statements, which are always independently audited by the Auditor General. The city received an unqualified report for FY2007, the first time since the implementation of the new demarcation of the city's boundaries.

The executive management appears to be competent in their fields of specialisation. The contractual appointments of most of the experienced directors have been renewed for the next five year-period, which generates some stability with regard to the strategies and running of the metropolitan's operations.

### **Extraordinary Support Considerations**

Moody's rating of Aa2.za for Johannesburg reflects the BCA of 7 and a moderate likelihood that the national government would act to prevent a default by the municipality. The moderate likelihood of support reflects Moody's assessment of the national government's policy stance of promoting greater accountability and financial sustainability for South African municipalities. Reputational risk for the central government is deemed modest, mainly in light of the large predominance of bank loans instead of bonds. Despite the new legal framework

regulates the recovery of municipalities experiencing financial difficulties, it does not suggest timely extraordinary bail out actions to avoid defaults on debt obligations. However, Moody's recognises some interest of the government in addressing major financial problems that could be experienced by the metropolitan municipalities, in view of their relative importance countrywide.

Moody's rating committee also assigns a moderate level of default dependence for Johannesburg, reflecting a low reliance on national government transfers, own-source revenue distinct from that of the central government, and a local economic base that is integrated with the national economy.

### **Output of the Baseline Credit Assessment Scorecard**

In the case of Johannesburg, the BCA scorecard (presented below) generates a BCA of 8, close to the BCA of 7 assigned by the rating committee.

The BCA scorecard, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, is a tool used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by the scorecard provide a good statistical gauge of stand-alone credit strength; however, the estimated BCAs generated by the scorecard do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Concomitantly, scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Moreover, the limited number of variables included in the scorecard cannot fully capture the breadth and depth of our analysis. Nevertheless, the performance statistics captured in the scorecard are important and, in general, higher ratings can be expected among issuers with the highest rankings from the scorecard.

### **ABOUT MOODY'S SUB-SOVEREIGN RATINGS**

#### National and Global Scale Ratings

Moody's assigns national scale ratings in certain local capital markets in which investors have found the global rating scale provides inadequate differentiation among credits or is inconsistent with a rating scale already in common use in the country. Moody's National Scale Ratings are opinions of the relative creditworthiness of issuers and issues within a particular country. While loss expectation will be an important differentiating factor in the ultimate rating assignment, it should be noted that loss expectation associated with National Scale Ratings can be expected to be significantly higher than apparently similar rating levels on Moody's global scale. Moody's National Scale Ratings rank issuers and issues in order of relative creditworthiness: higher ratings are associated with lower expected credit loss.

National Scale Ratings can be understood as a relative ranking of creditworthiness (including relevant external support) within a particular country. National Scale Ratings are not designed to be compared among countries; rather, they address relative credit risk within a given country. Use of National Scale Ratings by investors is only appropriate within that portion of a portfolio that is exposed to a given country's local market, taking into consideration the various risks implied by that country's foreign and local currency ratings.

The Moody's Global Scale rating for issuers and issues in local currency allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

#### Country Ceilings for Foreign Currency Obligations

Moody's assigns a ceiling for foreign-currency bonds and notes to every country (or separate monetary area) in which there are rated obligors. The ceiling generally indicates the highest rating that can be assigned to a foreign-currency denominated security issued by an entity subject to the monetary sovereignty of that country or area. In most cases, the ceiling will be equivalent to the rating that is (or would be) assigned to foreign-currency denominated bonds of the government. Ratings that pierce the country ceiling may be permitted, however, for foreign-currency denominated securities benefiting from special characteristics that are judged to give them a lower risk of default than is indicated by the ceiling. Such characteristics may be intrinsic to the issuer and/or related to Moody's view regarding the government's likely policy actions during a foreign currency crisis.

#### Baseline Credit Assessment

Moody's baseline credit assessment incorporates the government's intrinsic credit strength and accounts for ongoing operating subsidies and transfers from the supporting government. In effect, the baseline credit assessment reflects the likelihood that a local government would require extraordinary support.

#### Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or

local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as low (0% - 30%), moderate (31% - 50%), high (51% - 70%), very high (71% - 95%) or fully supported (96% - 100%).

#### Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to RLGs, default dependence reflects the tendency of the RLG and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the higher-tier government to provide extraordinary support and prevent a default by an RLG is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' baseline default risks, the lower the benefits achieved from joint support. In most cases, the close economic links and/or overlapping tax bases and/or close intergovernmental fiscal arrangements between different levels of government result in a moderate to very high degree of default dependence.

Default dependence is described as low (0% - 30%), moderate (31% - 50%), high (51% - 70%) or very high (71% - 100%).

#### Rating Factors

##### Johannesburg, City of

Baseline Credit Assessment	Value	Score	Sub-Factor Weighting	Sub-Factor Total	Factor Weighting	Total
<b>Scorecard - 2008</b>						
<b>Factor 1: Operating Environment</b>						
National GDP per capita (PPP basis, \$US)	10,054	15	50.0%	9.75	60.0%	5.85
National GDP Volatility (%)	3.2	3	25.0%			
National Govt Effectiveness Index (World Bank)	0.72	6	25.0%			
<b>Factor 2: Institutional Framework</b>						
Predictability, Stability, Responsiveness	7.5	7.5	50.0%	10.00	10.0%	1.00
Fiscal Flexibility (A): Own-Source Revenues	7.5	7.5	16.7%			
Fiscal Flexibility (B): Spending	15	15	16.7%			
Fiscal Flexibility (C): Extent of Borrowing	15	15	16.6%			
<b>Factor 3: Financial Position &amp; Performance</b>						
Interest Payments/Operating Revenue (%)	5.4	9	25.0%	10.50	7.5%	0.79
Cash Financing Surplus(Req)/Total Revenue (%)	-9.5	12	25.0%			
Gross Operating Balance/Operating Revenue (%)	5.9	9	25.0%			
Net Working Capital/Total Expenditures	-5.1	12	25.0%			
<b>Factor 4: Debt Profile</b>						
Net Direct and Indirect Debt/Operating Revenue	34.8	1	50.0%	1.50	7.5%	0.11
Short-Term Direct Debt/Direct Debt (%)	2.9	1	25.0%			
Net Debt/Operating Revenue Trend	-6.2	3	25.0%			
<b>Factor 5: Governance &amp; Management</b>						
Fiscal Management	1	1	40.0%	2.95	7.5%	0.22
Investment & Debt Management	7.5	7.5	20.0%			
Transparency & Disclosure (A)	1	1	15.0%			
Transparency & Disclosure (B)	1	1	15.0%			
Institutional Capacity	7.5	7.5	10.0%			
<b>Factor 6: Economic Fundamentals</b>						
Regional or Local GDP pc PPP - estimated (\$US)	20,678	6	100.0%	6.00	7.5%	0.45
<b>Estimated BCA</b>						<b>8</b>

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