

RWE AG

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RWE AG

Major Rating Factors

Strengths:

- Strong competitive positions in most markets covered, in particular its leading positions in Germany in electricity generation and supply.
- Prudent trading and hedging policies, mitigating high volatility of electricity prices.
- An integrated business model, which should enable RWE to capture value across the energy value chain.
- Share of stable, regulated operations.

Corporate Credit Rating

A-/Negative/A-2

Weaknesses:

- High carbon intensiveness of electricity generation operations.
- Challenging market outlook characterized by falling generation spreads and rising carbon dioxide costs.
- Premature closure of a share of RWE's profitable nuclear fleet.
- Operating and political risks attached to nuclear operations.
- Structurally impaired gas operations and unfavorable cost structure of imported gas.
- Reducing contribution from low-risk regulated grid activities owing to recent disposals.

Rationale

The ratings on Germany-based integrated utility RWE continue to be underpinned by Standard & Poor's Ratings Services' view of the group's leading position in power generation and supply in Northwestern Europe, particularly Germany, its reasonable business and geographic diversity, and significant share of regulated earnings (about 26% of EBIT in 2010).

We see these strengths as partly offset by our expectations of weakening credit metrics in 2011 and 2012, and by the high carbon intensity of RWE's generation fleet and ensuing negative effects of tightening carbon constraints in the EU as of 2013. They are further offset by the group's exposure to wholesale power prices, although this is mitigated by a prudent strategy of selling the bulk of output forward.

Key business and profitability developments

Despite strong financial results in 2010 and the first quarter of 2011, we believe market conditions affecting RWE's key electricity and gas operations will become more difficult over the near to medium term. This is exacerbated by an announcement by the German government that it will permanently shut down eight nuclear reactors in Germany, two of which belong to RWE. These factors, combined with high levels of capital tied up in the group's significant capital expenditures (capex) program, are likely to weigh on RWE's profitability in the coming years, in our opinion.

In the near to medium term, continued uncertainties we perceive about the cost of nuclear operations (losses on power sold forward, investments in safety, and a nuclear fuel rod tax), as well as the near- to medium-term negative effects on cash flow of falling generation spreads and structurally impaired gas wholesale operations, are likely to

weigh on RWE's credit profile. The nuclear issues could be mitigated by rising power prices over the medium to long term, which could result from the early closure of part of the German nuclear fleet and the planned total phase-out of nuclear power by 2022. This will likely benefit RWE because it has a large share of electricity production based on lignite from its own mines and through its remaining nuclear baseload production.

Key cash flow and capital-structure developments

We expect heavy investment commitments, lower operating cash flows, and still significant dividend payments to weaken RWE's credit metrics. We believe that over the next two years this will make it very difficult for RWE to achieve adjusted funds from operations (FFO) to debt of 20%-25%, which we view as commensurate with the 'A-' rating level. RWE's adjusted FFO to debt was 26% in 2010, but we believe it could weaken significantly in 2011 and 2012.

We note that RWE is implementing an efficiency program, intends to complete up to €8 billion in divestments in the coming years, and aims to cut back on capex over the longer term. We expect these efforts to support a gradual recovery of credit metrics in the longer run. We also believe that market conditions affecting electricity generation and gas midstream operations will improve over the long term, which should support a recovery in profitability and cash flows.

Liquidity

The 'A-2' short-term ratings are based on our view of RWE's liquidity as adequate, underpinned by:

- Access to cash and marketable securities of €7.3 billion on March 31, 2011;
- An undrawn €4 billion credit facility maturing in November 2015; and
- Our expectation that RWE will generate substantial, albeit materially lower, FFO in 2011 than the €7 billion achieved in 2010.

This compares with our expectations for 2011 of:

- More than €7 billion in capex;
- Dividend payments at about €2 billion (paid in April); and
- €1.8 billion in short-term debt (of which €1.5 billion is maturities of long-term debt and excluding collateral for trading).

RWE has announced its intention to divest up to €8 billion worth of assets, the majority of which are currently unidentified, in the coming years. Any disposal proceeds received should further support the group's liquidity profile.

We understand that the group has no restrictive covenants in its debt documentation.

Outlook

The negative outlook reflects our view of the likely impact on RWE's credit profile from challenging market conditions and high investment levels. It also reflects our view that the group will see margin pressure in 2013 because of its significant carbon exposure. It further reflects uncertainty we perceive about the success and timeliness of disposals, which in our view could cause the group's credit metrics to deteriorate beyond levels we deem adequate for the ratings over the longer term.

Our base-case scenario assumes that RWE's adjusted FFO-to-debt ratio will fall significantly below the 20% threshold in 2011, gradually recover in 2012, and then strengthen to above 20% in 2013 and thereafter. A recovery in credit metrics would depend on the group's ability to improve cash flows and reduce debt levels over the medium term.

A weakening of our assessment of the group's financial risk profile could lead to a one-notch downgrade in accordance with our rating methodology. This could result if RWE's adjusted FFO to debt were to remain below 20% for an extended period. Similarly, we could lower the ratings if RWE were unexpectedly to make a large debt-financed acquisition, if its operating performance were to deteriorate beyond our current expectations, or if the group were to expand its investment program beyond the current levels.

We would affirm the ratings if RWE were to successfully implement measures to maintain a financial profile at the level we consider commensurate with intermediate financial risk profile. Our 20% FFO-to-debt threshold is contingent on RWE's maintaining a meaningful share of regulated activities (typically 20%-25% of EBIT, adjusted for any minority dividends). A material dilution of the contribution from the group's regulated activities could lead us to revise our financial targets for the 'A-' rating upward.

Business Description

RWE is publicly listed and headquartered in Essen, Germany. It has a fragmented ownership base and municipal investment vehicle RW Energie-Beteiligungsgesellschaft (not rated) is the largest shareholder (16%).

RWE is active in the generation, trading, transmission, and supply of electricity and has vertically integrated gas operations, including a growing position in upstream oil and gas. RWE is the largest power producer in Germany, the second largest in The Netherlands, and the third largest in the U.K.

Table 1

RWE AG Business Divisions' Revenues, EBITDA, And Pretax Profits								
(Mil. €)	--2010--				--2009--			
	Sales (external)	Adjusted EBITDA	EBITDA margin (%)	Capital expenditures	Sales (external)	Adjusted EBITDA	EBITDA margin (%)	Capital expenditures
Germany	19,528	6,728	34.5	2,410	19,386	5,811	30.0	2,813
Netherlands/Belgium	6,510	660	10.1	1,144	1,799	277	15.4	156
U.K.	7,759	504	6.5	876	7,843	445	5.7	853
Central/South Eastern Europe	5,297	1,440	27.2	430	5,254	1,285	24.5	368
Renewables	366	211	57.7	614	245	126	51.4	447
Upstream Gas & Oil	1,353	619	45.8	507	1,208	437	36.2	855
Trading/Gas Midstream	7,517	(7)	(0.1)	4	6,937	986	14.2	2
Other	4,990	101	2.0	394	5,069	(202)	(4.0)	419
Total group	53,320	10,256	19.2	6,379	47,741	9,165	19.2	5,913

Source: RWE AG 2010 annual report.

Business Risk Profile: Leading Domestic Position And Prudent Hedging Partly Offset By High Carbon Intensiveness And Weak Market Outlook

We consider RWE's business risk profile as strong according to our criteria, supported by the following factors:

- Leading position in the German electricity market and strong position in The Netherlands in both electricity and gas. RWE maintains a market-leading presence in most segments of the German power market, including its position as the largest generator in Germany. It has a reasonably strong competitive position due to a significant share of large scale, low-variable-cost plants. Generation operations are reasonably diversified, although there is a large share of carbon-intensive lignite and hard coal plants. Despite severe competitive pressure, RWE is also a leading electricity and gas supplier in Germany and The Netherlands, as well as maintaining solid market positions in the U.K.
- Share of operating income from low-risk regulated network activities (26% of EBIT in 2010). These activities mainly comprise electricity and gas networks in Germany. Regulated operations generally present low operating risk and fairly predictable revenue streams, with only limited volume exposure. The main risk is the quality of assets managed and the regulatory environment they are subject to. Overall, we think the regulatory frameworks in the markets where RWE operates are well established. We believe, however, that RWE could consider selling parts of its regulated activities as a part of its significant divestment program, which could lead to a continued weakening of its business risk profile in our view.
- Prudent hedging policy and integrated business model. RWE systematically sells forward the bulk of its output, locking in margins. RWE also benefits from the natural hedge provided by its integration downstream in supply but also upstream in exploration and production (the gas production of the RWE DEA unit will represent an increasing share of the group's overall gas requirements). The group has reasonably good earnings visibility in the near term. It has a long hedging position in electricity in the coming 12 months, which is due to the unexpected loss of output from two nuclear reactors having been shut down in 2011. Medium-term visibility is more limited, however, but we believe RWE is likely to achieve better prices on its open 2012 and 2013 positions, as power prices have increased following the recent closure of eight of Germany's 17 nuclear reactors.

These supporting factors are partially offset by:

- High capital intensity. This involves significant ongoing investments in RWE's generation capacity and networks. Due to high capital intensity, the industry's return and break-even horizons are often further out, because of the need to invest heavily in fixed assets and production capacity. Operating leverage and, consequently, the need for high capacity utilization adds to the group's risk profile. RWE's remaining nuclear operations are most sensitive to the need for high capacity utilization.
- Substantial carbon intensiveness of RWE's generation operations and resulting exposure to increasing carbon constraints. From 2013 under Phase III of the EU ETS (Emissions Trading Scheme), RWE will no longer receive free allocation of carbon dioxide (CO₂) certificates. The full auctioning of CO₂ emission certificates under the EU ETS will, in our opinion, reduce the group's operating earnings and cash flows over the medium to long term. RWE emitted 165 million metric tons of CO₂ in 2010 and receives about 115 million metric tons for free annually until 2012. Including new fossil-fuel plants to be commissioned, we expect RWE to face an incremental cost of about €1.5 billion-€2 billion annually to cover its shortage of carbon allowances in 2013 and onwards, assuming a CO₂ price of €15-€20 per metric ton.
- A challenging industry and market outlook, leading to pressure on profitability requiring ongoing cost

optimization. Power and gas utilities, RWE included, face an increasingly complex, volatile, and uncertain operating environment, exacerbated by rising political risks and regulatory uncertainty.

- Exposure to volatile wholesale power prices. RWE's overall profitability is closely correlated to, and dependent on, achieved power prices and generation spreads. Central European power prices are highly volatile and seasonal, owing to their link to the price of commodities, particularly coal, oil, and gas. Power prices are becoming increasingly volatile across Europe, mainly due to the significant addition of intermittent renewable electricity generation sources.
- Risks related to nuclear generation. Nuclear operations carry significant financial and operating risks. Nuclear operations remain exposed to inherent political risks as well as stricter environmental and safety requirements following the March 2011 nuclear incident in Japan. See "Credit FAQ: Japan's Nuclear Crisis Could Have Lasting Effects For European Nuclear Operators," published March 16, 2011, on RatingsDirect.

Financial Risk Profile: Under Pressure Due To Expectations Of Weaker Operating Cash Flows And Sustained Capital Spending

The main strengths of RWE's intermediate financial risk profile, according to our criteria, are:

- Healthy cash flow from operations and modest leverage over the cycle. For the ratings, we expect RWE's mid-cycle FFO-to-debt ratio to average 20%-25%.
- Focus on debt reduction and strengthening of the group's balance sheet. RWE's management has taken measures to strengthen its balance sheet over the medium term, mainly by sharply reducing investment levels. The group also intends to continue to dispose of noncore assets and to boost profitability by improving operating efficiency.
- Adequate liquidity and financial flexibility. RWE is a well-established borrower with strong banking relationships and good access to public debt markets. The group uses a wide variety of funding alternatives. RWE's debt and committed back-up facilities do not include any rating triggers, onerous financial covenants, or material adverse change clauses. On March 31, 2011, the group's debt maturities were reasonably well spread, although with some concentration in the medium term.

These strengths are moderated by:

- Expectations of a significant deterioration in credit metrics in the coming two years. We believe this will be a function of RWE's limited discretionary cash flow capacity given its weakening operating cash flows, substantial capex program, and dividend payout of 50%-60% of recurrent net income.

Financial Statistics/Adjustments

RWE reports under International Financial Reporting Standards. We view overall accounting disclosure as adequate, but believe disclosure with regard to working-capital items in the cash flow statement and disclosure of derivatives could improve. To calculate ratios, we make the following adjustments to the group's reported accounts:

- Asset-retirement obligations: These include obligations for the retirement of nuclear power plants in Germany, opencast mining operations, and oil and gas field infrastructure. Due to the conservative nature of the underlying cost assumptions, we have included the gross numbers in debt at about 70% of their on-balance-sheet value, i.e.,

€9.1 billion. Adjustments are made to interest expense to reflect the unwinding of the discount on the related provisions, along with an adjustment to FFO to reflect the increase in future obligations (new provisions plus interest accretion) less cash payments actually made. We will monitor, however, any potential announcement by RWE about any possible increase of its nuclear-related provisions due to the early closure of two reactors. We understand that this could lead to higher-than-expected dismantling costs and, thus, higher provisioning.

- **Postretirement liabilities:** We add to debt the deficit for funded plans (€1,337 million) as well as the liabilities under the unfunded plans (€1,925 million) minus the net deferred tax asset relative to pensions of €617 million. Similar adjustments to those detailed above for asset-retirement obligations have been carried out to interest and FFO with respect to postretirement liabilities.
- **Surplus cash:** In the calculation of adjusted debt, we give 100% credit for RWE's marketable securities (including both current marketable securities of €3.1 billion and €317 million of noncurrent securities) and unrestricted cash and cash equivalents (€2.5 billion). This is due to the intrinsic relationship between the value of marketable securities held and the unfunded future postretirement benefit and asset-retirement obligations. Eighty-four percent of RWE's securities were invested in fixed-income instruments at year-end 2010. However, we exclude the €1.3 billion of other financial receivables that we do not consider to be liquid enough, as well as collateral for trading activities received (€0.7 billion), both of which RWE includes in its liquidity position. Likewise, we exclude from debt the €567 million corresponding to collateral for trading activities owed by the group, which RWE includes in its financial debt.

Table 2

Reconciliation Of RWE AG Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €)								
--Fiscal year ended Dec. 31, 2010--								
RWE AG reported amounts								
	Debt	Shareholders' equity	EBITDA	Operating income	Interest expense	Cash flow from operations	Dividends paid	Capital expenditures
Reported	19,810	16,333	9,720	6,507	1,273	5,500	2,198	6,379
Standard & Poor's adjustments								
Operating leases	720	--	35	35	35	88	--	376
Intermediate hybrids reported as equity	880	(880)	--	--	8	(8)	(8)	--
Postretirement benefit obligations	2,645	56	7	7	147	(74)	--	--
Surplus cash and near cash investments	(5,921)	--	--	--	--	--	--	--
Capitalized development costs	--	--	(112)	(43)	--	(112)	--	(112)
Share-based compensation expense	--	--	7	--	--	--	--	--
Asset retirement obligations	9,051	--	--	--	623	(725)	--	--
Exploration costs	--	--	57	--	--	--	--	--
Reclassification of nonoperating income (expenses)	--	--	--	1,469	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	2,349	--	--

Table 2

Reconciliation Of RWE AG Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €) (cont.)								
Minority interests	--	1,084	--	--	--	--	--	--
Collateral for trading activities	(567)	--	--	--	--	--	--	--
Capital gains	--	--	(68)	(68)	--	--	--	--
Commodity derivatives	--	--	337	337	--	--	--	--
Total adjustments	6,807	261	263	1,737	812	1,519	(8)	264

Standard & Poor's adjusted amounts

	Debt	Equity	EBITDA	EBIT	Interest expense	Funds from operations	Dividends paid	Capital expenditures
Adjusted	26,617	16,594	9,983	8,244	2,085	7,019	2,191	6,643

Table 3

RWE AG Peer Comparison					
	RWE AG	E.ON AG	Electricite de France S.A.	Enel SpA	Iberdrola S.A.
Rating as of June 30, 2011	A-/Negative/A-2	A/Stable/A-1	A+/Stable/A-1	A-/Negative/A-2	A-/Negative/A-2
Stand-alone credit profile	N/A	N/A	a	bbb+	N/A
Business risk profile	Strong	Excellent	Excellent	Excellent	Excellent
Financial risk profile	Intermediate	Intermediate	Significant	Significant	Intermediate
GRE qualifier	N.A.	N.A.	Moderately high	Moderately high	N.A.
Installed capacity end-2010 (GW)	52.2	68.5	133.9	97.3	45.0
Electricity production 2010 (TWh)	225.3	275.5	630.4	290.2	154.1
Of which thermal (%)	75	63	15	54	52
Of which nuclear (%)	20	26	75	14	17
Of which renewables (%)	5	11	9	32	31
Gas sales 2010 (TWh; excl. trading)	246	246	260	N.A.	157
Gas and oil production 2010 (mil. boe\$)	14.8	14.8	N.A.	N.A.	N.A.
Regulated income* (% of EBIT)	26	27	16&	49&	52&
(Mil. €) --Fiscal year ended Dec. 31, 2010--					
Revenues	50,722	92,863	63,590	71,943	30,431
EBITDA	9,983	11,023	15,110	17,385	7,529
Net income from cont. oper.	3,308	6,689	634	4,390	2,871
Funds from operations (FFO)	7,019	8,828	9,815	11,231	5,656
Capital expenditures	6,643	8,032	10,048	7,341	5,045
Free operating cash flows (FOCF)	(1,973)	2,213	(568)	4,719	1,542
Dividends paid	2,191	3,101	2,353	3,147	610
Discretionary cash flows (DCF)	(4,163)	(888)	(2,921)	1,572	932
Debt	26,617	34,843	54,229	67,266	32,803

Table 3

RWE AG Peer Comparison (cont.)					
Equity	18,594	45,583	30,564	52,920	31,663
Adjusted ratios					
EBITDA margin (%)	19.7	11.9	23.8	24.2	24.7
EBIT interest coverage (x)	4.0	2.7	1.9	3.4	3.7
EBITDA interest coverage (x)	4.8	3.5	3.2	4.6	5.2
Return on capital (%)	19	10	9	10	8
FFO/debt (%)	26	25	18	17	17
Target FFO/debt (%)	20-25	>20	>17	>16	>17
Net cash flow/capital expenditure (%)	73	71	74	110	100
FOCF/debt (%)	(7)	6	(1.0)	7	5
Common dividend payout ratio (%)	56	43	341	72	21
DCF/debt (%)	(16)	(3)	(5)	2	3
Debt/EBITDA (x)	2.7	3.2	3.6	3.9	4.4
Debt/debt plus equity (%)	62	43	64	56	51

*Electricity and gas networks. †Iberdrola paid scrip dividends and share of EBITDA. \$Barrels of oil equivalent. **Including International Power. N/A--Not applicable. N.A.--Not available. GRE--Government-related entity. GW--Gigawatt. TWh--Terrawatt hours.

Table 4

RWE AG Financial Summary					
--Fiscal year ended Dec. 31--					
(Mil. €)	2010	2009	2008	2007	2006
Rating history	A/Negative/A-1	A/Negative/A-1	A/Stable/A-1	A+/Negative/A-1	A+/Negative/A-1
Revenues	50,722	46,191	47,500	41,053	41,169
EBITDA	9,983	8,932	8,396	7,678	6,842
Net income from continuing operations	3,308	3,480	3,125	2,941	2,405
Funds from operations (FFO)	7,019	6,867	5,834	5,495	5,566
Capital expenditures	6,643	6,000	4,454	4,093	4,553
Free operating cash flow	(1,973)	72	3,067	1,180	479
Dividends paid	2,191	2,592	2,005	2,199	1,208
Discretionary cash flow	(4,163)	(2,520)	1,062	(1,019)	(729)
Debt	26,617	24,393	15,073	11,270	17,833
Equity	16,594	13,796	13,140	14,331	13,440
Adjusted ratios					
EBITDA margin (%)	19.7	19.3	17.7	18.7	16.6
EBITDA interest coverage (x)	4.8	4.5	5.0	3.7	2.9
EBIT interest coverage (x)	4.0	4.5	5.2	4.3	3.1
Return on capital (%)	19.2	25.3	30.3	28.5	17.7
FFO/debt (%)	26.4	28.1	38.7	48.8	31.2
Free operating cash flow/debt (%)	(7.4)	0.3	20.3	10.5	2.7
Discretionary cash flow/debt (%)	(15.6)	(10.3)	7.0	(9.0)	(4.1)
Debt/EBITDA (x)	2.7	2.7	1.8	1.5	2.6

Table 4

RWE AG Financial Summary (cont.)					
Debt/debt and equity (%)	61.6	63.9	53.4	44.0	57.0

Ratings Detail (As Of June 30, 2011)*	
RWE AG	
Corporate Credit Rating	A-/Negative/A-2
Commercial Paper	
<i>Foreign Currency</i>	A-2
Senior Unsecured (19 Issues)	A-
Corporate Credit Ratings History	
08-Jun-2011	A-/Negative/A-2
08-Apr-2011	A/Watch Neg/A-1
13-Jan-2009	A/Negative/A-1
03-Jun-2008	A/Stable/A-1
25-Feb-2008	A+/Watch Neg/A-1
Business Risk Profile	Strong
Financial Risk Profile	Intermediate
Debt Maturities	
As of March 31, 2011*:	
2011 (nine months): €3.4 bil.	
2012: €2.6 bil.	
2013: €2.1 bil.	
2014: €0.8 bil.	
2015: €2.2 bil.	
Thereafter: €8.8 bil.	
*All interest-bearing debt and including collateral margin payments	
*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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