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Kensington and Chelsea (Royal Borough of)

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Table Of Contents

Major Rating Factors

Rationale

Outlook

Institutional Framework: Predictable And Supportive

Economy: Wealthy And Diverse Economy Benefits From Resilient Retail And Real Estate Sectors

Financial Management: Prudent And Very Positive For The Rating

Budgetary Flexibility: Greater Flexibility Than Other Councils

Budgetary Performance: Limited Reduction In Costs To Accommodate Lower Revenues Likely

Liquidity: Very Positive, With Exceptional Access To External Sources

Debt Burden: High Level Of Internal Liquidity Underpins Debt Reduction

Table Of Contents (cont.)

Contingent Liabilities: Minimal In An International Context

Financial And Economic Statistics Tables

Related Criteria And Research

Kensington and Chelsea (Royal Borough of)

Major Rating Factors

Issuer Credit Rating
AAA/Negative/A-1+

Strengths:

- Very strong U.K. local government framework that is predictable and supportive.
- Wealthy and diverse economy, benefiting from resilient retail and housing sectors.
- Substantial--though decreasing-- reserves and moderate debt levels.

Weakness:

- Generally low balances after capital accounts despite one-off capital revenue in 2014 and a moderate operating performance.

Rationale

The ratings on the Royal Borough of Kensington and Chelsea reflect those on the U.K. Our negative outlook on the long-term rating reflects the negative outlook on the sovereign, which means that if we were to downgrade the sovereign, the rating on the borough would be capped at the sovereign rating level. This is based on our view that the borough does not meet the criteria under which we would rate a local or regional government (LRG) higher than the related sovereign (see "Methodology: Rating A Regional Or Local Government Higher Than Its Sovereign," published Sept. 9, 2009, on RatingsDirect).

The ratings on Kensington and Chelsea reflect the strong support that the U.K. local government system provides to local authorities. They also reflect the borough's wealthy economy, substantial reserves, and moderate debt levels. Constraining factors include an overall fiscal performance that we expect to be weaker over the forecast period until 2016 in our base-case scenario. As in recent years, the borough plans to implement cuts in operating expenditure to match lower revenues from the U.K. government, but is likely to require larger expenditure on infrastructure projects. However, the borough might not engage in projects that could overstretch budgets or are not supported by future revenues.

The borough's budgetary performance has been good over the past few years, with strong control over budgeted costs. Its ongoing cautious fiscal stance has allowed it to build up substantial reserves, which we consider represent a comfortable cushion to accommodate current and future reductions in revenue arising from reductions in government grants. This is an important strength for the borough's credit standing, and underpins the rating in our base-case scenario. Despite temporarily drawing on its reserves for capital spending, our base-case scenario assumes that the borough will be able to cut spending accordingly and avoid depleting its overall reserves.

Despite continuous cuts in its main source of revenues over the past few years, the borough has been able to maintain a moderate level of operating performance of more than 4% on average in 2011-2013 owing to major efforts in reining in operating costs. We anticipate slightly lower surpluses as a result of expected further cuts in grants and more

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pressure in the provision of social services. That said, the borough could increase its council tax rate to boost revenues if needed. However, we consider it more likely that the borough would boost its financial position by other sources of revenue such as retention of business rates and service fees and charges.

The borough is set to benefit from savings from the tri-borough initiative, a shared service project between three councils in west London, namely Westminster, Hammersmith and Fulham, and Kensington and Chelsea itself. We anticipate that in contrast with successful attempts to cut costs in recent years, the borough's ability to continue to curtail costs at the same pace might be limited over the forecast period, mainly due by the need to maintain frontline services.

In our base-case scenario, we forecast that the borough will post a deficit after capital accounts of 3.5% of total revenues in 2013. We further project that this will rise sharply in 2014 to 8% due to large capital receipts from land sales. After 2014, we anticipate low average surpluses of 1% of total revenue, owing to the borough's ambitious capital program. That said, the planned capital works program is diverse, allowing some flexibility to defer individual projects. We consider that Kensington and Chelsea is well placed to cope with any increase in capital expenditure and to fund its capital program at the current rating level, given its moderate debt levels, significant reserves, and the prospect of further capital receipts from land sales.

The borough's low-to-moderate debt contributes positively to the rating. At financial year-end 2013, outstanding debt totaled £164 million, or about 28% of estimated operating revenues, which is low compared with the 'AAA' rating category average. The borough plans to reduce debt gradually to about 26% of operating revenues by 2016.

Liquidity

We view the borough's liquidity position as very positive for the rating, particularly given its exceptional access to external liquidity through the U.K. government's Public Works Loan Board (PWLB). The borough has a high level of free cash and short-term investments--about £156 million as of February 2013, after applying Standard & Poor's adjustments to each type of investment. This level of liquidity comfortably covers debt service for the next 12 months. The borough has no credit lines with banks, but it has access to the PWLB.

Outlook

The negative outlook reflects the negative outlook on the U.K. sovereign rating. The negative outlook on the U.K. reflects our view that there is an at least one-in-three chance that we could lower the sovereign rating during the next two years if the U.K.'s economic and fiscal performances weaken beyond our current expectations. In this weak growth scenario net general government debt could approach 100% of GDP, by our calculations, from its estimated current level of 85%.

In our base-case scenario, we expect that the borough will continue to enjoy a strong level of support from the U.K. central government and that budgetary performance will not vary substantially from our forecasts. Following a substantial surplus after capital accounts in 2014 as a consequence of higher-than-usual capital revenue, we anticipate much lower surpluses from 2015 onward. We expect the borough will successfully achieve the required savings to match the revenue shortfall, while maintaining other sources of revenue. Furthermore, we anticipate that debt levels

will gradually decrease to 26% until 2016, and that reserves will recover substantially from 2014, after a temporary decline.

In our downside scenario, the borough's deficits after capital accounts could deteriorate further as a consequence of weaker operating performance and larger capital expending, leading to peak debt of 41% of operating revenues in 2015 and a substantial decrease in reserves. This could lead us to lower the rating. In light of the borough's current strong commitment to fiscal consolidation and good track record of prudent fiscal policies, we currently view this scenario as highly unlikely. We would lower the rating on the borough if we were to downgrade the sovereign.

Institutional Framework: Predictable And Supportive

Supportiveness maintained despite lower government grants

We view the U.K. institutional framework for LRGs as one of the strongest globally. Under our criteria, we assess the U.K.'s framework as "predictable and supportive." We have assigned it a score of 1 (the highest) on a scale of 1 to 6, based on its high degree of transparency, accountability, and predictability, as well as the supportive role of the U.K. government (see "Public Finance System Overview: U.K. Local and Regional Governments," published April 5, 2011). Despite cuts to local government funding by the central government as a result of the Credit Spending Review 2010, we still view the U.K. institutional framework as one of strongest in the world.

As a result of new powers granted under the Localism Act 2011, which came into force in February 2012, councils have more flexibility to manage their housing stock by gaining control of the revenue raised by council rent. This long-term flexibility means that councils have had to take on more debt, corresponding to their part of the national debt linked to housing. Kensington and Chelsea, as a contributor to the national pool, has needed to take on only a limited amount of this additional burden, repaid by using internal reserves.

We consider that LRGs might need to widen the scope of their financial and risk management and adopt a longer term approach to managing their new powers and investments (See "Industry Report Card: Sector Reforms Are Unlikely To Damage U.K. Local And Regional Governments," published March 23, 2012).

Economy: Wealthy And Diverse Economy Benefits From Resilient Retail And Real Estate Sectors

Kensington and Chelsea is a wealthy, densely populated area, with a residential population of 158,300 (according to the latest projection for 2011 by the Office for National Statistics).

The borough's overall economic structure is well developed and diverse in terms of companies (more than 11,000) and sectors; 94.3% of employees are employed in services. Major local employers include retailers Harrods and Peter Jones, Brompton Hospital, the Daily Mail newspaper, and the borough itself. Furthermore, unemployment tends to be lower than in the rest of the country, and lower than the London average.

London contributed about 22% to the U.K. output in 2011 and its economy has been more resilient than the national

economy since 2007. In 2011, London's output grew at 4% in nominal terms compared with the previous year, while the rest of the country grew at less than 2%, according to the Office for National Statistics (March 2013). In particular, we understand that the borough's economy continues to perform above the national average, backed by the good performance of sectors such as retail (luxury goods), catering, tourism, and real estate.

Wealth levels in London are the highest in the country and some of the highest internationally. London's GDP per capita is high, compared with its international peers. For instance, GPD per capita in inner London stood at 328% of the EU-27 average in 2010, according to Eurostat. Kensington and Chelsea's output levels approach those observed in the west of inner London, where GDP per capita is £111,519, or more than 4x higher than the national level. Over the medium term, growth in the borough may be hampered by a lack of available and affordable real estate, given that Kensington and Chelsea has the highest housing prices in the country. At the same time, there are areas of relatively high socioeconomic deprivation within the borough, notably in the north around Ladbroke Grove. This area is a focus for regeneration and renewal initiatives and service spending pressures.

Financial Management: Prudent And Very Positive For The Rating

The borough has benefited from political stability since its formation in 1965. It has been under continuous majority leadership by the Conservative Party, which has brought continuity in financial strategy and fiscal policies.

In our view, the borough's financial management has a very positive impact on the rating. It demonstrates a high degree of expertise and commitment to transparency, as well as continuity, fiscal discipline, and well-defined financial policies. Our high score for the borough reflects very good planning and monitoring capacities, as well as prudent and well-defined debt and liquidity management.

Major changes at the top of the borough's management were announced in April 2013. After 13 years leading the council, Councilor Sir Merrick Cockell stepped down in May 2013, when his party elected Councilor Nicholas Paget-Brown to replace him. However, this position will have to be confirmed at the council's annual general meeting on May 22.

Kensington and Chelsea's chief executive, Derek Myers, who is also the chief executive of the London Borough of Hammersmith and Fulham, also steps down by end 2013. We understand that Mr. Myers' successor will be selected by both councils. In our opinion, these changes will not necessarily entail any weakening of the boroughs' commitment to share services under a bi-borough initiative or threaten Kensington and Chelsea's stance towards fiscal consolidation.

Budgetary Flexibility: Greater Flexibility Than Other Councils

Fiscal consolidation continues to be focused on cost-cutting efforts

As a result of recent cuts in government grants to local authorities, the borough has lost about £8 million in formula grant annually over the period 2011-2013--a loss of 10% in cash terms or about 2% of recurrent spending. On the other hand, the borough has mitigated the effect of these cuts with increased income from other sources and cuts in expenditure. For instance, as in previous years, the borough achieved net savings in 2011-2012 of about £23 million

under budgeted expenditure. A further £13 million in net savings was achieved in 2012-2013 (against £8.7 million planned in the budget) and a further £10.1 million are proposed in the 2013-2014 budget. From 2011-2012 until 2013-2014, savings achieved by the borough would have totaled nearly £46 million, which would have been obtained from both lower costs and higher revenue. Savings have been focused on staff reduction and re-allocation of services. Some services, such as the provision of libraries and adult care, are now shared under the tri-borough initiative.

Benefits from some revenue flexibility

Council tax, a highly predictable revenue source, accounts for about 12% of the borough's operating revenues. The council tax rate charged by Kensington and Chelsea is relatively low compared with the rate charged by most other councils. This gives the borough some political flexibility to raise rates in the future while keeping them within the lowest quartile of council tax rates for London. However, we understand that the council wants to avoid any increases. The borough has kept its council tax rate at the level set in 2009-2010 for four consecutive budget years. As a result, the borough has benefited from grant allocations from the U.K. government to councils that freeze their tax rates. The borough's budget for 2013-2014 stipulates a continued freeze of the council tax rate, but it is not clear if the full amount of the government grant will be rolled over.

We anticipate that in the short-to-medium term, the borough might have more flexibility from other sources of revenues, such as car parking fees, than from council tax.

Capital program involving several projects allowing for some flexibility

The current capital program foresees investment of £170 million from 2013-2014 onward. This program requires over £124 million of council funding, which will mainly be provided from the borough's own reserves and capital receipts. In this respect, the borough distinguishes the source of funding according to the type of projects. Investment in services will continue to be funded from the borough's capital resources and funds explicitly earmarked to capital investment. In contrast, "remunerative schemes" such as projects related to housing, will be funded from revenue reserves and will have to be repaid.

The borough's capital program is spread across a large number of diverse projects. As many of the projects have not yet started, we believe that the council has a high degree of flexibility in deferring expenditures. The largest projects by value under the program are the Kensington Aldridge Academy and Kensington Leisure Centre, totaling £57 million. Another major project is the rebuilding of Holland Park School. The council plans to fund this project through a land sale, which is expected to raise £95 million in September 2013. Further projects in the pipeline, which would require additional funding from the borough estimated at about £34 million, are not accounted for in the current capital program.

In our view, the borough's financial position could accommodate this additional capital expenditure without putting the ratings under too much pressure. Moreover, we consider that the risks involved should the borough seek external financing for the capital program would be low, because it expects to benefit from a large capital revenue stream in 2013 following a land sale.

Localization of business rates income likely to generate stable income

Under the Localism Act 2011, local authorities will be able to retain part of the surplus on current levels of business rate income from 2013-2014 onward. Business rate income has proven to be a stable and resilient source of revenue

for Kensington and Chelsea. In 2013-2014, we expect that retained business rates will account for more than 7% of the borough's total operating revenue. We anticipate that this source of revenue will increase further in line with inflation,although we believe that the benefit for the borough is more likely to come from businesses expanding. That said, this source of income is at risk if the economy slows further and the value of businesses shrink.

Budgetary Performance: Limited Reduction In Costs To Accommodate Lower Revenues Likely

Operating balance stable at moderate levels

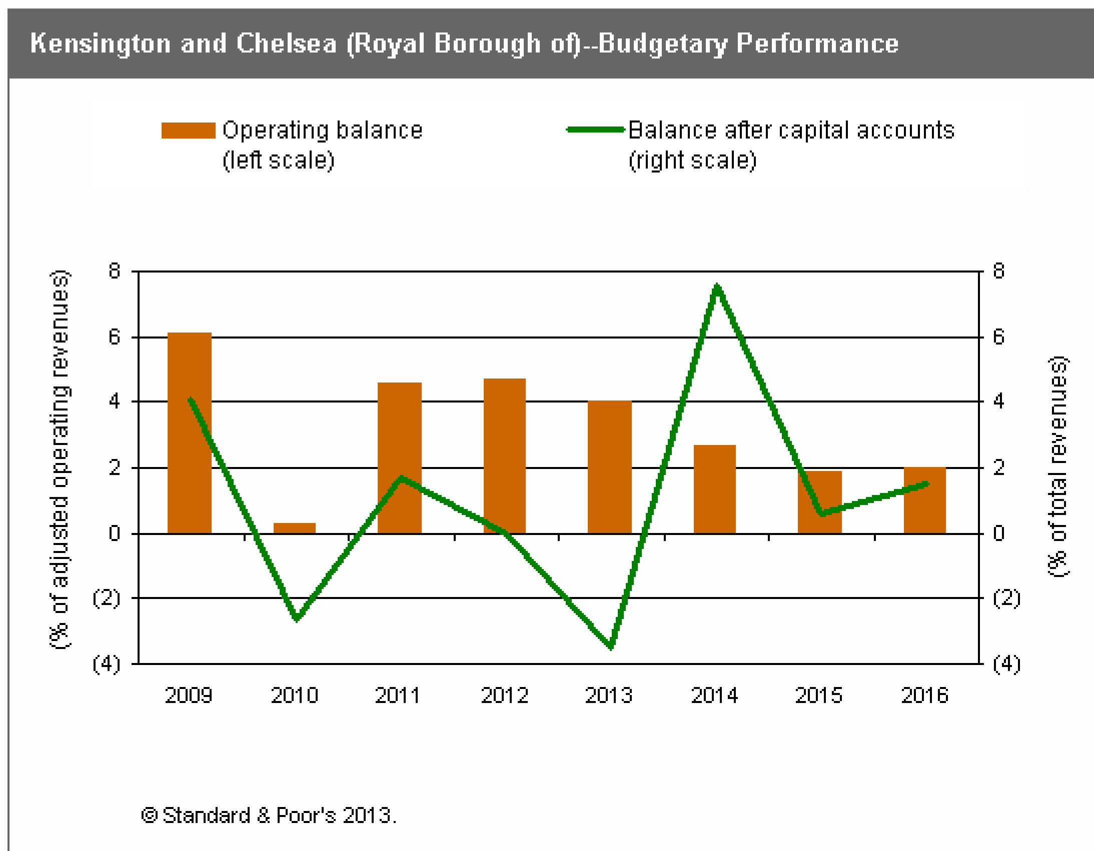
The borough's budgetary performance has been sound over the past few years, demonstrating good control over budgeted costs. Operating surpluses have been small, but surpluses of this level are not unusual for a U.K. local authority with such predictable revenues. Following cuts in grants by the central government since 2011, the borough has managed to cut expenditure to a larger extent than we previously expected. According to the latest estimates of the outturn for 2012-2013, the borough has managed to rein in its expenditure such that the operating balance for the year is 4% of operating revenues. We expect slightly lower surpluses (see chart 1) as a result of further cuts in grants and more pressure in the provision of social services. Although car park revenues have increased since 2010-2011, largely due to an increase in charges, these revenues can be more volatile than other sources of revenue because they depend on the local economy to a greater extent than other revenue streams. That said, business rate income--which also depends to some extent on the local economy--has continued to increase, despite the ongoing subdued economic climate.

The borough could increase its council tax rate, though we do not expect it to do so unless it comes under pressure to avoid a much steeper curtailment in services.

The borough is set to benefit from savings from the tri-borough initiative. It expects the initiative to achieve a total of about £40 million in savings through 2015-2016. The borough anticipates that slightly under one-third of the savings will be allocated to Kensington and Chelsea. We understand that the borough has already achieved savings of £5 million through the initiative. Moreover, the outsourcing of payroll and other payments as well as the streamlining the provision of information and communication technology services will drive future savings.

In contrast with successful attempts to cut costs in recent years, the borough's ability to continue to curtail costs at the same pace might be limited over the forecast period, mainly due by the need to maintain frontline services.

Chart 1



Balance after capital accounts recovers substantially and temporally in 2014

Due to Kensington and Chelsea's significant capital program, we expect a deficit after capital accounts of 3.5% of total revenues in 2013. Once this substantial capital revenue is received in financial year 2013-2014, we expect the accounts to exhibit a surplus of about 8% of total revenues (see chart 1). The capital accounts were in slight deficit on average over 2011-2013, but we forecast a rebound to over 3% on average for 2014-2016. In addition to one-off capital revenue, further capital delays and continuous cutting of the overall capital program would shield the balance from any material slippage over the forecast period.

Liquidity: Very Positive, With Exceptional Access To External Sources

We view the borough's liquidity position as very positive for the rating, particularly given its exceptional access to external liquidity through the U.K. government's PWLB. The borough's liquidity position is demonstrated by its high level of free cash and short-term investments--£156 million as of February 2013 (up from £143 million in March 2012, after applying Standard & Poor's adjustments.) On average and including unrestricted reserves only, such a level of liquidity covers more than 6x the next 12-months' debt service, and gives the borough a high degree of flexibility to fund its capital program. We expect a further improvement in liquidity levels in financial year 2013-2014, when the borough is scheduled to receive £95 million in proceeds from land sales. That year, cash is expected to cover more

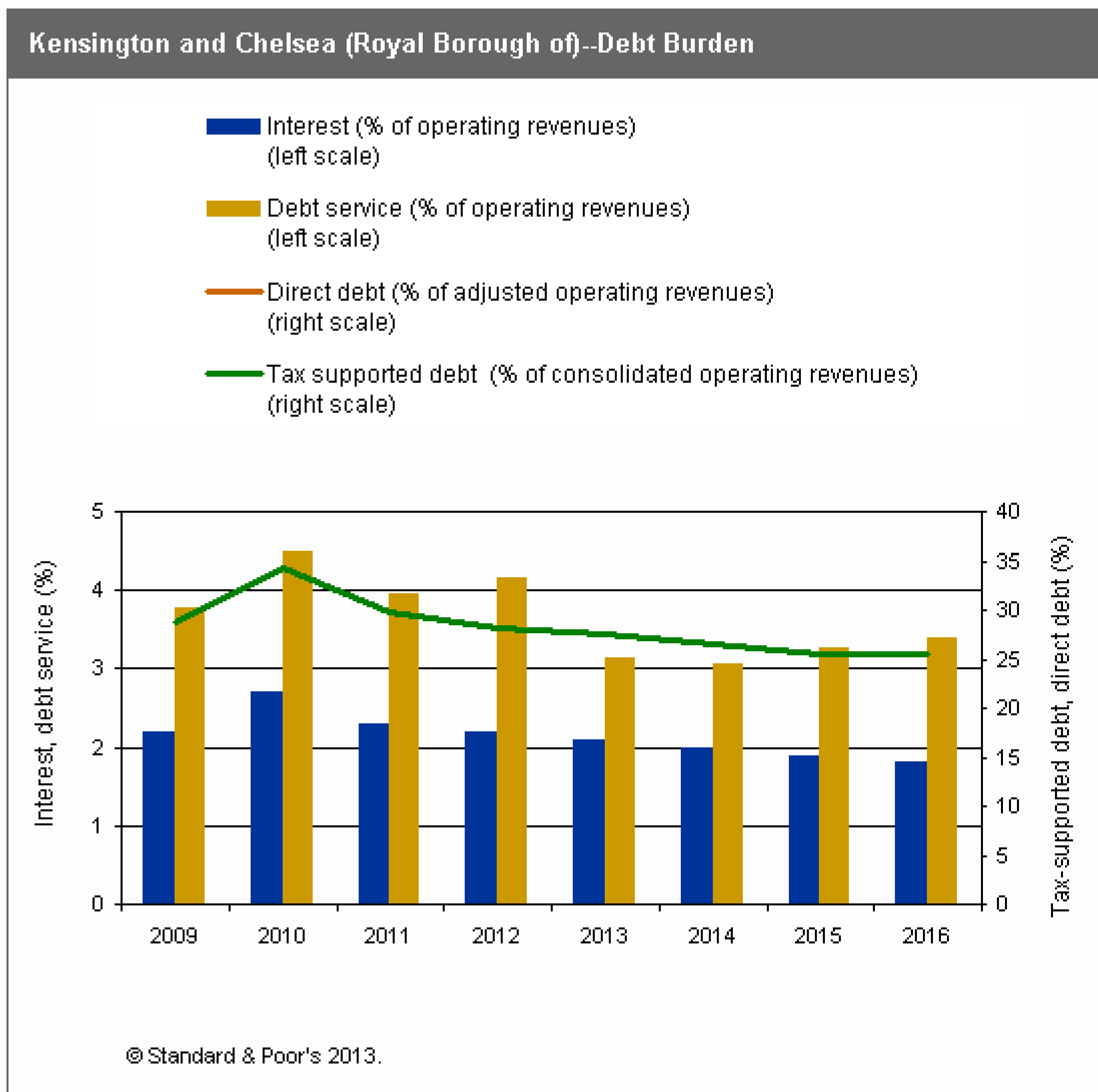
than 10x debt service.

A further source of liquidity is the PWLB, the government-funded main lender to the sector. The PWLB provides loan finance for capital investments on request, provided the borough is within its prudential code for borrowing limits and is acting legally. The borough has no credit lines with banks.

Debt Burden: High Level Of Internal Liquidity Underpins Debt Reduction

The borough's debt level is very low in an international context, and is a positive factor for the rating. Outstanding debt at financial year-end 2012-2013 totaled £164 million, or about 28% of estimated operating revenues. In March 2012, the borough funded over £24 million in additional debt linked to its housing revenue account (HRA) by using cash to avoid taking on more debt. Over the next few years, the borough plans to gradually decrease the total debt outstanding. We forecast that the debt ratio will gradually decrease to 26% by 2016 (see chart 2). We believe that the borough's substantial liquidity supports its planned deleveraging.

Chart 2



The borough's current debt is all from the PWLB at fixed rates and matures as follows over the next few years: £6.2 million in 2012-2013, £6.2 million in 2013-2014, and £7.9 million in 2014-2015. In April 2013, all debt held by the borough was transferred to the HRA, which is fully separated from the general revenue account. This means that the HRA will be serviced only by revenue and earmarked reserves linked to this account. The account contains rent income and subsidies related to the provision of housing by the borough. It had a surplus of £1.6 million in financial year 2011-2012 and has £19 million in ring-fenced reserves (after specific Standard & Poor's adjustments). Despite the healthy financial position of the HRA, the level of earnings and earmarked reserves are much lower than the borough's general resources and might be too limited to repay all debt coming due until 2015. The council could cover this gap by internal borrowing from the general revenue account. The general revenue account has a high level of reserves --about £137 million in February 2013. We understand that the council does not plan to raise further debt, and that it has not taken any decision as yet whether to refinance or to pay debt coming due until 2015. Unless capital market conditions are very attractive, in our opinion, the borough will avoid external borrowing.

In line with the borough's low debt level and gradual amortization profile until 2015, interest payments are low, at nearly 2% of operating revenues on average.

Pension deficit

The latest information available indicates that the borough's pension fund had a net liability of £292 million as at March 31, 2012. This represented about 46% of operating revenues, compared with a gap of 27% of operating revenues a year earlier. We might reconsider our risk assessment of the pension deficit in view of any corrective measures by the borough. That said, these financial liabilities are intrinsically volatile and the fund exhibits high levels of liabilities at the end of each financial year. Furthermore, we expect the borough to continue to take corrective measures to achieve a balance over a period of 10 years as planned.

Contingent Liabilities: Minimal In An International Context

Kensington and Chelsea has granted few guarantees and they amount to less than 1% of operating revenues. This level has been stable for several years. In addition to a maximum exposure of £250,000 related to service refunds, the bulk of the borough's contingent liabilities of about £2 million is related to claims on the borough's previous insurance fund, Municipal Mutual Insurance.

Municipal Mutual Insurance is an insurance company limited by guarantee and established by several local authorities. It is currently in run-off after experiencing material losses prior to 1992. Although it has underwritten no new business since then, the company has to deal with any claims on existing policies until these policies mature. The borough is liable up to the amount of the guarantee provided.

The borough has committed to fund a Crossrail station in the north part of the borough. The project would cost over £30 million and is subject to government approval.

We consider the borough's exposure to this level of contingent liabilities--about 5% of operating revenues including the Crossrail station--to be very low in absolute and relative terms in an international context.

Financial And Economic Statistics Tables

Table 1

Kensington and Chelsea (Royal Borough of) -- Financial Statistics										
	--Year ended March 31--									
('000 £)	**2016**	**2015**	**2014**	**2016**	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**
	Downside Case			**Base Case**			**Estimate**	**Actual**		
Cash flow metrics										
Operating revenues	543000	548,800.0	569,000.0	553,000.0	566,000.0	586,000.0	594,000.0	633,388.0	610,684.0	561,433.0
Operating expenditures	552000	575,000.0	580,000.0	542,000.0	555,000.0	570,000.0	570,000.0	603,435.0	582,845.0	559,687.0
Capital revenues	31000	150,000.0	42,000.0	31,000.0	55,000.0	137,000.0	40,000.0	34,145.0	26,000.0	18,000.0

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Table 1

Kensington and Chelsea (Royal Borough of) -- Financial Statistics (cont.)										
Capital expenditures (capex)	33000	180,000.0	98,000.0	33,000.0	62,000.0	98,000.0	86,000.0	64,100.0	43,000.0	35,000.0
Debt borrowed	0.0	65,000.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt repaid	8,500.0	7,796.0	6,231.0	8,500.0	7,796.0	6,231.0	6,225.0	12,148.0	10,185.0	10,206.0
Balance sheet metrics										
Tax-supported debt	214,242.0	222,742.0	157,742.0	141,371.0	149,946.0	157,742.0	163,973.0	170,198.0	182,346.0	192,531.0
Free cash & liquid assets	11,980.0	21,480.0	21,480.0	138,480.0	138,480.0	142,480.0	94,480.0	97,858.0	157,518.0	157,115.0
Key indicators										
Budgetary performance (%)										
Operating balance (% of adj. operating revenues)	(2.3)	(4.8)	(1.9)	2.0	1.9	2.7	4.0	4.7	4.6	0.3
Balance after capital accounts (% of adj. total revenues)	(2.5)	(8.0)	(11.0)	1.5	0.6	7.6	(3.5)	0.0	1.7	(2.6)
Budgetary flexibility (%)										
Modifiable revenues (% of adj. operating revenues)	40.1	39.4	37.1	40.1	38.2	36.0	34.7	35.6	49.6	59.4
Capex (% of total expenditures)	5.6	23.8	14.5	5.7	10.1	14.7	13.1	9.6	6.9	5.9
Liquidity (%)										
Free cash and liquid assets (% of debt service)	55.1	120.7	132.3	748.5	778.2	877.8	582.3	398.3	651.3	623.3
Debt burden (%)										
Tax-supported debt (% of consolidated operating revenues)	39.5	40.6	27.7	25.6	26.5	26.9	27.6	26.9	29.9	34.3
Interest (% of adjusted operating revenues)	2.4	1.8	1.8	1.8	1.8	1.7	1.7	2.0	2.3	2.7

Downside case and base case represent Standard & Poor's opinion on forecast scenarios that might lead to a downgrade or a stable rating.

Table 2

Kensington and Chelsea (Royal Borough of) -- Summary Of Published Rating Factor Scores	
Institutional Framework	Predictable and supportive
Financial Management	Very Positive
Liquidity	Very Positive
Indicative Credit Level	AAA
Overriding factors	Sovereign rating cap

Standard & Poor's assigns scores across eight main rating factors, of which we publish three.

Related Criteria And Research

- Industry Report Card: Sector Reforms, March 23, 2012
- Methodology For Rating International Local And Regional Governments, Sept. 20, 2010
- Methodology: Rating A Regional Or Local Government Higher Than Its Sovereign, Sept. 9, 2009

Ratings Detail (As Of May 17, 2013)	
Kensington and Chelsea (Royal Borough of)	
Issuer Credit Rating	AAA/Negative/A-1+
Issuer Credit Ratings History	
17-Dec-2012	AAA/Negative/A-1+
27-Oct-2010	AAA/Stable/A-1+
21-May-2009	AAA/Negative/A-1+
Default History	
None	
Population	158,300 (Office for National Statistics, 2011)
Per Capita GDP	£111,519 (2011 value for inner London (west), Office for National Statistics)
Current Government	
The borough council has been under continuous majority leadership by the Conservative Party since the formation of the borough in 1965. Councilor Nicholas Paget-Brown is the newly appointed leader-elect of the council, after Sir Merrick Cockell stepped down in May 2013. However, his position will have to be confirmed at the council's annual general meeting on May 22, 2013.	
Election Schedule	
Last council elections: May 6, 2010 Next council elections: 2014	

*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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