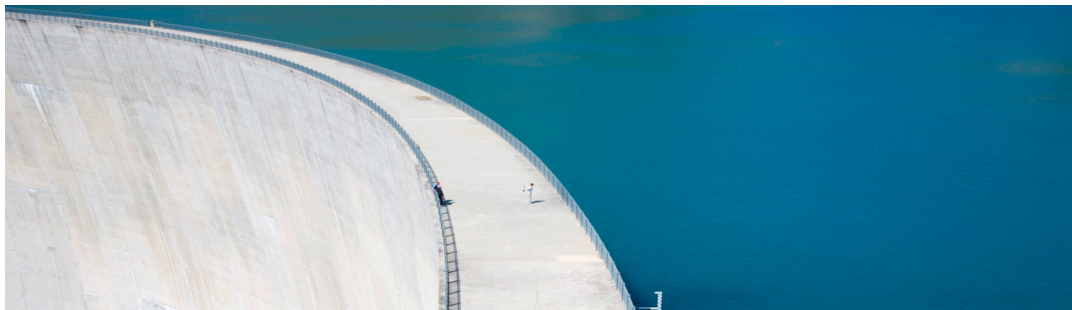


Industry Top Trends 2022

EMEA Utilities

Stable Outlook Amid Gas Crisis, Faster Energy Transition And Political Risk



This report does not constitute a ratings action

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What's changed?

Energy crisis. Global gas prices have surged up to 7x-10x in recent months, which has now led to an unsustainably high and structurally volatile price environment. For utilities, upside is mostly for outright power producers, but political-intervention risks increase.

Energy transition at a forced march. Electrification and decarbonization of the economy will drive the sector in Europe. To meet environmental targets, European renewables capacity needs to double from current levels by 2030.

Nuclear and gas come back. Nuclear and gas may now be considered as part of the solution to meet decarbonization targets, paving the way for new projects after years of hesitation and underinvestment. Yet we see challenges ahead.

What are the key assumptions for 2022?

(Much) higher power prices. Boost in power demand and early retirement of polluting baseload production result in tighter electricity markets. This adds to high gas prices and is exacerbated by more volatile and weather-dependent renewables.

Heavier investments. Recent strategic updates lead us to think that capex over 2022-2024 will be at least 20% higher than over the past three years, mostly to grow renewables and to upgrade networks.

Pilotable leverage. Despite much higher investment plans and energy market uncertainties, we believe the sector generally has solid balance sheets, derisked portfolios, and good access to capital, allowing for a good grip on financial leverage.

What are the key risks around the baseline?

Political and regulatory risks. Pressure to smooth the rise in energy bills could negatively influence our credit ratings if the burden is pushed to the utilities.

Supply chain bottlenecks. Pandemic and macro environment point to bottlenecks cross global supply chains, which is already delaying the roll-out of investments for the sector and could ultimately weigh on profitability of some projects.

Large-scale maneuvers. Race for size and catching up on green or portfolio reshuffling could lead to unanticipated large-scale transactions that could transform utilities' credit quality.

Ratings trends and outlook

Utilities – EMEA

Chart 1

Ratings distribution

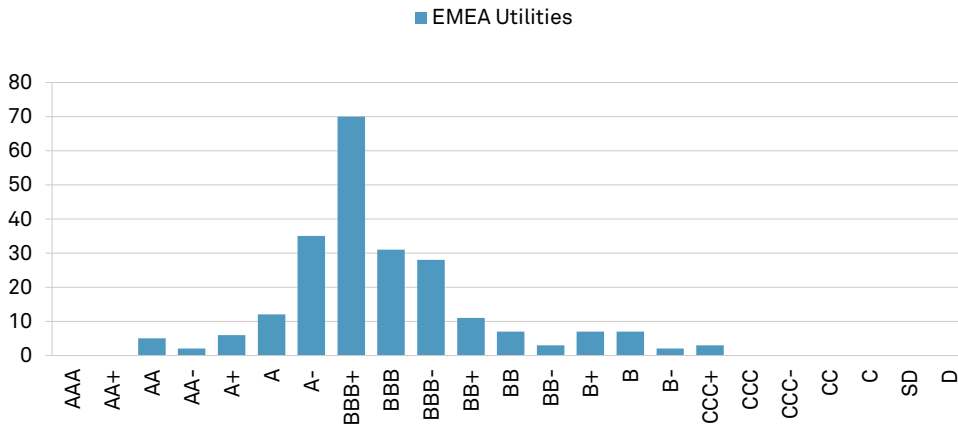


Chart 2

Ratings outlooks

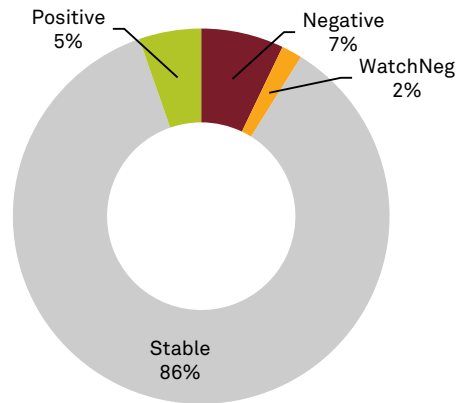
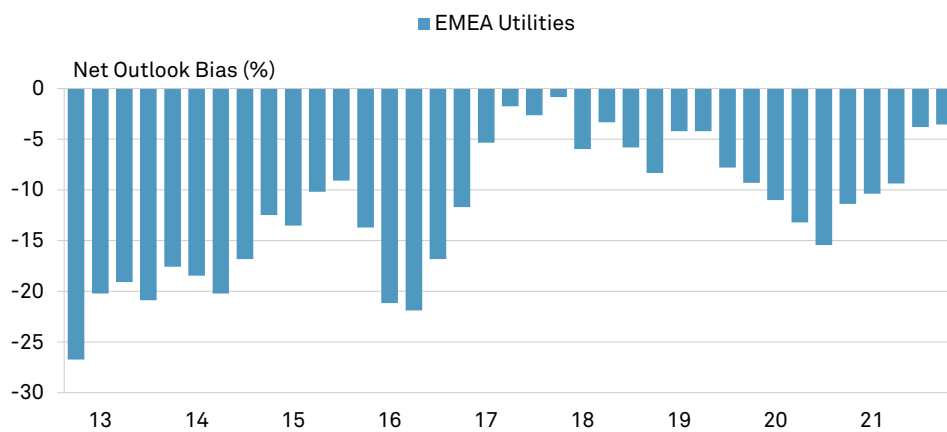


Chart 3

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter end.

Industry credit metrics

Utilities – EMEA Utilities Top 25 Rated Utilities

Chart 4

EBITDA (adjusted) – Largest 25 EMEA Utilities

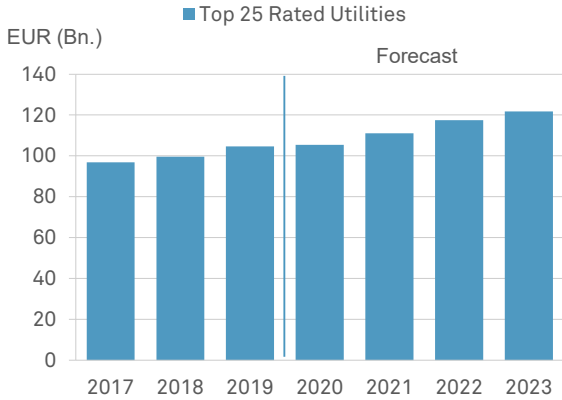


Chart 5

Total Debt (adjusted) – Largest 25 EMEA Utilities

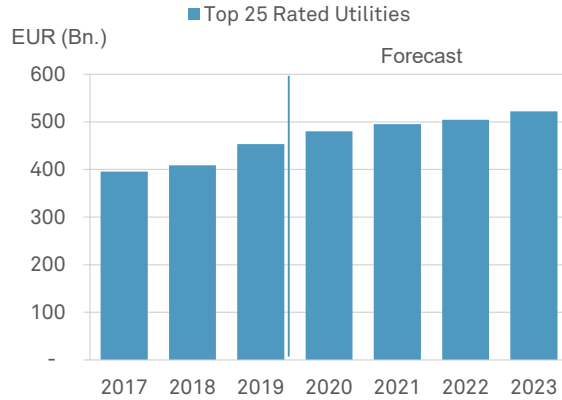


Chart 6

Capex – Largest 25 EMEA Utilities

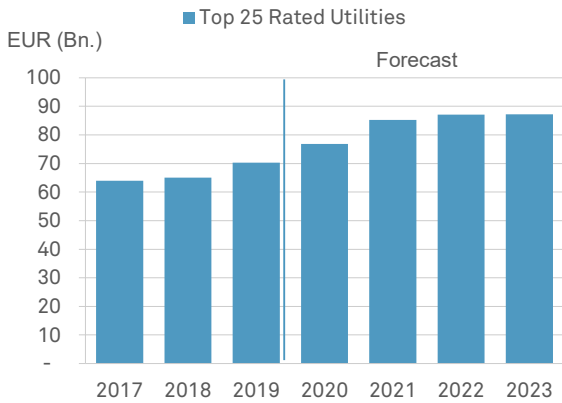
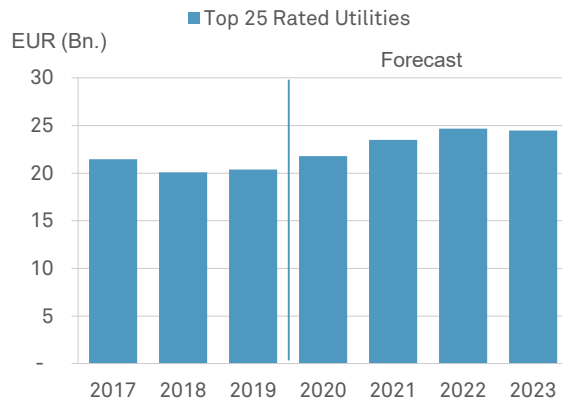


Chart 7

Dividends – Largest 25 EMEA Utilities



Source: S&P Global Ratings

Industry outlook

Ratings trends and outlook

Most of the credit ratings in the sector have a stable outlook, underpinning the solid fundamentals and medium- to long-term business prospects stemming from the energy transition. We anticipate that investments will rise and EBITDA will grow over the coming years for the vast majority of the sector, supported by the commissioning of new projects. The currently high power-price environment further supports earnings for power generators exposed to merchant activities. Downside risk to earnings may notably come from underdelivering on investments, underperformance of renewables due to unfavorable weather conditions, or negative regulatory developments. Yet we believe that utilities can generally manage such deviations, up or down, through remedial measures on their balance sheets. Asset disposals, hybrid capital, or equity are generally available options for the sector, as financial policy and credit rating commitments further support our stable outlooks. The mid to high 'BBB' rating band seems to still be the preferred territory for the sector.

Our negative outlooks are spread across the portfolio, although about half of them relate to negative regulatory outcomes, which have put pressure on future earnings due to a reduction in allowed revenues. This was notably the case for U.K. water utilities following the OFWAT price review, and for the Finnish distribution companies given the unexpected revisions to their framework.

Main assumptions about 2022 and beyond

1. (Much) higher power prices

Boost in power demand and early retirement of polluting baseload production result in tighter electricity markets. This adds to high gas prices and is exacerbated by more volatile and weather-dependent renewables.

2. Heavier investments

Recent strategic updates lead us to think that capex over 2022-2024 will be at least 20% higher than over the past three years, mostly to grow renewables and to upgrade networks.

3. Pilotable leverage

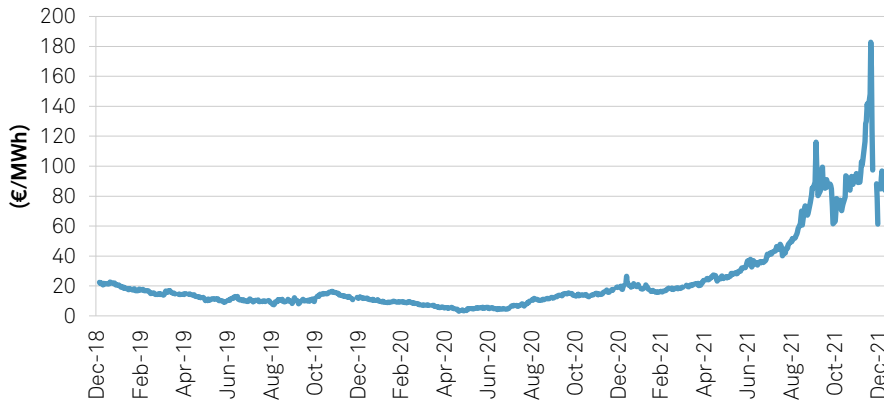
Despite much higher investment plans and energy market uncertainties, we believe the sector generally has solid balance sheets, de-risked portfolios, and good access to capital, allowing for a good grip on financial leverage.

Gas prices dominate the energy debate today. The surge in global gas prices and consequently of European power prices is shedding light on the energy transition challenges in Europe (see chart 8). Decarbonization efforts are accelerating the reduction of domestic gas production, increasing dependence on imports, and resulting in a lack of long-term procurement contracts, which all are structural weaknesses that Europe currently faces. Indeed, global demand for gas has increased amid economic recovery, primarily driven by Asia, which competes strenuously with Europe for gas flows. This also comes at a time when old, polluting generation capacity is closing more rapidly but replacement by new renewables is taking time--effectively longer than planned--while intermittency management solutions such as batteries or hydrogen are nascent. We explain in more detail these aspects in our report "[Price Tremors Threaten Europe's Gas Bridge](#)," published on Oct. 5, 2021. Pressure could also continue to rise if the continent

faces unfavorable weather and, in particular, a long and cold winter season combined with poor wind conditions, like happened in 2021. On this last point, so far Europe has had a relatively mild December and January, easing somewhat the risks of a worsened situation.

Chart 8

Evolution Of The TTF Gas Price Over The Past Two Years



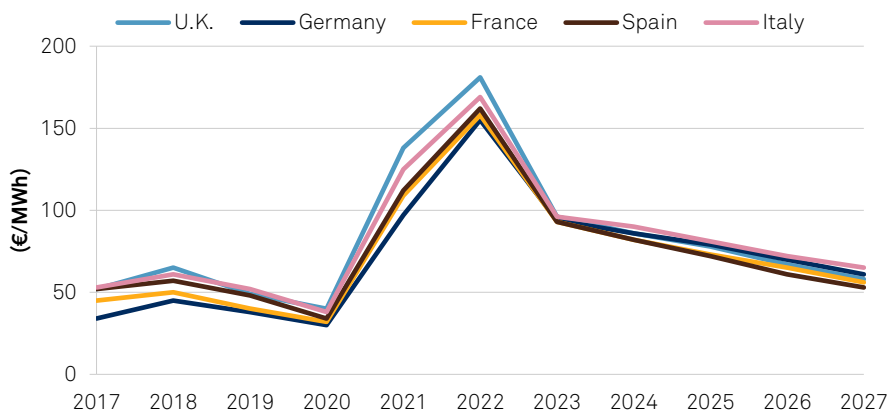
TTF—Dutch Title Transfer Facility. Source: S&P Global Ratings.

Electrification boost. While European economies are recovering from the pandemic and the European Commission’s Fit for 55 package is progressing, power demand is accelerating after years of stagnation. Indeed, the key pillar of Fit for 55 is to promote the green electrification of the economy, especially for the most polluting industrial sectors. This means demand for renewables will soar. That said, delivering on such growth remains a major challenge due notably to issues around permitting or connection to the grid.

As a result, on top of the gas price environment, supply-demand tensions are reappearing, pushing spot power prices to record highs in recent months. We expect tensions will remain, albeit not to the same extent, as LNG supplies to Europe increase, operational outages are resolved, and industrial usage cuts reduce demand. Still, our power price assumption for key European markets rose again this year by about 10% on average, following a 10% increase in September 2021 (see chart 9). We do not expect such supply-demand tensions to disappear before 2025 at best, when more significant renewables projects are commissioned.

Chart 9

European Power Prices Forecast



Source: S&P Global Ratings.

High power prices mean an EBITDA boost but also higher cash flow volatility. The most immediate effect is positive for power generators and in particular for outright producers, who can strike prices for their future production at higher levels, boosting EBITDA from 2023 onward (as 2022 production has been already largely hedged). Fossil fuel producers (particularly coal generators) will also benefit from the current environment, notably by running their plants even more than anticipated. Yet, while this is clearly a credit positive development, we believe that most of the earnings upside will be used to invest in greener technologies (organically or through M&A) rather than for sustainably improving balance sheets.

The other takeaway from the current situation is the materialization of the high volatility we had foreseen from the evolving energy mix. With more weather-dependent generation technology (wind, solar, hydro) and with the current market design that determines the clearing price of power based on the marginal cost of the called technology that is the most expensive at any given time (so-called “merit order”), prices are becoming increasingly sensitive to weather conditions. When renewables are running and demand is low, prices could reach zero to even negative territory, as we have seen in previous years. To the contrary, when renewables do not run and demand is strong, like during the winter season, prices can soar especially as carbon or commodities like gas trade at very high levels. This adds a degree of risk to energy management operations, in our view, especially on the liquidity side. The gas crisis has led to nearly 30 defaults of small to midsize U.K. energy suppliers as they were caught in a liquidity squeeze. Uniper and other utilities with large trading units are facing huge working capital swings, requiring them to significantly draw on their cash balances and bank lines to face margin calls. At this stage, however, we believe that our rated utilities do not face liquidity risks thanks to their ample liquidity resources and support from the banking system. That said, while generally well-managed, counterparty risk is increasing and could add pressure to these companies over the coming months.

The energy transition is coming faster, but maybe not fast enough. The current stressed situation in the energy market, however, is not stopping the European energy transition. In fact, to the contrary. Major steps were taken during 2021, including the European taxonomy, Fit for 55, and increased investment ambitions from European utilities. With greater clarity on the way forward, companies in the sector continued to grow their investment pipeline and we now expect capex to grow by more than 20% over the next three years, compared to 2018-2020. Investments will be notably skewed toward more renewables, as the European Union wants to double its capacity compared to 2020 to meet its 55% carbon reduction target by 2030, while the U.K. aims to reach 100% of the country's electricity coming from renewables by 2035. For the 10 largest European markets, the planned increase in renewables capacity is about 400GW by 2030, broadly equally split between solar and wind (onshore and offshore). Yet while we are seeing a rise in renewables ambitions, 2022 will be a year of scrutiny when it comes to execution. Indeed, we see continued supply-chain disruption risks, which could delay project implementation and increase procurement costs. At this stage, we observe relatively benign impacts on large renewable players, which is quite reassuring. We also believe that returns have not been materially hurt for now by the current situation, as utilities are able to both fix a large part of their costs prior to final investment decisions and to pass on price increases given the high demand for green power and currently high power prices. Yet we see ongoing increased pressure on returns stemming from the more competitive environment, increasingly tight supply chain, and material increases in global demand (and ultimately prices) for raw materials (such as copper or nickel). This also includes manpower, as the significant acceleration of projects requires adequately skilled staff, which may become a scarcer resource.

At the same time, most European markets are lagging their ambitious renewables targets and current trends do not show a rapid catch up. Beyond the current operational issues mentioned above, we see ongoing structural limitations preventing such acceleration.

These include long and complex permitting processes for new projects, local opposition (notably for wind), and capital deployment. While Europe tries to effectively tackle the permitting constraints, we believe it will still take time and it will depend on local and national governments' stances. For example, ahead of the French general elections in April, the question as to whether new wind capacity is needed is heating up the political debate, with the right wing adopting a clearly negative stance. Such risks of delay in reaching the set environmental targets could eventually increase pressure on utilities, which could be asked to do more, and faster.

If renewables take the spotlight in the rapidly changing European power generation landscape, investment in networks will be at least as important. Significant upgrades and new connections are needed. Main network developments include the smartening of grids (including automation and faster response) as well as increased capacity to manage intermittency (including energy storage solutions). These investments currently concentrate mostly on electricity networks, while gas grids have reached a more mature phase, with the growth of (unabated) natural gas becoming more subdued in a decarbonizing economy. For the latter, a new investment cycle may occur with the growth of biogases and hydrogen later in the decade, although not all will face the same prospects, depending on their localization and serviced area. Yet such prospects and investments remain uncertain at this stage.

Will nuclear be green? We may also see nuclear make a comeback in 2022, following its proposed inclusion in the European taxonomy as a green energy and a decarbonization solution in January 2022. This year we also expect the long-awaited OL3 Finnish reactor to come online, before France's FLA3 plant in 2023, as well as some further progress on the U.K.'s plan to build two new reactors in Sizewell, which would complement the Hinkley Point C reactors, currently under construction. Europe urgently needs to find a solution to replace its sizable and aging nuclear fleet. The acceleration of decarbonization targets, upcoming plant phaseouts, and today's energy crisis is prompting a change in the approach to nuclear, which would offer stable, carbon-free baseload generation in a more electrified economy. Yet we believe the nuclear industry needs more stable and longer term visibility about energy policy, remuneration frameworks, and industrial plans to make the necessary investments and streamline its cost base. Notably, the sector suffers from an underinvested supply chain, increasingly more stringent safety and security regulations, and still unproven waste management solutions. Ultimately, we believe that a return to nuclear power in Europe will not be quick or easy, as it would rely on difficult political decisions and require large financial outlays, public investment, and management of complex technical advances. Also, some European countries have already decided to phase out nuclear and are unlikely to change their stance, notably Germany. We believe that a nuclear renaissance is hardly possible without state support for access to funding, construction, operations, and managing end-of-life liabilities--which can come in varying shapes or forms. See our report "[Nuclear In Europe: Lessons Learned And Ways Ahead](#)," published on Dec. 16, 2021.

Draft on taxonomy also includes gas. After much debate, gas was included in the latest draft of the European green taxonomy as a transition fuel. It is yet to be finally approved later this year and comes with a number of important conditions. More specifically, gas-fired plants can qualify as transitional solutions only where they can't be currently efficiently replaced with renewables, where direct GHG emissions are below 270g/kWh, gas replaces coal, with at least 55% emission reduction per kWh of energy, and where there are effective plans or commitments to switch to co-firing of low-carbon gases. In our view, this admits the presence of gas-fired generation but will hardly be enough to boost its expansion in view of gas price volatility and additional technical conditions.

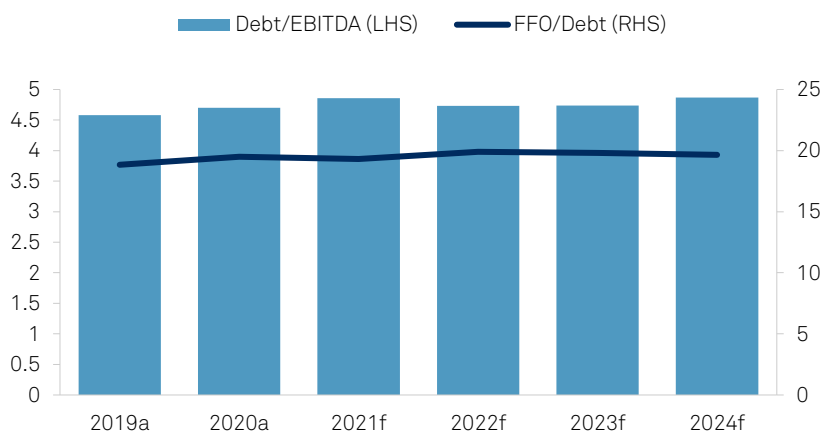
Credit metrics and financial policy

As a result of the high investment levels mentioned above, we anticipate debt for the sector will continue to rise. We estimate an annual increase in total debt of about 10% over the next three years for our rated universe. But, at the same time, we think current strategic plans allow for good management of the credit metrics, and ultimately credit ratings. Economic recovery, higher power prices, and new capacity commissioning will lead to earnings growth in the coming years. More importantly, financial policy and credit rating commitments support our stable outlooks. We currently expect utilities to pilot their balance sheets through the remedy measures they have to hand, including notably asset disposals, hybrid capital, or capital increases. While growth ambitions are significant, some could also reduce their investments in case of less favorable market conditions. Ultimately, our ratings underpin such financial policies.

We therefore do not see much improvement in credit metrics for the sector in the coming years, nor much deterioration (see chart 10). Upside earnings potential would likely be used to finance additional growth, while operating downside risk, as just explained, can be mitigated. Our current base case does not incorporate any major change in shareholder stance. This may include increased pressure on management teams for growth, notably via debt financed M&A, or higher dividend distributions to the detriment of credit quality. Another possible risk relates to increased shareholder activism in the sector, which may disrupt strategic plans and swing current financial equilibriums toward more shareholder-friendly remuneration schemes.

Chart 10

Debt/EBITDA And FFO/Debt Of Top Rated European Utilities



a—Actual. f—Forecast. Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Political and regulatory risks

Pressure from affordability will remain in 2022 to smooth the rise in energy bills, which could negatively influence our credit ratings if the burden is pushed to utilities.

2. Supply chain bottlenecks

The pandemic and macro environment point to bottlenecks cross global supply chains, which is already delaying the roll-out of investments for the sector. This could ultimately weigh on the profitability of some projects.

3. Large-scale manoeuvres

The race for size and the catch up on green or portfolio reshuffling could lead to unanticipated large scale transactions that could transform utilities' credit quality.

A policy-driven energy transition. In a European energy transition largely driven by policies and regulation, it comes as no surprise that political and regulatory risks remain high on the heat map for the sector. As mentioned above, the accelerated pace of energy transition offers a significant boost in investment opportunities in Europe. But it also means more stringent operating environment for laggards, notably with the rise in carbon prices, the early retirement of fossil fuel power plants, and the push toward new (less proven) technologies. We see this politically driven and fast-changing field as a real industrial challenge for the sector.

For networks, as we presented last year, we believe the key challenge is to reconcile the acceleration of the change in the energy mix toward greener technologies and their related uncertainties, with the longer (and somewhat inflexible) regulatory periods that govern the grids. It is also about finding the right balance between affordability and the incentive to invest heavily, notably for power grids. In Sweden and Finland, for example, this has led to challenging regulatory outcomes so far, with much reduced remuneration and high network growth ambitions (see our report "[Finnish Power Distributors Elenia And Caruna Ratings Put On CreditWatch Negative On Regulatory Remuneration Cuts](#)," published on Oct. 29, 2021). For gas infrastructure, it is about incorporating in the regulation the uncertainties around biogas in terms of sourcing and usage localization (routes), pace of adaptation, and technology (such as hydrogen).

Higher prices mean higher energy bills and increased risk of political intervention. In the shorter term, the rise in energy prices has intensified the risk of political intervention. To limit the resulting rise in energy bills for end-consumers, European states have taken a variety of measures. So far, intervention has mostly concentrated on helping customers rather than transferring the burden back to the utilities. Actions have included financial support to most fragile customers, temporarily reducing energy taxes from bills, or freezing regulated tariffs. The latter implies a working capital effect for players, although we expect flows to reverse over the coming quarters. One notable exception during the fourth quarter was Spain (see "[Spain's Plan To Claw Back Billions From Utilities Could Stunt Renewables Growth](#)," published on Sept. 29, 2021). Yet the Spanish government amended the initial gas clawback proposal to exclude power generation that was contractually hedged until the enactment of the Royal decree and generation that has a hedge of at least one year if it was signed after the introduction of the gas clawback. This change will reduce the sector impact to about €500 million from close to €2.6 billion before. In addition, although the CO2 clawback proposal hasn't been finalized, we expect it will have a similar structure to the one on gas, hence with a manageable financial impact for the sector. In France, the government has required the incumbent EDF to sell 20TWh at the discounted ARENH price in 2022, while the company would need to buy

such volumes on the market at much higher levels. We estimate the impact on EBITDA will be several billion for EDF. Other European countries also envisage implementing special taxes on above-average profits from power generators. We also recognize that this higher energy-price environment, combined with other inflationary trends in food products, could result in social unrest--as we saw in Kazakhstan in January 2022. We believe this will remain a major risk for this year across EMEA. In our report "[European Electric Utilities Face Higher Social Risks Than Their U.S. Peers](#)," published on Oct. 13, 2021, we highlighted the higher relative cost of electricity in Europe in comparison to the U.S. We believe power bills generally represent a larger share of disposable income in Europe and that, as a result, increases in bills attract greater political scrutiny. While affordability is a cornerstone of Europe's Fit for 55 strategy and Fair Transition Plan, we believe purchasing power in a context of energy transition will remain high on the political agenda, with increased volatility of energy prices and material investment plans to be financed. Also, as supply-demand tensions continue, we see rising security-of-supply concerns, resulting in potentially even greater risk of political intervention in the sector.

Supply chain and execution tensions persist. Beyond policies and regulation, we believe 2022 will also be challenging for the sector when it comes to supply chain bottlenecks. We flagged in "[Fit for 55: The Gains \(And Pains\) For European Utilities](#)," published on Sept 29, 2021, that as demand continues to grow, we see increasing pressure on European utilities' supply chains. This could result in heightened execution risks as utilities increase investments in renewables assets. Meanwhile, renewables supply chains are already struggling to keep up with the required pace of development, notably with domestic demand in China. We note that the European green electrification strategy increases the region's dependency on China for a large number of strategic parts and resources. We believe this situation, which we see as unlikely to change over the medium term, could add a degree of execution risks for European utilities. In its May 2021 Report ("The Role of Critical Minerals in Clean Energy Transitions"), the International Energy Agency flags China's significant market share in some products that are critical for the energy transition. In particular, China processes about 90% of rare earths (notably used in batteries), 40% of global copper (key for network cables), and about 60% of cobalt and lithium (also for batteries). Beyond dependency upon China's imports, the European supply chain needs to scale up in cadence with growth in investment and demand, which takes time and heavy investments. However, we understand that the largest renewables European players at this stage may have better procurement access than smaller ones.

Large-scale maneuvers. Finally, M&A will be again a key theme for 2022. The race for scale in renewables will continue, notably because this activity is scalable when it comes to procurement, asset management, and the ability to offer global decarbonization solutions to large customers. We believe acquisitions of existing renewables portfolios or investment pipelines are likely across the sector, although hard to predict. Valuations for such targets could vary but could also reach several billions. The oil sector, eager to grow its footprint in green energies, could also target some of the utilities' assets. Even if the sector has streamlined its activities in recent years, we also believe a portfolio refocus may lead to large disposals again this year, notably of gas infrastructure assets. Geographic rebalancing to the detriment of emerging markets (notably Latam) toward developed markets (Europe and the U.S.) could also increase, as the energy transition may now offer greater and clearer growth prospects. This trend could be credit positive, by eventually reducing utilities' country risk exposure. We also see European utilities' growing focus toward Asian markets, where they generally have less experience and weaker footprints. Another development is the greater group complexity that may stem from the growth in renewables, particularly offshore wind. Indeed, the almost systematic partnership approach through the disposal of stakes in projects adds a number of minority holders to group structures. While positive from a risk-sharing perspective given the size and sheer complexity of these projects, we also believe this could lead to potential reporting distortion due to consolidation methods. We therefore apply greater scrutiny to how these projects are accounted and what it means for utilities' financial

leverage targets. Apart from renewables, we could also see some M&A activity on networks. In 2021, we saw announcements of disposals of gas networks (SSE, National Grid) while the acquisition of U.S.-based network operator PNM by Iberdrola is still pending. These are generally very large transactions that can eventually reshape the utilities' asset portfolios as well as their balance sheets. In Europe, we see transactions in gas infrastructure assets as more likely than in power, as companies may have diverging views on how to manage these assets in the future as part of the energy transition.

Related Research

- [Nuclear In Europe: Lessons Learned And Ways Ahead](#), Dec. 16, 2021
- [ESG Credit Indicator Report Card: Power Generators](#), Nov. 18, 2021
- [ESG Credit Indicator Report Card: Regulated Utility Networks](#), Nov. 18, 2021
- [Price Tremors Threaten Europe's Gas Bridge](#), Oct. 5, 2021
- [The Energy Price Crisis: Examining The Impact On U.K. Suppliers](#), Sept. 30, 2021
- [Spain's Plan To Claw Back Billions From Utilities Could Stunt Renewables Growth](#), Sept. 29, 2021
- [Fit for 55: The Gains \(And Pains\) For European Utilities](#), Sept. 29, 2021
- [The Energy Transition And What It Means For European Power Prices And Producers: September 2021 Update](#), Sept. 17, 2021
- [European Offshore Wind Will Continue To Lead Global Growth](#), Sept. 8, 2021

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