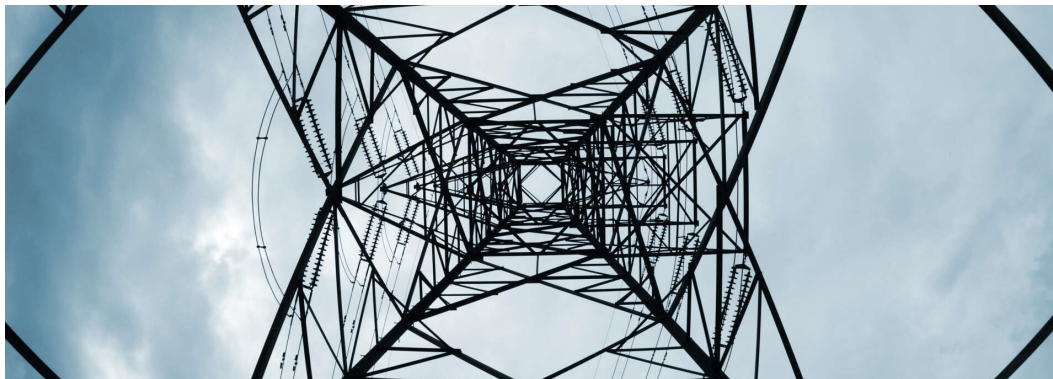


Latin America Utilities

Companies to withstand slow growth and high interest rates

January 9, 2024

This report does not constitute a rating action.



What's changed?

Inflationary pressures to continue. Although we previously expected high inflation to dissipate by mid-2023, we now expect general prices to remain elevated in the next few years, preventing a sharp drop in interest rates. However, we don't expect credit metrics to weaken further.

What are the key assumptions for 2024?

Sluggish economy will constrain electricity growth. We recently lowered our 2024 GDP growth forecast for the region, and now expect below-trend growth for the next few years. This should translate into electricity demand growth of 1.5%-2.0% in 2024.

Prevailing high interest rates constrain cash flows. Inflationary pressures should keep interest rates high, and we expect debt service costs to continue weighing on companies, especially those that rely on floating-rate debt. Still, utilities have shown resilience to economic downturns.

Renewable capacity to expand. Much of Latin America's electricity capacity growth will come from renewables, but the pace of execution might not meet energy transition targets.

What are the key risks around the baseline?

Hydrology and oil prices will drive electricity prices. A strong El Niño will have varying effects on Latin American countries, alleviating spot prices in Brazil and Chile but elevating them in Colombia and Peru. Oil prices should remain volatile as geopolitical risks continue.

Interest rates may stay high. Slower monetary policy easing could reduce cash flows and keep refinancing costs high.

Sovereign risk weakness. Given utilities' regulated nature, our ratings on most are either linked to or limited by sovereign risk. While the outlooks on Brazil, Mexico, and Colombia are stable, Argentina, Chile, and Peru have negative outlooks.

Contacts

Marcelo Schwarz, CFA

Sao Paulo
+55 11 3039 9782
marcelo.schwarz@spglobal.com

Cecilia Fullone

Buenos Aires
+54 11 4891 2170
cecilia.fullone@spglobal.com

Daniel Castineyra

Mexico City
+52 55 5081
daniel.castineyra@spglobal.com

Julyana Yokota

Sao Paulo
+55 11 3039 9731
julyana.yokota@spglobal.com

Veronica Amendola

Buenos Aires
+54 11 4891 2175
Veronica.amendola@spglobal.com

Gaston Falcone

Buenos Aires
+54 11 4891 2140
gaston.falcone@spglobal.com

Monica Gavito

Buenos Aires
+54 11 4891 2140
monica.gavito@spglobal.com

Bruno Ferreira

Sao Paulo
+55 11 3039 9798
bruno.ferreira@spglobal.com

Gabriel Gomes

Sao Paulo
+55 11 3039 4838
gabriel.gomes@spglobal.com

Ratings Trends: Latin American Utilities

Chart 1
Ratings distribution (including project financing)

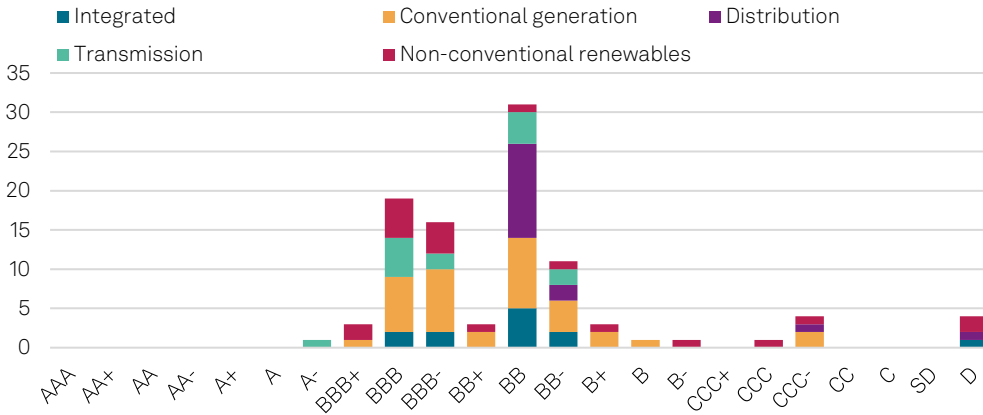


Chart 2
Ratings outlooks

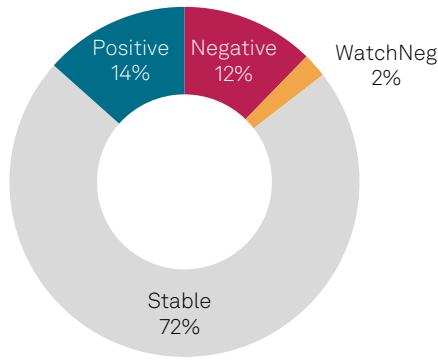
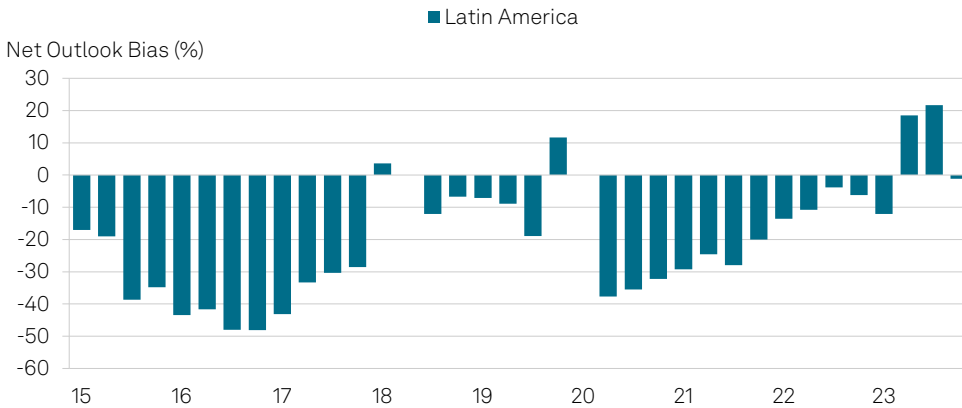


Chart 3
Ratings outlook net bias



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

Industry Credit Metrics: Latin America Utilities

Chart 4
Debt / EBITDA (median, adjusted)

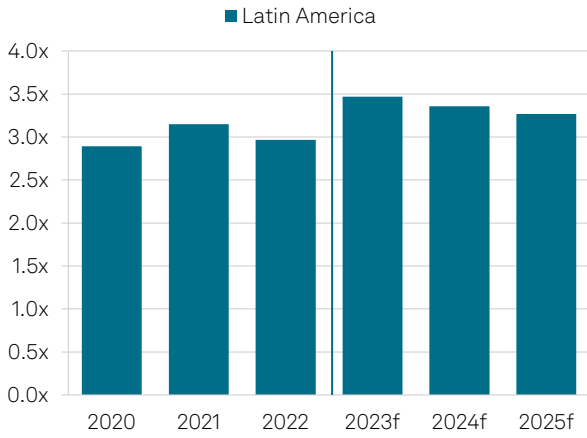


Chart 5
FFO / Debt (median, adjusted)

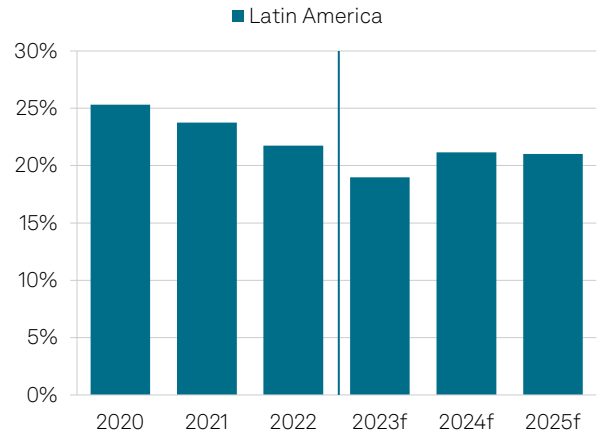


Chart 6
Cash flow and primary uses

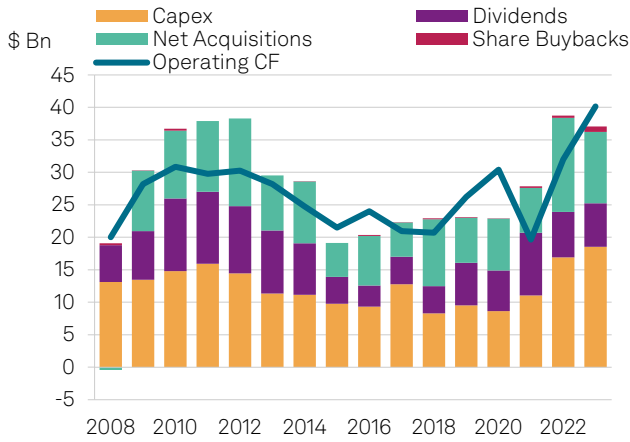
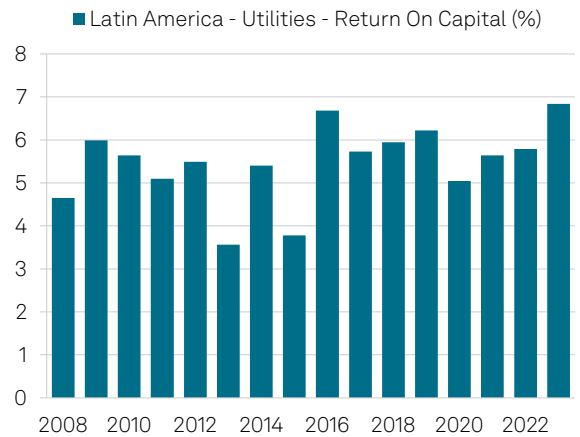


Chart 7
Return on capital employed



Source: S&P Global Ratings, S&P Capital IQ.

Revenue growth shows local currency growth weighted by prior-year common-currency revenue share. All other figures are converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations. Most recent (2023) figures for cash flow and primary uses and return on capital employed use the last 12 months' data.

Industry Outlook

Ratings trends and outlook

In the past few years, Latin American utilities have been able to preserve their stand-alone credit quality amid challenging economic conditions. The majority of the sector's outlook revisions and rating changes were linked to sovereign rating actions, such as those on Brazilian utilities.

Currently, about 72% of rated Latin American utilities have a stable outlook, as sovereign ratings continue to determine ratings on the region's largest regulated utilities. Given that about 14% of ratings on the utilities have a negative or watch negative outlook, we think downgrades may outpace upgrades in 2024.

Main assumptions about 2024 and beyond

1. Limited electricity demand growth as economic activity stalls.

We have revised our 2024 GDP growth forecast for Latin America to 1.2% from the previous 1.5%. Our main recent upward growth forecast revisions were for Brazil and Mexico, while we revised downward our forecast GDP growth for Argentina, Chile, Colombia, and Peru. In this context, we expect electricity demand to grow 1.5%-2.0% in 2024. Additional weakening of economic activity in the region could further reduce demand and prices.

2. Persistently high interest rates keeps weighing on companies' cash flows.

We expect real interest rates to remain elevated through 2024, although disinflation across the largest economies in the region in the coming quarters should encourage central banks to start lowering interest rates or continue doing so for those that have already started. As a result, debt service should continue to consume a large portion of operating cash flows, weighing particularly on the companies that rely on floating-rate debt. Still, the utilities that we rate have shown resiliency to economic downturns and have been able to access the credit markets even during more stressed periods.

3. Increased energy capacity, especially from renewables.

In general, we continue to expect governments in the region to keep fostering green energy, except Mexico, given its plans to prioritize fossil fuel sources. But higher-for-longer interest rates and input cost inflation could trim returns on long-term generation projects, slowing the energy transition in Latin America, particularly in Brazil given the prevailing low spot prices.

As inflation eases, some countries in the region are now in a position to lower their policy rates, and some have begun an easing cycle, such as in Chile and Peru. In Brazil, interest rates are still relatively high at 11.75% after jumping to 13.75% in 2022 and 9.25% in 2021 from 2.0% in 2020 (see table 1). We now project Brazil's central bank to finish the easing cycle with rates at 9.0% by the end of 2024. However, risks around food prices remain high, and the El Niño weather pattern is affecting harvests, especially in South America.

Financing conditions may improve as monetary policies across the region ease, but we expect financing costs will remain relatively high for issuers. Nevertheless, utilities that we rate in the region have been accessing funding from the credit markets. Financing conditions in Brazil have already improved after a dry spell in domestic capital markets in the first half of the year.

Table 1

Macroeconomic outlook for Latin America

%	2021			2022			2023f			2024f			2025f		
	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate	GDP growth	CPI inflation	Interest rate
Argentina	10.7	48.4	38.0	5.0	72.4	75.0	(3.0)	130.0	145.0	(1.5)	190.0	100.0	2.3	90.0	50.0
Brazil	5.3	8.3	9.3	3.0	9.3	13.8	2.9	4.6	11.8	1.5	3.6	9.0	1.9	3.7	9.0
Chile	11.9	4.5	4.0	2.5	11.6	11.3	0.0	7.7	8.5	1.9	3.5	5.5	2.7	3.1	5.5
Colombia	11.0	3.5	3.0	7.3	10.2	12.0	1.2	11.6	13.3	1.3	5.5	10.0	2.8	3.6	7.0
Mexico	6.1	5.7	5.5	3.9	7.9	10.5	3.3	5.5	11.3	1.8	4.1	9.5	2.0	3.2	7.0
Peru	13.5	4.0	2.5	2.7	7.9	7.5	0.2	6.4	6.8	2.2	3.2	4.5	2.8	2.3	4.0
Latam 6	7.6	-	-	3.9	-	-	1.7	-	-	1.2	-	-	2.2	-	-

CPI inflation data are annual averages. Interest rates are central bank policy interest rates at year-end. f—Forecast. Source: S&P Global Ratings Economics.

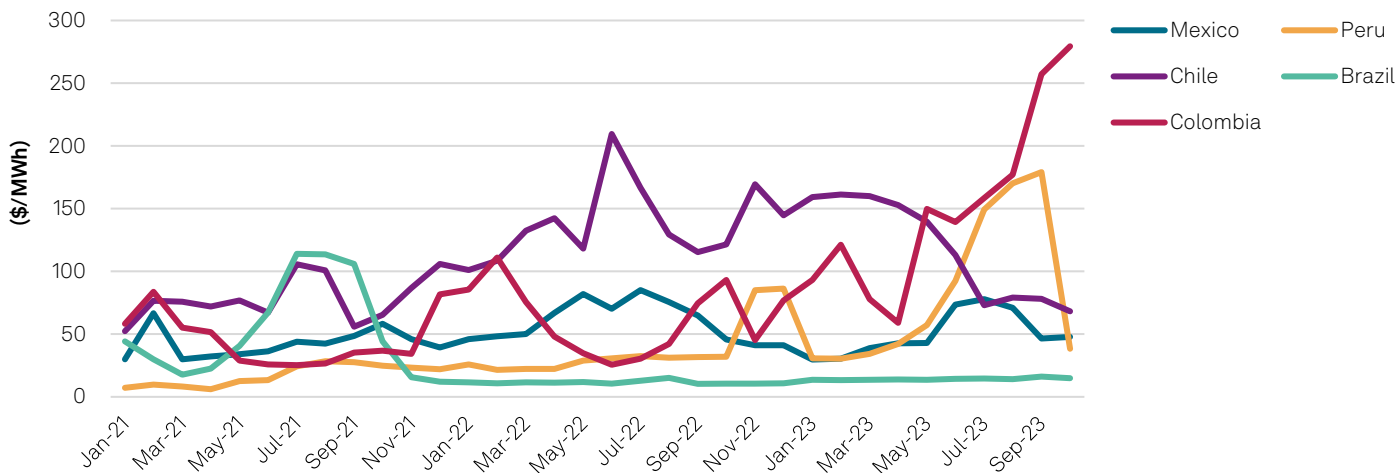
The makeup of the combined electricity market in Latin America is tilted toward renewables, with 37% of capacity in hydro, 14% in wind, and 10% in solar, while globally it's 37% in combined hydro, wind, and solar. The energy matrix is heterogeneous among the countries in the region, ranging from Brazil's 115 gigawatt (GW) hydro capacity (57% of matrix) and Mexico's 38 GW natural gas capacity (55% of matrix). This translates to a distinct energy transition path for each country.

As such, we expect hydrology conditions and oil and gas prices will remain the major drivers for electricity prices in Latin America based on our expectation that the composition of the electricity sector will remain stable in the next 12 months for most countries. Our 2024 price assumptions for WTI and Henry Hub are \$80 per barrel and \$3.00 per million British thermal units, respectively.

In the long term, we forecast that the transition to more nonconventional renewable energy will increase in speed and make overall prices decrease and then stabilize across the region. However, we think that staggered economic growth and political turmoil could delay investments and new additions of renewable energy, delaying reaching equilibrium prices according to each country's target.

Chart 8

Energy spot prices in Latin America



Source: S&P Global Ratings.

Credit metrics and financial policy

With a combination of still high cost of debt, a ramp-up in debt maturities, and slowing economic activity, utilities' credit fundamentals and liquidity continue to be key factors.

Despite a sluggish economic scenario and the high cost of debt, we don't expect credit quality to deteriorate in 2024, especially for those companies that rely on fixed-rate debt. If higher inflation persists, and given the regulatory lag in cost recoveries, rated utilities could face higher working capital needs. We continue to expect the largest rated integrated groups to post negative free operating cash flows, given their heavy investments, particularly in renewables and in maintaining and expanding their networks.

Still, comfortable liquidity should help utilities to navigate through the challenging economic conditions as refinancing needs increase in 2024 with higher debt maturities. Overall, we think that companies have flexibility to not only postpone investments but also reduce dividends, if needed, to preserve cash.

Key risks or opportunities around the baseline

1. Slower economic growth amid still high interest rates.

A prolonged period of slow growth and high interest rates could become more challenging as debt maturities increase, with most issuers facing still elevated debt service costs. This could be exacerbated as revenues slow, raising the real impact of still high borrowing costs.

2. Political and regulatory risk.

Given the expected subdued economic activity, lower disposable income could lead to less consumption and increased customer delinquency and energy theft in some concession areas. Also, since rates are generally linked to local inflation, the issue of electricity affordability can amplify political pressure on regulators, especially in less mature jurisdictions. Nevertheless, we don't anticipate significant government interventions, because we continue to consider regulations in the region to be generally supportive of the utilities' credit quality.

3. Electricity in the region depends on hydrology and oil prices.

The El Niño climate pattern could pose significant risks, but the impact varies throughout the region. El Niño should continue leading to lower spot prices in Chile and keeping them low in Brazil, but elevating them in Colombia and particularly in Peru in 2024, which is already experiencing the strongest El Niño in 24 years.

Argentina and Mexico, which rely mostly on thermal plants to produce electricity, could see more volatile electricity prices if geopolitical concerns deepen, for example if the war between Israel and Hamas escalates, and already intensified by the prolonged Russia-Ukraine conflict. Geopolitical turmoil could keep inflation high amid increasing economic uncertainty.

Country Highlights

Argentina

In 2024, the path for Argentina's utilities will depend on the specific policy initiatives under the recently elected government of Javier Milei. In the next year, we expect volatility and unpredictability will remain, considering the current economic imbalances in the country, including expected inflation rates of 190% and a GDP contraction of 1.0% in 2024. In this context, we think new investments in the sector will be low.

Brazil

Hydroelectricity reservoirs are currently at good levels thanks to above-average rainfall in the past two years. This has kept energy spot prices at the minimum regulatory level--Brazilian real (R\$) 69 per megawatt hour (MWh)--throughout 2023. Despite higher temperatures due to El Niño, which should persist at least until the first quarter of 2024 and boost demand, we assume energy prices will remain low in that time period, between R\$70/MWh and R\$80/MWh, due to the high reservoir levels.

In this scenario, generation companies should benefit from greater energy deliveries, although at lower spreads because of lower energy prices. The low spot prices will have an overall moderate negative impact on thermal plants because they rank later in the dispatch order. Nevertheless, Brazil's Electricity System Operator (ONS) may dispatch thermal plants more often relative to the past two years because of heat waves that have been lasting longer, increasing energy demand from more stable sources, considering Brazil's large share of intermittent sources with the surge of nonconventional renewables. In addition, lower inflation and favorable hydrology will help ease utilities' working capital needs, but still high interest rates continue consuming a large part of companies' cash flow because most of their debt is floating.

In addition, we expect the integrated energy groups to continue making sizable investments in the next couple of years, which should lead to negative free cash flows. This is even considering that some groups will continue divesting from noncore assets, such as Neoenergia S.A. (BB/Stable/--; brAAA/Stable/brA-1+), EDP Energias do Brasil S.A. (not rated), and Companhia Energetica de Minas Gerais – CEMIG (BB-/Stable/--; brAA+/Stable/--).

We expect still mild GDP growth in Brazil between 1.5% and 2.0% from 2024 onward, which should translate to maximum electricity demand growth of about 3% per year until 2032, according to the 2032 Ten-Year Energy Expansion Plan issued by Empresa de Pesquisa Energetica (EPE; the state-owned energy research office). Relatively low demand growth, coupled with oversupply of energy, should support still low energy prices in the next few years, which discourages new energy generation projects. Considering continued intermittent capacity expansion, we believe Brazil's challenge will be to continue investing in transmission capacity to foster system interconnectivity and reliability.

In 2024, we expect the government to disclose the final terms for the renewal of 20 distribution concessions in Brazil--which are coming due between 2025-2031--for an additional 30 years. At this point, we assume final renewal terms will be in line with the Ministry of Mines and Energy's preliminary proposal published in June 2023, which indicated that distribution concessions that are complying with service quality metrics--measured by duration and frequency of service interruptions--and the economical-financial regulatory requirements would be eligible for contract extensions without payment of grant fees.

Finally, we also expect Brazil's free energy market to widen in 2024, because starting in January, all high-voltage consumers will be able to select their energy supplier. In this context, integrated energy groups have been investing in more scalable solutions to convert their captive industrial and commercial clients, as well as attract new ones, to their free client base, generally by offering discounts on energy bills.

Brazilian Water Utilities

In the past couple of years, private companies have increased their market share to more than 20% of the population served in the country, mainly through large concessions, because stakeholders remain attracted to the inherent resilience of the sector's cash flows.

Despite tightening financial conditions in Brazil during the first half of 2023, groups such as Aegea Saneamento Participações S.A. (Aegea: brAA+/Stable/--) and Iguá Saneamento S.A. (Iguá: brA+/Stable/--) were able to access the capital markets to finance funding needs for their concessions.

The privatization of Companhia de Saneamento Básico do Estado de São Paulo (SABESP; BB/Stable/--; brAAA/Stable/--) is on the agenda of the new state administration that took office in January 2023. The administration has hired International Finance Corp. as an advisor to execute the privatization in 2024.

Banco Nacional de Desenvolvimento Econômico e Social (BNDES; BB/Stable/--; brAAA/Stable/--) has continued to be an important source for long-term capital expenditure financing in the sector and we expect it to continue to be in 2024. In addition, we expect BNDES to continue to act as a financial advisor because it is in advanced stages of privatization modeling for water and sanitation companies in the states of Rondônia, Sergipe, Paraíba, and Rio Grande do Sul.

Chile

Lower fuel prices and improved hydrology from higher snowmelt reduced volatility in the Chilean energy generation sector in 2023, steadying the national grid's performance. Marginal costs declined to an average of \$118/MWh in the first 10 months of 2023 from \$134/MWh in the same period in 2022, but remain high compared to an average of \$70 MWh in the last five years. We expect fuel prices will remain relatively stable in 2024 and we project generators will have natural gas available from Argentina. We project marginal costs to keep decreasing if there are no major hydrology events, while renewable capacity starts operating.

As of November 2023, 42.7% of the system's capacity came from nonconventional renewable sources and an additional 382 projects (about 6.4 GW) were under construction, which supports the country's plans to achieve carbon neutrality by 2050. Chile's large power players (Enel Chile S.A., AES Andes S.A., Engie Energia Chile S.A., and Colbun S.A.) will continue to build the majority of the increased capacity for the next three years.

The effect of the deployment of nonconventional renewable capacity on spot prices will also depend on the expansion of transmission lines and battery storage projects. This is because new assets are located either in the country's north or south, while most of the consumption is in the center, around Santiago. We expect transmission capacity constraints to remain until the Kimal-Lo to Aguirre transmission line is completed by the end of 2029. Meanwhile, we expect the regulator to implement measures to alleviate the transmission congestion. Those include the ability to bid for a certain zone of Chile (north, central, or south) to decrease the exposure to the decoupling effect, and the ability to bid for batteries, which should help to reduce volatility between solar and nonsolar hours.

The Chilean power generators were able to monetize the receivables pending from regulated contracts in the second half of 2023. Although this alleviated liquidity strains for some of the generators, we believe that in 2024 there could be further accumulation of receivables, which could pressure working capital requirements.

The Chilean government created the Small Distributed Generation Means (Pequeños Medios de Generación Distribuida (PMGD)) framework in 2006 for projects generating up to 9 megawatts (MW). We continue to expect the larger and geographically diversified PMGD portfolios to be better protected against adverse events, such as curtailment and construction delays. On the operational side, we continue to expect a relatively stable operating performance, because the high energy prices (close to \$70 in 2023 and near \$65 in 2024 and 2025) compensate for the lower-than-expected production, in part due to curtailment. The stabilized prices were--and will continue to be--much more stable than market prices, which reduces cash flow volatility and supports our view of these projects' credit quality, which is mostly investment grade.

On the construction side, we have seen average delays of more than six months in the start of operations of the assets. This is mainly due to the interconnection process which, in our view, is the main risk affecting PMGDs, considering that the interconnection contract does not include any compensation mechanism for the projects. We continue to expect the same trend in 2024, considering the large amount of PMGDs under construction.

Colombia

Colombia's energy transition process is underway. The renewable energy goal is part of the country's overall strategy to reduce greenhouse gas emissions from business-as-usual projections by 50% by 2030 and reach carbon neutrality by 2050. Nevertheless, we view the delays in the execution of nonconventional renewable projects and transmission lines as a medium-term risk for the system's capacity.

President Gustavo Petro continues to emphasize energy transition as a key priority of his administration and branded his policy as the "Just Energy Transition Plan," which will focus on electric power generation at the community level, including rural communities. Colombia's installed electric power generation capacity is currently 18 GW, with hydro accounting for 68%, gas and coal-fired power plants accounting for 31%, and the remaining from wind and solar units.

The country's energy matrix is highly dependent on climate conditions to generate hydropower. The hike in spot prices stemming from a drier season in the country could crimp liquidity and profitability of the Colombian distribution companies, which must comply with a rate ceiling since the implementation of the "opción tarifaria," which is a mechanism the government implemented in 2020 to smooth the impact of sudden increases in energy costs on electricity bills. The government is currently working on measures to alleviate the accrued receivables of these distribution companies while they're incurring higher costs.

Mexico

Nearshoring has gained attention as supply-chain disruptions during the COVID-19 pandemic made a case for manufacturers to diversify the location of their operations to minimize production disruptions. Mexico's long-standing manufacturing links with, and access to, the U.S. market make it an obvious potential beneficiary for nearshoring. In this context, additional energy capacity is a challenge to take advantage of nearshoring, especially regarding availability of clean technology, since the current Mexican administration has been reluctant to encourage the development of green energy sources.

We expect net energy capacity to increase about 20% in the next two years, versus recent annual increases of about 5%. An additional layer of complexity is the centralization of energy generation by the state-owned utility, Comisión Federal de Electricidad (CFE; foreign currency: BBB/Stable/--; local currency: BBB+/Stable/--), which leaves less room for the private sector to develop new energy sources. We will monitor if the current energy strategy remains after the presidential elections in 2024, and how this will affect the Mexican energy matrix and prices.

We continue to think that fossil fuel prices will remain the main driver for power prices in Mexico, and to a lesser extent, the inclusion of renewable capacity to the system and the overall national and regional demand and supply. In this context, we project power prices in the wholesale market to decline in the next 12 to 24 months as commodity prices decrease to about \$40/MWh from an average of \$50/MWh in 2022.

Finally, renewable capacity continues increasing year-over-year, and we expect nominal capacity for this technology will increase about 8 GW by 2026; although the increase will be gradual. Renewable generation edged up to about 25% of Mexico's total matrix in 2022 from 24% in 2021. We continue to expect that renewable capacity will be added to the system mainly through private companies in the next 12-24 months, while the bulk of CFE's investments will be for combined-cycle power plants.

Peru

The political crisis and the protests in southern Peru and in the city of Lima during the first quarter of 2023 haven't weakened utilities' credit quality so far. Although we think Peru's political and social conditions have recently been more stable, the country is facing the strongest El Niño weather pattern of the past 25 years, which is dampening economic activity, especially the agricultural and fishing industries.

As of November 2023, electricity demand was 4.5% higher than the same period last year, above our assumption of Peru's GDP growth of 0.9% for 2023. Still, we expect demand to grow in line with our assumption of 2.4% GDP growth for 2024.

El Niño has hurt hydropower generation. Hydro made up 46% of total energy production as of the end of November, below the 52% share during the same period last year. Moreover, the effects of the drought in southern and central Peru on marginal costs were exacerbated by the outage of two relevant hydroelectric plants in the system and the maintenance in Camisea's plants that restricted the supply of natural gas. As a result, spot prices peaked in the third quarter of 2023 and averaged \$82/MWh in the first ten months of 2023 versus \$28/MWh in the same period in 2022. However, we assume hydrological conditions will normalize in the second half of 2024, leading to lower spot prices averaging \$35/MWh for the year.

As of Sept. 30, 2023, Peru's installed capacity was 13.6 GW, of which 55% was thermoelectric, 38% was hydroelectric, 5% was wind, and 2% was solar. In addition, the Peruvian Committee of Economic Operation System (COES) approved 8.9 GW of wind projects and 7.7 GW of solar projects to be developed through 2029. Although there is a clear target to expand nonconventional renewable capacity share in the system, recent political turmoil and lower economic growth prospects could dampen investments and additions of solar and wind plants in the next two years. In this context, reaching the expected \$30/MWh optimal spot price could be delayed, considering in addition a possible delay in transmission infrastructure investments in Peru.

Related Research

- [The Energy Transition And Its Impact On Latin American Power Prices](#), Dec. 6, 2023
- [Brazil's Sanitation Regulatory Framework Remains Fragmented, Despite Recent Changes](#), May 8, 2023

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