

## Connacher Oil and Gas Ltd.

### Corporate Credit Rating

BB-/Stable/—

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### Major Rating Factors

#### Strengths:

- Long-lived oil sands reserves
- Stable production profile with negligible finding costs once operations commence
- Reduced exposure to heavy oil differentials, diluent prices, and natural gas costs associated with its refinery and conventional operations

#### Weaknesses:

- High leverage
- Cash flow volatility highly correlated to oil sands operating efficiency
- Potential cost inflation associated with capital intensive oil sands projects

### Rationale

The ratings on Calgary, Alta.-based Connacher Oil and Gas Ltd. reflect the company's relatively high leverage, the risk of cost increases on construction of its projects, the uncertainty regarding reservoir performance (albeit diminishing as Pod I begins production), and operating margins that are highly exposed to volatility during the ramp-up period. Somewhat mitigating these weaknesses are the above-average internal reserve replacement potential associated with its oil sands leases; the expected stable production profile; the negligible finding costs associated with oil sands extraction; and a reduced exposure to heavy oil differentials, diluent prices, and natural gas costs associated with Connacher's wholly owned U.S. refinery and Canadian conventional upstream operations.

Connacher's satisfactory business risk profile reflects its good internal reserve replacement potential, an expected stable production profile, and the vertical integration potential

associated with the company's conventional upstream operations and U.S.-based refinery. As the first phase (Pod I) of the company's Great Divide steam-assisted gravity drainage (SAGD) oil sands project is not yet at full production, uncertainty regarding reservoir performance somewhat offsets these strengths, although that has diminished now that the company is steaming and recovering small volumes of bitumen incidental to the steam circulation process.

Due to the negligible exploration risk associated with the company's oil sands resources, Standard & Poor's Ratings Services bases its assessment of Connacher's reserve replacement potential on its total proven and probable reserves. Connacher has 178 million barrels of gross proven plus probable reserves booked for its oil sands projects, based on independent estimates. The company estimates proven plus probable reserves and best-estimate contingent resources on its oil sands leases to be 304 million barrels. Further development of the leases associated with other identified pods will support medium- and long-term production growth and reserve replacement and growth. With the oil sands' large reserve base and minimal required exploration, Connacher should benefit from a stable production profile after start-up, providing the company with a steady cash source.

Connacher, however, faces some uncertainty regarding reservoir performance, because the company has not implemented a pilot project and is using the nearby JACOS Hangingstone project in production as an analogue, as well as internal simulation work and independent reserve engineer analysis for its estimates. Although the company has substantive seismic data and drilled core samples in addition to using the nearby operations to determine projected performance, the risk will not end until full production at Pod I happens in mid-2008.

Connacher's conventional natural gas production offsets the high fuel cost component in the company's Pod 1 SAGD project's unit operating costs; natural gas fuel costs could account for at least 55%, and possibly more than 70%, of the Pod 1's operating costs. Standard & Poor's estimates total per unit cash costs (including transportation, interest, diluent, and general and administrative expenses) of C\$26-C\$34 per barrel, depending on hydrocarbon costs at the time. These costs remain in line with the expected costs of similarly rated companies with SAGD projects. Unit cost estimates are highly sensitive to the steam oil ratio (SOR), which Connacher's independent reserve engineer estimates initially to be at 3.2-3.4, and 2.6 during the forecast life of the project. A reduction in the unit operating cost is contingent on the company's ability to lower its SOR. We expect the company's total operating costs to remain competitive with conventional full-cycle costs.

Connacher's plans do not include any upgrading options for its bitumen, exposing the company to both heavy oil differential and diluent cost risk. The company's Montana refinery, however, somewhat mitigates these risks. Although there is no direct pipeline link between Connacher's oil sands operations and the Montana refinery, the refinery can process Bow River crude, which is similar to the dilbit expected from Pod 1. Though Connacher has no plans to ship its bitumen production to its refinery (except for incidental volumes that will be used for analysis), its upstream exposure to heavy oil price differentials should be largely offset by enhanced downstream refining margins. The differential between what is bought at the refinery and sold at the Great Divide project might not be exactly the same, as the two operate in different markets; nevertheless, the Bow River and dilbit differentials have been highly correlated historically. Similarly, the company's ownership of the refinery moderates its exposure to diluent prices. The refinery produces naphtha, which is suitable as diluent; but transportation and market pricing variances could limit the effectiveness of this "natural hedge." Although the refinery addresses some of the concerns of wide differentials and diluent price exposure,

Connacher must refine its downstream strategy and increase its refining capacity to maintain an upstream-to-downstream volume balance and its natural hedge position as it proceeds with any incremental oil sands development.

Despite the strong credit fundamentals intrinsic to an oil sands operation, the ratings on Connacher are constrained by the company's aggressive financial risk profile, which reflects its relatively high leverage and intensive capital spending requirements as it proceeds with construction of its Pod 2 Algar project. Connacher will not generate any significant cash flows until Pod I achieves full production in 2008. In the interim, the company will use the surplus cash from its refinery and conventional operations (which are self-funding), as well as the proceeds of debt and equity issuances, to fund its capital and operational requirements.

Connacher's leverage is high compared with that of similarly rated exploration and production (E&P) companies. We expect total debt-to-capital to peak at 60% during Algar construction, but this remains in line for other rated oil sands peers. We also expect total debt-to-EBITDA in 2008 to be weak, at 4.8x-6.0x, but this reflects the full production at Pod I not happening until midyear and the increase in leverage to funds it next phase of construction. Despite these weak metrics, Connacher's reserve base supports the elevated debt, and debt per proven and probable barrels of oil equivalent (boe) should remain below US\$4.50/boe, which is comparable with that of E&P companies in the 'BB' category. Furthermore, the company has a fully funded one-year debt service account for its US\$600 million notes. Standard & Poor's believes Connacher's debt levels are acceptable as it proceeds with construction and development on Algar; however we expect to see debt to cash flow metric improve as Pod I reaches and sustains production at its design capacity.

#### ***Recovery analysis***

We rate the company's US\$600 million senior secured second-lien notes 'BB', one notch above the corporate credit rating, with a recovery rating of '2'. The '2' recovery rating indicates an expectation of substantial recovery (70%-90%) in a default scenario. The notes are secured equally and ratably by a second-priority security interest in all property of Connacher, whether owned by the company on the issue date or acquired by the company thereafter, but excluding the equity interests in Petrolifera Petroleum Ltd.; and all property of each restricted subsidiary of Connacher, but excluding the assets of Great Divide Pipeline Corp. on the issue date. The notes will be guaranteed by all of Connacher's existing subsidiaries and by all future restricted subsidiaries that become guarantors of the notes.

(For the complete recovery analysis, see )

#### ***Liquidity***

Connacher's liquidity should remain adequate during project construction through 2009. With the issuance of the US\$600 million in second-lien secured notes and new C\$150 million and US\$50 million first-lien, five-year revolving credit facilities, the company will have sufficient capital to complete its Pod 2 Algar project. Connacher's refinery and conventional operations generate sufficient internal operating cash flows to fund their operating and capital requirements, which are primarily discretionary in nature, and generate free cash flow that can be used to fund further development of its Great Divide assets. Furthermore, with it coming on-stream, we expect Pod I will generate cash flow in excess of its operating and capital requirements, with the surplus cash for Connacher's growth spending. Further liquidity could come from the company's approximately 26% ownership interest in

Petrolifera, which is currently worth about C\$130 million; but a near-to-medium-term sale of this asset is unlikely.

### ***Outlook***

The stable outlook reflects our expectation that Pod I of Connacher's Great Divide project reaches production at its design capacity in mid-2008, and internally generated cash flows will meet the company's debt and sustaining capital expenditure commitments for its operating assets. Furthermore, the outlook incorporates our expectation that Connacher will complete the development of its Pod 2 Algar project on schedule without any material cost increases or any need for significant additional funding. We do not expect, however, that Connacher's balance sheet will materially improve in the near-to-medium term as it begins spending on its Algar project. An outlook revision to positive depends on Connacher's ability to significantly reduce its debt, combined with improvements in free cash flow generation, which is unlikely in the near term. Conversely, should the company not maintain its financial risk profile as it proceeds with the Algar project, we could revise the outlook to negative.

### ***Business Description***

Connacher is an oil and natural gas E&P company whose principal asset is its 100% working interest in 95,000 acres of oil sands leases near Fort McMurray, Alta. Connacher also has conventional operations primarily at Battrum, Sask., and Marten Creek and Three Hills in Alberta, with production of 2,350 boe per day in third-quarter 2007 (ended Sept. 30). The company operates a 9,500 barrel per day refinery in Great Falls, Mont., and owns about 26% of and manages Petrolifera, which has interests in Argentina, Peru, and Colombia.

### ***Rating Methodology***

Standard & Poor's followed the methodology used for its traditional ratings on E&P oil and gas companies. This evaluation considered industry characteristics, the competitive position of the issuer, and management's strategy. To arrive at ratings conclusions, we assessed Connacher's business and financial profiles. The analysis of the company's financial risk profile addressed Standard & Poor's expectation of Connacher's financial policies, profitability, cash flow protection, and capital structure.

### ***Satisfactory Business Profile***

In assessing the business risk profile of pure-play oil sands companies, Standard & Poor's has traditionally attributed a very strong credit profile to the oil sands' long-lived reserves, which supports above-average internal growth. The size and quality of the reserves base effectively offset the credit weaknesses associated with single-project exposure. These factors lend investment-grade characteristics to Connacher's business risk profile; but the significant execution risk in bringing projects to commercial operations and the company's expected profitability profile, which has weakened as a result of general industry cost inflation and the potential for significantly weakened profitability with production volume variability, partially offsets these strengths.

### ***Extensive resources and reserve replacement opportunities***

Although Connacher has conventional operations in Western Canada, the majority of its reserves are associated with its Great Divide in-situ project near Fort McMurray, Alta. The company's conventional

operations include 7.1 million boe of proved reserves, which are a mix of 30% oil and 70% gas, however this is dwarfed in comparison to its 178 million barrels of gross proved plus probable reserves booked for its oil sands leases. Furthermore, Connacher has 126 million barrels of best estimate contingent resources as estimated by an independent engineering firm. Although the contingent resource amount appears small compared with those of other rated oil sands projects, this is primarily the result of company strategy rather than poor lease quality. Connacher has focused the majority of its spending on developing its projects rather than defining its resource base, so there have not been enough core samples and well drilling carried out on its additional leases for the reserves engineers to estimate the recoverable bitumen. The company has plans to drill 120 core holes in first-quarter 2008 and shoot an additional 84 square kilometers of three-dimensional seismic data, which should increase the volume of reserves and contingent resources. The reserve life of its in-situ assets based on Pod I production is significantly high, at about 37 years. Connacher also plans to proceed with the second pod (Algar) of its in-situ project, which, subject to regulatory approval and completion on-schedule, should give full production of 10,000 bitumen barrels per day (bbl/d) by year-end 2010. As a result, we expect Connacher's significant reserve replacement opportunities and negligible exploration risk to effectively offset the limited geographical diversification of its assets.

***Cost structure and profitability to benefit from natural hedges***

The SOR is a critical measure that indicates operational efficiency of a project and the likely natural gas costs associated with production. In the absence of an independent pilot project, Connacher's estimated long-term SOR at Pod I of 2.6 should be comparable with that of the nearby JACOS project's SOR; consequently natural gas will constitute 55% to possibly more than 70%, of operating costs. Connacher's exposure to natural gas price volatility will be mitigated, however, by its conventional natural gas production which should exceed the fuel consumption requirement at Pod I. In addition, conventional natural gas production should increase in line with the start of steaming at Algar in late 2009, so as to keep the balance of natural gas from the conventional segment about equal to or greater than what the SAGD operations consume.

The downstream margins at its Montana refinery should offset Connacher's exposure to heavy oil price differentials. The refinery capacity of 9,500 bbl/d is almost comparable with its Pod I estimated production of 10,000 bbl/d. Although the company does not plan to use its bitumen production as an input in the refinery, the adverse impact due to higher differentials should be somewhat offset by the incremental benefit to its downstream margins. Similarly, the refinery's production of naphtha should protect Connacher's profitability from rising diluent cost risk. Although there is no plan sanctioned for an expansion to the refinery coinciding with the Algar project completion, Connacher is evaluating the possible expansion of the Montana refinery to increase capacity to 25,000 bbl/d, thereby maintaining the ratio of bitumen production to refining capacity at about 1:1.

As a result of the conventional natural gas production and the refinery operations Connacher's integrated operations will receive a higher netback per barrel of bitumen produced compared to a pure bitumen producer.

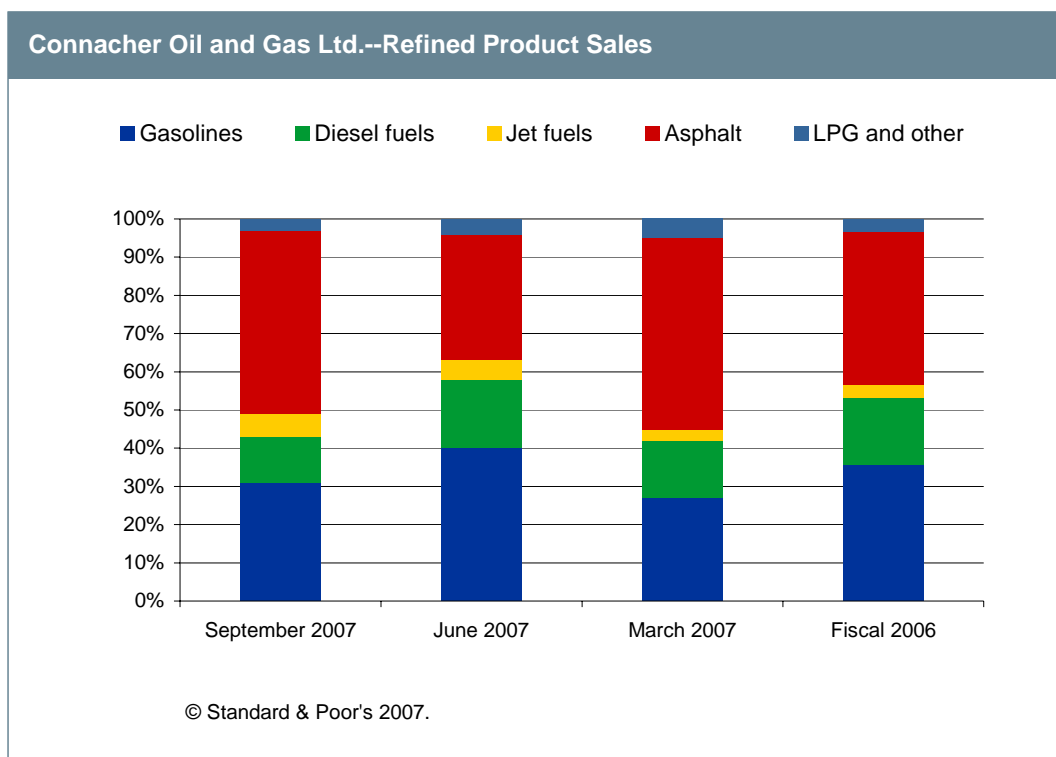
***Self-sustaining conventional operations***

Connacher's conventional operations in Alberta and Saskatchewan provide some asset diversity with proved reserves at June 30, 2007 of about 7.1 million boe, 70% of which are natural gas reserves. The

assets have a reserve life of about eleven years on a proved basis with production for the nine months ended Sept. 30, 2007 averaging at 2,366 boe per day. As these operations generate strong netbacks (C\$26.03 per barrel for the nine months ended Sept. 30, 2007), cash flow generated from the segment should be sufficient to internally fund capital expenditures on these properties necessary to keep production at current levels. Furthermore, Connacher's conventional assets have multiyear drilling opportunities and 231,000 net undeveloped acres. As a result, in the near-to-medium term, Connacher will successfully replace conventional reserves while keeping production stable.

**Refinery provides added revenues and risk mitigates**

The Montana refinery, acquired by Connacher in March 2006, should provide a natural hedge against heavy oil differential and rising diluent cost risk for the company's in-situ operations. The refinery which is equipped with a hydrocracker, processes about 9,500 bbl/d of Canadian Bow River heavy crude and produces approximately 10,000 bbl/d of finished products. Sales of refined product vary somewhat between seasons but the output is about one-third gasoline, one-third asphalt, and one-third diesel and jet fuels and other. The Montana refinery operates in a niche area and sells its finished products primarily in local markets which insulates the company somewhat from the volatility of refining spreads. In addition, with strong refining margins (18.2% for the nine months ended Sept. 30, 2007) and nearly full refinery utilization (99%), the segment has contributed substantially to consolidated cash flows. The chart examines refined product sales.



**Aggressive Financial Risk Profile**

Connacher's financial policy is aggressive. This largely reflects the use of debt to fund Pod construction costs; potential cash flow strain from cost overruns and scheduling risks as the company proceeds

through expansion phases; and absence of meaningful revenues until full production from Pod I. However, the company has also used equity to fund its 2008 exploration capital commitments. Connacher has hedged some production and is considering hedging more through the use of collars. We expect the company is expected to continue generating negative free cash flows as it proceeds with its Algar expansion project, but Connacher's debt-to-capital should range around 60%, and EBITDA interest coverage should be about 2x, which is in line with the 'BB-' rating category.

### ***Accounting***

Connacher prepares its financial statements in accordance with Canadian GAAP. Its financial statements were audited by independent auditors Deloitte & Touche, who issued an unqualified audit opinion for 2005 and 2006. Connacher reports its reserves in accordance with National Standard 51-101 using forecast prices and costs, as opposed to the FAS 69 and SEC convention of using constant prices and costs, and independent petroleum engineers prepare the company's reserve valuation and reports.

On March 16, 2006, Connacher acquired Luke Energy Inc for about C\$205 million. The transaction, which was accounted for using the purchase method, added goodwill of C\$104 million.

In assessing Connacher's financial risk profile and key cash flow protection measures, Standard & Poor's adjusts the company's reported debt to include the present value of the company's future operating lease commitments and asset retirement obligations. Although these adjustments increase Connacher's total debt by about 7% through our calculations, the company's financial risk profile is not materially affected, given the long-term nature of these obligations.

Standard and Poor's will continue to monitor the ongoing conversion process from Canadian GAAP to IFRS, but we do not expect any material impact on our assessment of the company's credit profile.

### ***Cash flows unlikely to cover capital spending as company expands***

Once Pod 1 production reaches design capacity in mid-to-late 2008, it will generate cash flow in excess of its maintenance requirements. Furthermore, cash flow from Connacher's refinery and conventional operations are also sufficient to internally fund maintenance capital expenditures for each respective segment. However, with the estimated cost of the Algar project at C\$326 million (which includes a contingency of C\$32 million), funds from operations will not cover Connacher's capital spending program through 2009. Although free operating cash flow will be negative, with the US\$600 million senior notes recently issued and C\$150 million and US\$50 million revolving credit facilities, Connacher has adequate liquidity to complete Pod 2 Algar development to start-up in late 2009, barring any material cost escalations. Any sizable increase in costs on the project however will likely require additional capital. Moreover, the company's cash flows post Pod I start-up will be contingent upon volatile oil prices and operational reliability of the project.

### ***Asset quality supports capital structure at current rating level***

Connacher's credit rating is limited by its capital structure, which reflects the company's use of debt to help fund the development of its oil sands projects. With the new debt issuance, Connacher's unadjusted debt has increased to about C\$678 million from C\$287 million at Sept. 30, 2007. Although this is high for expected average production of about 11,300 boe/d in 2008 (C\$60,000 per flowing barrel), Connacher's long-lived oil sands assets and the expectation of an addition 10,000 barrels

coming on stream in 2010 support its current capital structure. Furthermore, Connacher's approach of primarily using debt only to fund projects with an associated future revenue stream also supports the 'BB-' rating despite leverage being on the weaker end when compared to similarly rated companies. Debt reduction in the intermediate term is unlikely, as the company continues to proceed with growth projects; however, coverage ratios should improve due to increasing EBITDA from incremental production.

Table 1

**Connacher Oil and Gas Ltd.—Peer Comparison\***

*Industry sector: Oil and gas*

	—Fiscal year ended Dec. 31, 2006—		
<i>(Mil. C\$)</i>	<i>Connacher Oil and Gas Ltd.</i>	<i>MEG Energy Corp.</i>	<i>OPTI Canada Inc.</i>
Rating as of Dec. 14, 2007	BB-/Stable/—	B+/Stable/—	BB-/Stable/—
Revenues	243.7	0.5	0.0
EBITDA	49.7	(8.3)	(8.5)
Net income from continuing operations	7.0	5.9	(10.2)
Funds from operations (FFO)	37.4	11.4	(46.0)
Capital expenditures	188.3	977.7	1,061.8
Debt	248.6	875.8	1,719.0
Equity	385.1	779.8	1,443.6
<b>Adjusted ratios</b>			
Operating income (before D&A)/revenues (%)	17.4	(2,913.6)	N.M.
EBIT interest coverage (x)	2.8	29.0	(0.5)
EBITDA interest coverage (x)	8.3	(39.4)	(0.2)
Return on capital (%)	4.4	0.6	(0.9)
FFO/debt (%)	15.0	1.3	(2.7)
Debt/EBITDA (x)	5.0	(106.0)	(201.1)
Debt/total capital (%)	39.2	52.9	54.4

\*Fully adjusted. N.M.—Not meaningful.

Table 2

**Connacher Oil and Gas Ltd — Financial Summary\***

*Industry sector: Oil and gas*

	—Fiscal year ended Dec. 31—					
<i>(Mil. C\$)</i>	<i>Average of past three fiscal years</i>	<i>2006</i>	<i>2005</i>	<i>2004</i>	<i>2003</i>	<i>2002</i>
Rating history		B+/Stable/—	N.R.	N.R.	N.R.	N.R.
Revenues	87.3	243.7	9.1	9.0	8.1	3.7
EBITDA	19.2	49.7	4.3	3.6	4.3	1.2
Net income from continuing operations	1.7	7.0	1.0	(3.0)	4.2	0.5
Funds from operations (FFO)	14.8	37.4	4.4	2.5	3.8	1.2
Capital expenditures	74.4	188.3	17.1	17.6	39.0	7.1
Debt	85.4	248.6	3.8	3.8	16.4	4.0
Equity	184.9	385.1	129.1	40.5	24.5	5.3

Table 2

**Connacher Oil and Gas Ltd — Financial Summary\* (cont. 'd)**

**Adjusted ratios**

Oper. income (before D&A)/revenues (%)	19.1	17.4	37.9	45.5	58.2	34.1
EBIT interest coverage (x)	1.5	2.8	(3.4)	(3.0)	0.7	1.5
EBITDA interest coverage (x)	7.5	8.3	7.2	3.2	4.1	7.0
Return on capital (%)	2.2	4.4	(2.3)	(8.1)	2.8	2.8
FFO/debt (%)	17.3	15.0	118.2	66.6	23.4	28.8
Debt/EBITDA (x)	4.4	5.0	0.9	1.0	3.8	3.3
Debt/debt and equity (%)	31.6	39.2	2.8	8.6	40.1	43.4

\*Fully adjusted. N.R.—Not rated.

Table 3

**Reconciliation Of Connacher Oil and Gas Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts\***

—Fiscal year ended Dec. 31, 2006—

<i>Connacher Oil and Gas Ltd. reported amounts (mil. C\$)</i>	<i>Debt</i>	<i>Shareholders' equity</i>	<i>Operating income (before D&amp;A)</i>	<i>Operating income (before D&amp;A)</i>	<i>Operating income (after D&amp;A)</i>	<i>Interest expense</i>	<i>Cash flow from operations</i>	<i>Cash flow from operations</i>	<i>Capital expenditures</i>
Reported	229.3	385.4	41.0	41.0	8.1	5.1	30.9	30.9	175.0
<b>Standard &amp; Poor's adjustments</b>									
Operating leases	14.6	—	1.1	0.5	0.5	0.5	0.6	0.6	13.3
Postretirement benefit obligations	N/A	(0.3)	0.0	0.0	0.0	0.0	(0.2)	(0.2)	N/A
Share-based compensation expense	N/A	N/A	N/A	7.8	N/A	N/A	N/A	N/A	N/A
Asset retirement obligations	4.8	N/A	0.3	0.3	0.3	0.3	(3.1)	(3.1)	N/A
Reclassification of nonoperating income (expenses)	N/A	N/A	N/A	N/A	7.8	N/A	N/A	N/A	N/A
Reclassification of working-capital cash flow changes	N/A	N/A	N/A	N/A	N/A	N/A	N/A	9.3	N/A
Total adjustments	19.3	(0.3)	1.5	8.7	8.7	0.9	(2.8)	6.4	13.3
<b>Standard &amp; Poor's adjusted amounts</b>	<b>Debt</b>	<b>Equity</b>	<b>Operating income (before D&amp;A)</b>	<b>EBITDA</b>	<b>EBIT</b>	<b>Interest expense</b>	<b>Cash flow from operations</b>	<b>Funds from operations</b>	<b>Capital expenditures</b>
Adjusted	248.6	385.1	42.5	49.7	16.8	6.0	28.1	37.4	188.3

\*Connacher Oil and Gas Ltd. reported amounts shown are taken from the company's financial statements but might include adjustments made by data providers or reclassifications made by Standard & Poor's analysts. Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts. N.A.—Not applicable.

**Ratings Detail (As Of 14-Dec-2007)\***

**Connacher Oil and Gas Ltd**

Corporate Credit Rating	BB-/Stable/—
Senior Secured	
<i>Foreign Currency</i>	BB

**Corporate Credit Ratings History**

08-Nov-2007	BB-/Stable/—
06-Sep-2006	B+/Stable/—

<b>Business Risk Profile</b>	Satisfactory
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<b>Financial Risk Profile</b>	Aggressive
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\*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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