

# Credit Analysis

# Moody's Global Corporate Finance

September 2008

## Veolia Environnement

Paris, France

### Corporate Profile

#### A Global Leader In The Provision Of Outsourced Services To The Urban Environment

Headquartered in Paris, France, Veolia Environnement SA ("Veolia/the company/the group", rated A3/Prime-2, stable outlook) is a leading global provider of environmental management services. The company, which was initially listed in Paris in July 2000, had a market capitalisation of about EUR15 billion at September 2008.

Veolia operates in more than 65 countries and provides water and wastewater services to more than 130 million people, treating nearly 66 million tons of waste, supplying energy to roughly one hundred thousand buildings and transporting approximately 2.7 billion passengers per year. The Group's business model involves thousands of contracts and concessions for outsourced services and often requires the establishment of separate legal entities to contract with customers. The result is a complex, decentralised, group structure, comprising more than 2,500 operating companies, although it operates essentially through four divisions, grouped around intermediary holding companies (see Appendix 1):

- Veolia Water (*Eau*), which is the largest and most profitable, provides drinking water and waste water services including desalination, and re-use of treated water. Through its subsidiary Water Solutions and Technologies, the Group also designs and builds the facilities needed to provide these services.
- Veolia Environmental Services (*Propreté*), the waste division, is the world's largest provider of waste collection, recycling and treatment services, managing liquid and solid, hazardous and non-hazardous waste from collection through to energy recovery.

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This Credit Analysis provides an in-depth discussion of credit rating(s) for Veolia Environnement and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website. [Click here to link.](#)



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- Veolia Energy (*Services Energétiques*), which is Europe's leading provider of energy services to companies and municipalities, provides services ranging from heating and cooling networks to the installation and maintenance of production equipment and to street lighting.
- Veolia Transportation (*Transport*), the smallest of the four divisions, operates road and rail transportation networks under contracts with public authorities. It delivers a range of services including urban mass, and intercity and regional, transportation.

The divisions are linked by a common customer base, mainly public authorities (roughly 67% of turnover) and industrial customers (33%), which provides scope for revenue and cost synergies. The chart below illustrates how Water and Environmental Services, which cumulatively accounted for almost 61% of revenues and 77% of recurring operating net income in the first six months of 2008, are the Group's most profitable segments. Roughly balanced in terms of revenue generation, the two larger divisions' stronger margins reflect their scale and leadership position worldwide, as well as their expertise in providing complex services and efficiently managing costs.

### Divisional Analysis: Revenue & Profitability

Division	Turnover 1H 07 €MN	Turnover 1H 08 €MN	2008 Share %	Change YoY %	Recurring Op Inc 1H 07 €MN	Recurring Op Inc 1H 08 €MN	Margin 1H 07 %	Margin 1H 08 %
Water	5,221	5,988	33.1%	16.6%	574	597	11.0%	10.0%
Waste	4,196	5,085	28.1%	26.7%	389	405	9.3%	8.0%
Energy Services	3,321	4,049	22.4%	21.9%	251	290	7.6%	7.2%
Transportation	2,724	2,970	16.4%	11.2%	48	63	1.8%	2.1%
Holding	-	-	-	-	-26	-55	-	-
<b>Total</b>	<b>15,462</b>	<b>18,092</b>		<b>19.5%</b>	<b>1,236</b>	<b>1,300</b>	<b>8.0%</b>	<b>7.2%</b>

## Management Strategy

Since its IPO in 2000, Veolia has pursued a consistent strategy mainly focused on the organic expansion of outsourced services to the urban environment within the company's four areas of expertise. Expansion of demand for such services in municipal markets is a function both of demographic factors, and economic activity and improving living standards. The Group's business model is based on the continuing and increasing trend towards outsourcing by public authorities and industrials against a background of increasing regulatory and environmental burdens.

### Renewed Emphasis On Profitability

More recently, in August 2008, against the background of the strengthening Euro, higher commodity prices and some underperformance versus expectations for certain recent investments, Veolia flagged its intent to prioritise a recovery in ROCE after tax to more than 10% by the end of 2010, from an expected 9%-9.5% in 2008. To that end, and in addition to continuing its efforts to grow turnover, Veolia signalled a number of measures including:

- a cost reduction plan targeting €400 million in savings over 2009 -2010, with a full contribution from 2011;
- the disposal of underperforming assets, with €1.5 billion disposals by end-2009, of which €1 billion to be achieved or committed in 2008; and
- moderated investment plan reflecting a tightening of control over capital expenditure.

### Growth Continues To Be Driven By Investment .....

Although the Group has moderated certain of its shorter-term targets, it has maintained its 10% per annum medium term revenue growth target, including turnover growth in excess of 12% in 2008. This will continue to be a function both of organic growth, through contract wins, the renewal/extension of contracts and new projects, supplemented by acquisitions. In the first half of 2008, example, 11.1% of turnover growth of 19.5%

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(at constant exchange rates) was generated internally, with the balance reflecting the impact of first time consolidation of recent acquisitions. During 2007, the Group invested over € 4.0 billion in new projects or acquisitions (and €6.9 billion in total), most of which in the Waste segment. The largest of these was the German waste management group Sulo, acquired at a total enterprise value of €1,450 million. More recently, in February 2008, it completed its €190 million purchase of Bartin recycling, the third largest metals recycling operator in France.

The A3 rating reflects that in the context of its recently stated profitability objective, Veolia has indicated a heightened selectivity of investments, with expenditure in the range of €5 billion and €4.5 billion expected for 2008 and 2009 respectively (versus the €6.9 billion in 2007). Aggregate maintenance and growth expenditure for the period 2007-2009 is likely therefore to come in between €16 to €17 billion, towards the lower end of the earlier targeted €15 to € 20 billion range. Moody's anticipates that to the extent further inorganic investment is made, this is likely to continue to be for the most part in the areas of Waste or Energy Services, where greater fragmentation promotes more opportunities.

### ...And Geographical Diversification

Veolia continues to generate solid growth in its established markets, including France where turnover rose by 6.4% in 2007, through a combination of renewals, changes in contract scope and investment in new projects and acquisitions. It has also for some time pursued a strategy to tap into the faster growth achievable in developing countries where demographic changes, urbanisation and economic development have accelerated significantly, such as in China. The Group has been successful at winning share in these faster growing developing markets in Asia-Pacific (where turnover grew at 35% in 2007), the Middle East and Africa (+41%) and Eastern Europe (+18%). Although Asia Pacific's and the Rest of the World's share of revenue remained relatively low at 12% in 2007, this is likely to rise as Veolia builds on its current position. While these fast growing regions provide valuable opportunities, Moody's cautions that prudent management of rising exposure to potentially less stable regulatory regimes and economies is likely to require close attention.

### Common Business Model Across Activities Promotes Synergies

Although they vary widely in scale, Veolia uses a common business model across its four divisions, based on establishing enduring relationships with public authorities or industrials for the provision of essential utility or utility-type services under long term contracts. Essentially a provider and manager of networks, Veolia is able to apply in each of its businesses a similar approach which promotes cost synergies and gives it the opportunity to cross-sell services across its customer base. The company estimates that approximately one third of its industrial contracts are multi-divisional.

## Key Rating Considerations

### Business Risk Factors

Veolia's A3 rating factors in a relatively low business risk profile, which is underpinned by its emphasis on long term contracts with creditworthy counterparties in a number of stable, cash generative business segments, particularly water and waste, and by the prudent management of its contractual risks.

### Large Portfolio Of Long Term Contracts Provides Predictable Cashflows ...

Veolia's business model is based on building long-term relationships with and providing essential services to its customers. This creates a strong base of recurring revenues, generated from its portfolio of thousands of contracts (its Water business worldwide comprises some 4,400 agreements) gives a high degree of visibility around future income streams. Given the breadth of the Group's business activities, contract structures vary, although Moody's notes that those involving a commitment of capital by Veolia tend to be of longer duration – including those where, as part of the agreement, it is either building, renewing or improving the standards of the assets operated. By and large, agreements with municipalities tend to be longer than those with private sector entities.

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Veolia's contracts can therefore run for up to 30 or occasionally even 50 years, as for example in China where Veolia is establishing several water and wastewater treatment systems, which it is first designing and constructing, before then operating. In the French water sector, where Veolia replaces and upgrades equipment, contracts are typically 12 years. By contrast, waste collection contracts (typically 1 to 5 years), transport management contracts (2 to 12 years) and energy services to industrials (6 to 7 years) tend to be shorter.

Broadly, long term contracts where capital is required provide greater cashflow certainty, although with a potentially lower return on capital employed in the early years of the contract. Veolia's current approach, which combines a mix of contracts, therefore aims to balance cashflow certainty and returns on capital employed.

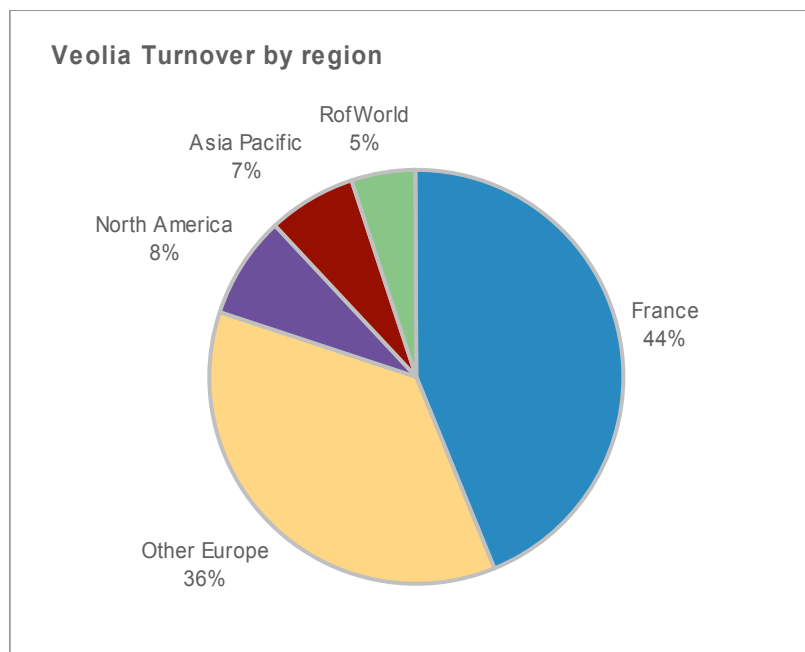
### ... Supported By Good Contract Retention Rates

Veolia's contract driven business model relies on its ability to renew contracts at the end of their term, which is in turn dependent on its performance during the contract, its relationship with the customer and the price offered at renewal. Moody's notes that Veolia has a good record of renewing its contracts at expiry achieving, for example, a renewal rate of 95% in the local authority water sector in France, as well as at Veolia Energy – and this has been reflected also in its consistent track record of organic revenue growth. In this respect, Moody's notes that the critical nature of the services provided by Veolia can help promote contract continuity because of concern by the outsourcing entity at the potential for interruption.

In Moody's view average contract term is also an important rating factor given Veolia's focus on contracts and relatively low proportion of "owned" assets. A material reduction in average contract duration or average debt maturity that exceeds the average contract term could indicate a decline in credit quality. To date, Veolia has managed to balance longer dated, capital oriented contracts with shorter term operating contracts, and broadly maintain the average contract term.

### Developed Markets Continue To Generate Majority Of Revenues

Veolia's A3 rating takes account that about 95% of its revenues are generated in countries with ratings of A3 or above, reflecting relatively stable political, legal and economic profiles. The chart below illustrates how France alone accounted for approximately 44% of turnover in 2007, with the rest of Europe, including the fast growing Eastern European market, accounting for a further 36%. The rating also factors in that while the importance of operations in the Middle East, Africa and Asia, (where like-for-like turnover growth in 2007 was over 25%) will continue to increase, these are unlikely in Moody's view to alter materially the balance of revenues or cashflow from its more mature, stronger, markets in the short/medium term.



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### Veolia Is A Leading Player In Many Of Its Principal Markets

Although competitive pressure is often more regional and local, the Group's scale and reach mean that its business position is underpinned by leading shares in many of the markets in which it operates:

- Veolia Water is the world's leading water and waste water company, operating in 60 countries and providing services to 130 million people. The company is especially strong in France, where it holds approximately 50% of the water and 40% of the waste water markets, ahead of its competitors Suez Environnement and Saur.
- The Group ranks as the world's second largest waste company, with Veolia Environmental Services providing an integrated environmental service, treating approximately 66 million tonnes of waste per annum, with nearly 60 million customers in 35 countries in waste collection services.
- Veolia has a leading position in the European energy services sector through the 66% owned Veolia Energy<sup>2</sup>, the market leader in the UK, France and Central Europe. With operations in 35 countries, the division manages the energy requirements of more than 100,000 facilities. With regard to competition, the only two players with international presence are Elyo and Cofathec, part of Suez Environnement.
- Veolia is also a major private operator of public transport systems with activities in 30 countries through Veolia Transport, which carried approximately 2.7 billion passengers in 2007.

### Creditworthy Counterparties Reduce Financial Exposures

A strength of Veolia's business from a credit perspective is that its medium and long term contracts are largely with various public or quasi-public authorities (such as municipalities, cities, urban transport authorities) and industrial and non-industrial customers. Across the group, approximately 67% of Veolia's revenue is generated from contracts with public authorities, and 33% is derived from industrial and commercial customers. Such counterparties typically have relatively low credit risk, and in Veolia's developed markets, can be backed by the tax base of a Aaa rated government credit.

### Contracts Structured To Minimise Risks

Moody's believes that over time, Veolia has developed strong contractual frameworks that enable it to effectively allocate the risks of a contract, and thereby minimise its exposure to those risks (which it can manage using its operational and technical skills). Although the company does carry some project risk exposures, for example the volume of waste deliveries on some contracts, transportation numbers and BOO project power price risks, Moody's believes these to be relatively small in the context of the group as a whole.

Veolia is also exposed to some residual contract risks through its 66% stake in Dalkia Holdings, which it jointly owns with Electricite de France ("EDF", rated Aa1/stable outlook). However, since a decision in 2000 not to be involved in primary energy production, Dalkia's focus has been on energy services, maintenance, installation, and the optimisation of energy infrastructure management and price risks for third parties. Dalkia's own price risk exposures are therefore limited, even if they include some timing differences. Veolia's waste-to-energy plants are covered by French combined heat and power legislation under which EDF is obliged to purchase all the electricity produced at a fixed price, and are therefore not subject to wholesale price risk. Overall, Moody's views the Dalkia alliance with EDF as positive, bringing together, as it does, complementary skills and customers.

### Rate Of Growth Will Be Impacted By Progress Of Outsourcing Trend

Veolia's longer-term growth outlook will be impacted by the extent to which the trend to outsourcing seen in certain European and Asian countries continues. Demand for outsourced services is usually driven by increases in population and economic development, but can also result from particular local circumstances – such as the move towards outsourcing the upstream water operations in Australia following years of drought. Outsourcing has strengthened over the past few years in Eastern Europe, Asia and Middle East in particular, with favourable development prospects in countries such as Australia, Spain, Japan China and the US. On certain estimates just 10% of the water market, and less than 20% of the waste and energy services markets

<sup>2</sup> The remaining 34% is owned by Electricite de France.

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have moved to the outsourced model, underscoring the potential for further growth in the longer-term. Moody's cautions however, that certain segments have shown little sign hitherto of embracing the outsourced model including, for example, the provision of water services which remain 90% controlled by local authorities in both Italy and Germany.

### Changing Regulation Implies Both Risk And Opportunity

Today, most businesses face changing standards and regulations, but few more than in waste and the provision of services to the public. Whilst Moody's believes that Veolia has adequately structured its contracts, maintains systems to control standards, and undertakes risk assessments, changing regulations or events could nevertheless pose risks. That said, tighter regulation of the waste sector appears more likely to create opportunities for Veolia as complexity increases and barriers to entry rise. In the case of carbon emissions, the impact is felt by the customer, which Veolia's role is to manage, potentially through additional maintenance or upgrades to facilities,

### Financial Risk Factors

#### Core Operating Businesses Deliver Stable Cashflows

Veolia's financial risk profile is underpinned by the cashflows generated by its operating businesses. These cashflows are highly stable and predictable, accruing, as they do, from multi-year contracts involving essential and critical services with low credit risk counterparties. The company's portfolio of thousands of contracts across its four divisions and the diversity of such by sector and by geographic spread, reduces the volatility of its cashflows, as does its record of contract retentions and the average remaining life of these contracts.

#### Leverage Has Stabilised In Recent Years...

Veolia's 2007 balance sheet net debt (after deducting cash and marketable securities and before Moody's adjustments) was approximately EUR15.1billion - a slight increase over 2006, reflecting the €4 billion spend allocated to new projects and acquisitions in 2007, as part of the company's investment programme, partially offset by FFO (as defined by Moody's, see below) of €3.7 billion and the €2.6 billion capital increase finalised in July 2007.

### Financial Ratio Analysis

Eur Million	2007	2006
Gross Financial Debt	18,212.4	17,361.7
Fair Value on hedging instruments	27.7	-28.8
Cash & Marketable Securities	-3,115.5	-2,724.4
<b>Net Debt as reported</b>	<b>15,124.6</b>	<b>14,608.5</b>
Operating Leases	2,970.0	2,976.6
Pensions	490.7	615.2
Debt guarantees	355.6	300.7
<b>Net Debt as adjusted by Moody's</b>	<b>18,940.9</b>	<b>18,501.0</b>
Gross Cash Flow before WC changes as reported	3,101.0	2,918.8
Reversal of Working Capital movement related to interest and taxes	-99.7	-92.5
Pension contributions in excess of service cost added back	13.1	6.4
Two-Thirds of operating lease expenses	330.0	330.7
Principal repayments on operating financial assets	360.7	438.1
<b>Funds from Operations (FFO) as adjusted by Moody's</b>	<b>3,705.1</b>	<b>3,601.5</b>

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## Financial Ratio Analysis

Eur Million	2007	2006
Dividends	-564.3	-479.2
Retained Cash Flow (RCF) as adjusted by Moody's	3,140.8	3,122.3
FFO/Net Adjusted Debt	19.6%	19.5%
RCF/Net Adjusted Debt	16.6%	16.9%

## ... But Is Likely To Rise On The Back Of Further Investment

Net debt increased during 1H2008 to €16.3 billion, and is likely to rise further on the back of aggregate planned capital expenditure of €9.5 billion over 2008-2009, and pressured operating margins. This should enable Veolia to manage its capital structure towards its committed Debt Ratio Target<sup>3</sup> of between 3.5x-4.0x, over the period 2007-2009, from the 3.3x reported at December 2007, and 3.4x at June 2008

With regard to dividend policy, Veolia has committed to a payout range of between 50% and 60% of recurring net income over the medium term and an increase by at least 10% per annum. Whilst the implementation of its investment programme and dividend payments are expected to result in an increase in leverage, on the basis of current operating assumptions Moody's anticipates that Veolia's credit ratios should remain in line with guidance for its A3 rating (ie RCF/Net Debt of between 14% and 18%) during the period 2007-2009. Moody's cautions however, that although planned investment spending includes small and medium sized acquisitions, potential larger acquisitions are not included and are not therefore factored into the A3 rating.

## Operating Margin Negatively Impacted By Growth And Macro Factors

The Group's recurring operating margin has come under pressure in recent periods from a number of sources. Having declined from 7.8% in 2006 to 7.6% in 2007, the outlook is for a further decline in 2008 given the 7.2% reported during 1H2008, down from 8% in 1H2007. The table on page 1 shows how the three larger divisions each experienced margin weakness, even if turnover growth was strong. This has in part reflected the dilutive impact of certain recent acquisitions in the Waste division (including higher goodwill amortisation), and the rising contribution of lower margin and less capital intensive engineering works businesses in the Water division. However, it also reflects certain negative macro trends including:

- rising fuel costs, which despite the company's contractual ability to recover a portion thereof, nevertheless negatively impacted operating income by roughly €36 million (€21 million and €15 million in the Transportation and Waste divisions respectively) during 1H2008
- US\$ and sterling weakness against the Euro, which contributed to a net negative impact on operating income (mainly felt in the Waste division) of roughly €30 million during 1H2008

The outlook is for operating margins to remain under pressure in the shorter-term, from higher energy prices and the strength of the Euro, although they should be underpinned from 2010 onwards, supported by the recently announced initiatives to restore ROCE to more than 10%. In that context, Veolia's June 2008 guidance was that even if its medium-term growth and performance commitments remain unchanged:

- operating cashflows (at current exchange rates) in 2008 are expected to increase by around 6% compared to 2007 (vs. a previous expectation in the double digit range). and that
- the targeted 10% increase in net income is unlikely to be reached

## Liquidity Remains Strong

With €2.8 billion in cash, cash equivalents and marketable securities as at June 2008, Veolia's liquidity profile is solid. The company has access to a €4 billion syndicated facility maturing in 2012, which is currently undrawn, and to bilateral facilities of over €1 billion. These facilities contain no triggers, covenants, MAC or

<sup>3</sup> Defined as net financial debt/cash flow from operations + repayment of operating financial assets.

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general restriction. Veolia also has a €4 billion Commercial Paper Programme in place, of which €285 million was outstanding as at June 2008. The group accesses the CP market on a daily basis and aims to cover a high proportion of its short term debt, including CP outstanding at any given time, by its undrawn committed bank lines and cash. Peak CP usage is not expected to exceed €2 billion at any point during the next 12 months. The company also has a €12 billion Euro Medium Term Programme in place, of which €9.1 billion was outstanding as at June 2008.

The Group has a well spread debt maturity schedule, with €1 billion maturing before 2010, with an average debt maturity of 9.6 years from June 2008.

### Debt At Subsidiaries Contained by Centralised Funding Policy

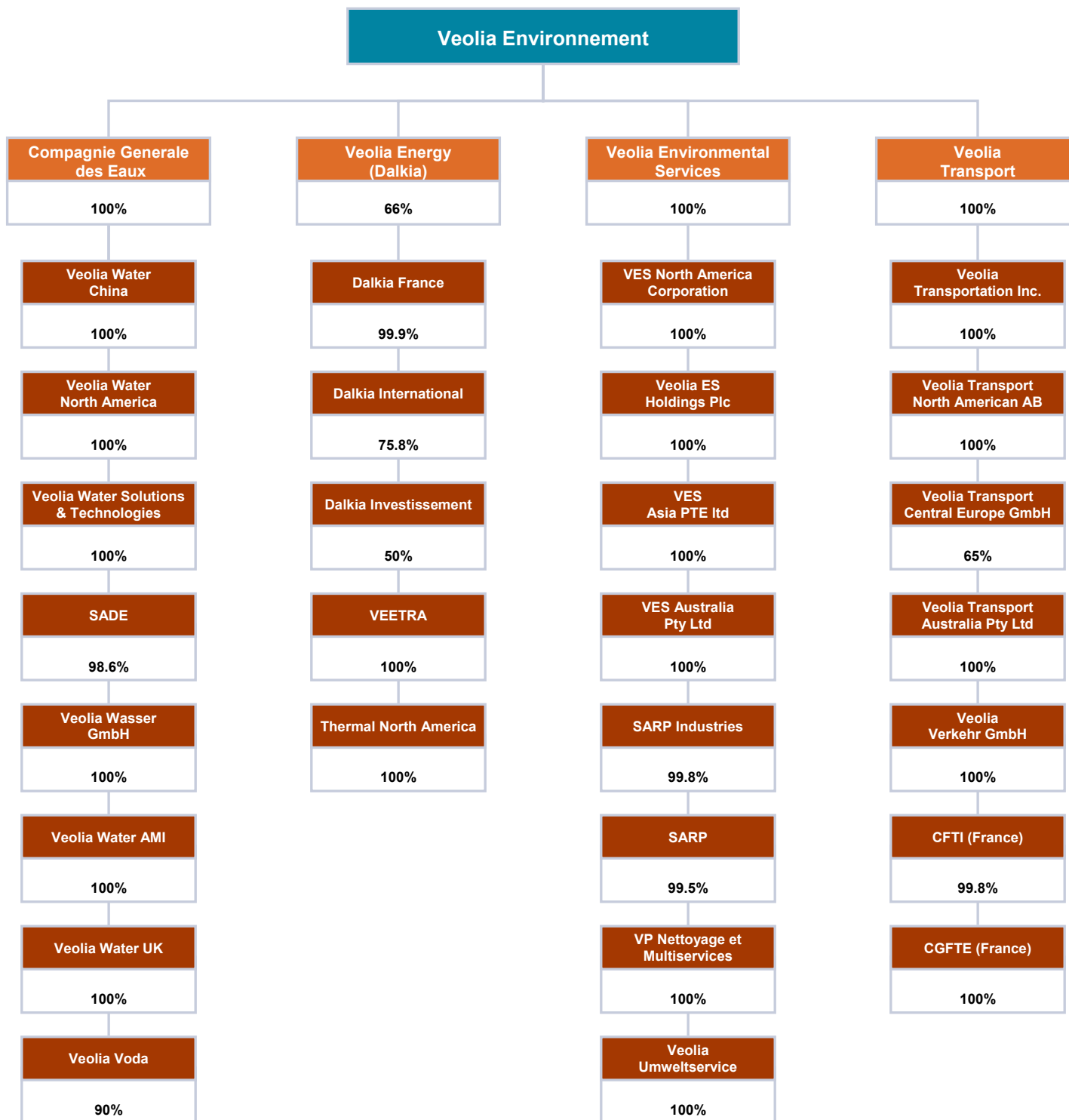
Because Veolia's business model often requires the establishment of separate legal entities to contract with customers, the result is a very complex group structure comprising more than 2,500 operating companies. However, as far as funding arrangements are concerned, Veolia adopts a policy of concentrating external debt at the holding company level - other than Project Finance debt and debt at proportionately consolidated entities - and funding the four principal business divisions via intercompany loans.

As at 31 December 2007, total gross external group debt amounted to EUR18.2 billion, of which approximately 26% (EUR4.7 billion) was Project Finance debt and debt located at proportionately consolidated entities; all of which is non-recourse to the group. Of total gross external group debt with recourse to the group, approximately 20% (EUR2.7 billion) was held at subsidiaries, and the balance of 80% (EUR10.8 billion) was located at the parent. Moody's notes that Veolia is committed to reducing external financial liabilities at the subsidiary level in a timely manner, and does not consider that the current level of pure subsidiary debt is sufficient to warrant notching for structural subordination.

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## Appendix

## Veolia Illustrative Corporate Structure



Note: Some of the companies shown are indirectly owned by Veolia

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**Moody's Related Research****Rating Methodologies**

- Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations – Part II, February 2006 (96729)
- European Regulated Utility Groups; Methodology Update – January 2007 (101671)

**Special Comments**

- Corporates in EMEA: 2007 Review & 2008 Outlook, January 2008 (106716)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*

## Veolia Environnement

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