

## Public Finance Ratings



## Research: Transport for London

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### ISSUER CREDIT RATING

Issuer Credit Rating AA/Stable/--

### Issuer credit rating history:

June 5, 2000 AA

### ■ Rationale

The rating on Transport for London (TfL) reflects its strong links with the U.K. government, both through the provision of funding via transport grants and central oversight by the U.K. local authority framework, and strong fare-generating capacity. TfL, an executive body of the Greater London Authority (GLA; AA+/Stable/--), is responsible for certain public transport functions in London, including bus services. TfL benefits from a grant settlement, as set out in the 2002 government Spending Review, which provides grant-funding certainty to 2004-2005, with indicative funding for 2005-2006. The next Spending Review in 2004 will determine the settlement for 2005-2006 for the next two years, with indicative funding for 2007-2008. TfL also benefits from strong fare-generation capacity based on its exclusive provision of a large share of essential public transport services in London.

These strengths are offset by the challenges of managing cost pressures, particularly following the transfer of London Underground Ltd. (LUL), and the associated public-private partnership (PPP) contracts, to TfL. Additionally, TfL is liable for 95% of the £5 billion (\$9 billion) debt of the underground PPPs if a put option is exercised in the event of project default. This risk is reflected in the rating on TfL. The Department of Transport has strong incentives to step in to pay this obligation, which is treated as a contingent liability of the U.K. government and is supported by a letter of comfort. This support, however, is not legally binding and may not be timely. TfL also faces uncertainties regarding the future level of government grant needed to meet its ambitious

capital program, which is designed to improve London's wider transport infrastructure and meet the needs of a growing city. These uncertainties are reflected in the existence of a future funding gap.

TfL was established in July 2000, and since then has had a number of successes. These include the impact of the congestion charge on London's traffic levels and the growth in bus ridership, which have helped the government meet some of its environmental targets. There has also been progress in the integration of LUL and the relationship with the PPP contractors. Furthermore, TfL's experienced senior management is now starting to see the benefits of its implementation of new systems of management and financial control. The rating on TfL has always reflected the opinion of Standard & Poor's Ratings Services that LUL and its PPP-associated obligations would transfer to TfL. There was therefore no rating action taken at the time of LUL's transfer to TfL.

TfL's budgetary performance, which includes LUL for the year to March 2004, is forecast to result in some surplus, primarily due to delays to the finalization of the Underground PPPs. In TfL's business plan, a funding gap of close to £1 billion per year, beginning in 2005-2006, has been identified. The majority of this gap, however, arises from what TfL has calculated it needs to deliver improvements in London's transport systems, and what the government has indicated it may provide. Standard & Poor's recognizes that there are wider funding pressures on the Department of Transport's budget, and some of the projects TfL has identified to improve London's transport network may have to be reprogrammed.

TfL must by law produce a balanced annual budget, and will consider a range of options to meet any funding shortfalls, including direct borrowing, which may be permitted under the government's Prudential Borrowing Code for local governments. Standard & Poor's will examine TfL's potential borrowing capacity based on specific proposals. Such borrowings will be considered against TfL's overall projected financial position and funding support, and its ability to demonstrate a level of future financial flexibility.

## ■ Outlook

The stable outlook reflects the progress made regarding the transfer of LUL and the improved political relationship between the Mayor of London and TfL and the government. A clearer funding framework has also been agreed regarding adjustments to the transport grant for unforeseen events. The establishment of a reserve is a further source of credit stability. Government transport spending is under growing pressure owing to wider transport issues. Standard & Poor's expects TfL to work within the resources it receives from government and its own-source income. Furthermore, there is a certain level of flexibility for TfL to delay or cut back some of the areas of expenditure to improve London's transport infrastructure it has identified.

## ■ Background

TfL is an executive body of the GLA, responsible for providing an integrated transport service in London covering the London Underground metro system, buses, taxis, and strategic trunk roads. Although TfL is an executive arm of the GLA, it is constituted as a separate local authority body. TfL has a different credit risk profile from the GLA. The strategic goals of TfL and GLA should be closely aligned because the Mayor of London is also Chairman of TfL. The Mayor also appoints the Transport Commissioner for London, who heads the executive management team. The Mayor and TfL work very closely together, but TfL's interests may not always necessarily coincide with those of the Mayor or the GLA.

TfL is subject to the support and constraints of the U.K. local government financing system, which translate into a variety of financial and regulatory controls that are significant credit strengths. These include the requirement to provide a balanced budget, restrictions on the amount of debt that can be raised, and the requirement for external audits. Government funding is agreed on a three-year spending cycle, and funds are provided to TfL on an annual basis.

TfL is constituted as a local authority and has direct responsibility for the London Underground metro system, buses, highways and roads, taxi licensing, and congestion charging. The income-generating operations (the Underground and Docklands Light Railway, buses, river services, and congestion charging) are set up as separate subsidiaries under a holding company, Transport Trading Ltd. (TTL). For tax purposes, TTL and its subsidiaries are incorporated under the Companies Act. Although TTL and its subsidiaries are separately constituted from TfL, they are subsidized by and centrally managed and controlled by TfL.

The PPP solution for the Underground split infrastructure (trains, tracks, stations, and signaling) maintenance and renewals from train, signal, and station operations. Three separate private project companies, two of which are under a concession to Metronet and the third to Tubelines (see "Transfer of London Underground") are responsible for upgrading and maintaining discrete areas of track, trains, and signaling for a 30-year period.

About one-third of staff previously employed by LUL have transferred to the private project companies. Train, signal, and station operations have remained with LUL, and therefore now come under TfL.

## ■ Business Position

TfL has a strong business position, but there is a need for increased investment. This investment is needed to bring assets up to a good state of repair, improve services, and make them safer and more environmentally friendly.

TfL benefits from very strong demand for its services and the Mayor and TfL have flexibility to increase TfL's income through the farebox, congestion charging fees, and TfL's share of the precept. Increasing fares significantly, however, is likely to deter people from switching to public transport from private cars. There is a wider public policy agenda, supported by the Mayor and the government, which seeks to reduce congestion and car pollution and encourage more people onto public transport. Any increases in congestion charging fees or the precept would be relatively small.

Given the limitations of using the farebox to find the finance needed for investment, TfL is negotiating with the government to agree appropriate grants for the necessary investment. The improvement of transport in London is not only of political benefit to the Mayor--the U.K. government has a very strong interest in seeing transport improvements in London because the city is a major net contributor to the U.K. economy and a failure in its transport infrastructure is one of the major factors that would inhibit its future growth.

The London Plan, a key part of the Mayor's role, and which has been the subject of wide consultation, sets out the spatial development strategy for London. The Transport Strategy is an integral part of the Plan, and is designed to improve accessibility across London, including to new development areas.

## ■ Transfer of London Underground

LUL was transferred to TfL in July 2003. The transfer was delayed, owing to delays in the finalization of the PPP contracts, disagreements between the Mayor and the government regarding future funding arrangements, and the Mayor's threat of legal action against the PPP process. These issues were addressed before the transfer, and on transfer TfL inherited the PPP contracts previously agreed between LUL and the PPP infrastructure companies, Infraco JNP (bank loan BBB+/Stable), Metronet Rail SSL Finance PLC (bank loan BBB+/Stable; senior secured debt AAA, BBB+(SPUR)/Stable), and Metronet Rail BCV Finance PLC (bank loan BBB+/Stable; senior secured debt AAA, BBB+(SPUR)/Stable).

Relationships with the PPP contractors are businesslike, and TfL and LUL managers are working to help ensure that the PPP objectives are delivered. Furthermore, TfL is working with Infraco JNP on that PPP's proposed refinancing. TfL is supporting the refinancing. Its risk profile will not materially change as a result, and it will share in the financial benefit.

A significant amount of work was done before the transfer to assist with the process of integration. This work included the introduction of IT systems and a review of business processes.

Under the terms of the PPP contracts, in the event of default TfL guarantees 95% of the outstanding debt associated with the PPPs. In the event that TfL is obliged to honor its guarantee, it would seek a special grant from the government. The government has provided a letter of comfort, but not a guarantee, in support of TfL's obligations. Standard & Poor's considers that it would be untenable for government to allow TfL to fail to meet its obligations under the guarantee and risk the consequent disruption to London's transport system and economy. Standard & Poor's also expects TfL to keep the government fully informed of developments that may lead to a need for additional government support.

A key concern for TfL is that the PPPs associated with LUL tie it to a long-term funding commitment that is not matched by a similar long-term funding commitment from government. This situation reflects the government's Spending Review cycle, which does not allow for 30-year funding commitments.

LUL is in the process of being reorganized under a new Underground Managing Director, Tim O'Toole. Mike Brown was also appointed as Chief Operating Officer to restore line-focused management structures, with the objective of improving employee identity and service quality on individual underground railway lines. LUL is also seeking to improve efficiency and further identify risks and uncertainties to ensure it plans effectively for the future. Over the past three years, LUL has introduced corporate risk management analysis into its business

processes. This provides it with more detailed information and a longer-term perspective on risk and funding needs.

In February 2003, TfL and the Mayor made considerable progress toward the agreement with the Secretary of State for Transport of protocols for funding LUL (see "Transport For London Outlook Revised to Stable; 'AA' Long-Term Rating Affirmed", published on March 12, 2003, on RatingsDirect, Standard & Poor's Web-based credit analysis system). The secretary of state has agreed to consider unforeseen spending pressures between Spending Reviews and has supported the buildup of a £170 million reserve. Furthermore, at each Spending Review the secretary of state will consider changes to LUL's forecast revenue and expenditure, changes associated with payments to PPP contractors, and funding of any pension obligation shortfalls.

These protocols should ensure that the risks and uncertainties associated with LUL do not unduly burden TfL. The protocols should also enhance LUL's future credit stability, a prospect welcomed by Standard & Poor's. Despite pressure on government spending, Standard & Poor's expects the Department of Transport to act in support of LUL and TfL in the event of unforeseen expenditure pressures.

Day-to-day management of the PPP contracts is split between LUL and the PPP infrastructure companies, and the management of the PPPs to date has been relatively smooth given the complexity of the contracts. It is expected that, as the relationship between LUL and the PPP contractors develops, information flows between all parties will improve further.

TfL has also inherited private finance initiative (PFI) schemes previously agreed by LUL. The ticketing project (Prestige) has progressed well and the rollout of the Oystercard has been successful. The communications project, Connect, however, has overspent, and claims of about £100 million against LUL are in dispute. TfL admits that the original contract agreed by LUL did not provide sufficient protection. A reserve provision of £130 million is anticipated to be funded to cover future claims by the end of this fiscal year, with a final amount of £170 million to be funded by 2006-2007.

In order to meet the needs of PPP line upgrades, LUL needs to improve power supply. It is in the process of developing the scope of the project and expects to revise its power PFI contract in 2005. Total costs could be more than £1 billion, but will be much smaller over the business planning period.

TfL and LUL do not intend to change the strategy of using PFI as a method of procurement. They do recognize, however, that an ever-growing number of contractual relationships across a complex business can be difficult to manage. The use of PFI and PPP, from a credit perspective, also reduces an organization's level of financial flexibility because a proportion of its revenue is essentially set aside for contractual payments. There remains a risk for unforeseen costs outside the scope of existing PPPs/PFIs, where the PPP/PFI operator may seek recourse to TfL/LUL. In the absence of significant borrowing powers, however, PFI is likely to continue to be an important way of funding projects. Standard & Poor's will continue to monitor the development of new PFI contracts and how they interact with existing contractual arrangements.

LUL suffered some financial setbacks in 2003 owing to the closure of the Central Line for several months for health and safety reasons. The closure followed the derailment at Chancery Lane station on Jan. 25, 2003. A review of the full cost of the closure is still in progress, but part of the loss of income was made up by an increase in patronage and revenue on London buses as a result of commuters switching transport mode. From a TfL group perspective, therefore, the net impact of the closure was not as bad as it could have been. Further derailments, at Camden and Hammersmith, later in 2003 are also under investigation. None of these safety incidents have been attributed to failures in the structure of the PPP contracts.

The Underground network continues to suffer from the threat of industrial action. The Underground workforce is highly unionized and strikes cause significant disruption to London's transport system. Standard & Poor's will continue to monitor the impact of any industrial action on revenue and expenditure.

## ■ Congestion Charging

The London Congestion Charge was launched in February 2003. In terms of environmental benefit, the charge has been a success. Congestion in central London has been reduced by 32%, helping the U.K. government meet its congestion reduction targets. The amount of revenue received, however, has been below budget. This is because traffic flows have been lower than forecast, and because there have been technical and administrative problems with the issuing of penalty charge notices. TfL has had to renegotiate the outsourcing contract on less favorable terms to itself. TfL is seeking a new partner to take on the enforcement of penalty charge notices in 2004. The shortfall in forecast revenue associated with the congestion charge has been

accommodated within TfL's wider budget through the reprogramming of other projects.

There are proposals to extend the zone west to include parts of Kensington and Chelsea and Westminster by 2006. Any additional net income generated by this proposal will benefit TfL's financial flexibility. Factors such as the impact on local businesses of the extension of the charge will have to be considered, however.

## ■ Revenue Sources

TfL has strong fare-raising ability and a transport grant settlement confirmed in the 2002 Spending Review. A significant proportion of income comes from fare revenue. The Mayor has the flexibility to increase fares, which is a credit strength for TfL. Demand for public transport services in London is strong and is unlikely to change significantly, although it has shown potential to decline in periods of significant economic downturn. The flexibility to increase fares is set against a context of relatively higher fare than in other European cities.

Over the past couple of years there has been a downturn in London's economy, and this, together with a reduction in tourism due to terrorist threats and the temporary closure of the Central Line for health and safety reasons in 2003, has resulted in some decline in use of the London Underground. This decline now appears to have been reversed. Usage of London's buses has, however, shown strong growth over the past few years.

The operating companies in the TfL group do not make enough to cover their costs and have to be subsidized by grants from government. About one-half of TfL's revenue comes from grants, and therefore the outcome of this year's Spending Review settlement will be a key credit factor.

TfL also receives revenue from the GLA precept on council tax bills in London. The precept can be adjusted by the GLA to take account of transport priorities within the authority's existing budgetary constraints. Given the relatively small size of the precept compared with TfL's total budget, however, it represents only minimal financial flexibility.

TfL further increased its own-source revenue by introducing the congestion charge on private vehicles in central London in February 2003. Although the charge has been highly effective as a traffic management tool, it has not brought in as much income as forecast in the first months following its introduction, there are plans to extend the zone westwards into Westminster and Kensington and Chelsea. Any increase in net income related to such an extension, however, is not expected to be significant.

## ■ Demand

TfL has strong demand, with a near-monopolistic position in its specific transport markets in London.

London's population is about 7.1 million, and the catchment area for commuting into the city covers a significantly larger population base. The city's population is forecast to grow by about three-quarters of a million by 2016. London has a major financial services industry and is a major administrative and tourism center. The vast majority of London commuters working in central London travel by public transport.

Significant increases in transport capacity are required to deal with the forecast growth. For example, the rail projects proposed by TfL, including CrossRail and the Jubilee Line upgrades, aim to meet a 39% increase in demand by 2016. Bus capacity will also expand by a similar amount over this period. London buses carry about 5.4 million passengers every weekday, and usage has risen in recent years. TfL has plans to increase bus capacity further and is investing in service improvements. Bus services are tendered out to private operators, but TfL has a monopolistic position regarding the allocation of contracts.

LUL carries about 3 million passengers each weekday and accounts for more than one-third of all journeys to work in central London. Each day, as many passengers use the Underground as use the entire U.K. rail network.

TfL has a strong position regarding the delivery of public transport services in London within most of its markets, particularly after the transfer of LUL. Only in parts of south London, where privatized national rail companies provide significant local commuter services, is there alternative public transport provision not under TfL's direct control. There are limited Underground services in these areas and the private rail services are not a significant competitive threat.

The only possible alternative transport competition is from private motor vehicles. Private car use has reached saturation levels, with declines in recent years during peak travel periods because London suffers from serious

peak-hour congestion. Demand for public transport is likely to increase further if the congestion charges are successful in further reducing private vehicle trips to central London.

## ■ Governance and Management

TfL is subject to all the legal and regulatory constraints that apply to U.K. local authorities, including restrictions on raising debt, the requirement for a balanced budget, and the requirement for an annual external audit. TfL is closely linked to the GLA, which is also constituted as a local authority, because the GLA has to approve TfL's annual budget. The GLA passes on the transport grant, allocates a precept to TfL, and monitors financial and operational performance. The links between the two bodies are further reinforced by joint working groups and the fact that the Mayor chairs TfL.

The next mayoral election in London will take place in 2004. The current Mayor, Ken Livingstone, is expected to be re-elected.

The Mayor chairs the TfL Board, and the Commissioner of Transport for London, Bob Kiley, who was appointed by the Mayor, reports directly to the Board. The Board is advised by four specialist committees (Remunerations, Finance, Audit, and Safety, Health, and the Environment) and specific panels for modes of transport (Rail Transport, Underground, and Surface). The Audit Committee is responsible for overseeing corporate governance and ensuring that the Code of Corporate Governance is integral to the functioning of TfL.

The executive management team comprises a mix of managers, including some who transferred from organizations brought under the control of TfL. The Commissioner of Transport has previous experience of running mass transport systems in the U.S., and he has introduced high-caliber managers from there. His appointments continue to bring a good degree of business rigor to the running of TfL.

Central government provides significant grants to TfL and retains a strong level of oversight and control over funding. As with all other U.K. local authorities, the relevant secretary of state, for Transport in TfL's case, has ultimate powers of intervention.

## ■ Financial Profile

The financial management of TfL is good. Standard & Poor's expects that departments will continue to be tightly managed because TfL has challenging efficiency targets and cost pressures, particularly regarding LUL. It also has an ambitious expenditure program to meet the Mayor's and the U.K. government's objective of improving transport services in London.

### **Financial performance.**

TfL balanced its budget and achieved significantly increased spending targets in 2002-2003, following some slippage in spending in the previous year. Overall, TfL has seen a strong increase in revenues from improved grant settlements and the transfer of LUL to TfL in 2003. In 2002-2003, a number of key projects were delivered, including congestion charging and improvements to, and expansions of, the bus network. The Docklands Light Railway extension to City Airport is now well under construction and due for completion in 2005. No significant additional borrowing was required and reserves were increased.

On-target spending and continued cost control are evidence that TfL is consolidating as an organization after a period in which the different parts that make it up had to come to terms with their new arrangements. The delay to the transfer of LUL helped TfL to an extent. It is now more established and better positioned to deal with the challenges of managing the Underground.

TfL's income and expenditure in 2002-2003 does not include income or expenditure associated with LUL other than spending on systems and management structures to prepare for the transfer. The figures for TfL in 2003-2004 will include figures for LUL from July 2003. There will not be full consolidated figures including a full year of LUL operation until financial year 2004-2005.

TfL's grant is used to fund its operations, such as road improvements and congestion charge development, and to subsidize its transport operations. TfL also passes on part of this grant to subsidize TTL's operations.

<i>(Mil. £)</i>	<i>2003-2004*</i>	<i>2002-2003</i>	<i>2001-2002</i>
Own-source income	2,302	717	522
Grant income	2,621	1,065	728
Revenue expenditure	4,302	1,525	1,107
Capital expenditure	593	249	132
Surplus	28	8	11

\*Budgeted. Includes London Underground Ltd.

## ■ Funding Arrangements and the Spending Review

The U.K. government only provides strong commitment for TfL's grant funding for three years following each Spending Review. From 2005-2006, TfL has identified a funding gap of more than £900 million per year, based on the illustrative funding statement provided by government. This includes cost pressures associated with LUL and other transport improvement programs, which would help meet the requirements of the Mayor's transport strategy and the government's transport objectives. TfL is working to secure the best possible outcome from the 2004 Spending Review and will submit its business plan to government in late March 2004. The outcome of the Spending Review is expected to be announced in July 2004 and will set the levels of grant funding for TfL for the following three years.

Standard & Poor's recognizes the fiscal constraints faced by government, and does not expect all the funding gap to be made up by grant payments. The funding gap will not affect contractual payments under the PPP arrangements, but is likely to mean that certain transport improvement projects TfL is planning for the next few years will have to be reassessed. TfL's baseline expenditure requirements can be funded through resources from fares and indicated government grant funding.

The funding agreement agreed in February 2003 between the Mayor and TfL and the Secretary of State for Transport reflected a commitment by government to full consideration of the cost pressures associated with the PPPs and LUL at the 2004 Spending Review. The illustrative funding statement provided by the government identifies year-on-year efficiency savings following the transfer of LUL. Full realization of these savings will continue to be a challenging issue for TfL. Furthermore, the illustrative funding statement only covers the eight years up to the first PPP contract review point and not the full term of the contracts. This creates longer-term uncertainty for TfL.

The funding agreement of February 2003 also allowed the creation of a reserve fund that will build up to £170 million over the next few years. Standard & Poor's welcomes this reserve because it gives TfL some flexibility to respond to certain unforeseen events without turning to government. The reserve will be topped up in the event that it is used.

The outcome of this year's Spending Review will be a key credit factor for TfL. Standard & Poor's considers that good progress has been made in the political relationships between TfL and government over the past year. Although political risk will always be a factor in the credit rating on TfL, the confrontational style that characterized the relationships in the period before the transfer of LUL has softened. The economic environment, however, has been less positive and there is increased fiscal pressure on government, which will in turn put pressure on the fiscal settlement with TfL.

TfL has the ability to raise debt, although in the short term this is likely to be restricted to small amounts used as a working capital facility at year-end. TfL is, however, exploring, with government, the possibility of using the flexibilities possible under the Prudential Borrowing arrangements, which come into effect in April 2004. TfL could therefore borrow larger sums in the future. TfL will submit any plans to borrow as part of the GLA's overall Prudential Borrowing plans. If the use of debt is undertaken without clear plans for how TfL's resources would support debt-related payments, it could have an impact on the rating. Standard & Poor's will evaluate the business case for any increase in debt when proposals are made.

## ■ Business Plan

TfL's updated six-year business plan is going through an approval process due to be completed in March 2004. The government grant for 2003-2004 is already known and will increase to about £2.4 billion, split almost equally between the LUL-related grants and grants for the rest of TfL. The transfer of LUL significantly increases the level of grant received by TfL.

TfL continues to face an aggressive £17 billion program of transport improvements to support the London Plan. This spending pressure results in a funding gap of about £900 million per year, as shown in the table below. Not all this investment expenditure will necessarily be met by grant funding, and TfL is exploring the possibility of a variety of funding solutions. In the event that solutions are not forthcoming, TfL will have to reassess the transport improvement plans. TfL is under a legal obligation to balance its budget each year and therefore must work within the resources available to it.

The budget for 2004-2005, based on the Consolidated Business Plan, has been passed by the GLA Assembly as part of the Mayor's Budget. The agreed budget is balanced. Pension costs of £45 million are being paid in 2004-2005 by the LUL risk reserve fund. TfL will be asking government to reimburse these costs in its grant settlement.

<i>(Mil. £)</i>	<b>2004-2005</b>	<b>2005-2006</b>	<b>2006-2007</b>	<b>2007-2008</b>	<b>2008-2009</b>	<b>2009-2010</b>
Total income	4,924	4,784	4,847	4,912	4,940	5,038
Own-source income	2,539	2,595	2,708	2,765	2,833	2,896
Government grants	2,385	2,190	2,139	2,147	2,107	2,142
Total expenditure	4,969	5,729	5,832	5,863	5,907	6,053
Baseline expenditure	4,609	4,815	4,810	4,795	4,831	4,967
Improvement expenditure	360	914	1,022	1,068	1,076	1,086
Funding gap	45	945	985	951	967	1,015

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