

## Health Care Service Corp. (d/b/a Blue Cross & Blue Shield of Illinois, New Mexico, Oklahoma, and Texas)

### Financial Strength Rating

#### Local Currency

AA-/Stable/—

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### Major Rating Factors

#### Strengths:

- Excellent balance sheet strength.
- Very strong competitive position.
- Strong profitability.

#### Weaknesses:

- Geographic underwriting concentrations.
- Financial profile is moderately less diverse relative to peers.
- Diminishing prospective earnings strength relative to historical trend.

### Rationale

The insurer financial strength rating on Health Care Service Corp. (HCSC), which does business as Blue Cross & Blue Shield of Illinois, Texas, Oklahoma, and New Mexico, reflects its very strong competitive position, excellent balance sheet profile, and strong profitability. Offsetting factors include a moderately less diversified earnings profile and more limited geographic underwriting profile relative to peers.

HCSC's excellent balance sheet profile is well supported by a highly liquid investment portfolio, high tangible net worth, and very modest debt leverage. HCSC's consolidated capital adequacy ratio (CAR), based on Standard & Poor's Ratings Services' model, is very strong relative to the rating level. In 2007, surplus grew by \$832 million, or 16%, to \$6.1 billion, mainly due to the retention of net income.

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The company maintains strong franchises in its core markets through the Blue brand leverage, establishing a meaningful presence across key market segments. By means of its well-developed distribution channels, long-standing provider relationships, and competitive servicing capabilities, HCSC has established itself as the leading provider of health insurance coverage in each of its primary markets. As of Dec. 31, 2007, HCSC provided health insurance and related services to more than 11.8 million members, reflecting a five-year cumulative annual growth rate (CAGR) of about 10% (excluding Blue Card Host members).

HCSC's earnings adequacy ratio (EAR), as measured by Standard & Poor's model, is estimated to be 500%-550% for the five-year period ended Dec. 31, 2007, which is considered strong overall relative to the rating.

Pretax income for 2007 was \$1.1 billion (6.4% return on revenue [ROR]), which was in-line with our expectation but meaningfully lower compared with the prior two years and the most recent five-year average. This is partly because of higher administrative expense related to project oriented information technology expenditures and tighter pricing in certain product segments. Overall, relative return has steadily improved on a rolling five-year average basis, but prospective earnings strength is expected to diminish relative to historical trend toward a moderately lower normalized rate of return as revenue growth exceeds earnings growth.

Most of HCSC's insurance contracts are aligned with customers that reside in two generally competitive state markets: Illinois and Texas. HCSC's at-risk or insured membership constitutes 35% of total membership (including federal employees), which generates 88% of revenue. Its large base of customers overall enhances provider contracting and boosts operational efficiencies. Because of the at-risk concentrations, HCSC's insured customer base is somewhat less diversified geographically compared with its peers. Such a concentration of insured members potentially exposes the company in a more significant way to adverse developments on the legislative, regulatory, and economic fronts. In addition, most of the company's cash flow derives from a limited number of markets. Its unregulated fee-based cash flow resources are modest relative to total revenue, and are essentially driven by its network rental business, which is tied to its national profile.

### ***Outlook***

The outlook reflects no expectation for a rating change in the next 12-18 months. The company is capably executing its growth strategy and returns objectives, bolstering its competitive position, strengthening its balance sheet, and producing strong operating performance.

We expect HCSC's enrollment on a same-store basis to grow by about 4% and be near 12.3 million members for 2008. Consolidated pretax income is expected to be about \$1.0 billion (about 6% ROR), which is considered strong but moderately below the expected five-year average pretax ROR in the range of 8%-9%. If HCSC meets our expectations for profitability, interest coverage is expected to exceed 35x, and debt leverage will be less than 10% on an adjusted-net-worth basis (including the unfunded pension obligation). We expect surplus growth of 10%-15% and capital adequacy to be very strong relative to the rating level.

### ***Competitive Position: Strong Franchise Through Blue Cross Blue Shield Brand***

HCSC's business profile has improved significantly in connection with the sustained development of its national account business, which has been a significant contributor to member growth in the past

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several years. The company has developed a strong franchise in its core markets by leveraging the Blue brand and by means of its well-developed distribution channels, long-standing provider relationships, and competitive servicing capabilities.

Table 1

| <b>Health Care Service Corp./Selected Statistics</b>                   |                             |             |             |             |             |
|--|-----------------------------|-------------|-------------|-------------|-------------|
|  | <b>—Year ended Dec. 31—</b> |             |             |             |             |
| <b>(Mil. \$)</b>   | <b>2007</b>                 | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> |
| Enrollment (000s) - from statutory statement                           | 11,784.2                    | 11,225.0    | 10,561.5    | 9,526.2     | 8,765.3     |
| Premiums earned  | 14,348.4                    | 12,971.6    | 11,713.9    | 6,991.3     | 6,249.8     |
| Net underwriting gain/loss   | 721.3                       | 1,144.5     | 1,168.1     | 1,225.4     | 785.0       |
| Net income/loss  | 865.7                       | 1,115.4     | 1,145.6     | 1,049.4     | 624.6       |
| Pretax return on revenue (excluding realized capital gains/losses) (%) | 6.9                         | 10.6        | 11.3        | 12.1        | 10.5        |
| Pretax return on revenue (including realized capital gains/losses) (%) | 7.1                         | 10.6        | 11.3        | 12.1        | 10.4        |
| Total assets   | 10,007.7                    | 9,162.7     | 7,770.4     | 5,886.8     | 4,939.4     |
| Total adjusted capital   | 6,095.7                     | 5,262.8     | 4,268.3     | 2,911.4     | 2,156.9     |

Table 2

| <b>Health Care Service Corp./Business Statistics</b> |                             |             |             |             |             |
|--|-----------------------------|-------------|-------------|-------------|-------------|
|  | <b>—Year ended Dec. 31—</b> |             |             |             |             |
| <b>(Mil. \$)</b>                                     | <b>2007</b>                 | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> |
| Enrollment (000s)                                    | 11,784.2                    | 11,225.0    | 10,561.5    | 9,526.2     | 8,765.3     |
| Year-over-year change (%)                            | 2.9                         | 6.3         | 10.9        | 8.7         | 9.9         |
| Premiums earned                                      | 14,348.4                    | 12,971.6    | 11,713.9    | 6,991.3     | 6,249.8     |
| Year-over-year change (%)                            | 10.6                        | 10.7        | 67.6        | 11.9        | 13.4        |

HCSC is a leading provider of insurance coverage and related service. The company maintains a particularly strong presence in its 'Blue' branded markets. Based on an estimate of the insured commercial market, the company's market share positions are Illinois, 47%; Texas, 28%; Oklahoma, 25%; and New Mexico, 32%. HCSC has achieved member growth in part through ceding arrangements with other licensed Blue Cross Blue Shield (BCBS) plans. In most instances, these plans could opt to service the accounts directly, which could result in slower short-term growth for the company.

**Historical**

HCSC is a noninvestor owned mutual legal reserve company that conducts business as Blue Cross Blue Shield of Illinois, Blue Cross Blue Shield of Texas, Blue Cross Blue Shield of Oklahoma, and Blue Cross Blue Shield of New Mexico. At year-end 2007, the company provided health insurance products and services to 11.8 million members (65% self-insured and 35% at-risk) in the private and public sectors.

The company is primarily a managed care organization, with more than 90% of its membership enrolled in managed care plans. A substantial portion of HCSC's health insurance business is transacted through the HCSC legal entity, which is also the parent to several downstream companies. HCSC markets its products and services primarily in Illinois, Texas, Oklahoma, New Mexico, and nationally through affiliations with other BCBS plans as approved by the Blue Cross Blue Shield Assoc.

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(BCBSA). HCSC provides group and individual indemnity health insurance and managed care products, such as HMOs, participating provider/preferred options (PPOs), point-of-service (POS) plans, and consumer-driven health plans (CDHP), as well as Medicare supplemental coverage, dental, vision, and prescription drug products. HCSC also now provides Medicare Part D prescription and Medicare Advantage products in limited markets.

HCSC has built strong relationships with several national consulting organizations, general agents, producers, and brokers to distribute its products. HCSC works closely with consulting firms to sell to larger groups and national accounts, which usually are the accounts with the highest customization of products. In the individual and small-group segments, general agents, producers, and independent brokers are primarily used in each local market. Online quoting and enrollment capabilities have helped to improve growth in the highly competitive small-group market segment.

***Prospective***

We expect HCSC to focus mainly on existing core market opportunities in 2008, and in the next 12-18 months, not likely to be involved with significant merger and acquisition (M&A) deals that might result in material operational risk for the company. Instead, Standard & Poor's expects the company's efforts to be directed at sustaining its already strong market positions in Illinois, Texas, Oklahoma, and New Mexico while pursuing organic national account growth opportunities. For 2008, we expect HCSC's enrollment on a same-store basis to grow by 3%-5% to 12.2 million-12.4 million members.

HCSC has eased away from its consolidator stance, but acknowledges that merger opportunities with smaller nonprofit Blue plans will always be considered. Standard & Poor's believes a merger could result in at least some temporary disruption to ongoing operations, depending on the magnitude of the deal. In the near term, Standard & Poor's believes that HCSC will rely more on targeted investments and additional Blue collaboration to drive competitive advantage.

***Management And Corporate Strategy: Balanced Growth Through Increased Membership And Industry Consolidation***

HCSC is successfully executing its intermediate strategy of maintaining a balanced growth in membership and earnings by leveraging its brand positioning and enhancing product design. Strong operating performance has also provided the means to support expansion as the industry continues to consolidate.

***Operational management***

HCSC's operational objective is to build on its financially sound, efficient, and competitively priced product assortment that leverages its infrastructure capacity and consolidates its negotiating power with providers and distribution channels. The company's recent history has included some M&A activity. The primary objective of this strategy is to enhance the scale and cost efficiency needed to compete effectively with large national health care companies while remaining true to its mission as a noninvestor-owned Blue Cross Blue Shield carrier.

***Financial management***

HCSC's leadership is committed to conservative financial management of the company. The company adheres to fundamentally sound business practices, including its reserving and underwriting, while

maintaining prudent risk-adjusted capitalization. Given the need to remain price-competitive, particularly in its national and large account segments, HCSC has adopted a policy of expense control that emphasizes improved efficiencies, enhanced technology, and economies of scale.

The company maintains a somewhat conservative level of debt, with a target maximum of 20% of total capital on an adjusted-net-worth basis. Adjustments to better approximate GAAP valuation include provisions for various assets, including certain receivables, deferrals, goodwill and other intangibles. Standard & Poor's uses this valuation to compute and assess financial leverage and other balance-sheet-quality measures. On this basis, as of Dec. 31, 2007, debt leverage was less than 10% and intangibles as a percentage of adjusted net worth was less than 5%, which Standard & Poor's views as very conservative.

The issuance of debt has historically improved the company's ability to fund strategic acquisitions and strengthen its working capital. The target capital structure would be exceeded only to finance a major acquisition, with the intention of returning it to 20% in the intermediate term.

### ***Enterprise Risk Management: Conservative Risk Profile And Uncomplicated Product Portfolio***

HCSC's ERM is adequate and reflects the conservative risk profile of the company. The company's product portfolio of health care products is not particularly complex. Its major risk is underwriting risk. The underwriting and pricing discipline is evident by the strong financial performance and the capital strength that HCSC has achieved in the past five years. Its current systems of monitoring claims and pricing trends are considered to be adequate. Management is expected to dedicate the resources needed to maintain its operational capabilities to manage its risks.

### ***Accounting***

HCSC's financial reporting is reasonably conservative and transparent. Standard & Poor's believes the company employs revenue recognition methods that are in the mainstream for its industry. HCSC does no off-balance-sheet financing, nor has it established any special-purpose entities for any reason. Contingent liabilities are established at the best estimate if the exact amount is unknown, and in the middle of the range of reasonably possible outcomes if a best estimate is not given. The company tends to use operating earnings to set up reserves for various contingencies and has established medical reserves for its core health plan at or above claim development for each of the past five years.

### ***Operating Performance: Indemnity And PPO Products Improve Performance***

The company's earnings adequacy ratio (EAR), as measured by Standard & Poor's model, was 530% for the five-year period ended Dec. 31, 2007, which is strong relative to the rating. Profitability in 2007 was strong and met our expectation, but was lower on a relative return basis because of modestly higher-than-expected revenue growth relative to plan. Pretax ROR was limited in part because of materially higher technology related expenditures. Earnings quality has been bolstered by the material amount of fee-based revenue and income generated from its major/national account business lines.

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Table 3

| <b>Health Care Service Corp./Operating Statistics</b>                     |                             |             |             |             |             |
|---|-----------------------------|-------------|-------------|-------------|-------------|
|   | <b>—Year ended Dec. 31—</b> |             |             |             |             |
| <b>(Mil. \$)</b>  | <b>2007</b>                 | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> |
| Total revenue   | 14,629.9                    | 13,228.5    | 11,883.9    | 9,813.4     | 8,194.6     |
| Net underwriting gain or loss   | 721.3                       | 1,144.5     | 1,168.1     | 1,225.4     | 785.0       |
| Pretax income (excluding realized capital gains or losses)                | 1,002.7                     | 1,401.4     | 1,338.1     | 1,295.9     | 857.8       |
| Pretax income (including realized capital gains or losses)                | 1042.1                      | 1,398.4     | 1,338.4     | 1,298.0     | 855.5       |
| Net income or loss  | 865.7                       | 1,115.4     | 1,145.6     | 1,049.4     | 624.6       |
| Pretax return on revenue (excluding realized capital gains or losses) (%) | 6.9                         | 10.6        | 11.3        | 12.1        | 10.5        |
| Pretax return on revenue (including realized capital gains or losses) (%) | 7.1                         | 10.6        | 11.3        | 12.1        | 10.4        |
| Earnings adequacy ratio (%)   | 511.0                       | 566.0       | 529.0       | 494.0       | 328.0       |
| Medical loss ratio (%)  | 83.2                        | 81.3        | 81.5        | 80.6        | 78.5        |
| Expense ratio (%)   | 11.6                        | 9.7         | 8.5         | 7.8         | 6.6         |

**Historical**

Premium revenue (excluding equivalents) increased 14% (\$1.8 billion) to \$14.9 billion as of Dec. 31, 2007, compared with \$13.1 billion in 2006. The increase was driven by a combination of member growth and rate increases. Pretax income and pretax ROR (as a percentage of premium revenue and self-funded account fees) in 2007 were \$1.1 billion and 6.4%, respectively, compared with \$1.4 billion and 9.5% in 2006.

**Prospective**

For 2008, we expect pretax income to be flat and be \$1.0 billion-\$1.1 billion (reflecting 5%-6% ROR), which is strong. Furthermore, the five-year average pretax ROR is expected to be 8%-9%. Accordingly, the EAR for the five-year period ended Dec. 31, 2008, is expected to exceed 500%, which is also considered strong for the rating. Standard & Poor's expects profitability to be sustained by HCSC's core books of business in Illinois and Texas. If the company meets Standard & Poor's expectations for earnings, interest coverage would likely be considered very strong relative to the rating.

**Investments And Liquidity: Focus On Capital Preservation And Dependable Cash Flow**

The company's investment portfolio is carefully managed, with an investment philosophy that focuses on preservation of capital and dependable cash flow. HCSC's investment portfolio contains mostly high-credit-quality fixed-income investments that provide strong liquidity. More than 98% of its fixed-income portfolio is in NAIC Class 1 securities, with 79% maturing within one year. The plan has also had strong cash flow from operations in the past several years.

Table 4

| <b>Health Care Service Corp./Investment Statistics</b> |                             |             |             |             |             |
|--|-----------------------------|-------------|-------------|-------------|-------------|
|  | <b>—Year ended Dec. 31—</b> |             |             |             |             |
| <b>(Mil. \$)</b>                                       | <b>2007</b>                 | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> |
| Net investment income                                  | 286.2                       | 258.5       | 159.3       | 51.7        | 25.3        |
| Net realized capital gain                              | 39.3                        | (3.1)       | 0.3         | 2.1         | (2.3)       |

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Table 4

| <b>Health Care Service Corp./Investment Statistics (cont. 'd)</b>    |                             |             |             |             |             |
|--|-----------------------------|-------------|-------------|-------------|-------------|
|  | <b>—Year ended Dec. 31—</b> |             |             |             |             |
| <b>(Mil. \$)</b>   | <b>2007</b>                 | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> |
| Net investment gain  | 325.6                       | 255.4       | 159.5       | 61.8        | 23.0        |
| Net investment yield (excluding realized capital gains and losses) % | 4.7                         | 4.7         | 3.7         | 1.6         | 0.9         |
| Net investment yield (including realized capital gains and losses) % | 5.3                         | 4.7         | 3.7         | 1.9         | 0.8         |
| Total invested assets (excluding real estate)                        | 6,393.4                     | 5,876.5     | 5,093.9     | 3,612.9     | 3,030.4     |
| <b>Portfolio composition</b>   |                             |             |             |             |             |
| Cash and short-term investments (%)                                  | 44.7                        | 42.2        | 39.0        | 52.8        | 46.0        |
| Bonds (%)  | 32.5                        | 36.2        | 41.4        | 25.9        | 24.7        |
| Preferred stock (%)  | 0.3                         | 0.0         | 0.0         | 0.0         | 0.7         |
| Total common stock (%)   | 17.4                        | 17.1        | 15.1        | 14.7        | 21.6        |
| Unaffiliated common stock (%)  | 7.8                         | 6.8         | 5.6         | 4.4         | 3.4         |
| Real estate (%)  | 4.8                         | 4.2         | 4.3         | 5.7         | 7.1         |
| Other (%)  | 0.3                         | 0.3         | 0.2         | 0.8         | 0.0         |

Table 5

| <b>Health Care Service Corp./Liquidity Statistics</b>                      |                             |             |             |             |             |
|--|-----------------------------|-------------|-------------|-------------|-------------|
|  | <b>—Year ended Dec. 31—</b> |             |             |             |             |
| <b>(Mil. \$)</b>   | <b>2007</b>                 | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> |
| Cash flow from operations  | 682.1                       | 743.2       | 1,245.5     | 569.6       | 583.1       |
| Cash and short-term investments  | 3,000.2                     | 2,589.0     | 2,074.8     | 2,025.3     | 1,498.8     |
| Total invested assets (excluding real estate/affiliated investments/other) | 5,723.9                     | 5,232.9     | 4,579.2     | 3,185.9     | 2,414.8     |
| Unpaid claims liability  | 1,416.6                     | 1,287.6     | 1,158.8     | 962.0       | 686.2       |
| Quick liquidity ratio (%)  | 211.8                       | 201.1       | 179.0       | 210.5       | 218.4       |
| Cash flow from operation to unpaid claims (%)                              | 48.1                        | 57.7        | 107.5       | 59.2        | 85.0        |
| Liquidity ratio (%)  | N.A.                        | 245.0       | 253.1       | 200.3       | 193.1       |
| Claims turnover (days)   | 43.3                        | 44.6        | 44.3        | 41.0        | 51.0        |

N.A.—Not available.

Liquidity is very strong for the rating, measured by an estimated liquidity ratio of 275%-325% at year-end 2007, based on Standard & Poor's model estimate. The company maintains an untapped five-year, \$300 million line of revolving credit with a consortium of banks, which will expire in November 2009.

**Capitalization: Improved Statutory Net Income Grows Surplus**

HCSC is very well capitalized relative to its business risks. Its CAR, as measured by Standard & Poor's previous CAR model, was 395%, which is moderately higher compared with the prior two years (350%-375%).

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Table 6

| <b>Health Care Service Corp./Capitalization Statistics</b> |                      |             |             |             |             |
|--|----------------------|-------------|-------------|-------------|-------------|
|  | —Year ended Dec. 31— |             |             |             |             |
| <i>(Mil. \$)</i>   | <i>2007</i>          | <i>2006</i> | <i>2005</i> | <i>2004</i> | <i>2003</i> |
| Total assets   | 10,007.7             | 9,162.7     | 7,770.4     | 5,886.8     | 4,939.4     |
| Total liabilities  | 3,912.0              | 3,899.9     | 3,502.1     | 2,994.0     | 2,798.5     |
| Total adjusted capital                                     | 6,095.7              | 5,262.8     | 4,268.3     | 2,911.4     | 2,156.9     |
| Total debt to capital (%)                                  | 6.4                  | 7.4         | 8.6         | 12.1        | 15.6        |
| Capital adequacy ratio (%)                                 | 394.8                | 378.1       | 346.6       | 277.6       | 203.7       |
| Total equity assets to capital (%)                         | 24.8                 | 24.8        | 24.2        | 26.9        | 44.3        |

***Historical***

Consolidated capital adequacy, which includes provision for its life subsidiary operations, has been very strong and moderately improving over the past few years because earnings retention has moderately outpaced revenue growth. HCSC has generated and retained on its balance sheet significant statutory earnings in the past few years, which has led to the material strengthening of its capital adequacy.

***Prospective***

Given our expectation for sustained insured premium growth (10%) and earnings retention for 2008, consolidated capital adequacy is likely to be stable and continue to be viewed as very strong relative to the 'AA' level.

***Financial Flexibility: Capital And Earnings Provide Strong Flexibility Despite Not-For-Profit Status***

HCSC's significantly enhanced capital position and improved earnings strength provide it with strong financial and operating flexibility, which have permitted investments in business growth through acquisitions, strategic alliances, and the development of its managed care networks. Nevertheless, HCSC's financial flexibility is limited somewhat by its noninvestor owned mutual legal reserve corporation status, which restricts access to the equity capital markets. We do not expect the company to change its corporate structure over the near to intermediate term.

Its primary sources of funds consist of internally generated cash flow and its five-year, \$300 million credit facility, which expires in November 2009. We expect HCSC's capital needs to be funded primarily with internally generated funds, which should be more than sufficient to meet the company's needs. Nonetheless, HCSC's strong financial profile and modest financial leverage would allow for relatively easy access to the debt capital markets if needed.

In 2001, the company raised \$400 million in 10-year senior unsecured notes by means of a 144A issuance. The majority of the proceeds were used to repay a commercial bank revolving credit facility. The notes bear interest at a rate of 7.75% per annum, payable semiannually in arrears on June 15 and Dec. 15 of each year, and will mature on June 15, 2011. As of Dec. 31, 2006, debt leverage (as a percentage of adjusted net worth) was less than 10%, and debt to EBITDA was 0.3x, which we believe is conservative for the rating. We do not expect these metrics to change in the next 12-18 months in a way that would pressure the company's financial profile.

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**Ratings Detail (As Of 22-Apr-2008)\***

**Operating Company Covered By This Report**

**Health Care Service Corp. (d/b/a Blue Cross & Blue Shield of Illinois, New Mexico, Oklahoma, and Texas)**

Financial Strength Rating

**Local Currency**

AA-/Stable/—

Counterparty Credit Rating

**Local Currency**

AA-/Stable/—

Senior Unsecured

**Local Currency**

AA-

**Domicile**

Illinois

\*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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