

Tax Supported
Special Report

Tax-Supported Rating Considerations for 2010

Analysts

Amy Laskey
+1 212 908-0568
amy.laskey@fitchratings.com

Amy S. Doppelt
+1 415 732-5612
amy.doppelt@fitchratings.com

Ann Flynn
+1 212 908-0315
ann.flynn@fitchratings.com

Kelly McGary
+1 813 223-6600
kelly.mcgary@fitchratings.com

Steve Murray
+1 512 215-3729
steve.murray@fitchratings.com

Overview

This report discusses Fitch Ratings' expectations for municipal credit performance in 2010 and identifies trends and concerns that could lead to rating downgrades, as positive rating activity is expected to be infrequent.

While the national economy may be stabilizing following the most severe downturn since the Depression, most municipal governments will face at least another year of heightened financial pressures. Stabilization of and improvement in sales and other economically sensitive taxes will likely be offset by weakness in property taxes, the cornerstone of most local governments' revenues, as continued property value declines work their way through the property assessment system. Also, Fitch expects local governments to feel the impact of continued state budget gaps due in part to the scheduled phasing out of federal stimulus relief.

Many U.S. local governments have already experienced two fiscal years of significant recessionary strain, affecting both financial and economic metrics. In Fitch's view, management has played a significant role in how this stress has affected credit quality, leading to differing results for issuers that have experienced similar economic deterioration. Fitch has long cited

the importance of management to credit quality, and believes it is as important as ever, if not more so in the current economic environment. While there may be cases where economic or financial weakness overwhelms even a strong management team's ability to make offsetting adjustments, actions by local officials in recent months have demonstrated that proactive, conservative management practices can avert or at least minimize the erosion of credit quality. Nevertheless, the trend in tax-supported rating activity shifted negatively in 2009, as indicated in the table above.

As in the past, Fitch does not assign a rating outlook to the entire local government tax-supported sector. Given the broad scope of local borrowers across the 50 states, with various financial positions and subject to vastly differing revenue-raising and spending authority and restrictions, economic environments, and state relationships, assigning a rating outlook to the sector would be overly broad and not particularly meaningful. Fitch notes that the rating outlook for a particular issue pertains solely to the direction the rating may be headed, not the overall economic condition of the issuer.

Key Rating Drivers

- While the national economy may be stabilizing, most municipal governments will face at least another year of heightened financial pressures.
- Local governments are likely to continue to see weakness in property tax revenues for at least the next two years, as even governments with tax-raising margin will

Trends in Tax-Supported Rating Activity

(% of Ratings)

	2009	2008	2007
Downgraded	8	3	2
Upgraded	5	6	7
Outlooks Revised to Negative	6	3	1
On Negative Outlook or Watch at Year-End	10	4	2
On Positive Outlook or Watch at Year-End	2	3	3

find such increases politically difficult until the economic recovery has taken a firmer hold.

- The effect of state budget imbalances on local government issuers will vary based on the magnitude of stress at the state level and the extent to which the locality is dependent on state funding.
- The extent to which revenue declines can be offset with spending adjustments depends on the nature of a government's expenditure demands and the practical and political elements that influence budgetary actions.
- Management has played a significant role in how economic stress has affected credit quality; the impact of eroded operating margins will be mild if management has demonstrated its willingness and ability to make the necessary adjustments to maintain prudent reserves.
- While Fitch expects that economically sensitive revenues will stabilize or improve slightly in the coming year, actual results could underperform expectations and ratings could decline in areas where recovery lags the nation's.
- Fitch believes local government debt levels will be stable to slightly higher in 2010.
- The highest probability of rating declines among local governments this year are expected to rest in municipalities with the following characteristics:
 - Notable further revenue deterioration and legal or political impediments to raising tax or fee rates.
 - Modest and reduced reserves.
 - An inability (due to high fixed, mandated, or contractual costs) or unwillingness (due to political or practical considerations) to make necessary expenditure cuts to avoid more serious reduction in or depletion of reserves.

Resources

Overall, Fitch expects that local governments will continue in 2010 to enact relatively minor adjustments in taxes and fees but by and large will not seek to implement significant increases to the tax burden. As will be discussed, recent history has shown that political pressures can sometimes be as significant as legal restraints in limiting an entity's revenue-raising flexibility, increasing uncertainty as to governments' ability to stabilize their financial positions.

Given the lag between property valuation changes, taxable value assessments, and tax levies and collections, local governments are likely to continue to see weakness in property tax revenues for at least the next two years. Some federal programs that have assisted homeowners and, thus, protected residential property values are ending, which may have delayed, but not averted, further decline. As discussed in Fitch Research on "U.S. Structured Finance: 2010 Outlook," dated Dec. 8, 2009, national home prices are expected to decline about another 10% from current levels (which showed recent improvement) and commercial real estate fundamentals will likely continue to decline over the next 18–24 months. However, Fitch expects regional and local markets to continue to vary greatly in their near-term performance.

The extent to which falling property values affect property tax revenues varies depending on state and local assessment practices, limits on AV growth, and tax rate or levy caps. Given persistent high unemployment and lack of income growth, Fitch believes that, even for governments with tax-raising margin, such increases will be politically difficult until the economic recovery has taken a firmer hold. Even if residential AV begins to stabilize, declines in commercial values are just beginning to

work their way into assessments and are likely to hamper recovery in AV for communities with a sizable commercial base in the near term.

While most local governments are highly dependent on property tax revenue, some have more diverse revenues sources, with sales taxes being the most common. Sales tax revenues respond more quickly to economic conditions, and Fitch expects at least some stabilization in the near term. However, given the outlook for continued consumer restraint, Fitch does not foresee a strong rebound. In some areas hit hard by the recession, particularly those with chronically high unemployment rates or large declines in tourism-related activity, sales tax revenues may take longer to improve.

The effect of state budget imbalances on local government issuers varies based on the magnitude of stress at the state level and the extent to which the locality is dependent on state funding. School districts, counties that are responsible for social services, and localities in states that provide revenue-sharing are the most affected. State governments have experienced extreme financial stress in the downturn, with dramatic drops in revenues in fiscal 2009 and continued weakness in the current fiscal year. Given that most state revenue systems rely on economically sensitive income and sales taxes, in general, stress at the state level has been more severe than at the local level. Although federal stimulus funds mitigated the need for what otherwise would have been draconian budget cuts, the phase-out of stimulus funds, coupled with the expected tepid revenue recovery and increased spending demands for state-funded social services, will likely pressure the states' ability to maintain local assistance funding. In addition, some states have delayed payments to local governments as part of their efforts to address budget and liquidity pressure. Fitch expects to see increased short-term cash flow borrowing if state aid delays continue.

Fitch expects financial reserve levels for most issuers to remain satisfactory despite continued moderate deterioration that began over the last two years. In some cases, however, reserves are likely to fall below levels that Fitch believes provide adequate protection against revenue and expenditure pressures, and some deficit positions are likely. If not offset by prompt action to improve or at least stabilize reserves, this could result in negative rating action. For special tax bonds whose ratings rely on sound debt service coverage from pledged revenues, declining revenues have led to rating downgrades in several cases. While Fitch expects that economically sensitive revenues, which support the majority of Fitch-rated special tax bonds, will level off or improve slightly in the coming year, actual results could underperform expectations and ratings could decline in areas where recovery lags the nation's. For example, Fitch would expect a resumption of growth in such revenues in Florida, but perhaps not in Michigan, where governments have experienced long-term decline and indicators do not point to a change in this trend.

Obligations

The extent to which revenue declines can be offset with spending adjustments depends on the nature of a government's expenditure demands and the practical and political elements that influence budgetary actions. Labor costs comprise two-thirds to three-quarters of spending for a typical local government, so actions such as hiring and salary freezes, vacancy elimination, benefit changes, furloughs, and layoffs are key to making meaningful spending adjustments. In evaluating these actions, Fitch pays close attention to whether current-year expenditure reductions are true cuts and result in longer term savings or are deferrals that will shift expenditure increases onto future budgets.

Fitch has observed that, in some states with strong labor unions, workers have been more willing to at least discuss implementation of actions that in prior years were

beyond the realm of consideration. Having seen furloughs and the like implemented, Fitch believes that labor pressures may abate somewhat. Nevertheless, the ability to alter ratified labor contracts is uncertain at best, and challenges in some cases have been successful. Labor savings are limited further by the need to provide adequate staffing for such vital or mandated functions as education, public health, and public safety, although new, lower staffing thresholds than envisioned in the past are being used in many places.

Controlling variable labor costs, such as salaries and healthcare benefits, is particularly important to creating financial balance, because fixed costs, including debt service, pension, and other post-employment benefits payments, are on the rise for nearly all entities. Also, even where work force reduction is legally and practically possible, Fitch has observed cases of management's reluctance to take such action, yielding to political pressures to provide some economic stability during this period of high unemployment.

Debt Issuance Impact

Fitch believes local government debt levels will be stable to slightly higher in 2010. The popularity of the Build America Bonds (BAB) program may have led to more issuance in 2009 than capital plans would suggest. Whether this trend continues to be as strong in 2010 will likely depend at least in part on whether the program is made permanent, albeit at a lower subsidy level, as is proposed in President Obama's fiscal 2011 budget submission. Governments may issue debt as part of a local economic stimulus plan, in some cases providing funding for development projects that would have been done by private sector entities if their access to credit were more readily available. Low interest rates and favorable construction bids may lead issuers to accelerate debt-funded capital projects.

Potentially offsetting these increases, lower costs may lead to reduced borrowing unless issuers use the savings to fund additional projects, and issuers may be more reluctant to seek voter approval for general obligation authorizations, as they are likely to be more difficult to obtain in this employment climate.

Impact of Management

In 2008 and 2009, Fitch saw great variation in the way municipalities' management reacted to economic and financial trends. Some chose to use reserves, either with the expectation that recovery would begin quickly and reserves could be replenished or the belief that sound reserves were less important than maintaining or lowering the tax burden in a time of economic stress. In some cases, these issuers had built up very large reserves during the period of strong economic growth that led up to the current recession, with the clear intent to utilize the amount above their policy levels either for pay-as-you-go capital financing or as a buffer against immediate spending cuts when a downturn occurred. Others employed what turned out to be optimistic budgeting assumptions, leaving few options as time passed other than drawing down balances beyond expectations because it was too late in their fiscal year to effect meaningful spending cuts. Still others budgeted conservatively and adjusted spending proactively in anticipation of a more prolonged revenue downturn.

In fiscal 2010, Fitch has observed that budgeting has generally turned more conservative, with management more realistically assessing the likelihood of further revenue declines. Having already suffered erosion in operating margins, most are facing at least some reduction in reserves. Fitch has more confidence that this reduction will be mild if reserve policies have been consistently adhered to in the past and management has demonstrated its willingness and ability to make the necessary

adjustments to maintain prudent reserves. Where reserves have already declined by moderate or greater amounts and management appears unwilling to adjust spending or increase revenues, Fitch will reassess whether the level of financial flexibility expected after further reserve reductions is consistent with the issuer's current rating. In other words, downgrades may occur even if reserves are currently satisfactory if indications are that they will decline sizably. Fitch notes that where significant expenditure cuts have already been made, remaining spending options may be limited, leaving only difficult revenue increases or a reduced financial position. In some cases, fewer spending reductions may be needed if outlays have already been adjusted to reflect sufficiently a reduced revenue framework.

Credit Risks in 2010

While each credit is reviewed individually, the following spotlights the states Fitch believes are most likely to present credit concerns this year. Although only 48% of Fitch's 2009 actions on tax-supported ratings were in these nine states, 80% of the downgrades and 80% of Rating Outlook revisions to Negative were in these states. The table at right illustrates the percentage of securities in each state that ended 2009 with Negative Rating Outlooks or Watches, compared with levels nationally and the very limited portion that were on Positive Rating Outlooks or Watches.

Status of Rating Outlook/Watches at Year-End 2009

State	Total No. of Ratings	% on Negative Outlook or Watch	% on Positive Outlook or Watch
Nevada	8	63	—
Rhode Island	9	33	—
Michigan	67	25	—
Arizona	73	25	3
Indiana	26	23	—
Ohio	66	20	—
Illinois	48	17	—
California	298	15	1
Florida	224	14	—
All States	1,589	11	2

California

In California, Fitch's rating activity for tax-supported local credits was more negative than in any prior year. Negative rating actions in 2009 included downgrades to 12% of the rated credits and Rating Outlook revisions to Negative from Stable on 11%. In contrast, only 5% of rating actions were positive, with most of these being upgrades. Fitch affirmed the existing ratings and Rating Outlooks in two-thirds of its 2009 rating activity.

Riverside County provides a good illustration of factors that may lead to a rating downgrade of a California issuer. After revising the Rating Outlooks to Negative on the county's 'AA' implied general obligation and 'AA-' lease ratings in August 2008, Fitch downgraded these ratings to 'AA-' and 'A+', respectively, on Oct. 14, 2009 and retained the Negative Rating Outlooks. The downgrades reflected the county's housing-led economic downturn, now more severe than expected in mid-2008, along with its impact on the county's financial stability and minimal expectation of a near-term return to reserve levels consistent with the prior ratings. AV dropped by 10.5% for fiscal 2010, one of the largest declines in California and in stark contrast to the 15.5% average annual AV increases experienced from fiscal years 2002–2008. The county's unreserved fund balance for fiscal 2010 is projected to drop by two-thirds to a still satisfactory 5% of expenditures. The county's proactive financial management, as evidenced through a three-year financial rebalancing plan and other actions, was critical to keeping the rating adjustment modest. However, by retaining the Negative Rating Outlooks, Fitch expresses concern that achieving the rebalancing plan will be challenging if additional tax base declines are more severe and/or last longer than

currently anticipated.

Tax allocation bonds (TABs) held their credit quality better than might have been anticipated given the vulnerability of this security to tax base declines. Of Fitch's 2009 rating activity for this subsector, 69% were affirmations, and 14% were downgrades, slightly outnumbering upgrades. At the end of 2009, only three TAB ratings (6% of the total) carried Negative Rating Outlooks. This relative stability results from these entities' comparatively low leverage of incremental tax revenue, keeping debt service coverage well above the level required by their additional bonds test, even with declines in taxable value. Fitch does not expect much additional leverage at least in the near term, as development activity has been slow where it exists at all, although district tax bases may erode further. Also, TAB ratings are below average for tax-supported securities, because of their aforementioned vulnerability to AV and pledged revenue decline.

Fitch also experienced more negative rating activity for California school districts than in any prior year. Downgraded districts or those whose Rating Outlooks went to Negative from Stable generally experienced declining enrollment and have been unable to adjust spending to match lower total pupil funding as provided on a per-student basis. Many of these districts had seen rapid growth over several recent years and were not able to accurately project the enrollment drop they experienced. For these districts, Fitch believes the now lower fund balances reduce financial flexibility; Fitch also foresees continued financial pressures given the economic downturn and the state's fiscal imbalance.

Florida

In Florida, Fitch's negative rating actions outpaced positive actions by 3:1 in 2009. Fitch took negative rating action, including downgrades and Rating Outlook revisions to Negative, on 15% of rated securities in 2009, including 16 downgrades. In contrast, Fitch took positive action on just 5% of rated securities.

More than half of the rating downgrades and Rating Outlook revisions were for special tax bonds, specifically those supported by tourist, fuel, and sales taxes. Most were in the last category, reflecting both the number of credits Fitch rates and the magnitude of erosion of pledged revenue compared to expectations. The Rating Outlooks on all but two special tax credits that were downgraded were revised to Negative from Stable, reflecting Fitch's expectation that the rating level could deteriorate further over the subsequent two years.

More highly leveraged issuers were more likely to be downgraded as revenues weakened to a degree that they no longer provided debt service coverage consistent with the existing rating level. The Rating Outlooks for those highly leveraged issuers were frequently revised to Negative from Stable given the severity of the declines, the acceleration of the pace of declines, and uncertainty of the timing of meaningful recovery.

Hillsborough County School District, FL provides an example of divergent credit movement for the same issuer; the district's special tax bonds were downgraded to 'A-' from 'A+' and the Rating Outlook revised to Negative from Stable, while the Rating Outlook for the district's 'A+' certificates of participation (COPS) rating was revised to Positive from Stable. As was common in 2009, the downgrade on the infrastructure sales tax revenue bonds reflected the decline in debt service coverage. Maximum annual debt service (MADS) coverage declined to 1.19x in fiscal 2008, and at that time, year-to-date fiscal 2009 data showed a 5.9% reduction in revenues from the prior-year period, which would lower coverage to a slim 1.12x. The Negative Rating Outlook was based on the accelerated pace of declines, which indicated coverage would weaken further. Conversely, the Positive Rating Outlook for the COPs was based on district management's proven ability to maintain consistent financial results despite multiple

years of state funding reductions and moderating capital needs.

Fitch expects ratings in Florida to stabilize in 2010 but anticipates a smaller number of additional rating and Rating Outlook changes to reflect individual issuer responses to local revenue conditions and spending pressures. Fitch expects special tax revenue declines to moderate in late fiscal 2010 and many to stabilize at 2005 levels.

Michigan

Michigan issuers have experienced severe regional and local economic dislocation due to exposure to the automotive industry and the resulting pressure on revenue from declining income and property tax revenues. Revenue-raising limitations, due to property tax rate caps and continued taxable value declines, may lead to further deterioration in local governments' credit profiles. Fitch expects issuers that had limited financial flexibility in fiscal 2009 as a result of low reserve levels and expenditure growth pressures, due in part to heavy unionization, will see future negative rating actions, as indicated by the high number of Negative Rating Outlooks and Watches at the end of 2009.

For example, in 2009, Fitch downgraded the city of Port Huron's limited tax general obligation bonds to 'A' from 'A+' due to exposure to the automotive industry and a high 25.7% unemployment rate. Fitch's Stable Rating Outlook reflects its belief that the city's strong reserve levels should allow some flexibility to absorb continued taxable value declines over the near term. However, the city is operating at its property tax cap, and operations are likely to remain pressured given economic conditions.

Ohio

Ohio has experienced a significant loss of manufacturing jobs, primarily in the auto sector, resulting in rising unemployment rates. Revenue-raising measures are limited by the restrictive taxing environment. However, the strong presence of the healthcare and higher education sectors has provided stability to the region. Cuyahoga County, home to the Cleveland Clinic and University Hospital, continues its long history of stable operations and high reserve levels, although economic conditions and concerns about their impact on operating margins given the county's dependence on sales tax revenues led Fitch to downgrade the limited tax general obligations to 'AA+' from 'AAA.' Ohio credits are exposed to a heavy dependence on sales tax revenues, continued economic contraction, decline in the auto industry (including auto suppliers and dealerships), and rising fixed costs. These factors will likely pressure reserves and financial operations and may result in additional negative rating actions.

Indiana

Implementation of House Enrolled Act (HEA) 1001 in Indiana, which included instituting a "circuit breaker" that limits property tax levies, has already had an impact on Fitch's ratings. Fitch anticipates the potential for additional downgrades, particularly if income tax revenues do not begin to stabilize or rebound and there is a severe contraction of local tax base.

St. Joseph County's general obligation bonds were downgraded to 'AA-' from 'AA' in 2009, due in part to the circuit breaker's effect on the county's financial profile. Financial performance had begun to erode prior to HEA 1001, but the lengthy implementation process of the circuit breaker legislation and the massive delays in property tax collections forced the county to use a significant portion of its reserves. A weakened economy and ongoing structural imbalance may further pressure the county's financial flexibility.

Illinois

The state's fiscal challenges, including continued revenue deterioration and an inability

to achieve appropriate budgetary measures, have resulted in reduced state revenue distributions to local governments. These reductions, combined with a weakened economy, continue to place considerable credit pressures on local governments. In most of the state, local sales tax receipts are down, unemployment rates remain high, and exposure to subprime mortgages is significant. Fitch expects that these factors will continue to place downward pressure on local governments' overall financial flexibility.

For example, the city of Chicago is struggling with a large and growing structural imbalance in its operating funds, which has led to the accelerated use of its long-term reserves and other nonrecurring funding sources. In October 2009, Fitch placed the city's 'AA' rating on Negative Rating Outlook, citing the budget imbalance and the weakened economy, including persistently high unemployment rates and a pressured housing market that has a high degree of exposure to subprime mortgage delinquency and foreclosure risk.

Arizona

Over the past several years, Arizona has witnessed a collapse of the housing industry in its largest metropolitan area and weakness generally across the state in residential construction and retail activity. The impact currently is being felt most acutely in sales tax revenues, which, for many issuers, have registered double-digit percentage declines from recent peaks in 2007 and 2008. Most Arizona cities and towns are heavily dependent on sales tax receipts for operations, so these declines are forcing significant expenditure adjustments to maintain adequate reserves. Rating downgrades to date have been minimal, because Arizona municipalities had built up sizable reserves during the recent rapid growth period and, as a result, had significant financial cushion and flexibility going into the downturn. Fitch expects stabilization of sales tax revenues in the near term but no meaningful rebound for some time. Meanwhile, Fitch anticipates that budgetary challenges at the state level will continue to pressure the operations of Arizona school districts, as state funding for various programs is reduced.

AV declines in Arizona are expected to be as much as 35%–40% in some cities over the next two years, as reduced values migrate to tax rolls, but will likely not significantly affect most governments' finances as they provide only a small portion of revenue. Debt instruments that bear closest watching are sales tax and assessment districts, as there is no ability to adjust rates to compensate for declines in pledged revenues.

Nevada

Property value declines, along with their impact on property tax revenue, were the main cause of a negative rating trend in Nevada, where the bonds of one local issuer were downgraded in 2009 and those of three were revised to Rating Outlook Negative from Stable. The contracting housing market's impact was exacerbated by weaker visitor activity and tourism-related spending; various taxes on the visitor sector are a significant revenue stream for cities. The predominance of Rating Outlook Negative on rated debt in this state reflects Fitch's view that Nevada remains vulnerable to further property value declines.

Rhode Island

Fitch cites Rhode Island's recent economic performance as among the weakest of the states, as highlighted by high mortgage delinquency and foreclosure rates, declines in employment levels, and persistently high unemployment rates. Additionally, two recent state statutes limit local governments' operating flexibility, which Fitch believes will make funding their high fixed-cost burdens more difficult. At the end of 2009, three of Fitch's six ratings on Rhode Island local governments had Negative Rating Outlooks.

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