

Public Power
New Issue

Susanville Public Financing Authority (CA)

Utility Enterprise Project Revenue Bonds

Ratings

New Issues	
\$9.6 Million Revenue Refunding Bonds, Series 2010A (Senior Lien)	A-
\$24.5 Million Revenue Refunding Bonds, Series 2010B (Subordinate Lien)	BBB-

Rating Outlook

Stable

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Key Utility Statistics

(Fiscal Year Ended June 30, 2009)

System Type	Water and Gas
Customers (Gas System)	2,341
Customers (Water System)	3,770
Annual Gas Revenues (\$ Mil.)	4,650
Annual Water Revenues (\$ Mil.)	2,425
Top 10 Gas Users (% of Rev.)	25
Top 10 Water Users (% of Rev.)	115
Debt Service Coverage —	
Water (x)	1.4
Debt Service Coverage — Gas (x)	0.9
Days Operating Cash — Water	408
Days Operating Cash — Gas	0

Related Research

For information on Build America Bonds, visit www.fitchratings.com/BABs.

Applicable Criteria

- [Revenue-Supported Rating Criteria, Aug. 16, 2010](#)
- [Public Power Rating Guidelines, June 11, 2009](#)
- [Water and Sewer Revenue Bond Rating Guidelines, Aug. 6, 2008](#)

Other Research

- [2010 Water and Sewer Medians, April 6, 2010](#)
- [2010 Water and Sewer Sector Outlook, Feb. 10, 2010](#)

Rating Rationale

- Both series of bonds are secured by unconditional installment payments made by the City of Susanville’s water and gas enterprise systems. However, the water system makes installment payments equal to debt service on the senior lien bonds and the gas system makes installment payments equal to subordinate lien debt service. Once the installment payments are received by the trustee, the funds are allocated to senior lien bonds first.
- The sizable rating differential between the two series results from the obligation of each enterprise to only pay debt service on its respective series of bonds (senior 2010A bonds for the water system and subordinate 2010B bonds for the gas system), even though the bonds are secured by a combined revenue pledge once the funds arrive at the trustee. As such, the subordinate lien bonds rely solely on the gas system for payment.
- The two series of bonds do share the benefit of each system’s respective rate stabilization funds, which can be used to support a shortfall of either series of bonds. This provides a limited measure of additional credit support to the subordinate lien bonds. However, the rate stabilization fund is not a restricted fund and includes the utility’s operating cash, thereby minimizing the enhancement.
- The systems operate in a limited and concentrated local service area economy.
- In addition to the credit factors above, the ‘A-’ rating on the senior lien bonds also reflects:
 - Unconditional installment payments from the city’s water system net revenues that are further supported by funds available from the gas system installment payments, given the senior position of the bonds, and the gas system’s rate stabilization fund.
 - Modest but stable financial position of the water utility.
 - Potential financial pressure that could result from the use of all or a portion of the water rate stabilization fund (which includes the water system’s operating cash) to support the natural gas system.
 - Consistent water supply with low treatment costs that is sufficient to meet current and expected demand in the city.
 - Diverse, albeit small, customer base (which excludes large prisons in the area) with limited growth pressure.
 - High debt levels but limited future capital needs.
- In addition to the credit factors above, the ‘BBB-’ rating on the subordinate lien bonds also reflects:
 - Unconditional installment payments from the city’s gas system net revenues that are further supported by funds available in the water rate stabilization fund.

- Financial performance of the gas system has only just begun to break even. Liquidity is absent as the enterprise has historically relied on the general fund for operating cash.
- Debt service coverage is projected to be slim but exceed 1.25x, based on the aggressive proposed debt service structure with escalating debt service and an extended bond amortization schedule with final maturity in 2045.
- The natural gas system is relatively young (service began in 2001) and needs to continue building its customer base, primarily by converting existing businesses and residents given limited growth in the service area.
- Revenue variability may result from a variable rate structure applicable to certain large customers that pay rates based on the lowest index price of three different heating fuels.
- The city does not have a fuel adjustment factor in its rate structure, but the resulting risk of timing mismatch between expenditures and revenues is partially mitigated by a consistent, although informal, fuel purchasing strategy.
- Limited counterparty risk exists based on a full requirements contract with IGI for natural gas and Tuscarora Gas Transportation Company for transportation services.

Key Rating Drivers

- Ability and willingness to increase rates for each system, when needed, to account for cost increases, fund the liquidity reserve at the required amount, and preserve margins for bondholders.
- Continued success in converting residents to natural gas customers from existing fuel oil and propane heating sources.
- Continued economic stability resulting from the two prisons in the community that account for over half of the city's employment.
- Movement of indexed prices of natural gas compared to heating oil and propane over time given the city's use of a variable rate structure for certain large natural gas customers.
- Depletion of the water system's strong liquidity position could result in a downgrade of both series of bonds.

Credit Summary

While the senior and subordinate bonds enjoy a combined pledge of both systems, the disparity in the ratings reflects the structure of the payments and a dependence of the subordinate lien bondholders on payments from the city's natural gas system. Fitch Ratings views the natural gas system as significantly weaker in credit quality than the water enterprise, largely because of its need for operating subsidies until recently, weaknesses in its rate structure, commodity price volatility, and the need to continue to build its customer base. Each debt series represents a refunding of all outstanding prior debt for the respective enterprise.

The bond repayment structure is complex. The installment sale agreements that the Susanville Public Financing Authority has with each enterprise system only requires each system to make payments equal to the debt service on one series (senior debt service in the case of the water system and subordinate lien debt service in the case of the gas system). There is no requirement for either system to make additional payments in the event the other system does not make its full payment to the trustee. The only degree of cross-over support is the rate stabilization fund held by each enterprise that the city may use to make payments to the trustee for either system in

the event that net revenues are insufficient. In the case of the gas system, with essentially no operating cash and operations that are just beginning to break even, the access to the water system's \$3 million rate stabilization fund provides a degree of additional financial support. However, Fitch views the scope of this liquidity cushion as limited since the water system's \$3 million rate stabilization fund consists of its operating cash and reserves. There is no limitation on the water system spending this unrestricted reserve for its own needs, although each system is required to use its surplus revenues at the end of each fiscal year to replenish its minimum required funding level for its rate stabilization fund. Access to the water system's cash reserves and, potentially, ongoing surplus revenues contributes to the 'BBB-' rating on the subordinate lien bonds, given the credit risks associated with the natural gas system; the potential use of the water enterprise's cash by the gas system is considered in the 'A-' rating on the senior lien bonds.

Legal

Bonds are secured by installment payments made by the City of Susanville, CA, from its water and gas enterprise systems to the Susanville Public Financing Authority, which has assigned those payments to the bond trustee. The water enterprise makes installment payments equal to the senior lien debt service, and the gas enterprise makes installment payments equal to the subordinate lien debt service. Payments to the trustee are made five days prior to interest payment dates on the bonds. The full amount received by the trustee from both installment sale agreements is pledged to senior lien bonds first, then subordinate lien bonds, resulting in a revenue stream for the subordinate bonds that relies solely on payments from the gas enterprise. The payments from the City of Susanville are absolute and unconditional. No debt may be issued for either system with a repayment obligation that is senior to the pledge on net revenues for installment payments.

Rate Covenant

The installment sale agreement for each system requires that the adjusted annual net revenues (adjusted for rate stabilization fund transfers in or out) must equal 125% annual debt service, 105% annual debt service plus subordinate debt service (none outstanding at this time), and 100% all obligations.

Additional Bonds Test

The installment sale agreement for each system requires that the adjusted annual net revenues for 12 of the last 18 months be in compliance with the rate covenant, or that an engineer's report be completed to demonstrate that on a projected basis adjusted annual net revenues will comply with the rate covenant for the next five years either following the period in which interest is capitalized or the projects are completed that were funded with the additional bonds.

Debt Service Reserve Fund

The indenture requires that a debt service reserve fund be maintained for each series of bonds equal to the lesser of 1) 10% of par, 2) 125% of average annual debt service, or 3) maximum annual debt service. The city will fund a reserve fund for each series equal to maximum annual debt service, funded from bond proceeds.

The reserve funds are held for the respective use of each series and do not provide cross-support. In other words, the debt service reserve fund of the senior lien bonds cannot be used to pay debt service on the subordinate lien bonds. Replenishment of the reserve fund for each lien, if needed, is required to be funded from the respective enterprise for each lien, from revenues available after the payment of installment payments and prior to any subordinate obligations or transfers to the rate stabilization fund.

Rate Stabilization Fund

Each installment payment agreement requires that a rate stabilization fund be funded for each enterprise system. The water system is required to maintain a minimum rate stabilization fund of \$3 million. The funding requirement will be met from the water system's existing reserves. The gas system is required to maintain a minimum rate stabilization fund equal to maximum annual debt service (anticipated to be around \$1.8 million) and will be funded over time from surplus revenues. As described above in the Credit Summary section, the funds available in both rate stabilization funds can be used by the city to make installment payments due from either system. Each system is obligated to use its surplus revenues to fund the rate stabilization fund up to the minimum required amount on an annual basis.

Flow of Funds

The flow of funds for revenues of each system is as follows:

- Operating and maintenance expenditures.
- Installment payments.
- Replenishment of debt service reserve fund.
- Subordinate obligations.
- Transfers to rate stabilization fund.

Service Area

The City of Susanville is located in northeastern California, approximately 85 miles northwest of Reno, Nevada and 135 miles northeast of Sacramento. Susanville is the count seat of Lassen County. The local economy is concentrated in the employment provided by two prisons (one state and one federal), with diversification limited by the city's remote location. The population of the city is approximately 17,000, but this included an inmate population of 8,439 as of Jan. 1, 2010 (up from 8,298 as of Jan. 1, 2009). The two prisons account for over 50% of the city's employment. The prisons are not direct customers of either the water or gas enterprise systems, although they use the city's natural gas transportation services to deliver the gas.

Water System

The city provides retail water service to a customer base of 3,800 with modest annual growth averaging 1%. Water supply is provided by two springs and supplemented by four wells in the summer months when usage is the highest. The water sources require very minimal treatment, keeping costs low. Rates are affordable at approximately \$30 per month, or 1% of median household income for the area. A component of the rates is designed to fund ongoing water main replacement.

Customer concentration is minimal with the top 10 customers accounting for 11% of revenues. The two large prisons in the area have their own water supply and are not customers of the water system. The county is the largest customer at 3% of revenues.

Gas System

The gas enterprise is a start-up business that the city began in 2001. The new enterprise borrowed \$24 million to build the backbone infrastructure of a distribution system to provide natural gas to the city's service area. At their option, customers were converted over to the use of natural gas, primarily for heating, from other heating fuel sources. As of 2009, the city provides direct natural gas service to 2,341 customers. The enterprise also provides transportation-only services to large industrial natural gas

consumers, such as the prisons, that enter into direct commodity purchase arrangements and do not buy natural gas from the enterprise.

Customer concentration exists, with the top 10 customers accounting for 25% of revenues. The revenue risk associated with customer loss is mitigated by the fact that most of the large customers are governmental or educational facilities that are unlikely to close or move. The prisons are transportation-only customers and are not part of the top 10 in terms of gas system revenues.

Natural gas is purchased through a gas supply agreement with Interstate Gas Services Resources (IGI), a wholly owned subsidiary of BP Interstate Gas Services (BP IGS) that provides consulting, scheduling, balancing, and auditing services to the city. While IGI does not take ownership of the gas on behalf of the city, it advises upon and executes the city's risk management strategy regarding hedging a portion of its forward gas needs to minimize the impact of commodity price volatility. The lack of formal risk management policies and an oversight committee is a credit concern. On average, 41% of gas prices in the next four years are fixed, although in practice, the percentage amounts are approximately 65%–70% in the winter months while prices typically are not fixed during the less volatile summer months.

Rates

The city's current rate structure does not include an automatic fuel cost adjustment mechanism that would permit timely cost recovery of natural gas costs. While the city does have a risk management strategy that typically purchases 70% of winter gas up to one year ahead in order to provide a degree of price stability, commodity cost escalation is a risk to the enterprise's financial performance, given the lack of flexibility in the rate structure that is typically used by local gas distribution companies.

In addition to expenditure volatility, the enterprise faces revenue variability in approximately 23% of its revenues that are provided by customers on a variable rate pricing schedule. These customers pay the lowest fuel cost of natural gas, propane, and fuel oil in order to prevent these customers from flipping in and out of natural gas services as commodity prices move in relation to one another. The expected surplus revenues generated from the gas system in addition to the liquidity it can access at the water system should provide some level of protection against rapid commodity price movement until the city can get a retail rate adjustment approved by Susanville's city council, if needed. The city's limited local economy and the need for competitive rates to entice new customers to convert to natural gas likely will limit the enterprise's rate flexibility.

Finances

Water System

The financial performance of the water system is modest but consistent. Debt service coverage has been over 1.3x the past three years, resulting in surplus revenues annually of \$229,000 in 2008, \$455,000 in 2009, and \$233,000 in 2010. A slight rate increase in fiscal 2009 should improve surplus revenues to over \$300,000. Liquidity is robust, with \$1.7 million reported in the audited financial statements at the end of fiscal-year 2009 (or 408 days operating cash). According to the Susanville finance director (Mr. Bob Porfiri) the unrestricted cash and investment balance appearing in the audited water fund balance sheet was significantly understated in 2009. The city finance director indicated and the city auditor confirmed that a portion of the water fund cash balance of \$3.05 million was allocated to "due from other funds" for presentation purposes only in Susanville's 2009 comprehensive annual financial report.

Financial Summary — Susanville Water Utility

(\$'000, Fiscal Years Ended June 30)

	Audited 2005	Audited 2006	Audited 2007	Audited 2008	Audited 2009	2010	2011	2012	2013	2014
Balance Sheet										
Unrestricted Cash and Investments	752	1,077	1,028	1,546	1,704	—	—	—	—	—
Accounts Receivable	419	282	309	452	337	—	—	—	—	—
Other Current Unrestricted Assets	2,385	2,244	2,098	1,819	2,225	—	—	—	—	—
Available Restricted Cash and Investments	—	—	—	—	—	—	—	—	—	—
Current Liabilities Payable from Unrestricted Assets	(307)	(393)	(320)	(497)	(365)	—	—	—	—	—
Net Working Capital	3,249	3,210	3,115	3,320	3,901	—	—	—	—	—
Net Fixed Assets	(4,777)	(5,099)	(5,406)	(5,722)	7,067	—	—	—	—	—
Net Long-Term Debt Outstanding	10,433	10,288	10,132	9,971	9,799	9,626	9,326	9,131	8,926	8,711
Operating Statement										
Operating Revenues	2,049	2,046	2,064	2,050	2,425	2,320	2,451	2,451	2,451	2,451
Non-Operating Revenues	126	141	188	158	89	6	—	—	—	—
Connection Fees	—	—	—	—	—	—	—	—	—	—
Gross Revenues	2,175	2,187	2,252	2,208	2,514	2,326	2,451	2,451	2,451	2,451
Operating Expenses (Excluding Depreciation)	(1,330)	(1,309)	(1,299)	(1,276)	(1,526)	(1,251)	(1,369)	(1,369)	(1,369)	(1,369)
Depreciation	(365)	(338)	(335)	(331)	(337)	(336)	(336)	(336)	(336)	(336)
Operating Income	480	540	618	601	651	739	746	746	746	746
Net Revenues Available for Debt Service ^a	845	878	953	932	988	1,075	1,082	1,082	1,082	1,082
Senior Lien Debt Service Requirements	624	693	692	697	695	698	697	691	704	694
Total Debt Service Requirements	—	—	—	—	—	—	—	—	—	—
Financial Statistics										
Debt Service Coverage (x)	1.4	1.3	1.4	1.3	1.4	1.5	1.6	1.6	1.5	1.6
Days Cash on Hand	206	300	289	442	408	—	—	—	—	—
Days Working Capital	892	895	875	950	933	—	—	—	—	—
Debt to Net Plant (%)	—	—	—	—	139	—	—	—	—	—
Outstanding Long-Term Debt Per Customer (\$)	2,872	2,826	2,732	2,632	2,581	2,507	2,402	2,326	2,249	2,171
Operating Margin (%) ^b	35	36	37	38	37	46	44	44	44	44

^aEquals gross revenues less operating expenses. ^bEquals operating revenues less operating expenses divided by operating revenues. Note: Numbers may not add due to rounding.

Debt levels are high (at \$2,500 per customer in fiscal-year 2009) for a system with limited treatment operations. The water system has provided liquidity support via inter-fund loans to the gas system in the past. However, any significant use of its operating reserves to support the gas system or any other ongoing demand on its surplus revenues could result in a deterioration in credit quality of the senior lien bonds.

Gas System

The start-up nature of the gas enterprise has resulted in the need for the gas system to rely on the city's general fund and water fund for ongoing operating cash. The city estimates that fiscal 2010 will be the first year the enterprise fund ends the year with a positive cash balance (\$80,000). The debt borrowed to build the initial system is being refunded with the series 2010B bonds and will amortize over the next 35 years with a final maturity of 2045. Debt levels are exceptionally high (approximately \$9,617 per customer) and will remain high with the slow amortization (principal repayment continues to be delayed a few years in the proposed series 2010B bond structure), although no additional debt is expected for the system. System revenues began to fully support operations and the interest-only payments on the debt in fiscal 2007. Financial projections provided by the city indicate that with the escalating debt service on the 2010B bonds at the assumed interest rates, 1% growth in revenues, and 1% growth in expenses (including natural gas commodity purchases), debt service coverage should exceed 1.25x. Projections indicate surplus annual revenues should exceed \$400,000.

Financial Summary — Susanville Gas Utility

(\$000, Fiscal Years Ended June 30)

	Audited 2005	Audited 2006	Audited 2007	Audited 2008	Audited 2009	2010	2011	2012	2013	2014
Balance Sheet										
Unrestricted Cash and Investments	—	—	—	—	—	—	—	—	—	—
Accounts Receivable	264	235	243	279	226	—	—	—	—	—
Other Current Unrestricted Assets	2,576	2,505	2,528	2,493	2,490	—	—	—	—	—
Available Restricted Cash and Investments	—	—	—	—	—	—	—	—	—	—
Current Liabilities Payable from Unrestricted Assets	(1,291)	(1,272)	(1,260)	(901)	(1,030)	—	—	—	—	—
Net Working Capital	1,549	1,468	1,511	1,871	1,686	—	—	—	—	—
Net Fixed Assets	21,381	21,006	20,642	20,258	19,969	—	—	—	—	—
Net Long-Term Debt Outstanding	24,240	24,240	24,240	24,240	24,240	—	—	—	—	—
Operating Statement										
Operating Revenues	2,724	4,264	4,326	4,650	4,272	4,678	4,646	4,691	4,737	4,784
Non-Operating Revenues	126	(56)	94	139	41	—	—	—	—	—
Connection Fees	—	—	—	—	—	—	—	—	—	—
Gross Revenues	2,850	4,208	4,420	4,789	4,313	4,678	4,646	4,691	4,737	4,784
Operating Expenses (Excluding Depreciation)	(1,909)	(2,863)	(2,942)	(3,010)	(2,999)	(2,544)	(2,661)	(2,674)	(2,687)	(2,701)
Depreciation	(522)	(522)	(519)	(518)	(511)	(511)	(521)	(521)	(521)	(521)
Operating Income	419	823	959	1,261	803	1,623	1,464	1,496	1,529	1,562
Net Revenues Available for Debt Service ^a	941	1,345	1,478	1,779	1,314	2,134	1,985	2,017	2,050	2,083
Senior Lien Debt Service Requirements	1,428	1,414	1,414	1,414	1,414	1,414	1,498	1,578	1,604	1,628
Total Debt Service Requirements	—	—	—	—	—	—	—	—	—	—
Financial Statistics										
Gas System Debt Service Coverage (x)	0.7	1.0	1.0	1.3	0.9	1.5	1.3	1.3	1.3	1.3
Days Cash on Hand	—	—	—	—	—	—	—	—	—	—
Days Working Capital	296	187	187	227	205	—	—	—	—	—
Debt to Net Plant (%)	113	115	117	120	121	—	—	—	—	—
Outstanding Long-Term Debt Per Customer (\$)	12,199	11,637	11,094	10,968	10,707	10,362	9,900	9,581	9,272	8,910
Operating Margin (%) ^b	30	33	32	35	30	46	43	43	43	44

^aEquals gross revenues less operating expenses. ^bEquals operating revenues less operating expenses divided by operating revenues. Note: Numbers may not add due to rounding.

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