Fitch Affirms Marin Clean Energy's (CA) IDR at 'BBB+'; Outlook Stable

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Fitch Ratings - San Francisco - 13 Aug 2021: Fitch Ratings has affirmed the Issuer Default Rating (IDR) for Marin Clean Energy, CA's (MCE) at 'BBB+'.

MCE has no direct debt outstanding.

The Rating Outlook is Stable.

SECURITY

The IDR reflects Fitch's assessment of MCE's vulnerability to default on its financial obligations.

ANALYTICAL CONCLUSION

The affirmation of the 'BBB+' rating is based on continued strong financial performance in the past year. Days cash on hand (DCOH) increased to 162 at YE 2020 from 80 days at YE 2019 as a result of rate increases implemented in 2019. Fitch's liquidity cushion ratio, measured by the combination of annual cash flow, unrestricted cash reserves and available liquidity divided by operating expenditures, also nearly doubled to 0.79x from 0.42x over the same time period.
The 'BBB+' IDR also reflects MCE's limited operational role as a Community Choice Aggregator (CCA) and the inherent credit weaknesses in the CCA business model, which include a non-captive customer base that can elect service from PG&E and the resulting pressure to maintain competitive rates. To date, MCE has successfully retained over 86% of the customers in its service area that are eligible to opt-out. Positively, the restricted scope of MCE’s business, which is limited to the procurement of power, largely eliminates any material capex needs given current practices in securing power supply.

MCE's rating is further supported by a strong financial profile that reflects consistently improving liquidity levels over the past two years, and helps mitigate the risks associated with the competitive pressures. However, MCE's strong leverage profile is less of a consideration in the rating given the absence of direct debt obligations.

**KEY RATING DRIVERS**

**Revenue Defensibility: 'Weaker'**

MCE's weaker revenue defensibility assessment reflects a customer base that can opt out from MCE at any time and at minimal cost. This results in competitive pressure on MCE. While the potential for customers to switch providers creates incentive for MCE to maintain rates in line with PG&E, MCE's rates at times have exceeded PG&E. The risk of customer loss is not fully mitigated by MCE's independent authority to set and adjust rates, MCE's product differentiation, or MCE's legal ability to impose an exit fee on departing customers. The assessment also reflects MCE's lack of control over the Power Cost Indifference Adjustment (PCIA) charged to its customers and established by the California Public Utilities Commission.

**Operating Risk: 'Midrange'**

MCE's operating risk is limited given its narrow role as an energy-only provider. Power supply resources consist of over 350 energy and capacity purchase contracts with varying length of term and counterparties and minimal capital needs. The midrange assessment also incorporates the long-term financial risk associated with right-sizing a power supply for a potentially variable customer base, given the state requirement established by Senate Bill 350 that requires 65% of the state's required renewable portfolio standard (RPS) be secured under 10 year or longer contracts by 2021.

**Financial Profile: 'Stronger'**
MCE's stronger financial profile reflects robust operating margins and liquidity levels that are expected to continue to increase over the next two years. Cash flow has improved substantially since 2018, largely a result of the increased service to new member communities and an average 6.5% rate increase in fiscal 2020. Unaudited results for fiscal 2021 indicate margins that have remained healthy and an increase in cash balances.

ASYMmetric RISK ADDITIVE CONSIDERATIONS

No material asymmetric risk factors affected the overall rating.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--High levels of cash reserves that provide meaningful protection against a potential multiyear customer opt-out trend, given MCE's long-term contractual commitments for energy purchase;

--Cessation of competition from alternate energy provider;

--Enhancements to customer opt-out provisions that limits or reduces long term customer departures.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--An increase in the leverage ratio above 0.0x on a sustained basis or a trend of declining operating margins or reserve levels;

--Significant adverse change in the regulatory or competitive landscape within which MCE operates;

--Reversal to the pattern of declining renewable costs that erodes MCE's ability to compete with PG&E.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The
complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CREDIT PROFILE

MCE is a California joint powers authority (JPA) that was created on Dec. 19, 2008 for the purpose of implementing a CCA program. Since then, the JPA has grown from its initial eight members located within Marin County to include all of the following: Marin and Napa Counties (including all cities and towns), unincorporated Contra Costa County and Solano County, and the cities and towns of Benicia, Concord, Danville, El Cerrito, Lafayette, Martinez, Moraga, Oakley, Pinole, Pittsburg, Pleasant Hill, Richmond, San Pablo, San Ramon, Vallejo and Walnut Creek.

MCE serves a four-county service area but continues to grow through the in-fill addition of part of the counties not previously served. The governing body of each city or county must vote to join the MCE JPA, and MCE's board of directors must also vote affirmatively to extend service to the new community. Enrollments of the cities of Vallejo and Pleasant Hill in April of 2021 were the most recent expansion of MCE’s service, with approximately 56,000 new accounts moving to MCE. There are additional cities within the service area that may elect and be approved to join in the future, including the city of Fairfield that is expected to join in Q2, 2022. MCE currently has approximately 70 full time employees.

MCE provides energy supply to non-captive retail customers who elect MCE as their energy provider instead of PG&E. PG&E still delivers the energy to the customers of MCE over PG&E transmission and distribution lines and provides billing services as MCE’s collection agent. PG&E remits the funds daily to MCE and its role in this regard was well protected during the PG&E bankruptcy in 2019-2020.

REVENUE DEFENSIBILITY

Default Energy Supplier in Four County Service Area

MCE is the default provider of energy supply for all retail customers within the member's service area, as required by the 2002 California legislation enabling the formation of CCAs. The legally required default to MCE service is a strong credit feature. Customers are presumed to be price sensitive, but also relatively non-action oriented. Customer behavior tends to strongly favor the default assignment when automatic enrollment occurs. Fitch
reviews the default to MCE service, in combination with rate competitive with PG&E and a higher renewable content, as supportive elements to the final rating.

New members (i.e. counties, cities and towns) elect, by a vote of their City Council or County Board of Supervisors, to join MCE. Once part of the JPA, participating cities and counties are required under the agreement establishing MCE to remain part of MCE or pay the costs incurred on their behalf prior to their departure. In addition, any municipality seeking to leave the JPA must provide one year's notice.

Customer Opt-Out Ability is Key Credit Risk

Retail customers permanently retain the ability to opt out of service from MCE and revert to being an energy customer of PG&E at any time, potentially undermining the long-term stability of demand, and leading to Fitch's weaker assessment of revenue defensibility. Customers who opt out of MCE within the initial 60 days of being enrolled as an MCE customer are able to opt back into MCE at any time. Customers who opt out of MCE after the initial 60-day period are required to remain a PG&E customer for one year prior to being eligible to opt back to MCE.

MCE reports that it serves approximately 86.5% of the customers within its service territory, implying that approximately 13.5% of the customer base has selected PG&E as their power provider. MCE's Integrated Resource Plan (IRP) notes that participation rates have improved over time, with the initial communities (2010-2011) at approximately 78% and the more recent communities (2016-2020) resulting in higher retention rates from 89%-91%. MCE was the state's first CCA and its initial years included a higher degree of community education and opposition from PG&E than subsequent CCA formations. Given MCE's rates that are competitive with PG&E, Fitch expects the opt-out rate will continue to decrease from the initial start-up years.

MCE is legally able to impose an exit fee on customers switching back to PG&E. At present, MCE does not charge customers an exit fee if they opt out within the first 60 days of service. If a customer opts out after 60 days of service, MCE charges a one-time $5 (residential) or $25 (commercial) administrative fee. This fee could be increased to either stem departures or capture the costs incurred to service departing load. While legally permissible, this mechanism has not been used extensively, and Fitch expects that any effort by MCE to sharply raise its exit fee could be met with some level of political backlash. Fitch views the legal ability to implement an exit fee as a potentially important tool, but insufficient on its own to protect against a meaningful trend of customer departures and raise MCE's overall demand characteristics.
Very Strong Service Area Characteristics

MCE’s four county service area exhibits very strong service area characteristics, supporting ongoing electric demand and potentially, a greater customer interest in the product differentiation offered by MCE compared to PG&E. Marin, Napa, Solano and Contra Costa are located in the north and eastern portions of the San Francisco Bay area. Marin County, one of the largest customers, exhibits median household income levels that are 183% of the national average and unemployment rates that are around 62% of the national average. MCE’s current customer mix is approximately 51% residential and 49% commercial or industrial as measured by load served.

MCE’s current customer count is approximately 543,161, following an increase of approximately 56,000 accounts due to service expansion in the communities of Vallejo and Pleasant Hill in April of 2021. An additional 43,000 customers from the city of Fairfield are expected to join the system in Q2 of 2022. The customer base will continue increasing if additional communities elect to join. MCE’s customers are viewed as non-concentrated. Demand growth is expected to track economic trends in the region due to MCE’s position as the default electric provider in the service area.

Flat Overall Electric Demand

Electric sales to the existing customer base are generally expected to remain relatively flat on a per customer basis, given industry advancements in energy efficiency and conservation, although usage fluctuates with weather and economic conditions. MCE’s service territory did not see a significant impact from California’s stay at home orders in 2020, with increased residential demand largely offsetting a decline in sales from the commercial class.

Product Differentiation

MCE offers customers three programs to customers: 1) default 60% renewable "light green" option; 2) 100% renewable "deep green" option; and 3) 100% local solar option. The vast majority of customers (97.6%) participate in the light green program. MCE’s light green product offered 60% renewable content and 90% greenhouse gas free power, as compared with PG&E’s renewable content in its base rate plan, reported at 29% in 2019 (most recent power content label available). MCE’s IRP outlines the goal to increase the light green renewable content to 85% by 2029, subject to product availability and cost.
The higher renewable content of MCE's power supply appears to be the consideration that has garnered political and community support for MCE (and other CCAs). However, it appears less of a primary motivation for individual customer decisions given the limited election of the deep green option. Fitch does not view MCE’s product differentiation as sufficient to offset the otherwise weaker demand characteristic. In addition, PG&E (along with other California IOUs) are legally mandated to continue raising their power supply’s renewable content over time, reducing MCE’s current competitive advantage of a renewable content. MCE’s targeted investment in renewable projects within the service area though, will likely continue to be a distinguishing factor with the potential to build customer loyalty.

PG&E & Wildfire Risks

PG&E delivers the energy purchased from MCE to the retail customers over PG&E’s transmission and distribution lines, and bills the retail customer on a combined bill in the role of MCE's billing agent. The flow of MCE revenues collected by PG&E was protected during the PG&E bankruptcy from January 2019 through June 2020. One of the first actions the bankruptcy court took during the initial days after the bankruptcy filing was to maintain the existing collection arrangements between PG&E and CCAs, including MCE. PG&E remits the funds daily to MCE.

PG&E engages in public safety power shutoffs (PSPS) to reduce its exposure to wildfires during certain weather conditions in high-risk areas. At times, the PSPS events affect MCE's sales because its customers receive power delivered via PG&E's transmission and distribution lines. MCE has no ability to deliver power to its customers during a PSPS. PG&E declared 7 PSPS in 2020 which affected parts of the service area to varying degrees. The revenue impacts have been manageable to date and PG&E's notification timing has lengthened, which allows MCE to reduce the costs incurred to purchase and schedule energy deliveries via the California Independent System Operation (CAISO).

Wildfires have become more prevalent in California in recent years and calendar year 2021 is poised to be a potentially active wildfire season given the ongoing drought and expected summer heat. MCE does not own or operate generation or transmission assets, which limits the liability risk of a catastrophic wildfire event that may be initiated by these types of assets and have exposed California utilities to extraordinary liability claims as a result of permissive inverse condemnation laws, regardless of whether the utilities lines or operations are determined to have caused or contributed to a damaging wildfire.

Independent Rate Setting but Competitive Pricing Constraints
MCE has independent ability to adjust rates to fully recover costs. The board of directors makes rates decisions that are not subject to external review. While all participating municipalities have a seat on the MCE board, MCE is not under the local authority of participating member city and town councils. Fitch assumes that customers are rate sensitive over time due to the competitive pressure presented by PG&E as a potential alternate electricity provider and the lack of switching costs for customers. Together these aspects impose a practical limitation rate setting.

In practice, MCE sets its rates to be competitive with PG&E, which is sufficient to recover costs. In July 2019, MCE's board increased rates to capture the existing headroom between MCE's and PG&E's rates, but preserving MCE's cost advantage at approximately 0.3% on average for each customer class. The result was an overall average rate increase of approximately 6.5% across all customer classes. The rate increases boosted revenues in fiscal 2020, which increased MCE's operating margin and bolstered reserve levels.

In May 2020, PG&E raised rates, including the PCIA charge, which resulted in MCE's rates being 1.5% higher than those of PG&E, on average. The exception was for the new Solano County customers since their agreement included a rate match to PG&E through the first year (April 2021). MCE did not experience a notable number of new opt-out decisions after May 2020 as a result of its slightly higher rates. PG&E raised the PCIA component of their rate charged to MCE customers by approximately 33% on Jan. 1, 2021, further elevating MCE's rates above PG&E. Additional changes to PG&E's generation and PCIA rates are anticipated in 2022.

As long as MCE's rates remain competitive to those of PG&E, Fitch expects the vast majority of customers will decide not to opt out given the economic incentives to remain with MCE and the community support for the current product offerings. MCE's current rates do not offer future rate flexibility but the net margin produced by the rates has been used to build reserves from 2019 through 2021.

Power Cost Indifference Adjustment

MCE does not have ultimate control over one component of its rates, further limiting rate flexibility. MCE's customers are charged a PCIA that is determined by the California PUC. The 1.5% differential noted above between MCE and PG&E rates takes into account the PCIA charge paid by MCE customers to PG&E.

The PCIA is charged on a per kWh basis and is intended to reflect the difference in the cost of PG&E's portfolio developed to serve the departing customer, less the market value of the
portfolio, leaving PG&E 'indifferent' to the loss of that customer's energy load. The PCIA is adjusted at least annually and varies by the year that the customer joined the CCA. For example, a customer that began being served by MCE in 2015 would have the same '2015 vintage PCIA' charged to all other 2015 vintage customers.

In June 2021, PG&E filed its 2022 Energy Resource Recover Account (ERRA) application with the California PUC. The ERRA filing proposes a 2.4% average rate increase charged to its bundled customers and a PCIA rate decrease of 9.6% for direct access and CCA customers. These proposed PG&E rate changes would provide MCE additional headroom in rate flexibility, allowing MCE to raise rates while maintaining overall rates that continue to be competitive with PG&E's bundled rates.

**OPERATING RISK**

MCE's operational role is primarily limited to power supply procurement. The distribution, delivery and transmission of power, as well as billing and collections, remain obligations of PG&E. Cost drivers are well identified and power supply volatility is manageable given robust hedging practices. MCE does offer additional programmatic services such as energy storage programs for vulnerable customers and critical facilities and energy efficiency programs funded by the California Public Utility Commission but these are modest in scope and rely on received funding.

MCE's capex needs are negligible as MCE does not own any generation; all power supply resources are contracted. Positively, this means MCE generally does not bear the development, construction, operating, or system risks experienced by generation resource owners, integrated utilities, or distribution utilities. A change in MCE's operating risk profile through the development and/or ownership of generation resources could lead to a revision of the assessment.

Operating Cost Flexibility

Operating costs consist of the cost of power, marketing, and general administration and operating expenses. MCE's cost of power is largely known as power supply is contracted primarily through fixed price (or moderately escalating price), multi-year contracts. MCE's power procurement guidelines, as outlined by the 2021-2030 IRP, target the procurement of between 70% and 100% of the current year power supply under fixed-price contract, between 60% and 95% of power supply in the following year and up to 70% in the third year and beyond. The practice is designed to reduce exposure to market price risk and allow for annual rate setting.
While the cost of power per MWh is generally known, the volumes necessary to serve load along with potential fluctuations in energy received under each contract (particularly for intermittent renewables) creates some uncertainty regarding the actual price at any point in time and increases the need to maintain adequate liquidity. The risk of intermittent renewable supplies are partially mitigated by requirements for load-serving entities in California, such as MCE, to demonstrate a 15% reserve margin above its projected peak demand and the use of flexible capacity.

Resource Management

Robust power supplies are generally available to MCE with good transmission infrastructure in place. MCE's location within the CAISO, the prevalence of renewable generation in surrounding areas, the diversity of potential suppliers, and the geographical dispersion of potential resources position MCE well in terms of securing sufficient and adequately priced power to meet its needs.

MCE's power supply is currently met by over 350 energy, capacity and price hedging contracts with various suppliers incorporating multiple technologies and fuel types, including renewable, conventional and carbon free. Contracted resources are geographically diverse. MCE's energy mix was 60% renewable in calendar year 2019, which is well above state mandates and the renewable content available in PG&E's power supply.

Balancing Potential for Load Declines with Long-Term Power Supply is Credit Risk

MCE's largest resource risk is balancing its power supply with a potentially variable customer base, given MCE's lack of the exclusive right to provide energy supply. MCE has adopted a formal risk management plan that seeks to limit the potential risk of being either short or long power supply in any particular year. MCE's practice is to contract to fill short positions at years 1 to 5 to prevent significant pricing risks to emerge. MCE's practices call for it to have between approximately 90%-115% of its energy needs under fixed price contract during the current calendar year and successively lower amounts in each of the following four years.

Balancing supply and demand is further complicated by certain legislative mandates. CCAs must secure at least 65% of the RPS compliant power under contracts that extend 10 years or longer by 2021. While California's RPS compliance targets are well below the actual renewable content of MCE's power supply, the long-lived nature of the contracts pose challenges to adjusting power supply costs if significant load departure occurs. This risk is mitigated by MCE's demonstrated trend to date of maintaining customers through periods
Prepaid Energy Financing Expected to Lower Supply Costs

MCE is preparing a prepaid commodity transaction to be sold through the California Community Choice Financing Authority (CCCFA) that will prepay a portion of MCE’s energy supply for approximately 30 years. MCE, as one of four CCA participants in CCCFA, will enter into a new clean energy purchase contract for energy to be supplied at a fixed contract price. MCE estimates that savings from the prepayment will result in annual reduced energy costs of approximately $3 million.

Limited Capital Needs

MCE does not have any direct debt outstanding, but does have two operating leases that are capitalized for purposes of Fitch’s leverage calculation. The leases are for office spaces that terminate in 2023 and 2025. Annual payments appear to be manageable, varying between a high of $866,000 in 2023 to a low of $539,000 in 2025.

FINANCIAL PROFILE

Strong operating margins and liquidity levels are key supports of MCE’s stronger financial profile assessment and the final rating. Fitch’s leverage metric includes fixed obligations, such as debt and pension liabilities (of which MCE has neither) minus cash reserves as compared to cash flow. Given the absence of fixed obligations, Fitch’s leverage calculation for MCE is negative.

Strong operating margins and liquidity levels are key supports of MCE’s stronger financial profile assessment and the final rating. Service area growth in addition to rates and financial reserve policies adopted by the board resulted in notable improvement in the financial profile in fiscal years 2019 and 2020. Operating margin increased to 16% in fiscal 2020 from 3% in fiscal 2018.

The system's available cash balance at the end of fiscal 2018 was modest at approximately $34.4 million or 63 days. Available cash increased to $198.1 million by fiscal year end 2021, including a $15 million operating reserve fund. MCE established the operating reserve fund in November 2019 to allow for building a rate stabilization account. Although the revenues were deferred for accounting purposes in the 2020 audited financial statements, Fitch has included the initial $10.5 million deposit made in 2020 for liquidity and cash flow. Liquidity levels are enhanced by the use of lines of credit. MCE has a $40 million LOC with
JPMorgan. When the LOC is included, Fitch's days liquidity calculation at YE 2020 was 204 DCOH.

Management amended its reserve policy in November 2019 to target building cash reserves to 240 DCOH, up from 140 DCOH previously. MCE's policy includes available LOC, but does not include amounts set aside in the operating reserve fund. MCE expects to reach the new liquidity target by YE fiscal 2023.

ASYMMETRIC RISK ADDITIVE CONSIDERATIONS

Governance and Management

MCE is governed by a 30-member board of directors. The board members are elected city council members or supervisors from each of the member cities and counties served by MCE. While they are not elected to the MCE board, the representatives have been elected to represent their respective communities. The board has appointed experienced, executive leadership to run daily operations of MCE.

Regulatory Risk

The legal and regulatory environment for CCAs continues to evolve. Fitch does not currently view the legal and regulatory regime as an asymmetric additive risk factor that affects the overall rating, but changes could present a rating risk in the future. Regulatory changes could result in either positive or negative changes to credit quality.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

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# RATING ACTIONS

<table>
<thead>
<tr>
<th>ENTITY/DEBT</th>
<th>RATING</th>
<th>PRIOR</th>
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<tbody>
<tr>
<td>Marin Clean Energy (CA)</td>
<td>LT IDR</td>
<td>BBB+ Rating Outlook Stable Affirmed BBB+ Rating Outlook Stable</td>
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**VIEW ADDITIONAL RATING DETAILS**

**FITCH RATINGS ANALYSTS**

**Jeb Spengler**  
Director  
Primary Rating Analyst  
415-732-5615  
jeb.spengler@fitchratings.com  
Fitch Ratings, Inc.  
One Post Street, Suite 900 San Francisco, CA 94104

**Kathy Masterson**  
Senior Director  
Secondary Rating Analyst  
+1 512 215 3730  
kathryn.masterson@fitchratings.com

**Dennis Pidherny**  
Managing Director  
Committee Chairperson  
+1 212 908 0738  
dennis.pidherny@fitchratings.com
MEDIA CONTACTS

Sandro Scenga
New York
+1 212 908 0278
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 23 Feb 2021) (including rating assumption sensitivity)
U.S. Public Power Rating Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

ENDORSEMENT STATUS

Marin Clean Energy (CA) EU Endorsed, UK Endorsed

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