

Special Report

Russia Outlook: Four Key Issues for 2007

Ratings

**Foreign Currency**

Long-Term IDR*	BBB+
Short-Term IDR*	F2
Outlook	Stable

**Local Currency**

Long-Term IDR*	BBB+
Rating Outlook	Stable

Country Ceiling..... A-

\* IDR – Issuer Default Rating

Peer Group

A-	Bahrain Israel Latvia Malaysia Poland
BBB+	<b>Russia</b> Hungary South Africa Thailand
BBB	Aruba Bulgaria Kazakhstan Mexico Romania Tunisia

Ratings History

Date	FCIDR*	LCIDR
25 July 2006	BBB+	BBB+
3 August 2005	BBB	BBB
18 Nov 2004	BBB-	BBB-
13 May 2003	BB+	BB+
2 May 2002	BB-	BB-
4 Oct 2001	B+	B
29 Aug 2000	B	B-
8 Aug 2000	B-	-
26 Aug 1998	CCC	-
17 Aug 1998	B-	-
30 Jul 1998	BB-	-
7 Jun 1998	BB	-
7 Oct 1996	BB+	-

\* Long-term Foreign Currency rating prior to 2006.

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■ Summary

- What does 2007 have in store for Russia? Abstracting from recent lurid headlines, this note flags up four key issues to watch. Fitch Ratings' 'BBB+' Sovereign Rating is currently on a Stable Outlook. But trends in oil prices, fiscal policy, the political transition of power and investment could have a significant bearing on Russia's economic development and creditworthiness in 2007.
- **High oil prices** have precipitated a massive improvement in Russia's financial position and been a key factor behind recent sovereign upgrades. However, they have dropped 10% since 1 January and 32% since their peak in August, raising the spectre of a less supportive credit environment. Fitch's assumption for Urals is USD50 per barrel for 2007, compared with USD61pb in the 2007 budget. Nevertheless, that is still well within Russia's comfort zone – and should be compatible with a continued accumulation of Stabilisation Fund (SF) assets and foreign exchange (FX) reserves, which Fitch expects to reach around USD135bn and USD370bn, respectively, at end-2007.
- A significant **loosening of fiscal policy** is underway that will add to inflationary and real exchange rate pressures. The IMF forecasts that the general government non-oil deficit could widen to 8.3% of GDP in 2007 from 4.3% in 2004, and Fitch forecasts that the federal government surplus will narrow to 3% in 2007 from 7.5% in 2006. Nevertheless, this would still be an enviable performance and Russia's public finances remain a rating strength. Fitch estimates that the federal budget would still balance at around Urals USD38pb.
- The looming **transition of power**, with parliamentary elections due in December and presidential elections in March 2008, means that Russia is entering an uncertain political period. President Vladimir Putin's designated successor is highly likely to win the election and broad policy continuity is the most likely scenario. However, weak and opaque democratic institutions and the "winner takes all" nature of the contest raise event risk. And a post-election change in economic policies or heightened uncertainty over property rights cannot be ruled out. A smooth transition of power would improve Russia's risk profile, but major political instability could put the rating under negative pressure.
- A **take-off in investment** is underway, with growth of around 12% in 2006, record inward foreign direct investment (FDI) of USD31bn and net private sector capital inflows of USD42bn. Higher investment could help to sustain GDP growth and promote economic diversification, providing a stronger foundation for the economy. However, some adverse developments in the business climate pose a downside risk to the amount and efficiency of investment.

25 January 2007

■ Introduction

What does 2007 have in store for Russia, or indeed what does Russia have in store for 2007? Recent lurid headlines of assassinations, disputes with foreign investors and neighbours, and disruptions to energy supplies do not portray the country in a very flattering light, as seen from the West. However, such developments do not necessarily have much of a bearing on creditworthiness. This note focuses on four themes that may have a significant influence on Russia's economic development and rating in 2007: oil prices, fiscal policy loosening, the transition of power, and investment.

■ Declining Oil Prices?

High global energy prices have been a major factor behind Fitch's recent sovereign upgrades of Russia, as they have strengthened the country's financial position at a remarkable pace<sup>1</sup>. The level of oil prices in 2007 will again be a key influence on Russia's prospects.

However, oil prices have weakened markedly so far in 2007. Benchmark Brent crude was trading at USD53pb on 23 January, down 10% since the beginning of the year and 32% off its peak in August 2006. Fitch's latest assumption for annual average prices for Brent is USD53pb for 2007 and USD47.5pb for 2008<sup>2</sup>. That sort of price level is still well within Russia's comfort zone, equating to a slower pace of the accumulation of assets in the SF and Central Bank of Russia (CBR) FX reserves, rather than declines. But recent market moves suggest a greater probability distribution of outcomes in 2007, and Russia has not been tested by a major downturn in oil prices since its default in 1998.

Uncertainty over the oil price is exacerbated by the fact that Russia has adopted an Urals oil price assumption of USD61pb for the 2007 budget (also in line with the outturn for 2006) – significantly above both the current spot price and Fitch's forecast assumption of USD50pb. This is in stark contrast to the government's practice in previous years of very conservative oil price assumptions (see table).

Budget Oil Price Assumptions

Urals (USD pb)	2004	2005	2006	2007
Budget	22	28	40	61
Outturn	34	50	61	50 <sup>a</sup>

<sup>a</sup> Fitch forecast.

Source: Ministry of Finance and Fitch

<sup>1</sup> See "Russian Federation", Fitch Sovereign Report, July 2006

<sup>2</sup> "Sovereign Review: December 2006," Fitch Special Report

**Oil Prices Take a Tumble**

Brent Crude

(USD/barrel)



Source: Datastream

As a rule of thumb, around 40% of federal government revenues come from oil and gas sector taxes, and a USD1pb fall in the oil price would result in a loss of around RUB55bn (0.2% GDP) in revenue. If the outturn for the Urals oil price was USD50pb, rather than USD61pb in the budget, Fitch estimates the federal budget surplus would drop from the target of 4.8% of GDP to around 3% of GDP. Nevertheless, this would still be an impressive number, highlighting the strength of Russia's fiscal position. In addition, Fitch projects an increase in SF assets from USD90bn at end-2006 to around USD135bn at end-2007.

The oil price also has a large impact on Russia's external accounts. Other things equal, Fitch projects a USD1pb fall in oil and gas prices would reduce the value of exports, the current account balance and foreign reserves by around USD3.2bn in 2007<sup>3</sup>. However, a reduction in real incomes and monetary growth would be likely to dampen import growth, so that the net effect might be closer to USD2bn. Based on its 2007 Urals assumption of USD50pb, Fitch forecasts a decline in the current account surplus from USD96bn (10% of GDP) in 2006 to USD50bn (4%) in 2007. Again, this would still be a strong performance, consistent with a rapid increase in FX reserves, which Fitch forecasts at USD370bn at end-2007.

Lower oil prices would also marginally dampen GDP growth, other things equal, though the relationship is hard to estimate as it has changed over time, is non-linear and depends on whether it is perceived as temporary or permanent. A decline in the oil price to USD50pb in 2007 from USD61pb in 2006 might knock only around 0.5 percentage points off the growth rate, other things equal. In view of the

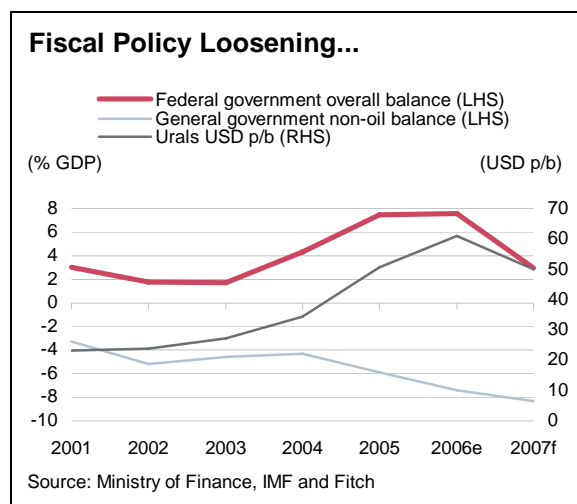
<sup>3</sup> In fact gas prices tend to lag oil prices by around 6-9 months, providing a more cushioned adjustment.

stimulus to demand from fiscal policy, capital inflows and credit growth, Fitch forecasts GDP growth of 6.5% in 2007.

In summary, oil prices are likely to remain at a level that helps to deliver budget and current account surpluses and a further accumulation of SF and FX reserves assets in 2007, bolstering creditworthiness. However, if the sharp decline in oil prices witnessed in January were to continue, then Russia's macroeconomic and financial position could offer less support to its rating.

### ■ Fiscal Policy Loosening

Notwithstanding large budget surpluses, a marked loosening of fiscal policy has been underway in Russia since 2005. This trend is set to continue in 2007, moderating the strength of the underlying position of the public finances and adding to pressures on inflation and the real exchange rate.



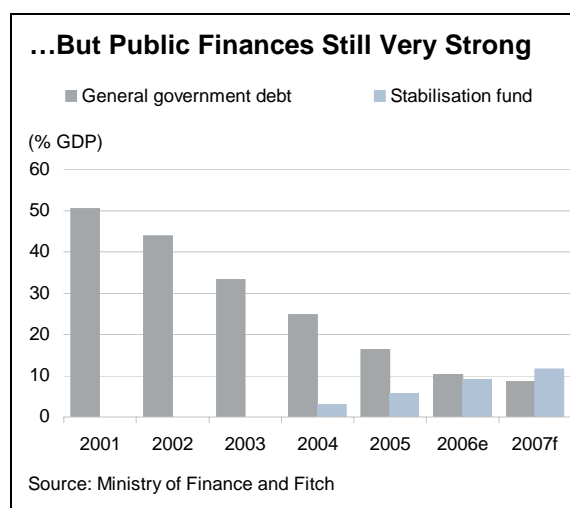
The IMF estimates that the general government non-oil deficit widened from 4.3% of GDP in 2004 to an estimated 7.4% in 2006 and a forecast 8.3% in 2007 (a total loosening of 4% of GDP over three years; and nearly 5% in terms of the primary non-oil balance)<sup>4</sup>. But the recently released outturn for the 2006 federal (central) budget presents a slightly better picture, with a surplus of 7.5% of estimated GDP, greater than the Ministry of Finance's previous forecast of 6.4%. The over-performance was mainly due to expenditure below projections, which may reflect delays in execution more than policy, and spending could be rolled over into 2007. Fitch estimates that the federal budget would balance at an Urals oil price of around USD38pb in 2007<sup>5</sup>. The

<sup>4</sup> "IMF Executive Board Concludes 2006 Article IV Consultation with the Russian Federation", IMF, November 2006.

<sup>5</sup> There is a margin of error around this estimate as the relationship between oil prices and the direct oil and gas revenues to the budget is non-linear. In addition, high oil prices provide an

creation of National Priority Projects (NPP) and the Investment Fund, which both came into effect in 2006, is one indication of spending pressures. But the amounts involved, around 0.7% of GDP and 0.3%, respectively, in 2007 are moderate.

Nevertheless the loosening in fiscal policy does not pose any risk to the solvency of the public finances. The medium-term equilibrium oil price appears to have shifted up markedly since 2004. In view of Russia's substantial infrastructure and social needs, it is rational to spend a proportion of the increase in apparently permanent revenues, though structural reforms would increase the returns on that spending. Moreover, Russia's policy of using the windfall to repay debt and build up a substantial buffer stock in its SF leaves it well placed to cope with even highly improbable negative oil price shocks. Fitch estimates that at end-2006, after the early repayment of USD22bn of debt to the Paris Club, Russia's federal government debt has dropped to just 9% of GDP, equal to the level of assets in the SF.



However, the fiscal stimulus will add to the risks of overheating, making it more difficult for the CBR to attain its targets of reducing CPI inflation to 6.5%-8% at end-2007, from 9% at end-2006, as well as dampening the pace of real exchange rate appreciation in order to support competitiveness (and mitigate the "Dutch disease"). Indeed, the CPI index rose 1% in the first nine days of January and the Ministry of Finance forecast an increase of 2.2% for the month as a whole. The rapid pace of private capital inflows and bank credit growth is exacerbating the policy dilemma facing the CBR.

indirect boost to the budget via higher incomes, spending and non-oil taxes. The estimate can also change over time if GDP rise faster than energy production.

There is also a risk that the draft 2008 budget, which the government will present in the autumn ahead of the Duma elections, could involve a further loosening in fiscal policy. The government's medium-term fiscal plan for 2007-2009 envisages a reduction in expenditure from 17.5% of GDP in 2007 to 17.3% in 2008 (and a budget surplus of 2.6% of GDP, based on a Urals price of USD54pb), which may be politically unrealistic.

A potential positive development to watch out for is a refinement of the rules governing the SF. Currently it automatically receives oil revenue from just two taxes (natural resource extraction tax and export tariff) once a cut-off price of USD27pb is exceeded, and also receives unused budget surpluses. The government could change the structure, for example so that all oil and gas revenues flow directly to the SF, which could then provide a subsidy of X% of GDP a year to the (non-oil) federal budget. Such a change would be positive in providing greater insulation of energy revenues and potentially help build up popular understanding and support for the prudent use of windfall revenues. At the same time, the authorities might also raise the RUB500bn (only 1.7% of projected 2007 GDP) threshold of the SF, below which withdrawals are not permitted, and more formally divide the SF into stabilisation and savings parts, with concomitant rules for the investment of assets. Fiscal rules can always be changed by new regimes, but clear institutional rules and structures provide some reassurance.

In summary, the Russian budget envisages a further relaxation of fiscal policy in 2007 that will add to demand pressures and make it harder for the authorities to meet their inflation and real exchange rate objectives. There is risk that populist pressures ahead of the elections could induce an even greater loosening of fiscal policy in 2007 and in 2008. Fitch expects the combination of lower oil prices and looser policy to lead to a reduction in the federal budget surplus to around 3% of GDP in 2007 and a slower accumulation of SF assets. Nevertheless, Russia's public finances are a rating strength, and the net government debt position should continue to improve, exerting upward pressure on the rating.

■ **The Transition of Power**

Russia is entering an uncertain and potentially volatile political period, with parliamentary elections due in December and then, more importantly, presidential elections due in March 2008. Under the current constitution, President Putin is not permitted to stand for a third consecutive term. The looming transition of power raises several uncertainties and concerns.

- Russia is a “managed democracy”, with power highly concentrated in the presidency, while institutions are weak and opaque. Thus, although Russians will vote at the ballot boxes, the outcome will be effectively decided in a non-transparent way within the Kremlin. President Putin's popularity (with approval ratings of 70%-80%), as well as the strong economy, budgetary resources, and state control of the media and levers of power, mean that whoever he endorses is highly likely to win the election.
- However, the “winner takes all” nature of the system and the huge political and commercial power at stake mean Russia is entering a time of relatively high event risk. There is a risk of an unsettling jockeying for position ahead of the elections between the various business and political groups in and around the Kremlin. And extreme scenarios cannot be entirely ruled out.
- President Putin has an impressive record of delivering rising economic prosperity (see table below) and political stability. After the elections, will his successor be able to unite the power groups in the Kremlin or could there be a ratcheting up of political conflict? Can he be trusted to maintain the political status quo or could there be a new wave of property redistribution? What will be the economic policies of the new team, in terms of fiscal discipline or populism, economic liberalism or dirigisme?

President Putin's Record

	End-2000	End-2006
GDP per capita (USD)	1,784	6,750
Government debt (% GDP)	63	10
Stabilisation fund (USD bn)	0	90
FX Reserves (USD bn)	28	304
Net external debt (% GDP)	50	-4
RTS equity index	143	1,911
Sovereign rating (FCIDR)	'B'	'BBB+'

Source: Fitch

President Putin is likely to wait before unveiling his designated successor until late in 2007, ahead of the Duma elections, to try to limit an ebbing of his power. At the moment there appear to be four main candidates.

- First Deputy Prime Minister Dmitri Medvedev is the chairman of Gazprom and head of the NPP public spending programme, and former head of the Presidential Administration. He comes from a legal and technocratic background and is seen as relatively pro-business.

- Deputy Prime Minister and Minister of Defence Sergei Ivanov is a former KGB officer and is seen as representing the security forces (“Siloviki”).
- There is reported pressure from within the ruling elite for President Putin to stand again, given that he would be the ultimate continuity candidate. Staying on would require a change in the constitution, though that should be possible given the Kremlin’s control over the political scene<sup>6</sup>. Perhaps with an eye on his legacy, President Putin has said he has no intention of standing, though in somewhat in Delphic terms, and this remains a fallback option. One of many possible scenarios is that the next president could quickly step down on health or other grounds, enabling President Putin to serve another (non-consecutive) term.
- A.N. Other – there are several other names of possible candidates doing the rounds. And, indeed, President Putin may decide to pluck someone from relative obscurity.

**Political Risk Indicators**

	Russia	BBB median	A median
Political rights index <sup>a</sup>	6	2	1
Civil liberties index <sup>a</sup>	5	2.5	1
Corruption perceptions <sup>b</sup>	2.5 (121st)	3.5 (66th)	5.0 (42nd)

<sup>a</sup> Freedom House, Freedom in the World 2007; 1 = most free, 7 = least free.

<sup>b</sup> Transparency International, 2006; score 10 = highly clean, 0 = highly corrupt; rank 1st = least corrupt, 163rd = most corrupt.

Source: Freedom House, Transparency International and Fitch

Another key factor that may emerge in 2007 is the future role of President Putin himself. He is young (54), popular and powerful, and has said he will continue to have a role. Possibilities might include prime minister, head of the United Russia party and/or chairman of Gazprom. On the one hand, his reassuring presence might help to facilitate a smooth transition of power; but on the other hand, an attempt to steer Russia from the backseat might exacerbate political uncertainty.

In summary, political noise and uncertainty are likely to increase in Russia this year, as different political/business groups manoeuvre for position, and questions loom over the policies of the new regime. However, President Putin’s designated successor is highly likely to win the election and

<sup>6</sup> A change in the constitution would require a two-thirds majority in the Duma (lower house of parliament), three-quarters in the Federation Council (upper house), two-thirds of regional assemblies and the agreement of the president himself.

broad policy continuity is the most likely scenario. Fitch’s ‘BBB+’ rating of Russia factors in this balance of risks. A smooth transition of power, particularly to a relatively market-friendly president, would improve Russia’s risk profile. But in the unlikely event of major political instability, the rating could come under negative pressure.

**■ Is Investment Taking Off?**

One of the most important and encouraging trends for Russia’s medium-term development is a pick-up in investment seen over the past 12 months. A key issue for 2007 will be whether it continues.

Russia’s strong recent real GDP growth rate – 6.5% average over the five years to 2006 – partly reflects temporary impulses from the initial competitive level of the rouble, utilisation of spare capacity, some structural reforms and massive commodity price-related terms of trade gains. Looking forward, however, sustaining a healthy medium-term growth rate is likely to require more normal factors: higher investment and structural reforms to improve the efficiency of factors of production. Investment is also required to help diversify the economy.



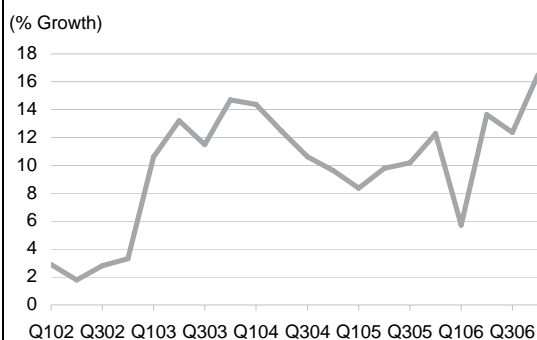
Years of under-investment (before and after the Soviet collapse) have left Russia with an antiquated and inadequate capital stock, evident in some of its dilapidated infrastructure, supply bottlenecks and inefficient production. Fitch estimates the ratio of domestic investment to GDP at a relative low 21% in 2006 (fixed investment just 19%), compared with a median of 26.5% for the ten new EU member states in Central and Eastern Europe.

Against this background, therefore, the acceleration of gross fixed investment through 2006 to an average of 17% yoy in October-November is a very positive development. Investment growth was just 5.7% in Q106, owing to the cold winter. Nevertheless,

investment growth should average around 12% in 2006, the fourth consecutive year of double-digit growth. And it should increase further in Q107, owing to the favourable base effect and a warm winter so far this year.

**Investment Recovering**

Real gross fixed capital formation



Source: State Statistics Service and Fitch

Investment growth has been volatile in the past, but the current recovery appears more firmly based, reflecting rising public investment, strong private sector balance sheets, easier access to financing from capital inflows and bank credit growth, tightening capacity utilisation and good growth prospects. Growth in 2006 was also supported by government measures such as profit tax depreciation allowance changes, VAT reimbursements and lower import duties. The new law on special economic zones could also provide a fillip.

**Structure of Investment**

Q106-Q306	Growth (yoy)	% Total
<b>Total</b>	<b>12</b>	<b>100</b>
Natural resource extraction	29	19
Manufacturing	6	18
Agriculture	43	4
Electricity, gas and water supply	1	7
Construction	6	4
Retail	0	3
Transport	15	21
Communications	4	5
Real Estate	4	11
State admin and social services	15	9

Source: State Statistics Service

However, the composition of investment still points to some imbalances, with the contribution of the natural resource sector accounting for around 45% of total investment growth in the first three quarters of 2006 (though partly reflecting a bounce-back from weakness in 2005) and manufacturing only 9% (see table).

Data on financing indicate a deepening source of funding for investment. Retained earnings remain the dominant source of funding, but bank loans and foreign financing are becoming more important (see table), which augurs well for competition and total investment itself.

**Sources of Investment Financing**

Q1-Q3 (% total)	2006	2005
Own funds	45	48
Loans from enterprises	6	8
Budget and off-budget funds	18	19
Bank loans	9	7
Other	22	19
o/w foreign financing	7	5

Source: State Statistics Service

**FDI and Capital Inflows Pick Up...**

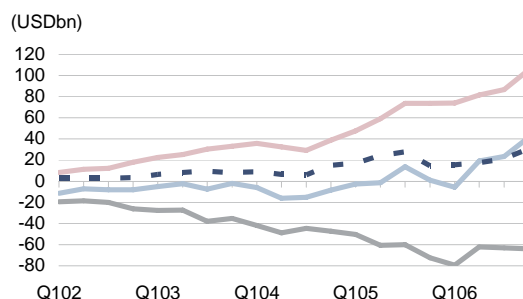
In particular, 2006 witnessed a marked increase in private capital inflows from abroad, including FDI. The stock of net FDI is exceptionally low in Russia, the European Bank for Reconstruction and Development estimates that it received cumulative net FDI of just USD61 per head from 1989-2005, compared with a Central and Eastern European average of USD2,714, though the basis of the comparison does not flatter Russia, as it makes significant investments abroad<sup>7</sup>.

FDI into Russia boomed to USD31bn in 2006, up from USD15bn in 2005 (while outward FDI increased to USD14bn the first three quarters of 2006 from USD12bn in the whole of 2005). Total net private sector capital inflows surged to USD41.6bn in 2006, from USD1.1bn in 2005 and a net outflow of USD8bn in 2004.

**Surging Private-Sector Capital Flows**

Four-quarter rolling total

— Total net  
— Total inward  
— Total outward  
■ Inward FDI



Source: Central Bank of Russia

<sup>7</sup> "Transition Report 2006", European Bank for Reconstruction and Development, 2005.

...But Risks from Business Climate

However, a number of retrograde developments over the past 12 months or so have darkened the business climate, posing a risk to a sustained take-off in investment.

- The state has been increasing its ownership of the economy and creating “national champions”<sup>8</sup>. Its relatively poor track record in managing companies suggests that rent-seeking could increase while corporate governance, competition, efficiency and output growth could weaken.
- A draft law has been tabled that would limit foreign investment to 50% of companies’ shares in seven designated “strategic” sectors (natural resource extraction, natural monopolies, weapons, nuclear, space, aerospace and special equipment).
- With echoes of the Yukos affair, the pressure from state authorities on the foreign companies owning the Sakhalin II project under a production sharing agreement that persuaded them to sell a 50% + 1 share to Gazprom may serve to undermine confidence in the rule of law and property rights. The dip in investment growth in 2004 and 2005 partly reflected the impact of the Yukos affair (as well as turbulence in the banking sector).
- Recent months have seen a spate of assassinations, including figures from banking, oil, the media and Andrei Kozlov, the first deputy chairman of the CBR, who was trying to crack down on money laundering.
- Corruption remains pervasive. According to Transparency International’s Corruption Perceptions Index, Russia’s score and rank improved only marginally to 121st (out of 163) in 2006 from 126th (out of 158) in 2005, which is the worst of any investment-grade country.

On a brighter note, 2007 could bring Russia’s long-awaited accession to the WTO, following the signing of a bilateral agreement with the US (though Georgia

has threatened to block it). Membership should improve the business climate by lowering tariffs, raising standards, encouraging FDI and sharpening competition.

In summary, investment accelerated in 2006 and has strong momentum going into 2007. A higher investment rate should help to sustain GDP growth in Russia and promote economic diversification, providing a stronger foundation for the economy in the event of a marked downturn in commodity prices, and thus mitigating one of Fitch’s main economic concerns. However, some adverse developments in the business climate pose a downside risk to the amount and efficiency of investment.

## ■ Conclusions

2007 is likely to be another eventful year for Russia. A key challenge for analysts and investors will be to discriminate between noise and genuine credit developments. Fitch has flagged up four issues to watch that could have a significant bearing on creditworthiness this year. Of course, other factors will also feed into Fitch’s rating judgements and, no doubt, there will be some surprises along the way.

Fitch’s Stable Outlook on its ‘BBB+’ Sovereign Rating signals that it currently has no bias towards changing the rating. However, Russia’s rating history has been volatile. And Fitch should note that the most recent upgrades were from a Stable Outlook, as oil prices exceeded forecasts by a wide margin delivering an unexpectedly massive and rapid improvement in the public and external balance sheets.

On current trends, if oil prices stay at around current levels, fiscal policy remains in the ballpark of the 2007 budget, the forthcoming transition of power does not precipitate major political instability and the positive trends of increasing investment and financial intermediation endure, then Russia’s creditworthiness could continue to improve this year. However, there are downside risks to creditworthiness from a further sharp drop in oil prices, a rise in pre-election populism, a major increase in political instability and deterioration in the business climate.

<sup>8</sup> See, for example, Table 1.5 “Russian Federation,” OECD Economic Surveys, November 2006.

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