S&P Global
Ratings

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Presale:

Tobacco Settlement Authority

Tobacco Settlement Revenue Refunding Bonds, Series 2018

June 4, 2018

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PRIMARY CREDIT ANALYST

Elizabeth T Fitzpatrick
New York
(1) 212-438-2686
elizabeth.fitzpatrick
@spglobal.com

SECONDARY CONTACTS

Jing Xie, CFA
New York
(1) 212-438-7101
jing.xie
@spglobal.com

Jie Liang, CFA
New York
(1) 212-438-8654
jie.liang
@spglobal.com

ANALYTICAL MANAGER

Kate R Scanlin
New York
(1) 212-438-2002
kate.scanlin
@spglobal.com

CORPORATE AND GOVERNMENT CREDIT ANALYST

Gerald T Phelan, CFA
Chicago
(1) 312-233-7031
gerald.phelan
@spglobal.com

Preliminary Ratings

Series	Maturity	Preliminary rating(i)	Preliminary amount ($)
2018	2022	A (sf)	10,600,000
2018	2023	A (sf)	11,500,000
2018	2024	A (sf)	22,635,000

(i)The rating on each class of securities is preliminary and subject to change at any time.

Profile

Expected closing date	June 2018
Collateral	Washington's pledged tobacco settlement revenues resulting from the MSA payments, fully funded liquidity reserve account, and interest income.
Issuer	Tobacco Settlement Authority
Trustee	US Bank N.A.
Lead underwriter	Jefferies

MSA--Master settlement agreement.

Rationale

The preliminary ratings assigned to Tobacco Settlement Authority's (TSA's) $44.735 million tobacco settlement revenue refunding bonds series 2018 reflects our view of:

- The likelihood that timely interest and scheduled principal payments will be made at each bond's maturity under our 'A' stress level.
- The credit quality of the two largest participating tobacco manufacturers: Altria Group Inc., parent of Philip Morris USA Inc. (Philip Morris), and British American Tobacco PLC (BAT), parent of Reynolds American Inc.
- The transaction's legal and payment structures.
- The liquidity reserve of $31,997,719 that has been established under the amended and restated indenture, dated October 2013.

TSA is a public instrumentality and agency of the state of Washington. Its legal existence is distinct and separate from the state, and it does not constitute a state government department. The state sold to the TSA the pledged tobacco settlement revenues generally consisting of 29.2% of the state's receipts under the master settlement agreement (MSA). The authority has assigned and pledged the pledged tobacco settlement revenues (TSRs) to the indenture trustee.

The series 2018 bonds are being issued as refunding bonds by the authority pursuant to an indenture, dated Oct. 1, 2002, as amended and restated on Oct. 17, 2013, and the series 2018 supplement, dated as of June 2018. The series 2018 bonds are being issued to refund three classes of the TSA's outstanding Tobacco Settlement Revenue Refunding Bonds series 2013 (series 2013 bonds), equal to $47.645 million principal in aggregate, and to pay the series 2018 bonds issuance costs. Following the refunding of the three classes of the series 2013 bonds, $134.835 million aggregate principal amount of series 2013 bonds will remain outstanding under the indenture. Series 2018 and 2013 are all serial bonds.

The series 2018 bonds, as well as the remaining series 2013 bonds, shall not be obligations of the state and shall be obligations only of the TSA, payable solely from the special fund or funds created by the TSA for their payment.

Based on our cash flow analysis, the preliminary series 2018 'A (sf)' rated bonds passed all of the rating runs and passed the sensitivity runs at the 'A' stress level (see Cash Flow Analysis section for more detail).

Transaction Strengths And Weaknesses

Strengths

In our opinion, the transaction's strengths include:

- Its structure, which allows the series 2018 preliminary rated bonds to withstand an approximately 18.9% year-over-year decline in cigarette consumption;
- The availability of the fully funded liquidity reserve account of $31,997,719 available to pay interest and principal when due for the series 2018 refunding bonds as well as the remaining series 2013 bonds;

- The existence of optional redemption features that could accelerate amortization of certain outstanding series 2013 and 2018 bonds, which we believe could more effectively mitigate the risks related to cigarette consumption forecasts and potential market share shifts to nonparticipating manufacturers (NPMs) from the participating tobacco manufacturers as well as lowering the interest expense.
- The state of Washington's ownership of 70.8% of the TSRs, as well as its residual position in this transaction after the series 2013 and 2018 bonds have been paid in full, which we believe may better align its interests with that of debt holders; and
- The investment-grade credit quality of the two largest tobacco manufacturers, which make the majority of the MSA payments.

Weaknesses

The transaction's weaknesses, in our opinion, include:

- The continued, and potentially greater, decline in cigarette shipments as a result of higher excise taxes imposed by the federal, state, and local governments, price increases by manufacturers, or the passage of new regulations (including increasing the legal age to purchase, restricting locations where cigarettes can be smoked, and requiring changes to packaging to highlight health risks (discussed in our article, "Volume Declines: Interpreting The Smoke Signals For The U.S. Cigarette And Tobacco Industry," published May 7, 2018);
- The U.S. Food and Drug Administration (FDA) July 28, 2017, announcement of a multiyear plan to significantly reduce addictive nicotine in combustible cigarettes, which we explored in our articles "Credit FAQ: The FDA's Plan To Take Aim At Combustible Cigarettes Could Hurt Large Tobacco Companies If Regulations Follow," published Aug. 9, 2017, and "Tobacco Securitization Criteria Will Remain Unchanged Following the FDA's Nicotine Reduction Announcement," published Aug. 15, 2017. It is uncertain if this will be enacted, and if it is, it could take five-to-15 years to implement changes, in our view;
- The litigation risk (current and future lawsuits) against tobacco manufacturers and claims challenging the MSA or qualifying statutes; and
- The increase in the popularity of alternative tobacco products, the sales of which would not result in payments under the MSA.

Mitigating factors

In our view, the factors that partly mitigate the transaction's weaknesses include the following:

- Our additional cash flow runs, which include scenarios designed to test the transaction's sensitivity to event risks. These scenarios include a market shift in NPMs, a one-time steep decline in cigarette consumption, and periodic steeper-than-historical average declines in cigarette shipments.
- The U.S. tobacco industry continuing to face hurdles, and class-action lawsuits, such as Engle Progeny, that allege cigarette manufacturers used unfair and deceptive trading practices when claiming that so-called light cigarettes were lower in tar and nicotine or were less hazardous than other cigarettes. Last year, S&P Global Ratings stated its view that cigarette manufacturers face manageable litigation risk given their strong recurring cash flows and the generally declining caseloads (see "The U.S. Tobacco Industry is Still Standing Tall Despite

Increased Regulatory Risks," published Aug. 11, 2016). Lawsuits may always arise, but it becomes more difficult over time for remaining smokers to claim that they were not aware of health risks.

- The FDA currently considering numerous cigarette regulations, and with the likelihood of more to come, which continue to be a risk to the industry and this transaction. However, S&P Global Ratings' opinion is that the major U.S. tobacco companies will successfully navigate these risks thanks to their regulatory expertise, deep financial resources, and protections afforded by the U.S. Constitution (see "The U.S. Tobacco Industry is Still Standing Tall Despite Increased Regulatory Risks," published Aug. 11, 2016).
- Alternative tobacco products still accounting for a small segment of the overall tobacco market, and any new products needing approval by the FDA. They currently have a large backload of new products seeking approval. In August 2016, the FDA began to regulate e-cigarettes, which is expected to have a major negative impact on this sector. Also on the horizon is "heat-not-burn" cigarettes. However, we believe, at this time, that these cigarettes will be included in the MSA definition of cigarettes and therefore will be included in the volume calculation.

Industry Characteristics: Sector Outlook

S&P Global Ratings' general outlook on the tobacco industry reflects its view of the following:

- The U.S. cigarette industry is mature, competitive, and highly concentrated, with the two major tobacco manufacturers controlling approximately 85% of the market.
- The industry is characterized by high profit margins and low capital expenditure requirements, resulting in significant free cash flow generation.
- We continue to assume annual cigarette volume declines of around 3%-4%, with increased likelihood at closer to 4%, as state tax increases will likely hurt demand and the positive effects of previously low gas prices will wear off. This decline level is close to the industry's long-term rate of decline.
- Manufacturers enjoy significant pricing power. This pricing power (across most tobacco products, including cigarettes, cigars, and smokeless tobacco) and higher non-cigarette product volumes, more than offsets lower cigarette volumes.
- High shareholder payments are expected to continue.
- We view the FDA's multiyear plan to reduce nicotine in combustible cigarettes, if enacted, as a long-term risk to the industry. However, there is significant uncertainty whether the package of proposals could be enacted, and we believe the time frame for any implementation would be at least five, and perhaps even 15, years. We do not believe there will be a fundamental impact on near-term profits and cash flow-generating ability.
- Litigation is an ongoing risk factor. Although trends over the past decade have been generally favorable, it is not a guarantee of the future.
- Philip Morris International Inc. (A/Negative/A-1) could receive approval over the next few months to start selling its heat-not-burn product in the U.S. through Philip Morris USA as its exclusive agent. BAT/Reynolds American Inc. is probably not far behind with its Glo product. It's possible that heat-not-burn products could resonate well with smokers, depending on the satisfaction derived from such new products and the cost relative to combustible cigarettes. The MSA's definition of a cigarette includes products that heat, although it's not entirely clear

whether such products will be included in the MSA. We do not believe there will be a material impact on MSA payments over the near term; however, if heat-not-burn (or other next generation) products win market share from combustible cigarettes and are excluded from the MSA, payments under the securitization could decline.

The MSA

The series 2018 bonds are collateralized by 29.2% of the payments that the participating manufacturers (PMs) make under the MSA that are due to the state of Washington. The MSA was signed in 1998 and settled various lawsuits filed by 46 U.S. states, Washington, D.C., and several U.S. territories against the four major cigarette manufacturing companies, known as original participating manufacturers (OPMs). The OPMs were Philip Morris, R.J. Reynolds Tobacco (Reynolds), Brown & Williamson Tobacco Co. (B&W), and Lorillard, until Reynolds subsequently acquired B&W (July 2004) and Lorillard (June 2015), leaving only two OPMs. In 2017, Reynolds was purchased by BAT. However, Imperial Brands PLC, formerly Imperial Tobacco Group PLC, purchased certain cigarette brands that Reynolds and Lorillard divested in the 2015 merger, and it makes MSA payments on these brands as an OPM. Various smaller tobacco manufacturers--known as subsequent participating manufacturers (SPMs)--also joined the MSA. Under the MSA, the PMs must pay each state annually indefinitely.

The MSA provides that payment amounts will be divided among the PMs based on market share. The MSA assumes that if a company stops manufacturing cigarettes, that company's market share would be reallocated among the remaining manufacturers. As long as the remaining companies continued to participate in the MSA, there would likely only be a temporary loss of settlement revenues. These losses would likely be eventually recaptured if the remaining participating companies absorbed the lost company's market share. To that end, rather than taking a company-specific approach, the MSA provides for an industry approach that accounts for the industry's overall strength.

Adjustment To The MSA

The MSA payments are calculated by an independent auditor and are subject to a number of adjustments. Assumptions about these adjustments can materially affect the projected revenues. The main adjustments have historically been for inflation, annual shipment volume, and for NPM adjustments.

The MSA recognizes that the PMs' payment obligations could result in certain cost disadvantages to the PMs that could subsequently shift market share to the NPMs away from the PMs. To level the economic playing field, the MSA states that the PMs may reduce their annual MSA payment obligations by asserting their right to claim an NPM adjustment because of these cost disadvantages. Historically, this resulted in reductions that were disputed and resulted in a large balance in the disputed payment account.

In December 2012, the three OPMs at that time and some other PMs reached an agreement initially with 19 jurisdictions, to resolve longstanding disputes related to the NPM adjustment disputes from 2003-2012. Washington was not one of those states. The 2003 NPM adjustment dispute was decided in favor of the state, 2004 is currently in arbitration, and arbitration has not begun for 2005 and later years.

Collateral

The bonds are secured by the state of Washington's right, title, and interest to 29.2% (pledged amount) of the state's share of the TSRs payable to the state of Washington from the PMs under the MSA. There are no principal payments due on the series 2013 bonds until 2019 and no principal payments due on the series 2018 bonds until 2022. Interest payments will commence Dec. 1, 2018. The debt service account has been funded to cover December 2018 interest payments.

TSRs include the annual payments, but no longer include strategic contribution fund payments that expired in 2017.

Washington's share of the annual payments under the MSA equals approximately 2.05%; 29.2% of that amount is pledged to the series 2013 and 2018 bonds. The TSA's claim to the pledged TSRs is on par with the state's ownership claim of the remaining 70.8% of all amounts that must be paid to the state under the MSA.

The state is entitled to receive residual payments but not until all interest and principal payments have been paid in full and there are no bonds outstanding.

Table 1

Actual Receipts Of Tobacco Settlement Revenue Payments To Washington

Fiscal year	Actual receipts (mil. $)(i)(ii) (iii)(iv)
2008	172.99
2009	187.20
2010	157.47
2011	147.80
2012	150.68
2013	150.63
2014	164.81
2015	146.32
2016	152.88
2017	151.18
2018	120.73

(i)29.2% of these payments are pledged to the TSA. (ii)Annual Payments are, and strategic contribution payments were, due from the participating manufacturers on April 15 of the applicable calendar year (payment year) pursuant to the MSA. Actual receipts are listed as of June 30 (the end of the state's fiscal year) of each year. (iii)Rounded. The state's allocable portion of base payments as represented in this table consists of the state's 2.0532582% share of annual payments under the MSA, and the state's 5.7647432% share of strategic contribution payments under the MSA. The final strategic contribution payment was paid to the state in April 2017. (iv)As reported by the National Association of Attorneys General. MSA--Master settlement agreement.

Transaction Structure

The state of Washington is issuing $44.735 million of series 2018 bonds. The three series 2018 bonds are serial refunding bonds with annual maturities beginning in 2022 through 2024. The series 2018 issuance is intended to refund three classes of TSA's outstanding series 2013 bonds, with maturity dates between 2027 and 2029.

The series 2018 bonds maturing on or prior to June 1, 2023, are not subject to an optional redemption. The series 2018 bonds maturing on June 1, 2024, are subject to redemption in whole or in part, at any time on or after June 1, 2023, at the option of the TSA at a redemption price equal to 100% of the principal amount being redeemed, plus accrued interest to the date fixed for redemption date.

Per the indenture, all amounts deposited into the surplus account must be used to pay an optional redemption on any bonds that are subject to an optional redemption, once eligible. If none are eligible in the current or next succeeding June payment period, amounts in the surplus account shall be used to purchase bonds or be otherwise retained to pay debt service on bonds in a future period.

The TSA is a public instrumentality and agency of the state of Washington. Its legal existence is distinct and separate from the state, and it does not constitute a state government department.

Cash Flow Analysis

S&P Global Ratings applied a quantitative analysis to the following cash flow stress tests:

- A cigarette volume decline test, which is intended to assess the transaction's ability to withstand steeper-than-historical average annual declines in U.S. cigarette consumption;
- A PM bankruptcy test, in which we assume the largest PM's Chapter 11 bankruptcy, and the subsequent temporary payment stoppage at various points over the transaction's term; and
- An NPM adjustment liquidity stress test, in which we assume a certain percentage of the payment is contested.

We expect a security rated in the 'A' category (before the application of maturity-based rating adjustments) to pass all three ratings tests with timely interest and ultimate principal payments.

We used the following cash flow assumptions for the stress tests for the bonds that will be considered for 'A' level ratings:

- The decline in cigarette shipments will be 5.00% in the transaction's first year, 5.25% in year two, and 4.75% thereafter.
- The shift in market share will be as follows: OPMs, to 81% from 83%; SPMs, to 9% from 10%; and NPMs, to 10% from 7%. We apply these stresses to market share shifts in equal increments over 10 years. After 10 years, we assume market share will remain stable. The higher the market share assumption for the NPMs, the more stressful it is for the transaction as it reduced the amounts made to the MSA.
- The NPM adjustment will be 15% and a recovery of 50% starting at year 14 (which is based on the current estimate for the settlement of the 2004 NPM adjustments).

For a more detailed description of these stress tests and our current assumptions and rationale, see "U.S. Tobacco Settlement Securitization: Ratings Methodology And Assumptions," published March 24, 2016.

Cash Flow Analysis Results

Based on our calculations, the results of our "standard" stress tests in table 2 below indicate that the series 2018 bonds would withstand the tests.

The series 2018 bonds, which mature between 2022 and 2024, passed the volume decline test, the NPM stress test, and the single-largest PM bankruptcy test at the 'A' stress level.

Table 2

Standard Stress Test Results(i)

Series	Maturity	Volume decline stress	Largest PM bankruptcy	NPM stress
2022	2022	A	A	A
2023	2023	A	A	A
2024A	2024	A	A	A

(i)Results reflect the highest rating level passed. PM--Participating manufacturer. NPM--Nonparticipating manufacturer.

Sensitivity Analysis

We designed the following additional stress tests to assess the transaction's sensitivity to event risks because of a tobacco manufacturer's potential bankruptcy, regulatory changes, or other events that might result in a one-time or periodic reduction or potential disruption in the MSA payments.

In addition to our assessment of the standard stress tests described above, the preliminary ratings reflect our assessment of the transaction's ability to withstand the following stresses:

- A greater market share shift to the NPMs from the PMs than assumed in our standard stress test;
- A one-time steep decline in cigarette consumption (due to what we consider to be an unlikely outright ban of menthol cigarettes, for instance); and
- Periodic price jumps or other events that we believe will likely lead to steeper long-term average declines in cigarette consumption.

We believe that these event risks have a different likelihood and cash flow effect than the three rating stresses above, and we do not necessarily expect the transaction to pass all of them. However, we believe it is beneficial to highlight the scenarios in which the transaction exhibits higher sensitivity.

We used the cash flow projections from the cigarette volume decline test (with the volume decline of 5.25% in the transaction's first year, 5.00% in year two, and 4.75% thereafter) as a starting point for the additional stresses. We only test those bonds that pass the 'A' category rating stress tests.

The market share shift to the NPMs from the PMs stress

We believe we could see greater market share shifts to the NPMs from the PMs over a longer time horizon because the PMs might focus more on profitability than maintaining market share or on sales of alternative tobacco products. Also, other events in the industry could affect the market share breakdown among domestic tobacco manufacturers. Therefore, we projected additional market share shifts as follows: OPMs, to 79% from 83%; SPMs, to 6% from 10%; and NPMs, to 15% from 7%. We stressed the market share shifts in equal increments over 10 years and then assumed the market share breakdown will remain stable at those levels in year 11 and thereafter.

Based on our calculations, this sensitivity test indicated that all tranches tested would withstand this additional stress.

The one-time steep decline in cigarette consumption stress

To assess the effects of a one-time sharp fall in MSA payments as a result of, for example, what we consider an unlikely outright ban of menthol cigarettes, we assumed there would be a steep decline of about 30% for one year. This is about three times more than the most severe decline that the industry has historically experienced--a 9.3% actual volume decline in 2009. We use 30% because it is approximately the menthol market's size by shipments. However, we did not design this test specifically for that case, but rather to assess the transaction's ability to withstand steep declines in general.

We applied the stress of 5.25% for year two and then assumed a more normalized decline of about 4.75% for all subsequent years. The 30% decline was moved out every five years to see the effects, though the most onerous test is to assume the one-time steep decline in year one. Based on our calculations, this sensitivity test indicated that all tranches tested would withstand this additional stress.

The periodic steeper-than-average declines in cigarette consumption stress

Based on historical information, declines in cigarette shipments are periodically steeper than average because of various events, such as cigarette price increases as a result of rising excise taxes. More specifically, we assumed that there would be three years of a more normalized decline of about 4.75%, followed by two years of a steeper dip (10%), and we repeated this pattern throughout the transaction's life. We applied the first steeper decline in year four. Our calculations indicated that all tranches tested would withstand this additional stress.

Payment Priority

Our preliminary ratings reflect our opinion that the transaction will pay timely interest and scheduled principal at each bond's stated maturity. On each June 1 and December 1 payment date, the funds will be distributed in the priority presented in the transaction documents. Because the MSA payments are made annually (on or about April 15) but the transaction's liabilities have a semiannual payment structure, the interest for the December payment is reserved when the MSA payments are received. Payments due Dec. 1, 2018, will be supported by the debt service account, which is fully funded at closing.

Table 3

Payment Waterfall

Priority	Payment
1	Operating expenses, up to the operating cap (which will be adjusted for inflation).
2	To the debt service account, any current interest on the bonds that will come due on the next two distribution dates, plus any unpaid interest.
3	To the debt service account, in addition to the above, an amount equal to the sum of the principal maturities and sinking fund installments (if any) due within the next year, and any such principal maturities and sinking fund installments unpaid from prior distribution dates.
4	Unless an event of default has occurred, to the liquidity reserve account, an amount sufficient to cause the amount on deposit therein to equal the liquidity reserve requirement

Table 3

Payment Waterfall (cont.)

Priority	Payment
5	To the operating contingency account, any operating expenses in excess of the operating cap.
6	Unless an event of default has occurred, to the surplus account, the remaining amount.(i)

(i)Per the indenture, all amounts deposited into the surplus account must be used to pay an optional redemption on any bonds that are subject to an optional redemption, once eligible. If none are eligible in the current or next succeeding June payment period, amounts in the surplus account shall be used to purchase bonds or be otherwise retained to pay debt service on bonds in a future period.

Events Of Default

Under the TSA transaction documents, each of the following constitutes an event of default:

- Failure to pay interest on any bonds when due;
- Failure to pay principal maturity or sinking fund installment, when due;
- Failure by the issuer to observe or perform any other provision of the indenture, which is not remedied within 60 days after written notice thereof is given to the issuer by the trustee or by the holders of at least 25% of the bonds' principal amount then outstanding; and
- The state materially breaches its covenants and such breach is not remedied within 60 days after written notice thereof is given to the issuer by the trustee or by the holders of at least 25% of the bonds' principal amount then outstanding.

Legal

In rating this transaction, S&P Global Ratings will review the legal matters that it believes are relevant to its analysis, as outlined in its criteria.

Surveillance

According to our surveillance criteria, we will periodically review this transaction to assess whether the ratings continue to reflect our view of the transaction's performance, and we will take any rating action that, based on our criteria, we consider to be appropriate. In addition, we will be monitoring the ratings on the PMs and their respective market share.

Related Criteria

- General Criteria: Methodology And Assumptions For Stressed Reinvestment Rates For Fixed-Rate U.S. Debt Obligations, Dec. 22, 2016
- Criteria - Structured Finance - ABS: U.S. Tobacco Settlement Securitization: Ratings Methodology And Assumptions, March 24, 2016
- General Criteria: Global Investment Criteria For Temporary Investments In Transaction Accounts, May 31, 2012
- Legal Criteria: Legal Criteria For U.S. Structured Finance Transactions: Securitizations By SPE

Transferors And Non-Code Transferors, Oct. 1, 2006

- Legal Criteria: Legal Criteria For U.S. Structured Finance Transactions: Appendix III: Revised UCC Article 9 Criteria, Oct. 1, 2006
- Legal Criteria: Legal Criteria For U.S. Structured Finance Transactions: Criteria Related To Asset-Backed Securities, Oct. 1, 2006

Related Research

- Volume Declines: Interpreting The Smoke Signals For The U.S. Cigarette And Tobacco Industry, May 7, 2018
- Tobacco Securitization Criteria Will Remain Unchanged Following the FDA's Nicotine Reduction Announcement, Aug. 15, 2017
- Credit FAQ: The FDA's Plan To Take Aim At Combustible Cigarettes Could Hurt Large Tobacco Companies If Regulations Follow, Aug. 9, 2017
- AcceptAllChangesShown Global Structured Finance Scenario And Sensitivity Analysis 2016: The Effects Of The Top Five Macroeconomic Factors, Dec. 16, 2016
- Research Update: U.K.-Based British American Tobacco On CreditWatch Negative Following Merger Proposal, Oct. 26, 2016
- The U.S. Tobacco Industry is Still Standing Tall Despite Increased Regulatory Risks, Aug. 11, 2016
- U.S. Tobacco Companies Face Persistent But Diminishing Litigation Risks, Aug. 11, 2016

In addition to the criteria specific to this type of security (listed above), the following criteria articles, which are generally applicable to all ratings, may have affected this rating action: "Post-Default Ratings Methodology: When Does Standard & Poor's Raise A Rating From 'D' Or 'SD'?," March 23, 2015; "Global Framework For Assessing Operational Risk In Structured Finance Transactions," Oct. 9, 2014; "Methodology: Timeliness of Payments: Grace Periods, Guarantees, And Use of 'D' And 'SD' Ratings," Oct. 24, 2013; "Counterparty Risk Framework Methodology And Assumptions," June 25, 2013; "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," Oct. 1, 2012; "Methodology: Credit Stability Criteria," May 3, 2010; and "Use of CreditWatch And Outlooks," Sept. 14, 2009.