Article Title: Criteria | Corporates | Industrials: Railroad Equipment Trust Certificate Rating Criteria Data: (EDITOR'S NOTE: —On Oct. 8, 2020, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.) Railroad secured debt and leases that qualify for special protection under Section 1168 of the U.S. Bankruptcy Code and are secured by equipment meeting certain economic standards receive higher ratings from S&P; Global Ratings. Rail equipment obligations are typically rated one full category above the company's senior debt, but in most cases, no lower than 'BBB-'. A rating increase is based on equipment creditors' likelihood of continuing to receive payment at contracted rates during a railroad reorganization (thus reducing default risk on those obligations), as well as on the relatively stable value of most types of railroad equipment (thus enhancing potential recovery if the collateral is repossessed and sold). Section 1168 excludes certain types of secured debt and leases from the automatic stay-of-creditor claims and substitution of collateral in a bankruptcy. Creditors may repossess collateral if the debtor does not resume debt service or lease rentals within 60 days of filing for bankruptcy. Railroads must file under special provisions of Chapter 11 of the U.S. Bankruptcy Code and cannot file under Chapter 7 (which provides for liquidation). The bankruptcy court can order liquidation, but only if a reorganization plan has not been approved within five years of filing. The railroad will continue to operate during the reorganization process, which usually takes several years. Because equipment is vital for rail operations, debtholders with equipment obligations can be more confident of receiving payment than other creditors. After the reorganization has been completed, the emerging railroad typically continues to use its predecessor's equipment and assumes most or all outstanding secured debt obligations. Our rating enhancement recognizes the strong legal support for continuing payment of interest and principal by railroads after filing for Chapter 11 bankruptcy protection, the relatively stable value of many types of railroad equipment, and the ready access to collateral provided by Section 1168 when payments are suspended. The potential rating enhancement for Section 1168 is greater than that accorded to airlines, which enjoy legally similar protection under Section 1110 of the Bankruptcy Code. The reasons for this difference and the factors that support credit quality of railroad equipment trust certificates are: Railroads cannot, by statute, enter Chapter 7 liquidation proceedings. Liquidation under Chapter 11 has historically been rare, although partial deregulation of the industry makes that outcome more conceivable than in the past; A trustee always is appointed to oversee a railroad reorganization and, as such, is explicitly charged with considering the public interest and that of other parties. In practice, this means maintaining service whenever possible; Railroads, with their proprietary rights of way, are often the only practical means of delivering bulk commodities such as coal, grain, and chemicals to certain shippers and customers. Congress and the regulatory bodies (historically, the Interstate Commerce Commission and, since Jan. 1, 1996, the Surface Transportation Board of the U.S. Department of Transportation) have tended to place a premium on maintaining service, which implies keeping equipment; Railroad equipment debt and leases represent a smaller proportion of total obligations than do those for airlines, and supply and demand for railroad equipment are in better balance. Consequently, continued debt service in reorganization is less burdensome for railroads than is sometimes the case for airlines; and Railroad equipment is typically financed in groups because the cost of individual units ($1.5 million to $3.0 million for a locomotive, $40,000 to $60,000 for a typical railcar) makes separate transactions uneconomical. A trustee would have to reject the whole pool to escape debt service, whereas airlines can reject leases on individual aircraft that no longer meet their needs. Qualifications for Rating Enhancement To qualify for a rating enhancement, creditors must have a security interest (or a purchase money security interest for equipment delivered prior to Oct. 22, 1994, when the Bankruptcy Reform Act became effective) or be a lessor or conditional vendor. Collateral must be locomotives, rolling stock, or accessories (such as auto racks). If the car or locomotive has been rebuilt, it must comply with the specifications of the American Association of Railroads' Interchange Rule 88, which assigns new equipment numbers and new birth dates. S&P; Global Ratings' criteria for evaluating whether an obligation qualifies for the Section 1168 rating enhancement is based on both legal and economic considerations. Legal opinions needed. S&P; Global Ratings requires the issuer to provide several legal opinions to support the case for rating enhancement: An opinion that creditors will be entitled to the benefits of Section 1168 protection in the event of the railroad's bankruptcy; An opinion that creditors have a first-priority perfected security interest in the equipment being financed and payments being made by the railroad under the related lease, if any, and that the relevant documents have been filed with the Surface Transportation Board; Where the lessor of the equipment to the railroad is a trust, an opinion bearing on non-consolidation of the assets in the trust of which the owner/participant is a beneficiary, with the estate of the owner/participant in bankruptcy. This opinion addresses the risk that cash payments from the lessee to the debtholder may be delayed or diverted due to the owner/participant's bankruptcy; For pass-through certificates, an opinion on the valid formation of the pass-through entity, and that the pass-through trust does not constitute an investment company as defined in the Investment Company Act of 1940, and is not subject to federal or state taxation; and An opinion that common-carrier railroad equipment obligations are issued under an exemption from registration with the Securities & Exchange Commission provided by section 3(a)(6) of the Securities Act of 1933, and that prior approval of the issuance by state regulators should not be required. Other opinions may be required, depending on the financing. Economic criteria. Term of the financing. Generally, financing terms should not exceed those specified in the table below. Guideline Life (in years) TOTAL LIFE AVERAGE LIFE New locomotives 21 14 Remanufactured locomotives 18 12 Auto racks 12 8 Other rolling stock 18 12 In our view, the problem created by debt having a long average life is that if the railroad enters bankruptcy in the debt instrument's later years, a significant portion of the asset's economic value would be depreciated while much of the debt would still be outstanding. This could prompt the trustee to reject the financing and return the equipment. The potential for economic and operational obsolescence also is related to a long average life. Although railroad equipment has substantially longer technology cycles than aircraft, the potential exists for a shift such as that now occurring in the high-horsepower, heavy-haul locomotive market. This may erode economic values faster than for some older equipment, but our existing guidelines are conservative, assuming fairly short economic lives. We do not draw fine distinctions on the basis of equipment design in assigning rating enhancements, but it will continue to assess the long-term implications of technology changes. In particular, some rail equipment being manufactured now (e.g., auto racks) is of higher quality than previous models due to better manufacturing technologies, maintenance requirements, and operating conditions (smoother riding cars, for example, that reduce wear and tear). For those classes of equipment that have demonstrably longer lives than previous generations of equipment, longer equipment trust certificate economic guidelines may be possible. Loan-to-value ratio. Loan-to-values of 80% to 85% at the outset are considered normal, but can be higher if other features of the transaction are particularly strong. Issuer's business position. We consider the size and strategic importance of the railroad behind the debt. Liquidation, always unlikely, is even more remote in the case of large, important railroads, even if they have speculative-grade ratings. On the other hand, smaller railroads, including regional and short-line operators, might be allowed to downsize drastically during bankruptcy, or even disappear entirely. Equipment use. We consider the extent of equipment use outside the jurisdiction of the U.S. Use of U.S. equipment in Mexico is now a greater likelihood due to the United States-Mexico-Canada Agreement and the privatized Mexican rail system with its increasing links with the U.S. rail network. Material usage in Mexico, without the overriding treaty relationship with the U.S. on 1168-related claims and the difficulties in perfecting security interests, could result in a lesser rating increase or no increase. S&P; Global Ratings will request information regarding the extent of equipment use in Mexico, as applicable, and will monitor the remedies available to creditors in North American railroad equipment financings as changes occur in the underlying legal environment. Although each of the foregoing factors constitutes a guideline, their legal and economic effects are considered as a whole. Limited weakness in one area can sometimes be offset by strength in others. Appendix: Frequently Asked Questions The criteria state that "rail equipment obligations are typically rated one full category above the company's senior debt, but in most cases, no lower than 'BBB-'." Is the enhancement on the equipment trust certificate (ETC) rating off the senior debt rating, or off the issuer credit rating? The starting point for rating ETCs is the issuer credit rating (ICR), and the degree of uplift is relative to the ICR. However, the company's senior debt (which may be secured or unsecured) will often be rated the same as the ICR; as such, if the transactions meet the conditions for receiving a rating uplift of up to one full category above the ICR, the ETC will also be rated a full category above the senior debt. When the senior debt is itself rated above or below the ICR, the rating differential between the senior debt rating and the ETC rating could be different. How does the issuer's business position affect whether an ETC is rated less than one full category above the ICR, or below 'BBB-'? As stated in the criteria, the degree of rating uplift above the ICR reflects the likelihood of continued payment on ETC obligations at contracted rates during a railroad reorganization (thus reducing default risk on those obligations), as well as the relatively stable value of most types of railroad equipment (thus enhancing potential recovery if the collateral is repossessed and sold). Typically, the three notches enhancement above the ICR would be applicable for large railroads that we have very high confidence will reorganize, as informed by our view of the railroad's competitive advantage and scale, scope, and diversity. Among those, the 'BBB-' minimum rating floor is reserved for ETCs of the largest, most diverse, and economically crucial railroads. Conversely, the ETCs of smaller (for instance, regionally focused) railroads would typically receive lesser enhancement, e.g. one or two notches above the ICR (even if the other features of the transaction are supportive), and the minimum 'BBB-' rating would not apply. Are recovery ratings assigned to railroad ETCs? No. However, ratings on ETCs reflect both the likelihood of default (which may be lower than the railroads' likelihood of default on other obligations, due to continued payment in bankruptcy), and the potential recovery that may be provided by the sale of the collateral in a default and repossession scenario. Therefore, if the likelihood of continued payment in bankruptcy of a given ETC is considered low, then our rating on the ETC will primarily reflect recovery related considerations. Would financing terms that are shorter or longer, or loan-to-value (LTV) ratios that are higher or lower, than the guidelines affect the degree of enhancement that may be achieved for the ETC rating? Potentially, yes. The guidelines the criteria provide for the terms of the financing and LTV ratio, if not exceeded, would typically allow for an ETC to be rated up to one full category above the ICR, provided other conditions described in the criteria are met. As such, unless offset by another factor, longer financing terms or a higher LTV ratio would generally reduce the potential enhancement otherwise achievable by the transaction. Shorter financing terms or a lower LTV ratio could offset other factors to support the maximum enhancement. As stated, limited weakness in one area can sometimes be offset by strength in others. For example, an ETC might have a 90% LTV but pay down quickly, improving the LTV over time, or have a relatively short maturity. In analyzing the LTV and its impact on rating enhancement, we would also consider the equipment being financed--it should be of good quality (technical and economic characteristics at least representative of what the railroad uses in its core operations; for example, not obsolete locomotives) in order to receive the highest level of rating enhancement. Revisions And Updates This article was originally published on Sept. 4, 2002. Changes introduced after original publication: On April 23, 2015, we classified this article as criteria and added the "Frequently Asked Questions" section. Following our periodic review completed on Sept. 2, 2016, we updated the contact information. Following our periodic review completed on Sept. 1, 2017, we added the "Related Criteria And Research" section. On Oct. 8, 2020, we republished this criteria article to make nonmaterial changes. We updated the contact information, and we removed references to Section 106(5) of the Canada Transportation Act, which has been repealed, as well as any associated informational requirements for this act. We also replaced a reference to NAFTA with a reference to its successor, the USMCA. Related Criteria And Research Related Criteria Group Rating Methodology, July 1, 2019 Corporate Methodology: Ratios And Adjustments, April 1, 2019 Key Credit Factors For The Railroad And Package Express Industry, Aug. 12, 2014 General: Corporate Methodology, Nov. 19, 2013 Principles Of Credit Ratings, Feb. 16, 2011 These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.