CREDIT ISSUES FOR PASSENGER RAILROADS

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INTRODUCTION

This article discusses how Standard & Poor's analyzes the financial strength of passenger railroads. While we do not have a public debt rating on Amtrak, we do rate seven railroads around the world that have passenger operations. Regulatory and operating characteristics vary from country to country, so I will concentrate on highlighting some of the important issues that we evaluate in determining credit ratings of railroads involved in passenger operations. First, a couple of observations about Amtrak compared to most of the international passenger rails that I will describe later. As many of you know, Amtrak typically covers a greater proportion of its costs from passenger revenue than many international railroads. Ironically given what I just said about covering costs from passengers revenues, most of the non-US passenger railroads receive more consistent government support than does Amtrak.

WHAT THE DEBT RATINGS MEAN

The scale for Issuer and Issue ratings is AAA to D, with pluses and minuses in each grade—except D. S&P's Issuer credit ratings are our current opinion of a company's overall financial capacity to pay its financial obligations. Thus Issuer ratings basically measure risk of insolvency.

Issue credit ratings, on the other hand, are our current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, which takes into account the provisions of the obligation and the relative position of the obligation in a bankruptcy, reorganization or other insolvency proceeding. We always start by assigning an Issuer rating and then look at the details of the issue to assign an issue rating. Either type of rating is not a recommendation to purchase or hold securities or a general purpose evaluation of the issuer. Rating Outlooks, either Positive, Stable or Negative, have been attached to every rating since 1986. The Outlook assesses the potential for change over a longer time period, usually one to three years. The Outlook statement incorporates trends or risks with less certain implications for credit quality. A Stable Outlook is not an opinion that the issuer's financial performance is necessarily expected to be stable, but rather that within expected ranges of performance, no changes in the rating are anticipated.

PASSENGER RAILROAD RATING CONSIDERATIONS

We divide the analytics into two categories—Business Risk and Financial Risk. The business risk side is used as a context for viewing the more quantitative financial risk factors. One difference in analyzing a pure private sector company versus a pure government supported company is the concept of bottom-up analysis versus top-down. If significant, consistent government support represents, by far,, the underpinnings of the credit, then a top-down analysis is likely to be appropriate, while for private companies, a stand-alone or bottom-up approach is more accurate. For companies that fall in the middle due to partial, inconsistent or eroding government support a hybrid approach is appropriate. There are many different forms of government support that we evaluate, including support separate from ownership. Consistency counts.

"What weighting do the numbers get," is a question many people ask. Well, at times a rating decision will be strongly influenced by financial measures. At other times, business risk factors may dominate. However, each rating analysis begins with an assessment of a company's industry environment. While a particular financial profile can be the overriding rating consideration, the industry risk assessment goes a long way toward setting the upper limit on the rating to which any issuer can aspire. So, there is no black box of number crunching, out of which the rating is generated.

INDUSTRY RISK

Absent government support, which I will discuss in a moment, we generally view the passenger railroad industry as having "worse-than average" industry risk, compared to other non-financial industry segments. This is largely due to the difficulty in making an operating profit, without some form of government support. By way of comparison, we view the industry risk of the airline industry as also worse than average, for different reasons, while the US freight railroad industry is seen as having better than average risk characteristics due to relatively stable demand for services, high barriers to entry, and good access to capital Because of the risk characteristics of passenger rails, all of our ratings incorporate varying levels

of government support, including outright sovereign guarantees, provisions for operating and capital subsidies and lesser forms of support such as stated public policy in favor of rail, partial government ownership, or a supportive regulatory structure,

COMPETITION & BARRIERS TO ENTRY

Competition among all types of rails is limited somewhat by the cost and near impossibility of obtaining land for significant new rail lines, but unlike freight railroads, the passenger railroads face can face far greater competition from other modes of transportation, depending on the country. Distinctions need to be drawn as well between commuter rail and long-haul operations.

REVENUE DETERMINANTS

Looking at what drives revenue, we view service territory as the largest determinant of traffic mix and degree of competition. The passenger railroad industry is mature in almost all developed countries. Route structure and density are factors in profitability and degree of competitiveness.

COST STRUCTURE

Labor, including wages, health and pension benefits and payroll taxes, is typically the largest component of cost and is generally higher for passenger than freight railroads or airlines. Productivity and cost control are therefore crucial to improve competitiveness. Fuel costs tend to be the next largest costs component Operating leverage—the proportion of costs which are fixed—is high, as with all modes of transportation that operate on a fixed schedule and offer a "perishable" product—available space for a specific destination at a specific time. Access to equipment financing is worse than for airline or freight railroads because of the more limited potential uses of the equipment Expenditures for track and facilities are typically financed using internal resources or general purpose debt.

INDUSTRY POSITION

For passenger rail, due to their typically monopolistic position within rail, the industry position comparison is really with other modes of transportation. Unlike an airline, it is difficult for passenger railroads to develop new markets or leave less desirable ones, so their flexibility is less than for the airlines. For traffic and yield measures, one must be aware of how the choice of measurement can affect comparison. Statistics are affected by the type of passenger and length of transit. As with most transportation industries, which have high operating leverage, density of traffic is almost always a good thing. Service quality is crucial in recapturing passengers which have left for other modes. For freight railroads or air freight, there is a saying about the use of older, used equipment—the freight doesn't care. This is not the case for passenger railroads, so p-assenger rails face higher spending requirements on revenue equipment, more akin to the passenger airline industry. Freight railroads have a cost advantage on the long distance line haul over trucks, but worse on-time service. Passenger rails generally do not have a cost advantage, unless the competing airline industry is still heavily regulated or priced high due to a supply shortage. In terms of equipment, the focus is whether a railroad is ahead or behind in investing in its assets. This is an issue of fmancial flexibility as well as operating efficiency. On the cost side, the labor issue is a complex one, involving multiple unions, often arcane work rules, as well as pay. Salaries, wages and benefits can be 50% or more of expenses so the labor situation is usually an important driver of profitability or lack thereof.

OPERATING PROFITABILITY

The key measure of operating profitability is the operating ratio—operating expenses as a percent of operating revenues—but this can be distorted by leasing or special charges. Clearly, a special charge drives up that years operating ratio to a misleading extent, On the other hand you can't simply ignore the special charge.

MANAGEMENT

Evaluating management's strategic and fmancial planning strategies is a key objective. We look at historical performance vs. peers, and examples of innovation and flexibility in reacting to change, among other things. Management is evaluated over the course of its relationship with S&P as well. Certain management teams have established more credibility than others and this can be an influencing factor in the rating process long term. We divide the evaluation of management into operating skill and financial policy components. AU freight railroad management have had to deal with a changing competitive and regulatory environment and transition from a hierarchical, quasi military, utility mentality to become customer oriented. Initially many were slow to respond to competition and the need to adapt their service to

customer requirements, but this has changed. For the passenger railroads, many are still operating under the former environment and expending varying degrees of effort to change. We evaluate how the management is balancing the tradeoff between owner and creditor interests. One indicator of the balance is the nature of any targeted fmancial structure, and the degree of commitment to reaching and maintaining it. The influence of supporting government entities can be a significant influencing factor. That concludes the qualitative aspects and I can't stress enough how much these qualitative areas set the base for the evaluation of the numbers.

RATING COMMITTEE

The qualitative and quantitative factors for each company are considered by a rating committee. Each analytical category is evaluated and considered by a rating committee to arrive at the rating. We look at the numbers relative to the business risk and consider the cash flow and financial flexibility to be extremely important. With all financial measures, we are focusing on expected performance in the future, and using historical results to the extent that they help in that projection.

IMPORTANCE OF GOVERNMENT SUPPORT

To indicate how important government support is the ratings of the passenger railroad industry, note that all ratings for passenger railroads are all in the 'A' category or better, with the exception of the one railroad that does not have government support, One note—if the sovereign rating is low, than the rating for a government supported passenger railroad would also be low. This 'A' or better rating level is in contrast to the US freight railroads, some of the most efficient in the world, almost all of whom are rated in the IBBB' category and the US passenger airlines, only one of whom is investment grade. So, you can begin to see the impact of government support on the ratings.

Without spending lots of time discussing median ratios and other modes of transportation, suffice to say that credit ratios for most of the higher rated passenger railroads would be considered very weak for their respective rating categories, which again speaks to the weight we place on a particular passenger railroad's share of government support. Two further examples to illustrate the impact of support are situation where companies are or were privatized—Canadian National Railway's privatization in 1995 and the proposed sale of the Australian government's share of National Rail Corp. In the case of Canadian National, the privatized company has made great progress in improving efficiency and competitive position, but our rating on the privatized company is lower than when it was unprofitable, but owned by the government. National Raff Corp. is on CreditWatch Negative with a rating of 'A-' since the government announced it may sell its ownership.