THE 2001 CAPE TOWN CONVENTION
ON INTERNATIONAL INTERESTS IN MOBILE EQUIPMENT

RAIL WORKING GROUP

An association under Swiss law

www.railworkinggroup.org

Baarerstrasse 98, PO Box 2258, 6302 Zug, Switzerland
Tel: +41 (0)41 760 28 88; Fax: +41 (0)41 760 29 09
Email: howard.rosen@railworkinggroup.org

DOES THE LUXEMBOURG RAIL PROTOCOL MATTER TO STATE OWNED RAIL OPERATORS?

The 2007 Luxembourg Protocol to the Cape Town Convention on International Interests in Mobile Equipment on matters relating to railway rolling stock (the Luxembourg Protocol) provides a new set of international rules which will facilitate private sector finance of railway rolling stock. It will achieve this by providing lessors and secured lenders greater protection in respect of their security interests through international recognition of those interests and the establishment of an international registry, in Luxembourg, accessible and open to public search 24/7 through the internet, where these secured creditors can register their security interests. By reducing the risks for private sector, and thereby attracting more financiers, it will lower the cost of private credit.

But if you are a state owned railway funding equipment procurement through cash flow and direct or indirect government grants or loans, you might assume that Luxembourg Protocol will have no relevance to you. Here are 12 good reasons why that assumption would be wrong:

1. **States have competing priorities for taxpayers' monies.** Perfectly sound economic cases for new rolling stock procurement will be rejected if the political circumstances determine that those resources are spent on hospitals, schools, defence or other priorities. At best allocation of funds for rolling stock procurement may restrict resources requested for rail infrastructure

development where state support is commonly needed. If there is a thriving private capital market financing rolling stock, this opens up the possibility for a railway operator to invest in new equipment regardless of whether the Finance Ministry is prepared to release funds for the project and to husband state support for infrastructure development.

2. **Even if the resources are available from the State, their availability may be restricted under international rules as a state aid.** International governmental bodies such as the European Commission and the OECD are becoming increasingly nervous about state owned operators receiving hidden subventions from their shareholder due to low or no financing costs, thereby undermining private sector competitors. One solution would be for state-owned operators to source funding independently through debt or leasing structures, with no government guarantee, from the capital markets on market terms.

3. **State loans may be more expensive.** This may depend on the creditworthiness of the State but this could also be the case even where the state has a high credit rating due to retrospective internal rate models where interest rates are falling or where attractive funding rates are available financing new procurement via export credit agencies or because a lessor, perhaps based in another jurisdiction, can leverage tax benefits into the funding rate not directly available to the State or the operator.

4. **The operator may not always be government owned.** Many governments have plans to privatise at least the operations side of state railways. From that point, as a quoted company, the operator will need to source procurement funding from the private sector and show a favourable return on equity. The Luxembourg Protocol will greatly assist with this.

5. **The operator's title rights may be challenged by third parties.** There may be rival claims to rolling stock in a particular jurisdiction – for example manufacturer's creditors in the case of new equipment or seller's creditors for used equipment or new equipment purchased through intermediaries. The operator will be entitled to register a notice of sale under the Luxembourg Protocol and, even better, may wish to finance the acquisitions internally via an internal finance entity which could then take, and register a pledge on the financed assets, thereby overreaching any unregistered (or later registered) security interest of a third party. This becomes particularly relevant for rolling stock actually or potentially crossing borders, where the law in the jurisdiction where the rolling stock is at the time of seizure may override the title claims of the operator, especially if the operator is not actually in physical possession of the assets.

6. **The operator may be a lessor.** A state owner operator may have good reasons to rent out some of its rolling stock for good business reasons on a short or medium term basis. In that case, it will need the lessor rights contained in the Luxembourg Protocol in order to ensure it receives the equipment back at the end of the lease, and is protected against claims by third parties, regardless of where the assets are physically.

7. **An operator may not wish to assume all asset risks.** Even if the resources are available, it may not be prudent for the operator to assume all operational and residual value risks. In such a case, procurement through operating leases may be more appropriate. The Luxembourg Protocol will be a major catalyst in the development of an operating lease market by giving lessors clear protection for their security interests. In the aviation industry, the operating lease was a major factor in the strong growth of the industry over the past 30 years all even the strongest airlines, such as Lufthansa, will lease a substantial part of their fleet of aircraft as part of a fleet strategic risk management system.

8. **Sales of rolling stock will be simpler.** An operator selling used rolling stock into the market will find the issues of title transfer considerably more straight-forward when the ownership provenance can be established through a search at the Luxembourg Rail Registry. In certain cases, the operator may wish to purchase or lease in rolling stock for a limited use and period. Again the Luxembourg Protocol will reduce the risks and costs of doing this.

9. **It will be easier for small sub-operators and franchisees working with the operator to obtain independent funding for its rolling stock.** It will be in the interests of state operators to support smaller companies who can operate a line or a small part of the network on an economically viable basis where this would not be possible for the state-owned operator due to its higher cost base. It will also facilitate cost transparency where assets are leased in – perhaps even from the state operator. In addition, joint ventures with private sector operators may be required to be financed without direct or indirect government, financial support.

10. **It will encourage manufacturers to provide credit to operators.** This will be either via conditional sales or lease arrangements and may be attractive to state operators as a way of receiving hidden discounts or leaving residual value or maintenance risks with the manufacturer.

11. **The Luxembourg Protocol will bring with it the new URVIS (Unique Rail Vehicle Identification System) concept.** The unique numbering system, which will be administered by the Registry, will create for the first time a universal system for permanently and uniquely identifying rolling stock, delivering benefits to operators such as facilitating vehicle tracking, insurance and accident records etc. in addition to the direct advantages in financing rail equipment; and

12. **It's good for the industry.** Even if the state operator does not use private sector financing directly, the Luxembourg Protocol will play a vital role in making the industry more competitive which can only be good news for state operators committed to a dynamic and efficient rail industry in the future.

For more information about the Luxembourg Protocol, please see www.railworkinggroup.org.