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THE LUXEMBOURG RAIL PROTOCOL TO THE CAPE TOWN CONVENTION: A SIGNIFICANT STEP FORWARD FOR RAIL OPERATORS.

1. INTRODUCTION

On 23rd February 2007, a Diplomatic Conference, sponsored jointly by UNIDROIT and OTIF and attended by 42 states and 12 international organisations, took a historic step by adopting the Luxembourg Rail Protocol to the Cape Town Convention on International Interests in Mobile Equipment. The Protocol now proceeds to signature and ratification.

The Convention provides a mechanism for recognising and recording international security interests created in high-value moveable equipment, usually overriding local title interests or claims. The Protocol extends the Convention to railway rolling stock. At a time when business and its financing is increasingly international, the Protocol will open the door to more sophisticated cross-border and domestic financing of railway rolling stock in situations where otherwise banks, lessors and other financiers funding assets not in their possession would risk losing their security position, especially if it moves across a jurisdictional border. By providing more security to the private sector and reducing risk for rail equipment financiers the Protocol will:

- reduce the cost of private sector finance for operators
- in some cases facilitate finance for operators where, up to now, their poor credit and/or the lack of a strong Government guarantee or legal infrastructure has prevented banks lending
- attract more private sector lenders into the market
- facilitate operating leases of rolling stock.

As a result, the Protocol will lower barriers to entry into the industry for operators, making them more competitive and reducing the dependence of state and private operators on state funding, leading to a more dynamic industry.

2. CREATING INTERNATIONAL SECURITY INTERESTS AND A GLOBAL REGISTRY

The Convention recognises as International Security Interests the property rights of:

- a secured lender

- a vendor selling with reservation of title
- a lessor under a lease

in relation to high-value moveable equipment covered by a protocol to the Convention. The interest will be assignable, and it will be possible also to register a prospective interest to protect the secured party in advance of completion of a financing.

The Luxembourg Protocol now applies the Convention to all rolling stock including trains, equipment running on rail tracks, trams, subway trains and light railway systems. Although the Protocol will be particularly helpful in respect of equipment which crosses borders, this is not a requirement; the Protocol will also apply to rolling stock operating in only one jurisdiction.

The Convention envisages a worldwide asset registry for each type of asset to which it applies, accessible via the Internet 24 hours a day, 7 days a week, through which any funder can check if any other party claims a security interest in the equipment to be financed. The funder will be able to register its interest which will then, in almost all cases, take precedence over any other unregistered security interest and over any subsequently registered interest. It will also take priority over any third party rights asserted in a bankruptcy of the possessor. The Registry will be operated by an independent organisation and will be overseen by a Supervisor, an international (possibly inter-governmental) body, appointed under the individual protocols.

The Protocol provides for a special Registry for the rail sector, which will be based in Luxembourg. The Rail Registry will also include a separate system for owner operators to register their acquisition of rolling stock, thereby placing third parties on notice of their title interest even when the asset is not collateral for finance, thereby also protecting railways in the public sector where they do not finance directly with private capital.

3. IMPROVED ACCESS TO PRIVATE CAPITAL MATTERS FOR THE RAIL INDUSTRY

In a study by Roland Berger Consultants published in January 2007 by UNIFE, the European Rail Manufacturers' Association, the annual worldwide accessible market for rolling stock was estimated at EUR 24 billion. Even small percentage savings on funding costs can have a large effect, and this ignores the expected investment stimulus from the Protocol itself. The study estimated annual growth in this sector of between 1.5% and 2%, but this is less than average GDP growth in most economies and is simply not enough. More capital investment is required urgently. In Europe, for example, the *average* life of freight rolling stock in circulation is close to its recommended useful life. In general, the rail sector is unable to offer consistently modern rolling stock to customers despite a commercial need to do so, and in many countries there is a critical lack of capacity. At the same time, manufacturing plants are being closed for lack of orders, losing valuable expertise, as more traffic shifts to the roads. In many cases, operators are state-owned, and as a result, resources are limited by budgetary constraints even when there is a good economic case for the investment.

The answer is for operators to access the private capital markets, with lenders providing funds without recourse to government guarantees or support. For both state-owned and private railways, this is often only practicable if lenders have security in the assets being financed. In the aircraft industry, a competitor to the rail sector, leasing and other financing techniques have led to solid growth of investment in the last 20 years due to the lender/lessor being secured through registration of title or mortgage interests. By contrast, capital investment in the rail sector has been stagnant and worldwide there is no national public registry where lenders or lessors can register their interests in financed assets. The Protocol provides a mechanism for both private and public sector rail operators to utilise the private capital markets cost-effectively and on similar terms to the aircraft sector, facilitating, in turn, a better service for the customer and a vital means of recovering market share from the road and air sectors in freight and passenger transportation.

4. CREATING NEW SECURITY SYSTEM FOR THE RAILWAYS

The rail sector was chosen as one of the first sectors to be covered by the Convention due to the additional risk that international financiers face in relation to assets which by their nature can cross borders. In addition, as the Protocol applies the Convention even in relation to rolling stock which does not cross borders, it will create additional security for lenders, even if the finance is provided as part of a domestic rail transaction. This should make financing of rolling stock considerably simpler, eliminating the need for complex legal opinions and reducing the costs as well as the cost of finance.

5. BENEFITS FOR RAILWAY OPERATORS

Even for state-owned railways, the Protocol will bring considerable benefits by increasing the sources of capital available for investment in new rolling stock without the need for direct state support (financed by borrowing or taxation), indirect support (e.g. Eurofima), or guarantees. Inside the EU, concerns over possible blockage of finance on the basis of “state aid” can be avoided with private sector finance. The Protocol will also open up possibilities for non-recourse securitisation and other forms of financing. It will give railways more autonomy as to how they develop their equipment requirements, and facilitate future capital investment – as well as secure funding for state-owned operators as governments gradually withdraw from the sector, either through partial or full privatisation, or through refusing to guarantee future debt incurred by the railways. Investment will be driven by requirements and economics and not limited by political considerations.

For the private operator, access to the capital markets, directly or through banks and leasing companies, will be essential to their entry into the rail sector, and this in turn will be a key element in the renaissance of the rail industry in the new century.

In each case, the more private sector capital there is available and the lower the risk a funder is required to take, the cheaper that capital will be. For example, a recent study by the Rail Working Group shows that even in Western Europe, the Protocol should reduce the cost of borrowing by up to 0.35% on the interest rate, which translates to a discount of over 3% on the sale price over the term of a typical 10-year financing. In central and Eastern Europe the benefit on locomotive finance could be close to 1% on the interest rate or an effective discount of close to 7% on the acquisition cost. For further details of the RWG study please refer to http://www.railworkinggroup.org/daten/cug/working%20papers/EconomicCase.pdf . This in turn should lead to more capital investment as operators look to acquire more equipment with private sector finance, new operators are attracted into the market as the need for initial capital reduces, and operating leasing encourages the development of a second user market.

The Protocol will bring more flexibility in the use of financed rolling stock and encourage the development of both finance and operating leases (due to the new protection afforded to the lessor) and a secondary market, significantly reducing the capital commitments required by the operator (or permitting it to offer more new and efficient rolling stock to customers without increasing its equity). The availability of operating leasing for aircraft has been a key factor in the development of the aircraft sector. Investors and lessors will be prepared to take more residual value risk due to the increased certainty that can be given to a lessor or investor in retaining its interest in the asset against local legal challenges.

Operators themselves constantly lease or sublease rolling stock to other operators as they cross borders. In the former case, registration of the lessor interest will allow the asset to cross borders without the lessor/operator worrying that its title or lease interest could be overridden by local operators or their creditors. In the latter case, if the owner's interest under the lease is already registered, that would already put any foreign innocent third party on notice of the prior rights of the lessor.

Lastly, debt financing for rolling stock at present means voluminous documentation – especially in relation to security issues as well as extensive legal opinions and continuing legal uncertainty for all parties. By significantly reducing the uncertainty, and by developing a universal interest, to cover assets used in various jurisdictions, the Convention should also result in much simpler security documentation, more modest legal opinions, and considerably reduced transaction costs.

6. A VITAL BOOST TO THE FUTURE OF THE RAIL INDUSTRY

The Luxembourg Rail Protocol to the Cape Town Convention will encourage significant capital investment in the rail sector. It will also allow the rail industry to compete more effectively for funding against other parts of the transportation sector, such as the aircraft sector, as well as drive down private sector funding costs and facilitate the development of a true operating lease market. It will also bring major benefits to operators, manufacturers, funders and governments.

Unlike the aircraft sector, there are few national registry systems in place to give funders (limited) protection. Further, the prevalence of direct or indirect state support for significant operators has discouraged funders from entering into the business (due to fine margins) and encouraged current lenders to ignore the security due to the quality of the credit. On the other hand, there is very limited private sector finance for investment in rolling stock where there is no government guarantee. However, public sector support of the rail industry will decline further in the future and new operators will be needed in the market. In the aircraft sector, that change has already occurred, with generally very positive results. We can expect a similar development in the next 10 years in the rail sector.

7. WHAT NEXT?

Governments have a legitimate role in financing infrastructure development. But because they build roads, this does not mean that they also pay for the cars that run on them. The private sector can deal with this. Similarly, whilst there may be a need for states to provide subsidies for particular services on environmental, social or economic grounds, there is no need for governments to pay for rolling stock, or for the rail industry to be dependent on government funds for this purpose. Provided that the right legal structure is in place, in most cases the private sector can cope.

The Luxembourg Rail Protocol provides this legal structure and the rail industry has a unique opportunity to press for an exciting and highly practical change in private international law that will fundamentally affect the way the industry develops in the 21st century. National governments need to hear from rail operators that:

- the Luxembourg Protocol will encourage more capital investment, helping the industry deliver a more modern and efficient service, a better environment (as traffic is diverted onto the rails), and leading in turn to growth in the rail sector and more jobs;
- it will facilitate private sector finance of rolling stock for joint ventures and other public private partnerships where state funding is restricted or inappropriate;
- it will allow governments to use precious resources to finance infrastructure investment where direct private sector finance is difficult; they will not have to use "budget" to finance the rolling stock as well;
- it will create vital support for new operators into the rail sector leading to more competition and a dynamic renaissance of the rail sector;
- it gives valuable support to operators working outside their home jurisdiction; and
- *they need to sign and ratify the Luxembourg Protocol as soon as possible.*

For information on the Protocol see www.railworkinggroup.org or contact howard.rosen@railworkinggroup.org

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