RAILWAYS AFRICA

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Why the **Luxembourg Protocol** will Boost **Railway Investment** in Africa

by Howard Rosen

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The strategic direction has been agreed at the highest level: to prioritise investment in the railways across Africa. But where will the money come from?

The African Union (AU) argues that lack of infrastructure in Africa is reducing growth by up to 2% a year. The African Development Bank stated in 2013 that the cost of transporting goods in Sub-Saharan Africa is the highest in the world. The WEF 2015 Africa Competitiveness Report calls the region's infrastructure shortfall a "critical bottleneck" to reaping the benefits of increased regional integration (today only 11.3% of trade in Africa is intra-regional). The 2012 report of the UN/AU Programme for Infrastructure Development in Africa (PIDA) predicted an increase in African transport needs of 600% to 800% between 2010 and 2040.

Railways could transform the continent, but currently plays an insignificant role. No wonder, with rail density of one kilometre of rail track for every 357 square kilometres of land. Compare this with the United States' one kilometre of track for every 43 square kilometres, and Germany, where the ratio is one to under 10. And it is getting worse. Between 2005 and 2011, usable rail tracks in Africa shrank from 58,000km to 50,000km.

Moreover, railways are not just essential for economic growth but a crucial part of any sustainable development agenda. Yet, according to the UNIFE 2014 world rail market study, annual investment in new railway rolling stock in Africa has been about 4% of global procurement, averaging just over $2bn per annum.

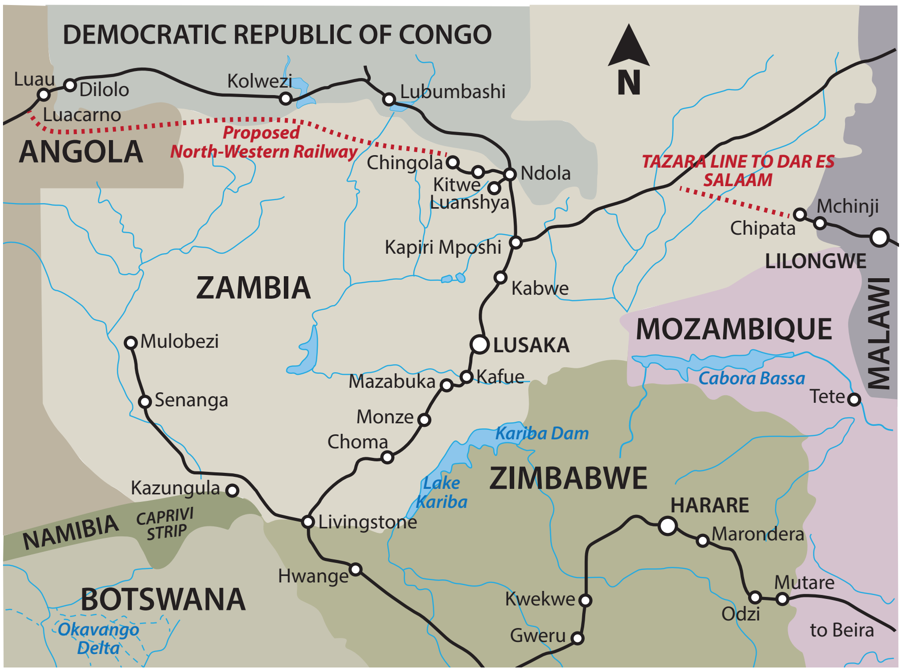
More Rail – But Who Pays?

True, the position is gradually changing. Large rail projects are under way in countries such as Kenya, Ethiopia and Mozambique, and there are plans to bring railways to Burundi and Rwanda. The $475 million, 34km Addis Ababa Light Rail Transit project opened in September – sub-Saharan Africa's first light rail service. But these projects stretch states' financial resources to the limit. The new Mombasa to Nairobi line has raised Kenya's external debt by about 17%. Implementing plans to extend the line north to Naivasha will increase this even further.

Other costs flow from the fact that the African rail system operates on three incompatible rail gauges. While AU policy encourages new rail using the European standard gauge, standardisation will have a heavy price. South African Transport Minister Dipuo Peters recently called for the conversion of her country's 20,000km of track to standard gauge. This alone could cost up to $110 billion. How is this all to be paid for?

According to UNCTAD, African countries invested an average of 15% to 25% of GDP in transport infrastructure from 2005 to 2012. India and China invested about 32% and 42% of GDP respectively in the same period. Richer countries in Africa can draw on their own resources and borrow on the capital markets, although this has limits, particularly when commodity prices fall. Loans are provided by states, notably China. Nevertheless, a recent PIDA report highlights an annual funding gap for infrastructure of close to $50 billion.

There is clearly an urgent need to attract investment from the private sector and for states to work with banks, investment funds and institutional investors to cover this shortfall. Yet, as another PIDA report also acknowledges, to do this countries must "ensure a competitive market based on clear legislation with enforcement of commercial law and transparency in procurement." The report continues: "The absence of enabling legislation and regulations, a lack of local skills and a poor understanding of public-private partnership (PPP) risk allocation are all bottlenecks currently preventing many countries from fully unlocking private sector interest, particularly on regional



New lines proposed in Zambia

projects. But if put to broader use, PPPs hold the potential for true transformational impact."

A Radical New Tool

Provision of rolling stock is of course a critical part of any PPP (for example "Build Operate Transfer" structures) between the public and private sectors. In any new rail project, the cost of rolling stock represents between 25% to 30% of total expenditure over the life of the PPP. Fortunately there is a radical new tool coming to allow states to lay off that cost to the private sector. This is the Luxembourg Rail Protocol to the Cape Town Convention on International Interests in Mobile Equipment, which will play a key role in bringing private capital to support existing and new rail projects by facilitating banks and other funders providing finance for rolling stock procurement.

Once in force, the Protocol will offer a new global system of international security rights for secured creditors (secured lenders and lessors). It delivers the legal framework for new and cheaper sources of private sector finance for railway equipment, with the advantage that a creditor can provide capital secured on the collateral of the financed assets, and not just have to rely on the credit status of the borrower. The new system will apply whether the debtor is state-owned or private. Indirectly it will lead to a more competitive and dynamic rail industry worldwide, and bring important social, environmental, developmental and economic advantages, as well as new business opportunities.

By giving lessors a clear set of rules protecting their interests, it will open the way to the provision of rolling stock in Africa through operating leasing. This will lower barriers to entry for new operators – currently a high risk, and therefore high-cost business - and create a system for more efficient use (including sharing) of existing and new railway equipment across the continent, moving the industry towards more standardised equipment and more consistent technical support and maintenance.

This is not a theoretical need. Grindrod Rail's rolling stock leasing joint venture, GPR Leasing, already offers leasing solutions for railway equipment across Africa. According to GPR's Divisional CEO Jacques de Klerk, the capital-intensive nature of rolling stock, as well as the ageing African fleet, present a huge need for rolling stock leasing solutions, the preferred model worldwide. He adds: "With the opportunity come risks, and for rolling stock leasing companies to survive in Africa, they need to have the ability to track and trace their assets, ensure the locomotives are maintained in line with OEM standards, and that they have the ability to uplift their assets on client non-payment."

A Common, Coherent System

The Luxembourg Rail Protocol sets out a common and coherent system for railway rolling stock finance. It establishes clear creditor rights both during the financing term and on termination due to default, insolvency, or otherwise where the creditor holds an "international interest" in the asset as set out in the Protocol. The new "international interest" arises from security created on the rolling stock in favour of three defined categories of creditors. These are: a lessor under a lease, a conditional seller under a title reservation agreement, and a secured lender. In each case, the counter party (lessee, conditional purchaser, or chargor) must have its principal place of business in a country that has ratified the Protocol.

The Protocol applies to all railway rolling stock in the broadest sense, from conventional rail locomotives and wagons through to light rail and metro trains, trams and even cable cars. The international interest can (and should) be registered on closing of the financing at an international registry to be based in Luxembourg. This is because if there is more than one international interest created on an asset, the first registration will have priority unless the creditors agree otherwise. The new registry will be entirely electronic, accessible via the internet, and searchable by the public 24/7. Prospective purchasers

Diesel multiple-unit set in Nigeria.

and financiers will be able to see, in real time, if another party has a claim on the asset about to be purchased or financed.

The Protocol also recognises and regulates a state's right to prevent repossession in the public interest in specific circumstances; deals with security rights in rail assets created prior to the Protocol coming into force; and guarantees parties' rights to choose the law applicable to the security or lease agreements.

One consequence of this new system is that for the first time in the rail industry, there will be a life-long, unique identifier for each item of rolling stock, issued by the registry and fixed permanently on the asset. This will bring interesting additional industry benefits, facilitating instant asset location tracking as well as helping with insurance issues and accurate maintenance records over the entire asset life.

Station scene on Mozambique's Nacala line. Photo: Roderick Smith.

The Protocol will be particularly important for ensuring a creditor's security when the rolling stock crosses borders, not just because the creditor's rights will be recognised in the same way in each of the states where the rolling stock happens to be (as long as that state has ratified the Protocol), but also making multinational financing easier, since the same rules will apply in different jurisdictions.

However the Protocol's application to pure domestic transactions, where none of the parties, or the financed assets, are outside the same country, will also be important, as currently there are rarely clear rules on a creditor's security position in any given state, or even a local title registry.

This new instrument will preserve capital for governments and save money for borrowers and lessees because the increased legal certainty for a creditor will not only lower risks generally, leading to greater readiness by banks, institutions and other private investors to provide funding for rolling stock procurement at a cheaper rate, but will also facilitate significant savings by reducing banks' capital requirements under "Basel III". In a recent presentation in South Africa, a major bank estimated that the positive difference in funding rates if the Protocol were operating would range from 0.45% to 1.9% over a five year period, depending on the customer's credit status.

Tried and Tested – and Coming Soon

The system is already tried and tested. The Cape Town Convention and a protocol applying the Convention to aircraft was adopted in 2001 and is now operating in about 60 countries, including many African states, with the aviation international registry in Dublin. It is a remarkable success: over 500,000 registrations covering 110,000 aircraft objects with an estimated value of over $US500 billion since it started operations in 2006. Moreover, export credit agencies in OECD member countries are permitted by a special OECD industry understanding, in defined circumstances, to offer lower financing rates for airframes and aircraft engines where the Aircraft Protocol applies.

The Luxembourg Rail Protocol was adopted in 2007. The European Union has already ratified the Protocol (in respect of its competences) and a growing number of European countries, as well as countries outside Europe, including South Africa, have either ratified the Protocol or are working towards this. The registry is expected to begin operations in 2017.

New standard gauge railway under construction in Kenya.

Every country in Africa should ratify the Luxembourg Rail Protocol at the earliest opportunity. There are no downsides (the costs of registrations should be easily outstripped by savings on documentation and cheaper finance rates). This new framework will relieve the state from significant financial burdens, create fresh sources of investment for the rail industry and thereby attract entrepreneurs and investors, as well as help underwrite Africa's economic development in the coming decades. It will also make future financing more focused and transparent, and empower African manufacturers, operators, lessors and financiers to provide solutions for Africa's needs in this area.

The commitment by African leaders to a major expansion of the rail sector, as a key component of a sustainable growth and development agenda, has already been made. The logic is undeniable and construction has begun. The only question is how to pay for it. By facilitating cost-effective private sector finance for rolling stock, the Luxembourg Rail Protocol will provide an important part of the answer.

For more about the Luxembourg Rail Protocol, visit www.railworkinggroup.org