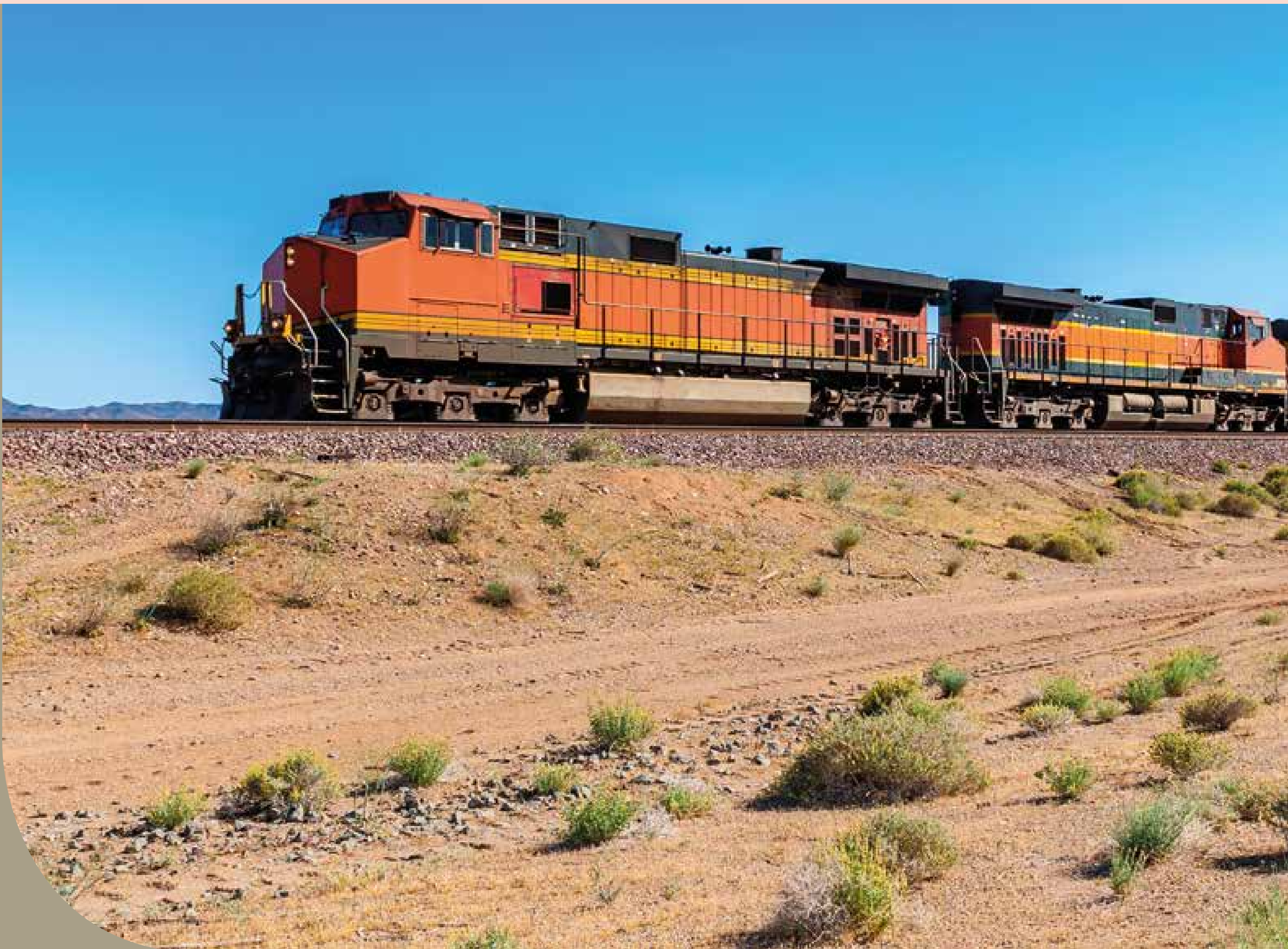
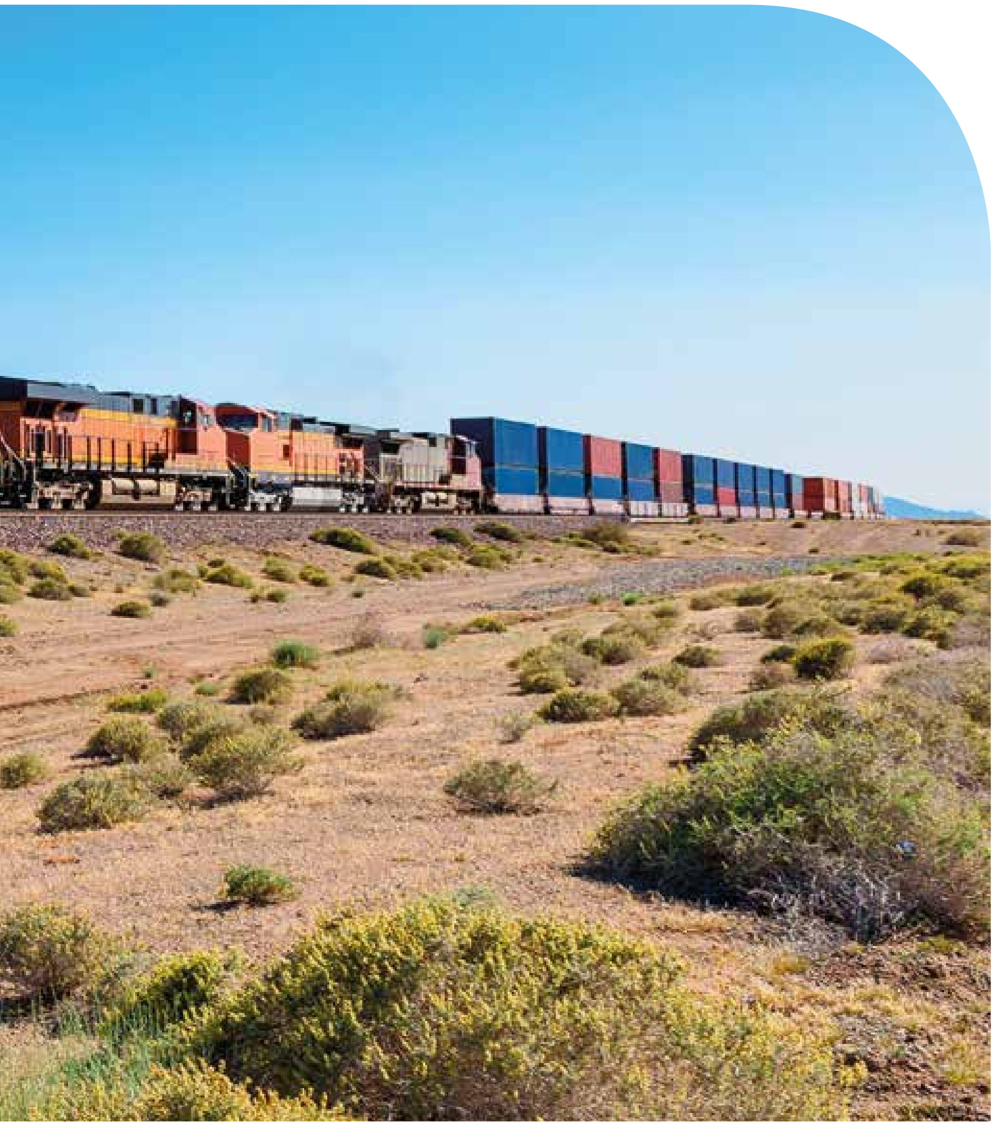
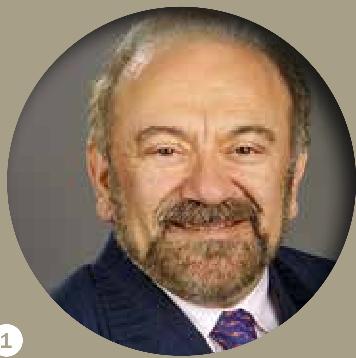
A LEGAL CHALLENGE FOR THE BELT AND ROAD INITIATIVE



At the beginning of May 2017, the first freight train service from the United Kingdom to Yiwu in Zhejiang Province, eastern China, completed its 12,000-kilometre journey. The landmark trip was made possible by the Belt and Road Initiative, a key part of which are new rail connections between east Asia and western Europe. This is a visionary project promoted, and in many cases financed, by the People's Republic of China.

The new network of rail routes, which echoes the ancient Silk Road, more than halves the time required to move goods between east Asia and Europe, compared with maritime transport. It also makes the process safer, more reliable and potentially cheaper than transporting goods by sea.





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The Belt and Road Initiative is the principal reason for the recent dramatic increase in Eurasian rail trade. A study by consultancy firm Roland Berger for the International Union of Railways (known by its French acronym UIC) noted that, between 2014 and 2016 – a period that coincided with the progressive introduction of the initiative's new routes – Eurasian trade by rail expanded from about 25,000 twenty-foot equivalent units (TEUs) per year to 145,000.

The UIC study predicts that this will reach 636,000 TEUs per year, equivalent to 27 trainloads per day, by 2027. Others expect the 1 million TEUs per year barrier to be breached before 2020.

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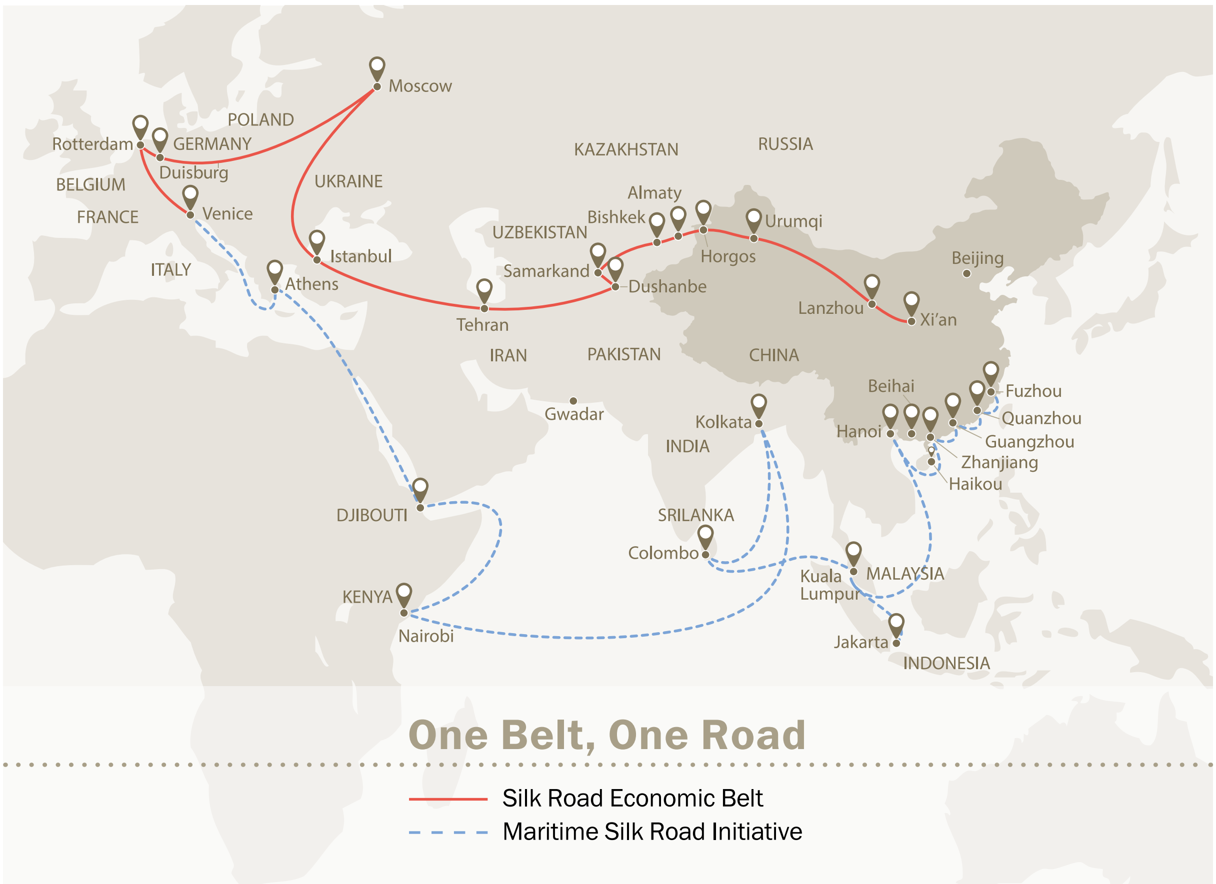
NEW INVESTMENT NEEDED

This expansion has the potential to deliver a major economic boost to the countries crossed by these rail routes, many of which are EBRD economies. But in order to meet the rising demand for rail freight transport and enjoy the benefits of the railway boom, these states will need more rolling stock.

Unfortunately, many of these countries are struggling to finance their existing rail infrastructure and operations. As a result, public and private operators in these countries will likely need to obtain other sources of credit, including private credit, so that they can procure new equipment.

Financial institutions, including banks (such as the EBRD) and pension funds, along with private investment funds are ready to provide credit secured on rolling stock or to lease locomotives and wagons to operators without recourse to sovereign credit. But the availability and cost of this finance will depend on the integrity of the collateral at their disposal.



MORE RISK, HIGHER COSTS

As things stand, the integrity of rolling stock as collateral is doubtful for two main reasons. First, there is no global harmonisation when it comes to property law in relation to railway equipment. This creates a great deal of uncertainty over the rights of creditors claiming security against rolling stock running through multiple countries with potentially very different legal systems and approaches to securing the title interests of non-possessory creditors. For example, the ability of a private creditor to repossess and redeploy rolling stock across the rail system is open to question. This is particularly critical where the operator or debtor is not an investment-grade credit.

The second reason for rolling stock as collateral being considered a weak form of security is that it can be difficult to clearly establish who holds ownership and security interests in the equipment. The rail sector has no national public registries in which title and security interests may be recorded and there is no common system for uniquely identifying rolling stock (whereas both facilities exist in the aviation industry).

The additional risk arising from these legal uncertainties translates into limited private credit for public or private operators seeking to purchase rail equipment. It also raises costs when such credit is available. Inevitably, this places the rail sector at a competitive disadvantage compared with other transport modes, despite the sound economic, social and environmental reasons for choosing rail.

Anything that can reduce creditor risk and lower costs will therefore help to secure the success of the Belt and Road Initiative and contribute to economic growth in the countries that it crosses. Fortunately, a solution is at hand.

A NEW SYSTEM OF RIGHTS

The Luxembourg Protocol to the Cape Town Convention on International Interests in Mobile Equipment is a new, ground-breaking global treaty that will make it much easier for the private sector to finance railway rolling stock worldwide. The protocol provides a new system of rights for the providers of private credit for rolling stock, secured lenders, lessors and vendors selling under a conditional sale agreement.

Their interests will be registered and searchable on a public online international registry based in Luxembourg that can be consulted 24 hours a day, seven days a week. The registry will also issue unique identification numbers for all items of rolling stock globally, ensuring that every creditor and operator can correctly identify and track rolling stock wherever it is in the world.

The protocol applies to rolling stock in the broadest sense: every vehicle that runs on tracks; or on, above, or below a guideway. And the protocol will allow parties to choose which law they wish to apply to any financing, regardless of where the debtor or the rolling stock is located.

TOWARDS AN EXPANDED RAIL INDUSTRY

The Cape Town Convention and the aviation protocol thereto were adopted in 2001 and went into operation in 2006. Both are in force in close to 70 countries and the system is tried and tested. The Luxembourg Protocol has been ratified by the European Union (in respect of its competences), Gabon and Luxembourg. It has been signed by France, Germany, Italy, Mozambique, Sweden, Switzerland and the United Kingdom – which are all moving towards ratification. Other European and non-European countries are working on the adoption of the Protocol.

In the EBRD region, Hungary and Ukraine have shown considerable interest. To that end, in September 2017, the LTP organised a seminar in Kiev titled *How the Luxembourg Protocol will Transform the Rail Sector in Ukraine and Beyond*. Among the speakers at the seminar were Volodymyr Omelyan, Minister of Infrastructure of Ukraine; Mark Magaletsky, Associate Director and Head of Infrastructure with the EBRD in Ukraine; Anna Veneziano, Deputy Secretary-General of the International Institute for the Unification of Private Law (UNIDROIT); registrar-designate Elizabeth Hirst from Regulis SA, the company that has been awarded the contract to run the international registry; and the authors of this article.

Minister Omelyan set out his clear support for the protocol. The seminar looked in detail at the different benefits it would bring to the rail sector in Ukraine and considered some of the technical issues that would need to be dealt with as part of the adoption process. The Legal Transition Programme of the EBRD is happy to provide technical assistance to the Ukrainian government on this journey.

We expect the protocol to enter into force and the international registry to commence operations in 2019. Once in place, the Luxembourg Protocol should reduce creditor risk, thereby facilitating more and cheaper finance from the private sector to support the procurement of much-needed new rolling stock.

It should also lower the barriers to entry for smaller, dynamic but more lightly capitalised operators, and facilitate operating leases of rolling stock. This will lead to more standardised equipment and create economies of scale for manufacturers and their customers.

SUPPORT FOR THE BELT

In the context of the Belt and Road Initiative, the protocol will not just provide an excellent new legal framework for rolling stock finance generally. It will also provide a common set of rules and creditor protections, regardless of the physical location of the rolling stock or the debtor, making the legal position easier to understand and enforce for creditors and foreign investors.

Consequently, any owner, lessor or operator running rolling stock through the various legal jurisdictions on the Belt connecting Europe and Asia can do so confident that their property and creditor rights will be respected. The overall result will be a more competitive and vibrant rail industry worldwide.

1 Chairman of the Rail Working Group, a not-for-profit rail industry association based in Switzerland. More information is available at http://www.railworkinggroup.org/about-us/ (last accessed 13 December 2017).