What impact would a no-deal Brexit have on rail finance?

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Banking & Finance analysis: Lisa Marks and Darren Fodey, both partners at Stephenson Harwood, assess the implications that a no-deal Brexit scenario would have on the rail finance market.

What impact would a no-deal Brexit have on the rail finance market?

New rolling stock is not available 'off the shelf' and has quite long lead-in times—typically a number of years between order and delivery. Therefore, Brexit is something which participants in rolling stock transactions—manufacturers, train operators and owners/lessors—have been weighing up for some time. The tripartite manufacture and supply agreement (MSA) is the agreement which allocates risk—including Brexit risk—between these parties.

While a number of manufacturers have factories or assembly plants in the UK, certain operations are based elsewhere in the world. A no-deal Brexit could:

- increase the risk of import duties/tariffs being imposed under World Trade Organisation (WTO) rules, and
- have contractual implications—such as where delivery dates for new rolling stock become more challenging due to delays at ports

Future trade between the UK and EU would be on WTO tariffs in a no-deal scenario. These tariffs are currently charged by the UK to any 'third countries' and would then also apply to each EU-27 Member State trading with the UK. WTO rules are particularly complicated to interpret—and we do not attempt to do so here. One point to consider is that tariffs may differ between component parts and the fully-assembled asset. The UK government has set out the different rates of customs duty payable by reference to the 'commodity codes' for different categories of goods. This situation could also apply to non-EU countries which have trade deals with the EU.

A no-deal Brexit is likely to restrict the free movement of goods at the UK/EU frontier—with separate customs checks being required by both the UK and the EU. This could bring delays in clearing customs, on one or both sides of the frontier. It will be important for parties to agree at an early stage in the transaction which party will be responsible for bearing delay risk—and whether this might constitute a 'permitted delay' under the MSA.

What preparations is the rail finance market making for a no-deal Brexit?

New rolling stock must be delivered by a date specified in the MSA and, if it is not, a number of remedies could apply. These include liquidated damages (LDs) or, in the worst-case scenario, cancellation of the contract and return to the manufacturer of everything previously delivered under that MSA (with the manufacturer returning all payments it has received).

An added complication is that the train operator will have franchise/concession commitments to the procuring authority to introduce the new rolling stock by a certain date—and they too could face remedial action if this does not happen. For the owner/lessor, they will be exposed to interest payments obligations on loans without having the benefit of lease payments from the operator.

Through no fault of the manufacturer, a no-deal Brexit could result in increased costs—through exposure to delay LDs to the owner/lessor and the operator, and increased import tariffs.

Brexit-related delays could also prevent milestone payments being made to the manufacturer, which would have cashflow implications. Preparations for a no-deal Brexit have therefore included addressing some of these issues.

Solutions might include no-deal Brexit-related delays being treated as a 'permitted delay', giving the manufacturer longer to deliver the rolling stock and thereby avoiding the imposition of LDs. Looking at the force majeure provisions may be another option. Which party will bear the risk of increased tariffs will also be a key point to consider—manufacturers will want to pass on to the owner/lessor any import tariffs imposed in the event of a no-deal Brexit, to insulate it from what could be very significant costs. This could be by way of an increase in the purchase price.

We might also expect more complex 'change in law' provisions in the MSA. Where the change of law is foreseeable, there is more of an argument that the manufacturer should bear the risk. Where a change of law is not foreseeable, it may trigger a variation under the MSA, offering the manufacturer financial protection. There will, of course, be different scenarios along this scale—including whether a change in customs duties actually constitutes a change of law at all, and at what date 'foreseeability' is assessed.

Are there any additional clauses, or other documentary changes, that should be made in preparation for a no-deal Brexit?

As of yet, there is no clear-cut market position on how delay risk should be allocated in a no-deal scenario. A parallel might be drawn with a force majeure scenario—where losses typically 'lie where they fall' in the MSA. However, this should be treated with caution as such a position is unlikely to be palatable to a manufacturer who will bear most of the financial risk. The train operator may have commitments to introduce the new rolling stock into service by a particular date—and is also unlikely to want to risk non-delivery or having to negotiate relief.

The owner/lessor will want the right to increase the rent payable for the lease of the rolling stock where tariffs are imposed, and it has been required to increase the purchase price payable to the manufacturer. Although the owner/lessor's financiers may agree to provide funding for the up-front payment of these import tariffs, they are likely to require the same residual value position at lease expiry, in which case the full import duty amount, plus the financing costs, will need to be paid by the operator by way of increased lease rentals over the lease term.

Is the prospect of a no-deal Brexit changing the way deals are structured eg security and registration issues?

Given that rolling stock owners are typically, for tax purposes, UK-registered companies, we do not foresee any changes in relation to the structure of asset-financed deals. However, after a no-deal Brexit, we would anticipate that some analysis would need to be done to determine where it would be most cost-effective to assemble and test new rolling stock. For example, if tariffs on importing pre-assembled rolling stock are lower than tariffs on its component parts, this may suggest assembly outside of the UK. Of course, transport costs, geography, facilities and expertise will also need to be taken into account in making this assessment.

If, as might be expected, there was to be a liquidity squeeze in the event of a recession following a no-deal Brexit (combined with uncertainty in the financial markets), forms of rail financing based on debt could become more difficult to obtain or more expensive. This could lead to opportunities for alternative financing solutions based on equity or bond-based financing. We have seen an increase in the availability of such alternative financing solutions recently and Brexit could be the catalyst for further change. That said, a recent Loan Market Association syndicated loans conference acknowledged that lending levels are much lower than in recent years. Infrastructure and sustainable financing are being looked at with interest by lenders in the syndicated loan markets so, once the uncertainty about which way Brexit will fall dissipates, more financing may become available. Of course, the make-up of a syndicate for large debt lending may be different. It is hard for any of us to predict pricing, as lenders will also have their own Brexit and regulatory requirements to contend with.

What impact would a no-deal Brexit have on cross-border rail arrangements, in particular in relation to the Channel Tunnel?

The UK government's plan, set out in the Brexit Political Declaration of 25 November 2018, is to enter into bilateral agreements with France, Belgium, Ireland and The Netherlands, to ensure the future smooth running of services through the Channel Tunnel and the Belfast-Dublin Enterprise line. Given the volume of passengers and freight using the Channel Tunnel—and the current alignment between licensing and interoperability regimes—our view is that there is appetite for ensuring the seamless continuation of these services. This sense is reflected in EU Commission papers—although this is by no means explicit.

According to Getlink (the public company which manages and operates the Channel Tunnel):

> 'fast and frictionless movement of goods and people at the border … has contributed to the growth of trade through the Channel Tunnel'.

Getlink also points out that, although there are sites on either side of the Channel Tunnel for 'safety and security inspections', 'neither site was intended as a customs clearance point', and that attempting to use the UK site for customs clearance would lead to 'congestion and delays which would disrupt trading, business supply chains, and in particular, just-in-time delivery'.

Are there any other issues, legal or practical, that rail finance lawyers and market participants should be aware of?

There has been a focus in recent rail franchising competitions on 'quality' which, in practice, has typically meant bidders proposing new rolling stock to win franchises. Many of these new fleets are in the process of being introduced or are expected to come on-stream in the next two to three years. Contrary to the position even ten years ago, this means that there is a lot of rolling stock—and potentially a lot of 'spare' rolling stock—in the system. Examples are being seen of relatively new rolling stock being sent 'off lease' (ie becoming surplus to requirement)—and there is likely to be other rolling stock with life left in it also being taken out of service.

This factors into pricing for new or refurbished rolling stock—and there is likely to become more of a market for the latter. This all depends on price—rolling stock manufacturers accounting in euros could see the cost of their new products increase relative to UK-based companies if the value of sterling in the currency markets continues to erode or fluctuate in a no-deal Brexit. This could make new rolling stock more expensive, and there may therefore be pressure on extending the life of existing trains, particularly if refurbishment options deliver substantially enhanced vehicles at reasonable pricing.

In a development unrelated to Brexit, in recent years we have seen more train manufacturers developing plants in the UK—such as Hitachi in Newton Aycliffe and Construcciones y Auxiliar de Ferrocarriles in Newport. This could offer an opportunity to mitigate the impact of a no-deal Brexit– although, in relation to tariffs on imports, this will depend on the extent to which the 'raw materials' are produced in, or imported into, the UK, and whether tariffs above 0% are imposed on them.

There has been a significant drive across Europe in recent years to harmonise the European rail network to achieve 'interoperability' where this is reasonably practicable, including the introduction of common Technical Specifications for Interoperability (TSIs). As a result, there is now a considerable degree of alignment in technical standards across Europe's rail network. Integration has also provided the rail regulator, the Office of Rail and Road, with a useful channel of communication with its European counterparts to ensure that a consistent approach is adopted to regulation.

In a no-deal Brexit, we struggle to see circumstances where these TSIs or other rail-related regulations would be high on the priority list of areas for change—and alignment with Europe would seem to be preferable on all sides. Of course, going forward, the UK would need to decide whether to continue to follow the European lead (without having any say in how the rules and regulations are developed) or to diverge and set its own path. This may create a novel set of challenges in the future—although our view is that this is a more medium-term than a short-term issue.

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