GERMAN RAIL ATTRACTS INSTITUTIONS

THE DIESELNETZ ULM TRANSACTION PAVED THE WAY FOR INSTITUTIONAL INVESTORS IN THE GERMAN REGIONAL PASSENGER RAIL TRANSPORT SECTOR. IN APRIL 2019 INSTITUTIONAL INVESTORS CLOSED WITH DIESELNETZ SACHSEN-ANHALT THE SECOND TRANSACTION IN THE SECTOR. BY DERK OPITZ, PARTNER AT ASHURST.

The German regional passenger rail transport sector, or Schienenpersonennahverkehr SPNV, is a fully liberalised sector and has been opened for privately owned train operating companies (TOCs) competing with the incumbent state-owned operators.

Given that regional public passenger transport in general is not organised as a self-sustaining transport sector in the sense of full funding through fare box revenues, the federal government through the local public transport authorities (PTAs) of the federal states financially supports regional public passenger transport, regionalisation funding.

In order to create a level playing field for the competing TOCs the PTAs in particular support the financing of the acquisition of the rolling stock needed for the respective operation, in particular when the PTA requires the TOCs to use new rolling stock.

The reason for that support is that the PTAs aim to promote competition and want the TOCs to compete with better services for passengers and not with better financing conditions. Therefore, the financing is supported in one way or the other to take the financing conditions out of the equation in a tender process.

If that was not the case, the state-owned TOCs would have a considerable competitive edge over the privately owned companies. For example, Deutsche Bahn AG, Germany's leading train operating company, is 100% owned by the German federal government and therefore benefits from the AAA rating of the federal government. Deutsche Bahn AG could theoretically finance its operations on the capital market at German public bond conditions, ie, at a coupon close to zero.

A peculiarity of the German SPNV is driven by European regulation and specifics of the German market for rolling stock.

Pursuant to European procurement laws a concession period for regional passenger rail transport services in Germany is in principle limited to a maximum period of 15 years. The average life time of rolling stock used for public transport is 25 to 35 years depending, in particular, on the type of traction.

As there is no fully functioning secondary market for used passenger rolling stock in Germany, a bidder for a concession faces the so called residual value risk, ie, if the bidder does not win the following concession period, it is left with a fleet of rail vehicles it cannot use any more, even though the rolling stock can technically still be used for another 10 to 20 years.

Against this background most of the 26 German PTAs support the financing of new rolling stock in a way that deals with the residual value risk and provides comfort for the financiers.

There is no uniform approach in Germany as regards the support of the financing of new rolling stock for the regional public transport. In fact, each of the 26 PTAs has its own approach.

Before Dieselnetz Ulm

European and German policy has been trying for years to support the financing of infrastructure by institutional investors. For example, Solvency II, the regulatory regime applying to insurance companies in Europe since 2016, introduced the concept of "qualified infrastructure", privileging the investments of insurance companies in public infrastructure.

At first glance financing of German regional passenger rail transport looks like the perfect investment for long-term and risk-averse investors such as life or health insurers given its long term and low risk profile. Notwithstanding that fact, until Dieselnetz Ulm, as further described below, there was no financing by institutional investors in this area. This had mainly three reasons:

- First, the financing of German regional passenger rail transport was a domain of the German semi state-owned banks, or Landesbanken. They purchased the remuneration claim against the PTA under a receivable purchase agreement to issue covered bonds backed by the claim against a public body. Even though there are no public bonds covering the full length of rolling stock financings, the banks offered to the TOCs public bond conditions for the entire term and thereby outpriced other financing sources.

- Second, the Solvency II definition of qualified infrastructure does not explicitly include rolling stock. Hence, at least as per today, it is the prevailing view among insurance companies that rolling stock does not qualify as infrastructure within the meaning of Solvency II.
- Third and most important, until Dieselnetz Ulm there was no market precedent for a financing with insurance companies. Usually the bid is awarded two to three years before the commencement of operations. The supply of a mid-sized fleet of vehicles can take two years. On average, the TOC has a maximum of six months to have its financing in place in order to be able to start the construction process in time.

Against this background, in particular the smaller, privately owned TOCs were hesitating to take the transactional risk and rely as counterparties on insurance companies, which have, at least in Germany, limited experience at the most with rolling stock financings.

The second institutional deal

Bayerische Eisenbahngesellschaft mbH (BEG), the PTA of the Free State of Bavaria, in 2018 selected DB Regio AG in a competitive bidding process to operate regional passenger transport services on the diesel rail network around the Bavarian city of Ulm (DNU) for a concession period from December 2020 until December 2032 with approximately 1.5m train kilometres per year.

The tender documents required from the TOC to operate the passenger services with newly purchased diesel multiple-units (DMUs). DB Regio AG will be operating the DNU with Coradia LINT diesel railcars with a purchase price of more than €90m.

BEG decided to support the financing of the acquisition of the new DMUs in Ulm with a redeployment guarantee in combination with a waiver of counter-claims.

- *Redeployment guarantee* – Under a redeployment guarantee the PTA guarantees the financiers that it will oblige the TOC being awarded the subsequent concession period to use the DMUs under the same terms as for the first concession period. In other words, the PTA guarantees the use of the DMUs for approximately 25 years. This allows financiers to put in place a financing with a term matching the lifetime of the rolling stock.
- *Waiver of counter-claims* – A waiver of counter-claims means that (i) the PTA allows the TOC to assign the portion of the fixed remuneration claim against the PTA relating to the costs of the rolling stock financing to the financiers and (ii) the PTA waives any counter-claims it would have against the TOC vis-à-vis the financiers in relation to such portion being assigned.

The waiver of counter-claims has the effect that even in case of a default of the TOC with its obligations towards the PTA under the concession, the financiers would still be remunerated. If the performance of the TOC deteriorates so much that the PTA is required to terminate the concession, the PTA would replace the TOC and oblige a new operator to assume the financing. Thus the project risk is taken away from the financiers and the financiers can rely on the solvency of the PTA instead of the TOC when assessing the likeliness of defaulting payments.

The BEG, however, is organised as a private limited company owned by the Free State of Bavaria. The remuneration claim is therefore not a direct claim against a public body.

For Diesel Network Ulm the time had come for a new financing structure. Given that BEG is a private company the remuneration claim against the PTA is not a direct claim against a public body and thus not eligible for a public bond issue. Hence, the semi state-owned banks were not able to offer covered bond financing for DNU.

As stated, the regional passenger rail transport in Germany is typically financed with a purchase of the remuneration claim against the PTA by the financiers under a receivable purchase agreement (RPA). One of the reasons for choosing an RPA, in particular over a loan, is that a loan governed by German law can be repaid without premium or penalty after 10 years no matter if the contractual term is longer than 10 years.

Under Solvency II, however, insurance companies are limited in their type of investments. As a direct investment insurance companies can only invest in loans, bonds or equity stakes. A financing by way of an RPA is not possible with insurance companies.

Therefore, DB Regio had to implement a structure that has never been used before for SPNV transactions. The investor category of institutional investors offered new opportunities but on the other side, the transaction had to meet further investment criteria such as in particular, the security principle laid down in § 124 (1) No. 2 of the German Act on the Supervision of Insurance Undertakings, Versicherungsaufsichtsgesetz – VAG.

DB Regio instructed Joh Berenberg, Gossler & Co KG to arrange a financing by way of a project bond with insurance companies. Berenberg selected Ashurst LLP as legal adviser to the investors. The group of investors arranged by Berenberg was made up of the German pensions funds, life and health insurers

Until Dieselnetz Ulm there was no market precedent for a financing with insurance companies. The smaller TOCs were hesitating to take transactional risk

represented by their asset managers MEAG, acting for DKV Deutsche Krankenversicherung AG and ERGO Lebensversicherung AG, and Talanx, acting for HDI Pensionskasse AG and neue leben Pensionskasse AG.

Ashurst chose registered notes, Namensschuldverschreibungen, to finance DNU because registered notes (i) meet the criteria of § 124 (1) No 2 VAG and (ii) can have a term of more than 10 years.

In spite of the fact that for both sides (the TOC and the insurance companies) the project marked new grounds away from well-known paths financial close was reached in less than three months.

The first institutional deal

In 2015, there years before DNU, the state of Saxony-Anhalt, the regional association for the metropolitan area of Braunschweig, Regionalverband Großraum Braunschweig, and the free state of Thuringia, together the DISA PTAs, awarded Abellio Rail Mitteldeutschland GmbH, a subsidiary of Dutch railway company Nederlandse Spoorwegen NV (NS), the contract for the provision of local rail transport services on the so-called diesel network Saxony-Anhalt, Dieselnetz Sachsen-Anhalt or DISA, with a concession term of 14 years.

The DISA concession, with approximately 9m train kilometres per year, is one of the largest concessions in the German local passenger transport market. Abellio will be operating DISA with 52 Coradia Lint 41 diesel railcars with a purchase price of more than €170m.

Similar to DNU, the DISA PTAs required the use of new rolling stock. The DISA PTA supported the financing by way of a residual value guarantee, Restwertgarantie.

- *Restwertgarantie* – Under a residual value guarantee the DISA PTAs assumed the obligation to purchase the vehicles at the end of the concession term for a guaranteed minimum price; in other words the DISA PTAs did provide a solution for the residual value risk, albeit in a different manner than for DNU.

The DISA PTAs did not, however, agree to a waiver of counter-claims. This means unlike for DNU, the DISA concession does contain a limited project risk, ie a default of the TOC with its obligations towards the PTA, can theoretically prejudice the TOCs ability to pay the finance costs.

After the concession was awarded to Abellio in 2015, Abellio's parent company NS financed the acquisition of the vehicles with a leasing structure. DISA Asset Ltd, a subsidiary of NS, served as leasing company. DISA Asset was financed in a rather traditional way by way of shareholder loans and a term loan from Sumitomo Mitsui Banking Corporation and KfW IPEX-Bank GmbH.

In April 2019, NS sold the shares in DISA Asset to 3i's European Operational Projects Fund. 3i decided to replace the existing traditional financing also with an institutional solution by replacing the existing debt simultaneously with the acquisition of the shares, making use of the experience from DNU.

3i instructed Ashurst with the implementation of the financing structure. As for DNU, the long-term financing was provided by registered notes, Namensschuldverschreibungen, subscribed by institutional investor MEAG. In addition, 3i included short-term loans in the financing structure provided by SMBC.

Last but not least, the financing structure had to allocate the project risk between the financing parties, the leasing company and the TOC. Hence, in the DISA transaction two more layers of complexity were added to the transaction.

Going forward

DNU opened a new financing source for TOCs active in the German regional passenger rail transport market and a new market segment for insurance companies. The long-term, stable cashflow and low risk investment can indeed become a perfect match for the insurance companies. DISA proved that institutional investors can be imbedded in complex financing structures.

For the suburban railway network of Hanover, the regional train network around Berlin (network Elbe Spree) and the Augsburg networks currently being financed institutional investors are more than a theoretical alternative. ■