<u>RSTAC Recommendation to the Surface Transportation Board</u>
<u>to Examine the Nation's Rail Boxcar Supply</u>

The voting members of the Railroad-Shipper Transportation Advisory Council ("RSTAC") respectfully request the Surface Transportation Board (the "Board") to reopen *Ex Parte* No. 334 or otherwise seek public comment on immediate solutions to address the looming "boxcar cliff" of insufficient new North American boxcar production to replace accelerating retirement of boxcars built in the 1970s and 1980s. Based on the RSTAC's review of this impending challenge, it is worthy of further formal consideration. The public interest would benefit from an inquiry into the current and future state of the boxcar fleet to meet current and future rail customer demand and into the existing car hire framework and alternatives to it, as well as the impact of the current framework on fair, market car hire rates.

In particular, the Board has the purview to remedy a principal cause of the boxcar cliff. As explained below, in 1994 the Board's predecessor, the Interstate Commerce Commission, empowered the Association of American Railroads ("AAR") to set a "Default Rate" for boxcars. This Default Rate, which does not apply to the TTX (an entity that is controlled by the Class I railroads and has a regulatory exemption from antitrust laws), has disincentivized new boxcar production. As a result, the North American railroad system and shippers across the U.S. face a devastating boxcar shortfall without sufficient new production to replace thousands of mandated and other planned boxcar retirements.

The RSTAC suggests the Board seek comment on boxcar supply, the boxcar cliff, and ways to promote replacement of the boxcar fleet for current traffic levels as well as the future growth that railroads tout to investors, including alternative approaches to the delegation to AAR of the administration of the Default Rate that would create more market-based rates to incentivize boxcar production. Alternatives to the Default Rate may include using a prior quarter's median paid or mean paid market rate, instead of the lowest negotiated rate, when calculating the Default Rate, and adjusting rates for a railcar at various times, instead of remaining constant over the life of the railcar.

Without an adequate supply of boxcars, shippers will shift rail carload traffic to trucks, with disastrous consequences for railroads, their employees, America's highways, the nation's supply chain as a whole, and our environment. The RSTAC therefore urges the Board to request public input on appropriate Board action to ensure free-market incentives for increased boxcar production to keep the North American railroad network and our national transportation system fluid and vital. A suggestion for a draft notice is attached at Appendix A.

I. The Boxcar Cliff Is Here

Boxcars remain integral equipment in our nation's rail transportation fleet. Boxcars move pulp, paper, lumber, wood products and other commodities, and come in a variety of sizes and capabilities.[1] Boxcars also offer a flexible platform particularly suited to the smaller shippers short line railroads often serve. Shortages in boxcars therefore affect small shippers and shortlines acutely.

Due to a surge in boxcars added in the late 1970s,[2] many boxcars are reaching regulatory interchange age limits as well as functional and economic obsolescence. This fact was confirmed to RSTAC by a recent presentation by TTX which showed that 35% of the nation's boxcar fleet will reach 50 years of age between 2022 and 2030. As these railcars age out, the number of cars available will shrink sharply without new investment. It is clear that construction of boxcars lags

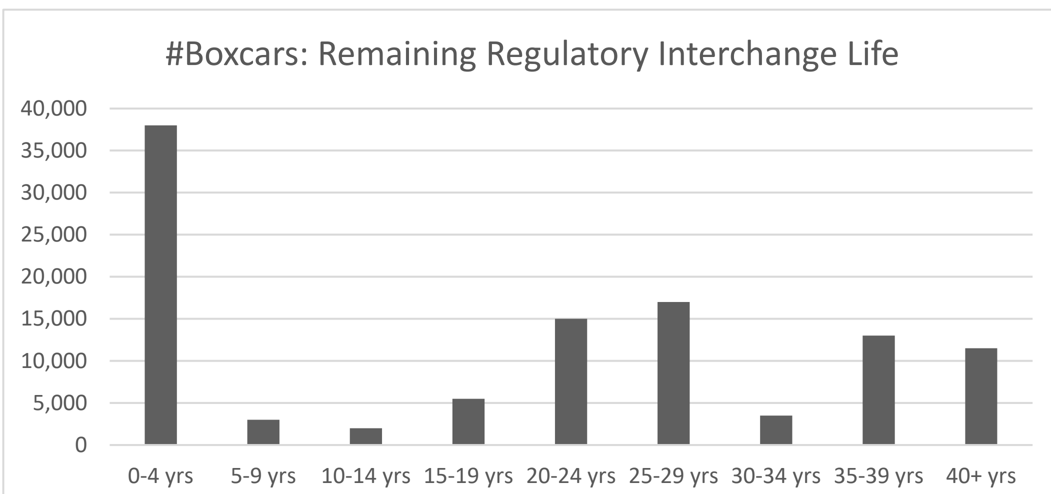

Figure 1: Boxcar Fleet Age Profile, Integrity Rail Partners, Umler, 108,923 cars

the retirement of these cars. The looming retirement of these cars without a replacement fleet coming online is known as the "boxcar cliff."

1 The aggregate use of boxcars has declined over time due to growth of intermodal services and changes in the rail market, but demand for boxcars remains.

2 The surge of boxcars built in the 1970s was a result of a market distortion in the car hire rates in the late 1970s, which demonstrates that the correlation between car hire rates and supply is high.

A principal cause of the boxcar cliff is the 'Default Rate' mechanism, which often sets boxcar hire rates artificially low and discourages new investment. These car hire rates drive the asset return on investment, based on payments made to the car owner to use the car. As Class I carriers have often and correctly noted, freight railroads must earn a positive rate of return to attract and maintain investment. This basic economic proposition also applies to rail equipment manufacturers, vendors, and users. Figure 1 makes clear that the return on the investment for boxcars has not generated replacement new boxcar production.

The current car hire rate mechanism sets default rates for boxcars that are substantially below the level required to generate a positive rate of return. Freight railroads, and disproportionately the Class I's, can refuse to negotiate any other rate except through an 'all-or-nothing' arbitration process that results in rates that disincentivize most potential investors in boxcars. The effect has been to dramatically reduce competition in car investment and ownership and to consolidate that ownership in TTX, which is not subject to the Default Rate and that possesses an exemption from antitrust laws.

The "boxcar cliff" has created an urgent threat to shippers, shortline railroads, car leasing companies and all rail stakeholders.

If the default rate issue is not addressed, nearly 1 million carloads could be at risk each year, with a substantial conversion lost to truck or truckload shipping. As noted in a 2020 study by the Brattle Group, smaller rail shippers will suffer as will shortline railroads serving this vital supply chain segment.[3] *Common carrier* availability of rail equipment for movement of goods is as essential to the nation as are tracks and locomotives and crews. Measures that examine historic boxcar shipment levels are not useful because they do not account for the freight that has not been able to move by rail as a result of a limited supply of boxcars. For example, potential boxcar shippers were turned away from rail during the boxcar crises of 2014-15 and 2021-22, and that lack of car supply remains a major hindrance to converting truck shippers to boxcars. The public interest requires a forward-looking policy that promotes boxcar investment by many market participants to grow rail freight by converting truck traffic into additional boxcar traffic.

The national transportation interest demands shifting more freight from truck to rail, reducing carbon emissions, fostering vigorous competition, and generating greater equity

[3] *Car Hire Rates, the Car Hire Market and Car Supply: A Case Study of the Boxcar Market,* prepared for Equipment Leasing Committee of Railway Supply Institute, The Brattle Group, June 4, 2020 ("Brattle Study"), at 35.

between large and smaller shippers. Achieving these and other vital national policy goals requires incentivizing new boxcar investment through reasonably set car hire rates, in a fair process subject to the Board's oversight.

II. The Current Car Hire Framework Needs Review

A. The Process Delegated to AAR Suppresses Car Hire Rates

Within the current statutory and regulatory framework, an earlier delegation of authority from the ICC to the AAR now challenges the nation's privately owned boxcar supply. At the core, railroads must furnish a safe and adequate supply of cars. 49 U.S.C. § 11121. The compensation and other terms set by railroads for the use of freight cars, known as car hire, must be fair. 49 U.S.C. § 11122; 49 C.F.R. 1033. This includes payments by a carrier to a car owner for the use of its cars, known as car hire or per diem charges. Congress requires the Board to consider a variety of factors in regulating car hire rates, including current costs of capital, repairs, materials parts and labor, current car ownership levels, and the adequacy of the national freight car supply. 49 U.S.C. § 11122(b).

In 1992, the ICC issued a rule, codified in 49 CFR § 1033.1, permitting car owners and users to enter negotiated agreements for market car hire rates, or arbitrate rates pursuant to the Association of American Railroad's ("AAR") Car Service and Car Hire Agreement ("AAR Car Hire Rules"), subject to the Board's oversight. *See Southern Pacific Transpo. Co. v. I.C.C.*, 69 F.3d 583 (D.C. Cir. 1995). Under the Code of Car Hire Rules established by the AAR, a rail car that does not have a negotiated or arbitrated rate is assigned a Default Rate equal to the lowest negotiated positive rate in effect for that equipment type at the end of the previous quarter ("Default Rate"). That rate is the rate under which a newly manufactured railcar enters freight service.

The car hire rules of compensation, reporting and payment are documented in the AAR Car Hire Rules. Rule 25 defines the process through which car owners and railroads can negotiate car hire rates. Here is how it works:

- If a shipment of freight will be shipped by Railroad A and Railroad B in a new railcar owned by Railroad A, then Railroad A will register the railcar pursuant to the AAR Car Hire Rules. At that point the railcar is assigned a Default Rate.

- Railroad A may then propose per diem car hire rates for use of loaded and empty railcars to Railroad B through the AAR system. Railroad B may then propose an alternative rate that is less than Railroad A's initial proposal.

- Rule 25 specifies that at either party's request, a car hire rate dispute will be resolved through an arbitration process.

- If no agreement is reached, the Default Rate becomes the applicable rate, which is equal to the lowest negotiated positive rate in effect for that equipment type at the end of the previous quarter.

Thus, Railroad A[4] will often take Railroad B's proposed alternative rate to avoid costly and time-consuming arbitration, even though that rate is below market; or if no agreement is reached, it will proceed with the Default Rate. The system therefore can function to ratchet down car hire rates for boxcars. And, once a car hire rate is set, this rate tends to remain in place for the life of the railcar.

B. The Framework for Car Hire Rates Results in Payments that Make Boxcar Investment Uneconomic

The Default Rate is a primary reason for the boxcar cliff because the Default Rate sets below market rates that do not incentivize investment. The Brattle Study determined that the Default Rates assigned to railcar owners under the current framework have a statistically significant effect in lowering the negotiated car hire rates paid to car owners.[5]

The Brattle Study applies the well-developed body of economic theory analyzing the conduct and outcome of two parties entering into a commercial agreement to the scenario of a boxcar car hire negotiation and notes several points. First, because the Default Rate is automatically assigned to the railcar, when Railroad A begins negotiations with Railroad B, the railcar user, Railroad B will have to agree to a higher rate than the Default Rate that is in place without any further benefit to Railroad B. Brattle Study, 11. Second, in most functioning markets a buyer will pay a higher price than other potential buyers to obtain a certain service that is preferential to other buyers, however in the car hire scenario, the price paid has little to no impact on the service or use of the railcar by Railroad B. *Id.* Finally, the only motivation for Railroad B to agree to a higher than Default Rate car hire rate is that doing so avoids the threat of

[4] The Brattle Study describes this negotiation as between 'Railroad A' and 'Railroad B'. In reality, 'Railroad A' also represents other railcar owners such as shippers, shortline railroads, or leasing companies
[5] Brattle Study at X.

arbitration. *Id.* at 12. Ultimately, the car hire rate is determined by the risk related to arbitration that each of the parties is willing to take, not the market. *Id*. Therefore, The Brattle Study makes an overall assessment that the Default Rate has a major effect on the outcomes of negotiations over car hire, skewing those outcomes downward. *Id*. at 13.

In codifying § 1033.1, the ICC transferred economic control of rail car supply from independent regulators to Class I railroads through the AAR. Allowing Class I's to control the Default Rate has depressed car hire rates for railroad marked boxcars below the threshold needed to incentivize investment to build new boxcars. Furthermore, the car hire rate regulations set forth in 49 CFR § 1033.1, as administered through AAR Circular OT-10 Code of Car Hire Rules ("AAR Car Hire Rules"), fail to provide a fair return or incentivize the proper supply of boxcars in the system.

C. The Board Should Assess Whether the AAR Is the Proper Entity to Set Car Hire Rates

Class I railroads have an interest in low car hire rates to reduce their own costs. Under the current, framework Class I railroads can continue to incur low costs but at the cost of investment in the Nation's supply of boxcars.

Moreover, through the car hire rules, the Class I railroads are effectively able to set the artificially low rates at which others must supply them cars. This misalignment gives Class I carriers economic control over their competitors to supply railcars and reduces the incentive for parties to reinvest in the car fleet.

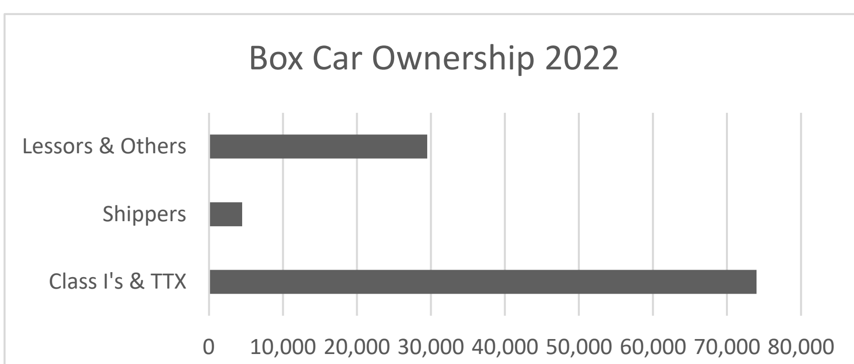

Figure 2: Boxcar ownership, aggregated. Source: Umler, Integrity Rail Partners, Inc.

It is important to note that the impact that the Default Rate has on boxcar car hire does not affect TTX, which is currently the largest supplier of boxcars and which is owned by the Class I railroads. TTX operates under a separate system that does not use a Default Rate framework. In fact, nearly two-thirds of the 15,000 boxcars built between 2015 and 2020 are owned and operated by TTX and are not subject to the car hire system administered by AAR. That compares to approximately 4,000 of these boxcars built during this time that bear railroad marks and are subject to the AAR Car Hire Rules and about 1,200 of these boxcars that are shipper-owned or leased cars operating outside of the car hire system. *Id*. at 5, 6.

Rail stakeholders have repeatedly expressed concern about the need for changes to the current frameworks for setting boxcar car hire rates to assure the adequacy of the national boxcar supply and reasonable competition among boxcar suppliers.[6] It is imperative for the Board now to reexamine the prior delegation by the ICC to the AAR of the administration of Default Rates for boxcars.

D. Other Frameworks for the Car Hire System May Better Incentivize Appropriate Levels of Investment in Boxcars

The Brattle Study used regression analysis and a simulation model to identify how slight changes in the framework might create more market-based rates. *Id*. at 24. Such changes include using a prior Quarter's median or mean paid market rate, instead of the lowest negotiated rate, when calculating the Default Rate, and/or adjusting rates for a railcar at various times, instead of remaining constant over the life of the railcar. *Id*. at 33. Rates could be compared to the TTX rates, as well, to determine what the market for railcars is at any given time. Utilizing data from the Brattle Study simulation, together with other input through public comment offering additional solutions for appropriate Board oversight adjustment to the current car hire framework, will bring car hire rates for boxcars closer to a market rate.

[6] Railway Supply Institute Letter dated July 28, 2019 to Chairman Ann D. Begeman, Vice Chairman Patrick J. Fuchs and Board Member Martin J. Oberman outlining the Railway Supply Institute's concern about the default rate rule set forth in the AAR Code of Car Hire Rules; "Why Railroads Can't Keep Enough Boxcars in Service," Wall Street Journal, June 21, 2015; "Shortage of Railroad Boxcars has Shippers Fuming," Market Watch, June 21, 2015; "I'm Singin' the Boxcar Blues," Railway Age, March 25, 2019; "Outside the Box: Can the US Rail Freight Sector Avoid a Boxcar Shortage," Railway Technology, October 31, 2019.

III. RSTAC Recommendation

The boxcar cliff jeopardizes the future shipment of rail carload traffic. The delegation to one stakeholder of the rate-setting process for boxcars, the lack of any meaningful change in the process, the rising prospect of a single anti-trust-exempt entity controlling the vast majority of the boxcar fleet, and the resulting challenges to our nation's future boxcar fleet merit the Board's attention. Examination of prospective changes to the car hire framework should, of course, assess whether the current framework for setting boxcar car hire rates is fair by considering current costs of capital, repairs, materials parts and labor, current car ownership levels and the adequacy of the national freight car supply, pursuant to 49 U.S.C. § 11122(b).

The RSTAC respectfully requests the Board to reopen *Ex Parte* No. 334 or otherwise seek public comment on the issue of the "boxcar cliff," immediate solutions to examine the "boxcar cliff," boxcar supply, the car hire system, and the incentives for investing in boxcars. Given the various stakeholders dependent upon an adequate and robust boxcar supply, including shippers, short line railroads, labor, car manufacturers and others, the Board would benefit from a public process to gather input on these issues to ensure that the car hire system is serving the public interest. RSTAC recommends that the Board seek input on implementing updated solutions that will create more market-based rates sufficient to stimulate new boxcar construction.

The RSTAC therefore urges the Board to examine the state of the boxcar fleet, the boxcar cliff, causes for the cliff, the existing car hire framework and alternatives to it, and the impact of the current framework on fair, market car hire rates. 49 U.S.C. § 11122 and 49 C.F.R. 1033. A suggested form of a notice to explore these issues is provided as Appendix A.

Adopted: March 16th, 2023 by the voting members of RSTAC.

APPENDIX A – SUGGESTED LANGUAGE FOR STB NOTICE

SURFACE TRANSPORTATION BOARD

NOTICE OF PROPOSED RULEMAKING

Docket No. EP ____

ISSUES RELATED TO THE NATION'S BOXCAR FLEET

Digest:[7] The Board invites comments on issues that relate to the adequacy of the boxcar fleet serving rail customers and incentives to invest in such fleet.

Decided: XXXX ___, 2023

The Surface Transportation Board (the Board) seeks comments on issues related to the boxcar fleet in the United States.

Boxcars are essential pieces of equipment in the movement of numerous commodities by rail. Today boxcars are primarily used for the movement of pulp, paper products, lumber, and wood products. Many of the boxcars from the 1970s are reaching regulatory age limits as well as functional and economic obsolescence. This will result in the anticipated "boxcar cliff." as illustrated in the age profile below. Approximately 38,000 boxcars, which represents about 35% of the existing North American fleet are over 40 years old and will reach their regulatory obsolescence by 2029 and are reaching their functional and economic obsolescence already. An insufficient supply of boxcars could affect the nearly one million annual carloads of boxcar commodity shipments today, with a heavy emphasis on paper and lumber may convert to truck or intermodal to meet their shipping requirements, as well as the opportunity for growth in rail shipments from this segment of freight traffic.

The STB has exclusive jurisdiction under 49 U.S.C. § 10501 over transportation by rail carriers and the Board's remedies with respect to car service rules (and various other aspects of transportation by rail carriers) are exclusive. In addition, under 49 U.S.C. § 11122, the Board's regulations on car service "shall encourage the purchase, acquisition and efficient use of freight cars" and such regulations may include the compensation to be paid for the use of a freight car. The Board retained jurisdiction over car hire rates related to boxcars in 49 C.F.R. 1039.14(b).

In 1992, the Board's predecessor agency -- the Interstate Commerce Commission ("ICC") -- issued regulations that phased out the car hire prescription system that had been in place for railroad-marked railcars since 1977, authorized rail carriers to enter into bilateral

[7] The digest constitutes no part of the decision of the Board but has been prepared for the convenience of the reader. It may not be cited to or relied upon as precedent. See Pol'y Statement on Plain Language in Digs. in Decisions, EP 696 (STB served Sept. 2, 2010).

agreements establishing market-based car hire rates for such railcars, and approved the arbitration provision of the Association of American Railroads ("AAR") Code of Car Hire Rules to enable subscribing rail carriers to arbitrate car hire rate disputes.[8] As part of its 1992 rulemaking deprescribing car hire, the ICC empowered the AAR by adopting the AAR Code of Car Hire Rules as the governing car hire compensation system for those rail carriers which are subscribers to AAR Circular OT-10.2. The default rate rule is included within the arbitration provision of the AAR Code of Car Hire Rules, which have been incorporated into AAR Circular OT-10.3.

The Board understands that in February of 2019 the Railway Supply Institute ("RSI") petitioned the AAR's Equipment Assets Committee to revise the default rate rule mechanism set forth in the AAR Code of Car Hire Rules. RSI's proposal was to change the default rate rule so that it is based on an average rate paid for cars used during the prior quarter for the equipment type at issue (instead of the lowest negotiated rate as specified in the current default rate rule). The AAR's Equipment Assets Committee voted in May 2019 not to make any change to the current method for determining default car hire rates.[9]

The Board is concerned that the unilaterally established "default rate" for boxcars has disincentivized new boxcar construction. The Board has heard this concern over time,[10] most recently from the Board's statutorily-created advisory group, known as the Railroad-Shipper Transportation Advisory Council. The Board seeks information on possible issues related to the size and health of the boxcar fleet in the United States, concerns about shifts in ownership over time of boxcars, the compensation regime for boxcar usage, the "default rate" set by the AAR, and the continuing appropriateness of the ICC's empowerment of the AAR to set the default rate.

Accordingly, the Board is interested in exploring issues related to the boxcar fleet so that the nation is not caught short of an adequate boxcar supply in the future. Further, although there is no set format for comments, the Board seeks input on the following issues:

- Is the Board's understanding about the state of the boxcar fleet today and the approaching regulatory and economic obsolescence correct?
- Is there an adequate boxcar fleet today to meet rail shippers' needs?
- How big a concern is the aging of the boxcar fleet?
- What is the effect of car hire rates on investments to replace boxcars?
- Is there a disconnect between default rates and market car hire rates such that there is currently an environment where the returns on investment are disincentivizing investment in boxcars needed to meet the demand of shippers?
- Should the Board reopen proceedings related to pooling authority for boxcars?
- Would a change in the default rate setting methodology encourage investment in the boxcar fleet and what change would create the desired incentive?

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[8] Joint Petition for Rulemaking on Railroad Car Hire Compensation, 9 I.C.C.2d. 80, Ex Parte No. 334 (Sub-No. 8) (Decided Oct. 23, 1992).

[9] *See also*, Letter-from-RSI-to-STB-re-Car-Hire-July-18-2019.pdf

[10] Id.

The above list of questions is non-exhaustive. Commenters should feel free to provide any information they believe will be helpful to the Board as it considers issues related to the adequacy of and investment in the boxcar fleet.

Interested persons may file comments by XXXXX ___, 2023. If any comments are filed, replies will be due by XXXXX ___, 2023.

It is ordered:

1. Comments are due XXXXX ___, 2023. Replies are due XXXXX ___, 2023.
2. This decision is effective on its service date.