

## **CALIFORNIA HIGH-SPEED RAIL PEER REVIEW GROUP**

March 21, 2012

The Honorable Darrell Steinberg  
Senate President Pro Tem  
State Capitol Building  
Room 205  
Sacramento, California 95814

The Honorable John Perez  
Speaker of the Assembly  
State Capitol Building  
Room 219  
Sacramento, California 95814

The Honorable Bob Huff  
Senate Republican - Leader  
State Capitol Building  
Room 305  
Sacramento, California 95814

The Honorable Connie Conway  
Assembly Republican Leader  
State Capitol Building  
Room 3104  
Sacramento, California 95814

### **Comments of the Peer Review Group on the Draft 2012 Business Plan**

The California High-Speed Rail Authority (CHSRA) issued a draft 2012 Business Plan (BP) on November 1, 2011. On November 3, 2011, the Authority's Board approved a Funding Plan that constitutes an official request for use of Proposition 1A (Prop 1A) bond funding. The Funding Plan incorporates the draft 2012 BP by reference. While the comment period for the draft BP was 60 days, the period for commenting on the Plan was subsequently extended by 16 days. The Peer Review Group (Group) was required by statute, however, to make "findings and conclusions" on the Funding Plan within a 60-day timeframe. In brief, we concluded in our comments on the Funding Plan that Prop 1A bond funds should not be released until a number of issues are addressed, with particular reference to the uncertainty of additional financing, questions relating to the independent utility of the Initial Construction Section (ICS), concerns about the business model, and the lack of necessary resources and skills to manage the project.

It is important to note that the Group's findings and conclusions, both on the Funding Plan and those contained herein, are focused on a draft 2012 BP that we expect to be changed in significant ways. These changes are anticipated based on conversations

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with board members and staff of the CHSRA, and as a result of public comments and other input received over the past few months.

The Peer Review Group has been reviewing the draft Business Plan since its publication in early November. As you know, with the permission of legislative leaders, the Review Group has delayed submitting its comments on the Plan, pending the outcome of talks between the Review Group and the Authority. The Review Group and Authority Board Members and staff met earlier last month to discuss the Plan, and there have been additional communications to further discuss issues of concern. We have been assured that the CHSRA has taken these issues into consideration, along with comments from other sources, in the development of the revised 2012 BP which is expected to be released by the end of March.

We may well reevaluate our opinion on the Funding Plan based on information contained in the revised plan, recognizing it is critical that any investment in HSR have some permanent utility within whatever financing is available. We also recognize that the draft 2012 BP, which is the subject of this review, represents an improvement over earlier business plans. The following comments on the draft Plan offer suggestions for further enhancement of the revised document. However, there are issues in the draft document that the Group believes can and should be addressed before the State borrows money or the Authority commences construction. While some concerns cannot be completely resolved in the near future, it is crucially important that the Legislature explicitly understand and accept what these elements are, their degree of uncertainty, and how they can affect the ultimate outcome of the project. We will provide a short summary of our comments below and look forward to reviewing the revised 2012 BP when it is finalized.

### Summary of Comments

As stated in our response to the Funding Plan, the lack of committed financing for segments beyond the Initial Construction Section (ICS), particularly in light of concerns over the independent utility of the proposed ICS, is the most serious issue in the draft 2012 BP. As stated above, this concern about the project has been discussed in our comments on the Funding Plan and will not be repeated here. For purposes of this letter, we present remaining areas of concern that are based on the draft BP. Again, we do understand that a revised Business Plan reflecting public input and other changes advanced by the Authority will be published in the next week or so. While funding issues and questions related to the independent utility of any investment present more difficult policy questions, the Group believes that many of the following comments should be addressed in the revised BP.

**Governance and Management.** Virtually every HSR in the world has been planned, built, financed and operated by an integrated state-owned railway enterprise organized in corporate form. As such, these enterprises have had full management authority along with access to public funding and to the planning and operating skills of the railway or its affiliates. Many countries have used the private sector for competitive

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construction contracting; some have used private finance, but rarely without the actual demand risk remaining with the enterprise. The Authority's plan is to transfer the demand risk to a private sector operator(s) as soon as possible after completion of an Initial Operating Segment and ridership is established. The proceeds from the sale of future revenues are proposed to be used for further capital infrastructure costs. By contrast with other HSR operations, California Law, under which the CHSRA operates, makes no provisions for a parent railway, and the Authority has no ability to take demand risk, no ability or authority to finance operating deficits, and no related agency to take responsibility for planning, system integration and operations. These are challenges of which the Authority is keenly aware and they will have to be dealt with as the project moves forward.

In terms of governance, the CHSRA has already acknowledged problems with managerial resources and we once again strongly suggest consideration by the Legislature and Administration of the statement in the Business Plan which says that "it is critical for the Authority to continue to develop and obtain resources to provide the management and support structure to support a multi-billion program development and operating program." Immediate steps need to be taken to correct the deficiencies that exist in the program's management structure, and we are pleased to see some progress in that direction.

**Alternative Investment.** The report presents a favorable estimate of the investment in other modes that might be "avoided" by HSR construction. In particular, it uses maximum **capacity** rather than predicted **demand** for rail service, and it does not take into account the ways in which highway and airport capacity can and will be increased whether or not HSR is built. The final BP should address these issues and should provide a range of potential alternative investment rather than a single point estimate.

**Capital Costs.** Capital costs continue to rise from BP to BP. The Authority believes that a system of contingencies at the project and system level combined with a relaxed schedule gives sufficient budget flexibility for the future that may be appropriate. Our experience, however, suggests that the transition from planning to construction rarely leads to cost reductions and that a great deal of caution about cost estimates is still in order. Moreover, as with demand forecasting, independent peer review of the capital cost estimates would add to the confidence in the estimates or would clarify the expected uncertainty in those estimates. We understand that this review has taken place and we look forward to reviewing that data.

**Business Model.** The Authority's general concept of public funding for infrastructure in combination with a private operator that earns an operating surplus that might repay a portion, but certainly not all, of the investment cost is consistent with international practice. Unfortunately, it is not consistent with the Authority's committed funding, and it places the Authority in the position of making a number of design decisions that might better be made by the eventual operator and could have liability consequences for the State.

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**Ridership and Revenue.** We have two concerns: unlike almost all other HSR projects elsewhere, HSR in California is a “greenfield” project with no existing base of effective rail service on which to build projections; and we believe that further examination and review of the demand forecasts would be valuable. The limited examination by the UC Berkeley Institute of Transportation Studies (ITS) in the past identified concerns about various details of the forecasting system. As was previously done, the Legislature may want to request CHSRA to retain ITS to complete a final review of the demand forecasts so that the Legislature can have the best possible picture not only of the demand predictions but of the inherent uncertainty in those predictions

**Risk Identification and Mitigation.** The report is an improvement over prior BPs in that it does provide a more comprehensive list and treatment of many of the risks to be expected on the project. A more robust discussion of mitigation should be included for other potentially serious risks that are described in the report, such as funding, organization and staffing, environmental litigation, demand and revenue, and the risk of completing the ICS alone.

**Benefit-Cost Analysis.** The benefit-cost analysis involves several issues – discount rate, values of time – that are beyond our expertise. If this analysis is to be used in evaluating the project, it should be subjected to full academic review by one of the State’s universities. The Authority has advised that an independent review has been conducted, and the results will be provided to the Group for consideration.

**Additional Funding and Financing Opportunities.** The draft 2012 BP proposes a segmental approach to constructing the HSR system, beginning with an Initial Construction Section in the Central Valley. Based on the statement in the letter from the Deputy Secretary of Transportation, dated January 3, 2012, that the Federal Railroad Administration cannot re-allocate Federal funding to other projects, the Group agrees that the Authority should move to a “blended” system that would provide for incremental investments in existing rail infrastructure in the Los Angeles Basin and San Francisco Bay Area. However, we would urge the CHSRA to be more specific in the revised BP regarding an implementation strategy for these “early investments.” The Group also suggests that the Authority explore additional potential opportunities for private investment in these segments as a combination of State and local funding for these improvements could attract interest from the private sector as well. Finally, we encourage every effort to maximize the utility of any investments through the closing, where feasible, of gaps between existing passenger rail facilities along the proposed alignment.

### Conclusion

This is the seventh report issued by the Peer Review Group. In all of the reports, we have emphasized that our comments are meant to be constructive in order to make the planning and justification of the project better and more relevant to the needs of the State. Unfortunately, anything less than all-out support can be interpreted as opposition, and the purpose of commenting in order to **improve** is lost. However, it is

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our role to review the facts and reports and assist the Legislature in making its assessment of the benefits, costs and risks of the project. To the extent that we are required to make "findings," we have based these conclusions on the facts available to us, filtered through our experience. Findings are always subject to change if information improves, issues are settled and problems are corrected.

The Group has repeatedly stated its support for the concept of high-speed rail in California. We believe that the State's long-term future requires an alternative to simply adding more highways and airport runways to our infrastructure. At the same time, international experience with high-speed rail, confirmed by the direct personal experience of the members of the Group, shows beyond any question that HSR is a prototypical "mega-project" with significant risks in terms of potential optimism in the identification of demand, the estimation of costs and schedules, and the allocation of benefits. These risks are multiplied in California's case by the pressure to spend the Federal American Recovery and Reinvestment Act money, or risk losing it, and the understandable desire to create jobs to stimulate the State's economy. While these circumstances create an incentive to move ahead as rapidly as possible, they do increase the risks associated with the project. This limits the Authority's choices in determining how to implement HSR as envisioned by the voters in November of 2008, and any future investments will need to focus on independent utility and system connectivity.

The State has now reached a critical stage for the Governor and Legislature to review, validate, or reshape the Authority's plans for HSR in California. Beyond this decision point, contracts will be awarded, jobs will commence and it will be much more difficult to influence the development of the system going forward. We commend the CHSRA for its positive approach in responding to input on the draft 2012 BP, and we look forward to appropriate changes in the revised Business Plan soon to be published. We do intend to provide comments on the revised BP, and we urge the Legislature and the Governor to review available information and to agree on a coherent vision for a HSR system in California before funding is actually approved.

Sincerely,



Will Kempton  
Chairman  
California High-Speed Rail Peer Review Group

c: Hon. Mark DeSaulnier, Chair, Senate Transportation and Housing Committee  
Hon. Ted Gaines, Vice Chair, Senate Transportation and Housing Committee  
Hon. Alan Lowenthal, Chair, Senate Select Committee on High Speed Rail  
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