California High-Speed Rail Peer Review Group

Gary Gallegos | Stacey Mortensen | Lou Thompson, Chairman | Martin Wachs

February 7, 2017

The Honorable Kevin de León
Senate President Pro Tem
State Capitol Building
Room 205
Sacramento, CA 95814

The Honorable Anthony Rendon
Speaker of the Assembly
State Capitol Building
Room 219
Sacramento, CA 95814

The Honorable Jean Fuller
Senate Republican Leader
State Capitol Building
Room 305
Sacramento, CA 95814

The Honorable Chad Mayes
Assembly Republican Leader
State Capitol Building
Room 3104
Sacramento, CA 95813

Dear Honorable Members:

Members of the Peer Review Group met with officials of the High-Speed Rail Authority (HSRA) on December 7, 2016, to discuss two issues: the Subdivision (d) Funding Plans covering the Central Valley Segment and the San Francisco to San Jose Peninsula Corridor, along with the related reports of the independent financial advisor (Project Finance Advisory Ltd – PFAL); and the Request for Qualifications (RFQ) to acquire early operator services. The documents referenced in this letter are listed in Appendix A.

THE FUNDING PLANS

The Subdivision (d) Funding Plans appear to be complete and in substantive compliance with the requirements of the law, though we take no position on potential issues of litigation. They address whether funds and fund sources already identified, authorized and appropriated and the scope, schedule and budgets are within the envelope defined by the 2016 Business Plan. The PFAL reports conclude that the projects covered by the plans can feasibly be completed within the existing schedules and budgets. The reports conclude that the Authority is learning from experience and that the identifiable potential problems and risks can be addressed by professional management. There are points we believe the Legislature may want to consider when assessing these reports.

General Issues

The Subdivision (d) plans deal with planning, financing and constructing the Caltrain electrification work between San Francisco and San Jose Diridon station, part of which is being financed by HSRA, and 119 miles of new work between Madera and Poplar Avenue in Shafter (approximately 18 miles north of Bakersfield). Because HSRA does not intend to operate stand-alone service on either of these sections, issues of demand, revenue, operating costs and operating subsidy are not addressed. The San Jose to San Francisco financing will contribute to electrified lines between San Jose and San Francisco that HSRA trains will eventually be able to use, and the lines should be in place by the time that HSRA might reasonably need to use them. The Central Valley financing will yield a 119 mile electrified line with two stations that will permit testing of HSRA trains at 220 mph, but no actual HSRA revenue service. It would be possible to re-route the San Joaquin service to the new line to save 40 minutes between Sacramento and Bakersfield. Inauguration of HSRA revenue service will await completion of the Madera to San Jose link through the Pacheco Pass. Completion of service into the planned Bakersfield station depends on acquiring the $2.9 billion in added money discussed in the 2016 Business Plan.

Implementation of both Funding Plans also depends on the Authority's receipt of a significant part of the Cap and Trade funding as projected. This issue was highlighted in our letter to the Legislature of August 24, 2016. Although the Cap and Trade receipts fill a critical gap in nearer-term financing, auction receipts have been volatile and may be unstable in the light of possible changes in emission reductions policies at the Federal level. We would like to repeat our recommendation in that letter that "...the Legislature ask the appropriate agency of government to develop an accepted estimate of Cap and Trade results under appropriate assumptions so that future Business Plans [and Subdivision (d) Funding Plans] by the Authority … will reflect a commonly agreed estimate for both potential receipts and risks related to those receipts."

San Jose to San Francisco Electrification

The "blended system" for joint operations by Caltrain and HSRA between San Jose and San Francisco: would not be possible without Caltrain electrification. The Funding Plan and the PFAL report generally indicate that the necessary work is now underway and that Caltrain should be able to deliver the system for HSRA operation by the time that it is needed, assuming that the planned Federal funding agreement is completed and implemented.

We believe that the operating agreement between Caltrain and HSRA needs further definition, as outlined in Article IV of the Funding Agreement signed by the Peninsula Corridor Joint Powers Board (PCJPB) and the Authority on August 9, 2016. The Memoranda of Understanding to date focus on facilities and money, but have not defined how the operating relationships will work. Who will do scheduling and train dispatching and under what priorities? Who will manage track maintenance work and who will pay what share of the maintenance? How will the pricing and marketing of Caltrain and HSRA services interact? How will the HSRA and Caltrain operators be coordinated? These operating provisions will have a very strong influence on how the facilities will be used and should receive more immediate attention as system planning and construction proceed. We understand that the PCJPB and the Authority are now starting work on the operating provisions and we encourage them to accord high priority to the work in the process of completing the project level environmental requirements.

A pertinent example of Caltrain/HSRA interaction is the recent announcement by HSRA that it may shorten its platforms in order to reduce the initial capital cost of the system. Shortening the platforms and trains leaves open the possibility that demand will eventually exceed the reduced station capacity, especially in the "bookend areas." We understand that the Authority will try to acquire the property needed for future extension of the platforms if needed.

An alternative potential response would be to use bi-level trains at the outset for HSRA service. We have recommended in past letters that the Authority consider adopting bi-level trains from the outset because the loading platform level would be consistent with the lower level used by Caltrain and Metrolink (and ACE if there are joint operations in future). In our discussions, the Authority indicated that they will consider inputs from the new system operator (discussed below). We recommend that this issue be addressed carefully before HSRA commits itself to a rolling stock fleet design.

More generally, we do not believe that the critical nature and the extreme complexity of the Caltrain electrification project have been fully reflected in the progress reports that the Legislature has received on the project. The Legislature may wish to consider hearing joint testimony from the two parties addressing progress and complications on the project. Similar issues may arise as HSRA develops closer relations with Metrolink in the Los Angeles Basin area.

The Central Valley Segment

As discussed above, this Funding Plan addresses a 119 mile segment that can be used for testing high-speed trains; it will not yield any passenger service except, possibly, a better route for San Joaquin service between Sacramento and Poplar Avenue in Shafter. It does not cover rolling stock or connections from Madera to San Jose or connection into Bakersfield.

PFAL concluded that plans for the remaining work are "aggressive" (PFAL, Central Valley, page 9), perhaps by as much as two years (PFAL, Central Valley, page 18), but that there is a reasonable chance that overall project schedules and budgets can be met. PFAL recommends strengthening of reporting and management and that an experienced rail operating advisor be brought on board as soon as possible. With respect to Cap and Trade funding, PFAL concluded that the projected funds would be made available to the Authority to support the Plan, but that "...the $500 million per year projection will require additional scrutiny in subsequent funding plans due to the volatility seen in recent auctions, the ongoing court case regarding the legality of state-auction allowances, and the uncertainty regarding the Air Resource Board's authority to continue Cap-and-Trade past 2020." (PFAL, Central Valley, page 29).

REQUEST FOR QUALIFICATIONS (RFQ) FOR EARLY TRAIN OPERATOR

The Peer Review Group strongly supports the Authority's proposal to bring in business expertise in the form of an early operator as outlined in the draft RFQ approved by the Authority's Board in December, 2016. The Authority is currently constructing a high-speed rail **line**, in order to support a **business** that will compete with airlines, buses and private automobiles. Public authorities are not suited to running market-driven businesses, a fact that the Authority has long accepted in expressing intentions to have the high-speed rail **services** provided by the private sector. This makes it important that an operator's viewpoint be included as soon as possible in design and construction decisions being made by the Authority and in managing the transition from purely public authority at the outset to an appropriate form of Public Private Partnership (PPP) for full operation of rail services.

In September of 2015 the Authority received a number of expressions of interest from potential private partners. The responses influenced the formulation of the RFQ that the Authority approved in December of 2016. The Authority intends to use the statements of qualifications and any comments received as the basis for developing a request for proposals (RFP).

A large body of worldwide experience can be drawn upon in private operation of rail passenger services. These range from highly directive management contracts in which the private operator's role is restricted to providing labor and operations management (Caltrain, Metrolink and ACE are examples) to full private ownership and operation as in most passenger railways in Japan. Most of the rail passenger PPPs fall on the spectrum from management contracts to franchises to concessions, where the role of the private partner in investment, operations, market planning and demand risk grows across the spectrum. The franchising experience in the U.K. spans the range from management contracts to privatization, and will furnish a good base on which to develop the approach in California.

The Authority currently envisions a three stage process. In the first phase, the early operator will provide paid consulting advice to the authority on design and planning decisions that ultimately will affect the safety, investment, demand and operating costs of the system. This will include design and negotiation of the terms of the second phase, for which the early operator will receive a short term franchise that will involve start-up operation of the system and development of the fare and marketing policies to be employed. The life of the second phase franchise should not extend much beyond the stage at which the demand and market potential for the Valley to Valley system has been demonstrated. The third phase would be a longer term concession for the system. The Authority expects phase three will generate significant investment from the franchise operator, but the amount generated will depend on the demand actually demonstrated.

The Authority expects that the early operator will perform both phase one and phase two, though there will be decision points at which either the Authority or the early operator could halt the partnership if desired. At the end of phase two, phase three would be opened to full competition from all potential operators.

Franchising and concessioning of passenger railways is complex and no single approach is guaranteed to succeed. Since there is essentially no experience in the U.S. with either rail passenger franchising or concessioning, the Authority must develop an approach suited to California on its own, hopefully with inputs on international experience from the early operator.

There is good reason to link phases one and two, because the early operator will have a much stronger incentive to provide good advice in phase one if it will benefit from better performance in phase two. There is a risk, of course, that the early operator will conceal the complete potential of the system during phase two in order to gain an advantage in bidding for phase three, but the Authority can minimize risk by requiring clear and detailed public reporting during phase two. The opt-out point at the end of phase one also provides protection. We agree that all three phases should not be awarded in one package, because the risk premium before demand is demonstrated would be too high. Contracting with an early operator is a good way to get an operator's input and to start the process of private delivery of market-driven services, but the Legislature should consider a number of potential public policy issues.

The $64 billion high-speed rail project is based on more than the difference between passenger revenues and operating and investment costs borne by the operator. Justification for public involvement rests to a large extent on benefits such as air pollution reduction, lowered carbon emission, less noise, improved overall transportation safety, investment avoided in alternative road or air transportation facilities, better land use, improved access to jobs and a host of other potential benefits that accrue to the public and not to the operator.

The 2016 Business Plan forecasts argue that the private operator will be able to cover operating costs and make a partial contribution to investment. Our letter of March 25, 2016, stressed that a public planning, investment and regulatory role will also be essential. There will need to be a **partnership** in which state and local authorities and private parties invest, and in which the benefits and costs are shared in a way that permits all to benefit.

A key policy issue is the commercial freedom that the Authority, as the owner, grants to the operator under the terms of the franchise or concession. If the operator were granted total freedom to set fares and determine service levels, the operator could generate maximum operating profits and thus make the largest contribution to the Authority for investment in future capacity or retiring existing debt. If the Authority decided that, in the interest of increasing public benefits, fares (or fare increases) should be controlled, or minimum service levels or frequencies should be imposed, or that service from low employment origins should be provided at lower than market-driven fares, then the operator's profits would fall and the ability of the operator to invest or take demand risks would be reduced accordingly. We recommend that the Legislature inform itself on the rationale that ultimately leads to the pricing, service and contract term approaches in the second phase, in the third phase requests for proposals, and in the policies the Authority follows when it is the **economic** "regulator" of the system.

Normal U.S. and international practice is to separate **safety** regulation from all owners and operators. The Authority and its operator will face a large number of detailed safety requirements that will have to be overseen by a regulatory agency whose objectives are separated from the financial performance of the system. Unfortunately, no state regulatory agency other than HSRA currently has the capacity or technical capability to oversee the safety of system operations because the technology and operational issues of HSR are different from and beyond those currently experienced in California. The Federal Railroad Administration (FRA) would also be hard pressed to provide adequate oversight because of a perennial lack of resources and because even the Northeast Corridor, which is the only existing high speed rail passenger system in the country, does not pose the same issues as the planned 220 mph operations of the HSRA. We recommend that the Legislature request that HSRA, other state regulatory agencies and FRA provide a joint report on how (and who) will provide adequate safety regulation of the design and operations of the HSRA system.

No investment, operating or demand risk has been transferred as yet from the Authority to an operator. We expect that an early operator's involvement in phase one will enable the Authority to reduce investment or operating costs and help the Authority identify and minimize the risks of coordinating the work of many different construction and design contractors. The early operator should also give advice on demand and operating cost forecasts that could increase the likelihood that the system will eventually operate without a subsidy and even generate some net revenue that can be shared with the Authority. This should establish a much firmer base for phase two and, eventually, set the stage for phase three.

Please let me know if you have any questions, need further information about our comments, or would like to meet with the Group directly.

Sincerely,

Louis S. Thompson
Chairman, California High-Speed Rail Peer Review Group

cc: Hon. Jim Beall, Chair, Senate Transportation and Housing Committee
Hon. Anthony Canella, Vice Chair, Senate Transportation and Housing Committee
Hon. Jim Frazier, Chair, Assembly Transportation Committee
Hon. Vince Fong, Vice Chair, Assembly Transportation Committee
Brian Kelly, Secretary, California State Transportation Agency
Mac Taylor, State Legislative Analyst
Ken Alex, Director, Governor's Office of Planning and Research
Dan Richard, Chair, California High-Speed Rail Authority
Jeff Morales, Chief Executive Officer, California High-Speed Rail Authority
Members, California High-Speed Rail Peer Review Group

Appendix A

Documents referenced in the December 7, 2016 meeting and in this letter

California High-Speed Rail Authority, "High-Speed Rail Subdivision (d) Funding Plans, PRG Briefing," December 7, 2016, Sacramento, CA

California High-Speed Rail Authority, "San Francisco to San Jose Peninsula Corridor Funding Plan," December 2016

Project Finance Advisory Ltd (PFAL), "Independent Financial Advisor Report to California High-Speed Rail Authority Regarding: Peninsula Corridor Funding Plan," December 6, 2016

California High-Speed Rail Authority, "Memo to File: Policy change regarding the use of coupled trainsets for operation," September 15, 2016

California High-Speed Rail Authority, "Central Valley Segment Funding Plan," December 2016

Project Finance Advisory Ltd (PFAL), "Independent Financial Advisor Report to California High-Speed Rail Authority Regarding: Central Valley Segment Funding Plan," December 8, 2016

Project Finance Advisory Ltd, "HSR-14-65 Draft Memo on Ridership and Revenue for Valley to Valley Line of the California High-Speed Rail System," memo to Boris Lipkin dated December 5, 2016

Boris Likpin, "Informational Presentation Regarding Early Operator Input and Development of and Policies on Fares and Schedules," memo to Chairman Richard and Board Members dated October 11, 2016

Jeff Morales, "Consider Providing Approval to Release a Request for Qualifications for Early Train Operator Procurement," memo to Chairman Richard and Board Members dated December 13, 2016

California High-Speed Rail Authority, "California High-Speed Rail Project: Request for Qualifications for Early Train Operator," draft dated 2016

CHSRA and PCJPB, "Agreement Regarding Funding Commitments Towards Peninsula Corridor Electrification Project," August 9, 2016