California High Speed Rail Peer Review Group Testimony before the Senate Select Committee on High Speed Rail
May 11, 2011

Chairman Lowenthal, Members of the committee, I am Will Kempton, Chairman of the California High Speed Rail Peer Review Group (Review Group). I want to thank you for inviting me to appear before you to discuss the work being done by the California High-Speed Rail Peer Review Group. In addition to my work with the Peer Review Group, I am the Chief Executive Officer of the Orange County Transportation Authority.

With me today is Mr. Walter Bell. Mr. Bell is a member of the Review Group, appointed by the office of the Treasurer. Currently, Mr. Bell is the Senior Advisor and member of the Investment Committee of the Infrastructure Asset Management Group of the Union Bank of Switzerland Global Management Asset Corporation. His background in the world of high-speed rail is extensive. He has been involved in high-speed rail projects from Asia to Europe. He has been a major contributor to the work being done by the Peer Review Group.

Lou Thompson, another valued member of the Review Group asked me to express his regret for not being here today. He would be happy to answer any supplemental questions that the members of the committee or the staff may have.

For your information, Mr. Chairman, on April 26th, I met with members of the Assembly High-Speed Rail Working Group to discuss with them the same issues that I will outline for you today.

When the voters approved the Proposition 1A bond measure in 2006, the State Legislature passed AB3034 which required that "the Authority shall establish an independent peer review group for the purpose of reviewing the planning, engineering, financing, and other elements of the authority's plans and issuing an analysis of the appropriateness and the accuracy of the authority's assumptions and an analysis of the viability of the authority's financing plan, including the funding plan for each corridor required pursuant to subdivision(b) of Section 2704.08 of the Streets and Highways Code."

The Review Group consists of eight members, of which there are six currently serving. The members are appointed from various appointing authorities including the Secretary of Business, Transportation and Housing Agency, the Director of Finance, the State Treasurer, and the State Controller.

I know that all of us would agree that the California High Speed Rail project is one of our nation's largest public infrastructure projects, and with any such

project, there are risks, challenges, and uncertainties. This is especially true given the fragility of our nation's economy, the limitations being placed on spending and the uncertainty of future federal and state transportation funding and policy.

In November of last year, the Review Group met with Mr. van Ark and his staff to discuss issues concerning the project. Also in November of 2010, the Review Group, per AB3034, sent to the State Legislature, its comments regarding the Authority's 2009 Business Plan. Specifically, those comments were sent to the Senate President Pro Tem, the Speaker of the Assembly as well as other appropriate members of the leadership and the chairpersons of the appropriate committees of both houses. In April of this year, the Group met again with Mr. van Ark and his staff to continue its dialogue concerning the project's progress. Following that meeting, the Review Group wrote a letter to Mr. van Ark as a response to those issues raised at that meeting. Copies of that letter have been sent to members of this committee, the other transportation committees in the Legislature as well the leadership of both houses of the Legislature, the Governor, the Treasurer, the Controller, the Director of Finance and the Legislative Analyst's Office.

As a result of its meetings with Authority staff as well as the Review Group's comments to the Legislature, the following important issues have been outlined and discussed:

1. **Staffing: The issue of staffing was not raised in the Authority's 2009 Business Plan, however, it has been discussed at length in the meetings between the Authority and the Review Group. While it is clear that there has been some limited progress made in addressing the extreme shortage of staff in the skills positions, current Authority staff resources are still inadequate for the job at hand. If this situation continues, the Authority will fall further and further behind its proposed schedule especially as construction commences. The Legislature must find a way whereby the Authority is given the flexibility to hire the exempt personnel it needs without encountering any further delay, including alternatives outside civil service parameters. Other options to solve this dilemma could be the creation of a State authority with a blanket exemption from restrictions on positions and salary limits, to the creation of a public benefit corporation with the authority to manage its personnel within the limits set by its board of directors.**
2. **The Business Model: The Review Group believes that the Authority has begun to focus on a process whereby it can develop a realistic business model by which to govern the project. For example, the Authority has excluded business models whereby the Authority would fully fund the project and operate the system with public funds and the Authority also recognizes that wholly private construction and financing is not viable either. It appears that the Authority is focusing on an approach**

whereby it would plan and manage construction with operations being performed by private entities. The Review Group has made it clear that the business model cannot be separated from the planned sources of financing. A model that looks to public financing of the project's infrastructure and the private financing of rolling stock and operations, for example, will not be adequate if the sources of public financing are neither secure nor adequate. On the other hand, if a model is selected whereby the private sector is requested to finance a significant share of the infrastructure, this will not be feasible unless the private partner is given a much larger role in the planning and management of the construction of the project and unless the return on that private investment is secure.

In its letter, the Review Group also emphasized the need for the public to be educated regarding the public versus private benefits of the project, especially, in a partnership where a significant share of the financing will come from public sources that will not be repaid by system revenues. Public benefits resulting from the project are reduced pollution, reduced emission of carbon dioxide, reduced highway and airport/airway congesting, reduced accidents and casualties on highways and air transport, lower transportation noise, improved land use and consumer surplus. Consumer surplus is defined in such cases as high-speed rail projects where the ticket prices are set at levels less than the maximum the user will pay; the surplus is the difference between the actual price and the maximum price. In the Authority's 2008 Business Plan, where 50 percent of the airfare would be charged, the consumer surplus was quite large. In the 2009 Business Plan when the Authority was going to charge eighty percent of the airfare, the consumer surplus naturally fell.

3. **Management of Risk and Uncertainty: While the Review Group and the Authority have had limited discussion regarding risk management, the Review Group is not yet convinced that there is a system in place, once risks have been identified, to actually manage those risks, nor has risk management been fully considered in conjunction with the development of the business model so that the roles of the various parties are fully consistent not only with the funds they are supposed to bring but also the risks they are supposed to bear. Because this project has no actual experience with any of its estimating, all of the budgets and costs are still based solely on assumptions and estimates. The Review Group urges the Authority to put in place a robust system before actual construction commences so that actual experience, as it emerges, can rapidly be included for future planning for bidding and budget management.**

4. Financial Plan/Gap: Currently, the Authority has an estimated \$3.6 billion in federal funding, with possible additional funding from states who have decided to cancel their high-speed rail projects. Allowing for \$2.8 billion in Prop 1A funds, with local match, the Authority now has an estimated \$5.5 billion available to begin the project's construction and \$400 million for environmental/engineering work. As the Review Group has discussed with the Authority over a period of time, the funding gap in the \$43 billion project is considerable. Funding availability from the private sector will undoubtedly be negatively impacted unless and until a public sector source of funding is both reliable and available. The Authority will need further assurances that federal funding will be available from additional sources in order to attract private sector interest. Without such assurances, attracting private sector interest will be problematic.
5. Demand Modeling: The Review Group is encouraged that the Authority has continued to improve its demand modeling. As this effort continues to improve, it will be important that the modeling show both the nominal projections along with the range of uncertainty in those projections as pointed out in the Berkeley ITS analysis. If the Authority selects a business model that is based on a PPP approach where there is significant public funding that will not be repaid by a private sector partner, then the importance of any public benefit, time savings, safety and improved air quality, etc. will have to be underscored much more extensively than in prior business plans.
6. Revenue/Demand Guarantee: As the Review Group stated in its November 2010 Report, the Legislature's definition of "operating subsidy" as contained in AB 3034, is unclear and needs further clarification. If the Legislature's intent was that the entire project at all stages be financially profitable, including the pay back of State bonds, etc., then the Review Group agrees with the Authority's position that there are only a few possible cases (the Tokaido Line in Japan and the Paris to Lyon TGV line in France) where high-speed rail systems meet this standard. As a result, the Review Group believes that strict imposition of a "profitability" requirement for each stage of the project would be unreasonable. In addition, the Review Group also believes that the appropriate standard for the overall project will be economic viability, not pure financial profitability
7. Right-of-Way (ROW) Alignment and Availability: Both the Review Group and the Authority agree that ROW identification and acquisition can be difficult. The Authority has taken steps to meet this issue with the hiring of a ROW manager. The Review Group has pointed out, however, that ROW problems will likely occur early on in the project and given the Authority's lack of managerial resources will do the most harm to the project's timetable and cost. The Review Group also pointed out at this stage of design, any budgeted ROW costs are not reliable and are likely

to increase as the project proceeds. This issue should be included in the project's risk management system.

8. **High-Speed Rail Seismic Design, Safety and Speed: The Review Group is encouraged that discussions between the Authority and the Federal Railroad Administration are proceeding regarding issues of the system operating at 220 mph. Given the recent earthquake in northern Japan where there were no passenger fatalities and only minor physical impacts to the high-speed rail system there, the Review Group believes that good design can be effective in managing earthquake risks. That is not to say, however, that standards issues should not be followed closely because these issues can always emerge unexpectedly.**
9. **Engineering/Cost Estimating: While the Review Group acknowledges that the Authority continues to make progress in updating unit costs as well as incorporating required procedures for federally funded projects, the challenge of accurate cost estimating can be daunting. The Authority has not established a cost estimating and budget management system that permits the incorporation of actual experience. It is important to note again that most of the project design is at the fifteen percent level which does not represent a solid base regarding cost estimates either for the estimated amounts or for the range of variation likely to be experienced. There may be little that can be done regarding this problem initially. However, the Authority should make every effort to state and qualify its estimates so that the public understands that the $43 billion total is a preliminary estimate and, as Authority staff has stated, could "trend upward".**
10. **Environmental Approvals: While the Authority appears to be making some progress in its environmental outreach efforts, it cannot be emphasized enough that without timely release of information to community stakeholders, which has not always been the case in the past, the result will be continuing negative reaction from communities affected. In addition, as with ROW issues, environmental reviews, approvals, etc. will suffer if adequate agency staff resources are not available. If this is the case, the project's budget and schedule will suffer.**
11. **Focus for the coming year: The Authority expects to focus on four activities in the near future:**
    a. **Complete the Final Environmental Report/Environmental Impact Statement documents, achieve fifteen percent design for selected American Reinvestment and Recovery Act sections and await execution of the Notice of Decision/Record of Decision: The Review Group agrees with this goal; however, it believes that without proper staffing, it will not be achieved.**
    b. **Prepare State Appropriations Request and Funding Plan(pre-appropriations and pre-commitment) for use of Proposition1A funds: The Review Group has cautioned the Authority that since this is the first request for project funding it will not only be a test of the**

justification and the preparation of the project, it will also trigger all of the necessary reviews and approvals. The Review Group will also be providing input on the appropriations request.

c. **Issue a RFP to Prospective Design-Build teams for first Design-Build contacts for the Central Valley: The Review Group, while not necessarily disagreeing with the decision, has cautioned the Authority that issuing RFPs for Design-Build contracts (which may be a function of pressure to spend federal funds for the Central Valley segment), will shape all of the future options for business models. It sends a message that the Authority intends to be in charge of all design-build activity and has the funds to so, which may be true for the Central Valley, but not on other segments. This decision may also underscore the fact that the Authority does not have the staff to plan, issue nor oversee these contracts. Also, if the Authority issues these contracts, it will relieve future private partners of the liability and responsibility for the Authority's decisions and may make decisions that will limit the future value of the private partner's business activity. Clearly, the full implications of this decision should be thoroughly and publically vetted.**
d. **Submit the Business Plan identifying funding and phasing options to deliver the Phase 1 HST system: The issuance of the Authority's Business Plan is required for Prop 1A funding. The Review Group recommends that the following issues be included and thoroughly discussed in the Business Plan: 1) after the nomination of the business model, to include the "initial Operable Segment" and the path to achieve it; 2) revised demand forecasts with a clear indication of a planned fare policy and expected ridership that has been thoroughly reviewed. These demand forecast should include the data needed to review all statewide ridership and revenues and projections; 3) measurements regarding the public benefits the project will develop to include air quality, safety, consumer and reduced congestion, amongst others; 4) the linkage of the financial modeling, sources of investment and operating income and the related business model 5) updated capital and operating cost estimates which have been thoroughly validated and 6) the Authority's proposed approach regarding the "operating subsidy" issue.**
e. **"Phased Implementation": During its discussions with the Authority, the Review Group urged the Authority to expedite the possibility of "phased implementation" in the urban areas between San Francisco and San Jose and Los Angeles and Anaheim. "Phased implementation" is a practice whereby the initial high-speed service in these two areas would be run at more conventional speeds (around 110 mph) in coordination with local rail passenger and freight providers. "Phased implementation" would reduce initial investment cost as well as the initial construction/environmental**

impact of the project while permitting high-speed rail operations and improving service of local trains. Such a service would reduce the project's technical and investment risks and could provide a demand base against which to develop future capacity expansion. Weighed against these benefits could be any added cost if the initial construction has to be re-worked to add future capacity and potential safety issues raised by joint operations. The Review Group also urged the Authority to work with rail stakeholders along the LOSSAN Corridor, between San Diego and Los Angeles which currently carries more than 2.7 million intercity rail passengers and 4.5 million commuter rail passengers making it the nation's second busiest rail passenger corridor, to explore the possibility of implementing the "phased implementation" concept with other service improvements along the corridor.

That completes my testimony, Mr. Chairman. I will be happy to answer any questions.