

High-Speed Rail Authority Follow-Up

Although the Authority Addressed Some of Our
Prior Concerns, Its Funding Situation Has Become
Increasingly Risky and the Authority's Weak
Oversight Persists

January 2012 Report 2011-504



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January 24, 2012

2011-504

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

This report presents the results of a follow-up review the Bureau of State Audits (bureau) conducted concerning the efforts by the High-Speed Rail Authority (Authority) to implement recommendations from an earlier audit report that we issued in April 2010. The bureau's report titled *High-Speed Rail Authority: It Risks Delays or an Incomplete System Because of Inadequate Planning, Weak Oversight, and Lax Contract Management*, Report 2009-106, examined the Authority's readiness to manage funds authorized for building the high-speed rail network (program) in California, including the \$9 billion in general obligation bonds the voters authorized in November 2008. As a result of our follow-up audit, we concluded that the Authority has fully implemented four recommendations, partially implemented five, and taken no action on the remaining one.

Although the Authority has implemented some of the recommendations we made in our prior report, significant problems persist. For example, the program's overall financial situation has become increasingly risky. This is in part because the Authority has not provided viable funding alternatives in the event that its planned funding does not materialize. In its 2012 draft business plan, the Authority more than doubled its previous cost estimates for phase one of the program, to between \$98.1 billion and \$117.6 billion. Of this amount, the Authority has secured only approximately \$12.5 billion to date. Further, the Authority's 2012 draft business plan still lacks key details about the program's costs and revenues.

In addition to our concerns related to the Authority's 2012 draft business plan, we also identified a number of critical, ongoing problems involving its oversight of the program. Specifically, in part because the Authority is significantly understaffed, it has delegated significant control to its contractors—especially the entity that manages the program (Program Manager). The Authority relies on the Program Manager to provide accurate, consistent, and useful information in its monthly progress reports. However, we found that these reports were often inaccurate and that at times the Program Manager appeared to misinform the Authority about the speed with which contractors for each region performed tasks. Finally, even though the majority of the Authority's role in administering the program involves its management of contracts, we discovered during the course of our work that the Authority had engaged in inappropriate contracting practices involving information technology services. The nature of these problems suggests that the Authority needs to significantly improve its internal controls to ensure that it effectively manages its contracts.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

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Summary

Results in Brief

Since 1996 state law has charged the High-Speed Rail Authority (Authority) with the development and implementation of intercity, high-speed rail service. As a result, when voters approved the Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century (Proposition 1A) in November 2008, the Authority became responsible for managing the \$9 billion provided for the construction of a high-speed rail network (program). In 2009 the Joint Legislative Audit Committee asked the Bureau of State Audits to assess the Authority's readiness to administer these funds, resulting in our April 2010 report titled *High-Speed Rail Authority: It Risks Delays or an Incomplete System Because of Inadequate Planning, Weak Oversight, and Lax Contract Management*, Report 2009-106.

In the nearly two years since the issuance of that report, the Authority has implemented some of our recommendations but it has still not completely addressed others. Specifically, the Authority fully implemented four recommendations, partially implemented five, and took no action on one. Although the Authority has secured funding for the Initial Construction Section (construction section)—the first portion of the program—the program's overall financial situation has become increasingly risky, in part because the Authority has not provided viable funding alternatives in the event that its planned funding does not materialize. In its 2012 draft business plan, the Authority more than doubles its cost estimates for phase one of the program, to between \$98.1 billion and \$117.6 billion. Of this amount, the Authority has secured approximately \$12.5 billion to date. The success or failure of the program consequently depends upon the Authority's ability to obtain between \$85.6 billion and \$105.1 billion by 2033. In its 2012 draft business plan, the Authority identifies the federal government as by far the largest potential funding source for the program, yet the plan provides few details indicating how the Authority expects to secure this money. Further, the plan does not present viable alternatives in the event that it does not receive significant federal funds. In fact, one of the funding options the Authority characterizes as an alternative is not yet approved for use on high-speed rail projects. Although it is possible that the Authority may obtain the necessary funding to move forward with the program, it risks significant delays or the inability to proceed if it does not.

Further, the Authority's 2012 draft business plan still lacks some key details about the program's costs and revenues. In particular, only within the business plan's chapter about funding—more

Audit Highlights . . .

Our review of the High-Speed Rail Authority's (Authority) progress in addressing issues we raised in our April 2010 report, revealed the following:

- » *Although it has implemented some of our recommendations, the Authority has not completely addressed others.*
- » *The high-speed rail network's (program) overall financial situation has become increasingly risky.*
 - *The cost estimates for phase one increased to between \$98.1 billion and \$117.6 billion—of which approximately \$12.5 billion has been secured.*
 - *Although the Authority identifies the federal government as its largest potential funding source, the plan provides few details about how it expects to secure this money.*
 - *The cost estimates do not include phase one's operating and maintenance costs, yet based on data in the plan these costs could total approximately \$96.8 billion from 2025 through 2060.*
- » *The accuracy of the Authority's estimates of the program's profits depends upon its ridership projections, which are fundamental to private investors' interest.*
 - *An independent assessment of ridership projections was conducted by a handpicked group.*
 - *The ridership review group presented several long-term concerns.*

continued on next page . . .

» *The Authority continues to struggle to provide an appropriate level of oversight.*

- *It is significantly understaffed and has struggled to oversee its contractors and subcontractors, who outnumber its employees by about 25 to one.*
- *It has delegated significant control to its contractors and may not have the information necessary to make critical decisions about the program's future.*
- *It engaged in inappropriate contracting practices involving information technology (IT) services by splitting IT services totalling \$3.1 million into 13 individual contracts with one vendor.*

than 100 pages into the plan—does the Authority mention that phase one could cost as much as \$117.6 billion, whereas it uses one of its lower cost estimates of \$98.5 billion throughout the plan. Moreover, neither of these cost estimates includes phase one's operating and maintenance costs, yet based on data included in the 2012 draft business plan, we estimate that these costs could total approximately \$96.9 billion from 2025 through 2060. The Authority projects that the program's revenues will cover these costs but it does not include any alternatives if the program does not generate significant profits beginning in its first year of operation. Further, the plan assumes, but does not explicitly articulate, that the State will not receive any profits between 2024 and 2060, because private sector investors will receive all of the program's net operating profits during these years in return for their investment.

The accuracy of the Authority's estimates of the program's profits depends upon its ridership projections, which are thus fundamental to private investors' interest. The ridership model the Authority presents in its 2012 draft business plan assumes an average ticket price of \$81 and projects that passengers will take a total of 29 to 43 million annual trips by the completion of phase one. However, when the Authority's chief executive officer commissioned a ridership review group to independently assess the ridership projections, he handpicked the group's members, which may call into question the independent nature of their assessment. Further, although the ridership review group determined that the ridership model was suitable for use in the 2012 draft business plan, the group presented several long-term concerns, such as potential biases in the survey data used in the model's development. The ridership review group's August 2011 report implied that if the Authority does not address these long-term concerns, the model may only be useful for projecting ridership for the operating section and not for the program's remaining sections.

In addition to our concerns related to the Authority's 2012 draft business plan, we also identified a number of critical, ongoing problems involving its oversight of the program. Specifically, in our prior report, we concluded that the Authority's processes for monitoring the performance and accountability of its contractors—especially the entity that manages the program (Program Manager)—were inadequate. During our follow-up review, we found that the Authority has continued to struggle to provide an appropriate level of oversight, in part because it is significantly understaffed. As of August 2011 the Authority had 21.5 filled positions to oversee the multibillion-dollar program. Without sufficient staffing, the Authority has struggled to oversee its contractors and subcontractors, who outnumber its employees by about 25 to one.

Our follow-up also revealed that the Authority has failed to ensure that it and the public is aware of its contractors' and subcontractors' potential conflicts of interest. Although the Authority's conflict-of-interest code requires its contractors to file statements of economic interest that help to identify any potential conflicts of interest that they may have, our review found that some of the contractors had failed to file their statements. Further, the Authority does not require any of its subcontractors to file statements of economic interest. As a result, the Authority has no way to verify that subcontractors do not have real or perceived conflicts of interest.

In part because the Authority has so few staff, it has delegated significant control to its contractors. As a result, it may not have the information necessary to make critical decisions about the program's future. For example, when we reviewed three of the monthly progress reports that the Program Manager submitted to the Authority to inform it of the program's progress, we found over 50 errors or inconsistencies of various types. Most significantly, we noted differences between what was reported in the regional contractors' reports and what the Program Manager summarized and reported to the Authority, thus demonstrating that the Program Manager had provided the Authority with misleading information. Additionally, the Authority has been minimally involved in the risk-management process, instead relying almost completely on its Program Manager to both identify and mitigate potential problems. According to the chief deputy director, the Program Manager is currently more engaged than the Authority in risk management because the Authority has not been able to hire a risk manager. Consequently, the Authority cannot be certain that it is aware of and addressing those risks that could significantly delay or even halt the program.

The largest part of the Authority's role in administering the program is managing contracts; however, during the course of our work, we discovered that the Authority had engaged in inappropriate contracting practices involving information technology (IT) services. Specifically, the Authority split its IT services totalling \$3.1 million into 13 individual contracts with one vendor over a 15-month period and awarded the contracts before obtaining the proper bids. The *State Contracting Manual* expressly prohibits agencies from splitting contracts to avoid competitive bidding requirements and purchasing thresholds for any series of related services that would normally be combined and bid as one job. As a result of the Authority's actions, we believe that it violated the prohibitions set forth in the *State Contracting Manual*. Further, the nature of the problems we discovered suggests that the Authority needs to significantly improve its internal controls to ensure that it effectively manages its contracts.

Finally, in our April 2010 report, we concluded that the Authority did not have a system in place to track its expenditures in order to ensure the program's compliance with Proposition 1A's limitations on administrative and preconstruction task costs. During our follow-up review, we found that although the Authority has made some improvements to its process, it still has not completed its expenditure tracking system. According to state law, the Authority can use only 2.5 percent (\$225 million) of its portion of bond funds from Proposition 1A for administration and only 10 percent (\$900 million) for planning, environmental review, and preliminary engineering (preconstruction tasks). According to the chief deputy director, the Authority had been developing a system to track its expenditures but paused further development in November 2011 due to staff vacancies as well as a lack of clarity on how to categorize its program costs. Despite the lack of a system, we observed that the Authority is making attempts to categorize its expenditures; however, until it has a system in place for tracking its expenditures, it cannot ensure compliance with Proposition 1A and risks running out of the bond funds available for administration and preconstruction task costs.

Recommendations

To ensure that it has adequately addressed all of the concerns outlined in our April 2010 report, as indicated in Appendix B, the Authority should fully implement the recommendations of that report. We have made the following additional recommendations based on our follow-up review:

To ensure that the public and the Legislature are aware of the full cost of the program, the Authority should clearly report total costs, including projected operating and maintenance for the program. Additionally, the Authority should clearly disclose that the 2012 draft business plan assumes that the State will only be receiving profits for the first two years of operation in 2022 and 2023, and will potentially not receive profits again until 2060 in exchange for the almost \$11 billion it assumes it will receive from the private sector.

To assure independence and instill public confidence in the process regarding the Authority's ridership model, the Legislature should draft legislation that establishes an independent ridership review group.

To ensure that it has adequate staff to effectively oversee the program, the Authority should continue to fill its vacant positions.

To comply with the Political Reform Act of 1974, the Authority should establish written policies and procedures for tracking whether all designated employees and consultants have completed and filed their statements of economic interests on time, thereby identifying any potential conflicts of interest.

To increase transparency and to ensure that it is aware of any financial interest that a subcontractor may have in the program, the Authority should require subcontractors to file statements of economic interest.

To ensure that the Program Manager's progress reports are accurate, consistent, and useful, the Authority should conduct monthly comparisons of the Program Manager's and regional contractors' progress reports to verify consistency.

To be aware of and respond effectively to circumstances that could significantly delay or halt the program, the Authority should hire a risk manager as soon as possible. Until then it should designate and require Authority staff to attend risk-management meetings and workshops. Finally, the Authority should monitor the Program Manager's risk-management practices to ensure that either it or the Program Manager identifies and promptly and appropriately addresses risks.

To effectively manage its contracts, the Authority should develop procedures to detect and prevent contract splitting.

Agency Comments

Although the Authority generally agreed with our conclusions and stated that it will take steps to implement our recommendations, it disagreed with our assessment that the Authority's funding situation is risky. The Authority also disagreed with some of our conclusions and recommendations regarding the Program Manager's monthly progress reports.

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Introduction

Background

The Legislature created the High-Speed Rail Authority (Authority) in 1996. Among other duties, state law charges it with the development and implementation of intercity, high-speed rail service that is fully integrated with existing intercity rail and bus networks. In November 2008 voters approved the Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century (Proposition 1A), which authorizes the State to sell \$9 billion in general obligation bonds for planning, engineering, and construction of a high-speed rail network (program) and an additional \$950 million in general obligation bonds either for capital improvements to other rail systems connecting to it or for capacity enhancements or safety improvements to those rail systems. The state law that placed Proposition 1A on the ballot stated the Legislature's intent that the entire network, from Sacramento to San Diego, be completed no later than 2020. The law also mandated that nonstop service between San Francisco and Los Angeles must take no longer than two hours and 40 minutes.

In 2009 the Joint Legislative Audit Committee (audit committee) asked the Bureau of State Audits (bureau) to assess the Authority's readiness to manage the Proposition 1A funds. In April 2010 we issued a report titled *High-Speed Rail Authority: It Risks Delays or an Incomplete System Because of Inadequate Planning, Weak Oversight, and Lax Contract Management*, Report 2009-106. In that report, we concluded the Authority had not adequately planned for the future development of the program. According to our statutory authority and the audit standards under which we operate, our long-standing practice is to conduct follow-up reviews of audits when resources are available and we determine it is prudent to do so. Additionally, state law requires us to periodically examine the Authority's use of the proceeds from Proposition 1A bond funds. For these reasons, we decided to conduct an audit of the Authority following the scope and methodology described in Appendix A. We present the status of the Authority's implementation of our prior report's recommendations in Appendix B.

The 2012 Draft Business Plan

The Authority's business plan is a key document that describes the Authority's vision for the program. The Authority published its first business plan in 2000, then released its second in November 2008, three days after voters approved Proposition 1A. In March 2009 the Legislative Analyst's Office stated that the November 2008 plan lacked many details and recommended that the Legislature require the Authority to provide additional information. In amendments to the 2009 Budget Act, the Legislature required the Authority to submit a

revised business plan by December 15, 2009, that included stated details about the program. State law now requires the Authority to submit to the Legislature a business plan every two years. To meet this requirement, the Authority released its 2012 draft business plan on November 1, 2011, and planned to submit the finalized plan by January 1, 2012. As of December 2011 the Authority was accepting comments from the public, legislative hearings, and other stakeholders and, according to the Authority's chief deputy director, it will likely make adjustments or edits based on the feedback during this comment period. The Authority anticipates finalizing the business plan by approximately February 1, 2012.

Although some elements of the 2012 draft business plan remain unchanged from the 2009 plan, in other ways it departs significantly from what the Authority previously proposed. The program continues to contain multiple phases of construction. According to both the 2009 business plan and the 2012 draft business plan, phase one will run from San Francisco in the north to Los Angeles-Anaheim in the south, and phase two will add sections north to Sacramento and south to San Diego. However, in the 2012 draft business plan, the Authority has more than doubled its estimate for the cost for phase one of the program, from \$42.6 billion to between \$98.1 billion and \$117.6 billion.¹ Further, according to the 2012 draft business plan, phase one will not be fully operational until 2034—14 years later than the Authority's 2009 estimate. It also shifts the program's starting point from Los Angeles-to-Anaheim to approximately Fresno-to-Bakersfield in the Central Valley because the Authority believes this route is the only location where it can test the high-speed train technology at its top speed of 220 miles per hour. The 2012 draft business plan also states that the Authority and the Federal Railroad Administration determined that the Central Valley was an appropriate location in which to start construction because of certain criteria related to the use of federal funds, such as the need for a September 2017 completion date for the program's first section.

The 2012 draft business plan also includes two new approaches for constructing the program: blended operations and phased implementation. The blended operations approach proposes that the high-speed rail share existing commuter rail infrastructure and facilities. The phased implementation approach divides the program into smaller, discrete sections that can operate independently so that the Authority can match work to available funding. As a result of the phased implementation approach, the Authority divided phase one of the program into four sections, each with different costs and timelines, as shown in Table 1. According to the 2012 draft business plan, the Authority plans to begin construction on the Initial Construction Section (construction section)—the first portion of the Initial Operating

¹ Given the long-term nature of the program, the Authority used the year-of-expenditure dollars in its 2012 draft business plan estimates, which the Authority calculated assuming a 3 percent inflation rate. We use these same estimates throughout this report.

Section (operating section)—in 2012, at an estimated cost of approximately \$6 billion. Figure 1 on the following page depicts the proposed routes for each section of the program and Figure 2 on page 11 shows planned timelines. Should progress of the rest of the operating section be substantially delayed, the Authority contends that the construction section can become an operational railway by allowing other passenger trains, such as Amtrak, to travel on it.

Table 1
High-Speed Rail Authority’s Planned Sections, Costs, and Timeline

PHASES OF PROGRAM	SEGMENTS	COST		CONSTRUCTION TIMELINE
		WITH NORTH OPERATING SECTION	WITH SOUTH OPERATING SECTION	
Phase One—San Francisco to Los Angeles/Anaheim Approximately 520 miles of high-speed rail system	Initial Construction Section (construction section): 130-mile “spine” through the Central Valley, stretching from just north of Fresno to approximately nine miles north of Bakersfield. It does not include passenger stations, maintenance and support facilities, traction electrification systems, and train control and communications systems as well as the necessary high-speed trains required for services.	\$6 billion		2012–17
	Initial Operating Section (operating section): Two options have been developed for extending the construction section: • North operating section (Central Valley to Bay)— Approximately 290 miles long, running from Bakersfield to Merced and San Jose. <i>OR</i> • South operating section (Central Valley to Los Angeles Basin)—Approximately 300 miles long, running from Merced to the San Fernando Valley.	\$24.7 billion	\$27.2 billion	2015–21
	Bay to Basin: Approximately 410 miles long and includes construction of a complete high-speed rail system from San Jose and Merced extending south to the San Fernando Valley. Provides the platform for blended high-speed and commuter rail operations in metropolitan areas.	\$24 billion	\$21.1 billion	2021–26
	Completion of Remainder of Phase One: The cost to complete the high-speed rail system, which is approximately 520 miles long, from San Francisco and Merced to the Union Station in Los Angeles and the Regional Transportation center in Anaheim.	\$43.8 billion		2026–33
Total Cost of Phase One		\$98.5 billion	\$98.1 billion	2012–33
Phase Two—Sacramento and San Diego	Extends the phase one system to Stockton and Sacramento via Merced in the north and to San Diego via the Inland Empire in the south. This will complete the approximately 800-mile statewide high-speed rail project as originally proposed. The High-Speed Rail Authority (Authority) does not present cost data for phase two.	Unknown		Unknown
Total Cost of Entire Program		Unknown		Unknown

Source: The Authority’s 2012 draft business plan.

Note: Although the Authority mentions in its 2012 draft business plan that the program could cost up to \$117.6 billion, the plan does not break down these additional costs by section in year-of-expenditure dollars. As a result, we only present the cost breakdown for the lower cost estimates.

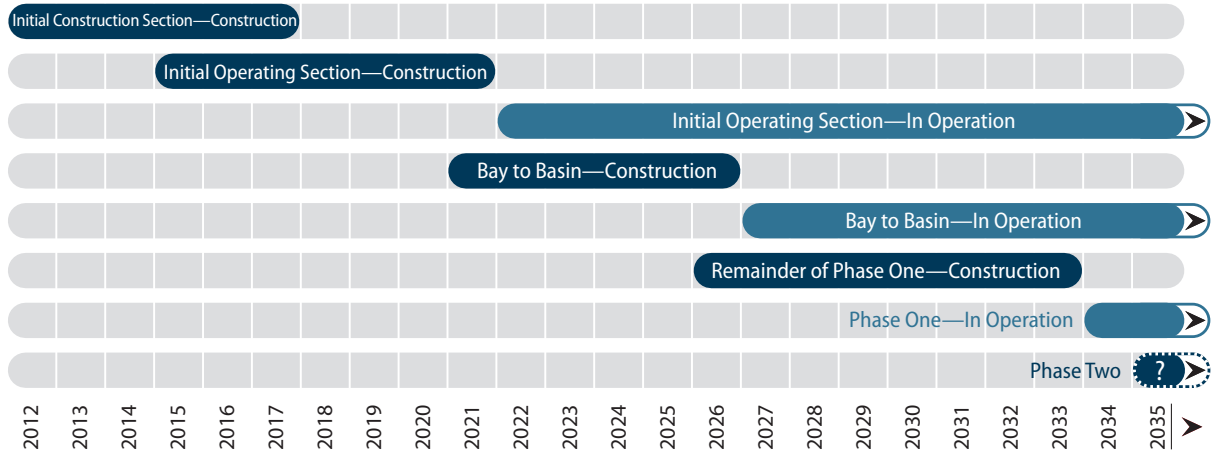
Figure 1
Proposed Routes for the High-Speed Rail Network



Source: The High-Speed Rail Authority's 2012 draft business plan.

Note: This map assumes the construction of Initial Operating Section South. Therefore, the Bay to Basin construction will be to the north connecting to San Jose and Merced.

Figure 2
Construction and Operation Timeline by Section



Source: The High-Speed Rail Authority's (Authority) 2012 draft business plan.

Note: Although the 2012 draft business plan begins its financial projections in 2013, the Authority estimates that construction on the Initial Construction Section will start in 2012.

Proposition 1A Bond Expenditures

Proposition 1A sets limits on how the Authority can request and spend its bond funds. These include a 2.5 percent (\$225 million) cap on administrative costs associated with the program, which the Legislature can increase up to 5 percent (\$450 million). The proposition also limits the overall amount of funds the Authority may spend on environmental studies, planning, and preliminary engineering activities (preconstruction tasks) to 10 percent of its total bond funds (\$900 million). We discuss the Authority's attempts to track the program's expenditures to ensure its compliance with these limits in Chapter 2.

As of June 30, 2011, the State Treasurer's Office had sold approximately \$410 million of the \$9.95 billion in bonds authorized by voters. As Table 2 on the following page shows, the Authority spent \$115 million and \$88 million during fiscal years 2009–10 and 2010–11, respectively, or about 2 percent of the total amount of \$9.95 billion. The Authority doubled its personal services expenditures, which include staff salaries and benefits, during the same two-year period. This increase in personal services expenditures occurred because it filled vacant positions—it increased its staff from 13.5 positions in fiscal year 2009–10 to 21.5 positions in fiscal year 2010–11. The table also shows that during this two-year period, the Authority spent approximately \$113 million and \$80 million, respectively, on consultant and professional services, neither of which count

toward the administrative cap discussed earlier. The contractor that serves as the Authority's program manager (Program Manager) was the largest single recipient of Authority funds, with a \$199 million contract extending more than six years. With over 100 full-time equivalents, the Program Manager provides day-to-day management and directs the contractors working on specific sections of the program. The Authority also contracts with six regional contractors to build the different sections of the program.

Table 2
High-Speed Rail Authority Expenditures of High-Speed Passenger Train Bond Fund by Category for Fiscal Years 2009–10 and 2010–11

CATEGORIES	FISCAL YEAR 2009–10	FISCAL YEAR 2010–11
Personal services	\$1,192,109	\$2,264,618
Consultant and professional services—external	113,211,054	80,417,410
Other operating expenses and equipment	2,468,477	5,284,209
Subtotals	116,871,640	87,966,237
Less reimbursements	1,500,000	–
Total Expenditures	\$115,371,640	\$87,966,237

Source: Bureau of State Audits' analysis of unaudited California State Accounting and Reporting System reports.

Notes: Our calculation of total expenditures excludes approximately \$76 million in encumbrances that are commitments related to unperformed contracts for goods or services.

The increase in personal services expenditures is primarily due to the High-Speed Rail Authority (Authority) filling open positions. The total number of filled positions increased from 13 in June 2010 to 21 in June 2011.

The \$1.5 million reimbursement was related to an interagency agreement between the California Department of Transportation and the Authority.

Oversight Activities

The Authority's nine board members have exclusive responsibility for the planning, construction, and implementation of a high-speed passenger train network. The board's operations committee—a small group of board members that generally meets quarterly—receives updates from the Program Manager and the consultant for program management oversight (oversight consultant) on the program's status.

State law requires the Authority to establish an independent peer review panel for the purpose of reviewing and analyzing its different plans, including the business plans. State law directs the Authority to establish this panel, but it leaves appointment of the panel's members up to four agencies—the State Treasurer's Office, the State Controller's Office, the Department of Finance,

and the Business, Transportation and Housing Agency. In our prior report, we concluded that the peer review panel is subject to the Bagley-Keene Open Meeting Act and must hold meetings that are properly announced and open to the public when it analyzes and evaluates the Authority's plans.

Finally, in January 2010 the Authority entered into an \$8 million, three-year contract with its oversight consultant. The oversight consultant is responsible for reviewing and monitoring the Program Manager's work to ensure that it is on schedule and in conformance with approved work plans. The use of one contractor to review the work of another is not unique to the Authority. The California Department of Transportation and the Federal Transit Administration have used consultants to oversee other consultants.

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Chapter 1

THE HIGH-SPEED RAIL AUTHORITY'S FUNDING SITUATION HAS BECOME INCREASINGLY RISKY

Chapter Summary

As discussed in the Introduction, in April 2010 we issued a report titled *High-Speed Rail Authority: It Risks Delays or an Incomplete System Because of Inadequate Planning, Weak Oversight, and Lax Contract Management*, Report 2009-106. This report concluded that the High-Speed Rail Authority (Authority) had not adequately planned for the future development of the high-speed rail network (program). Since our previous report, the Authority has addressed some of our recommendations. For example, it is no longer relying on revenue guarantees to attract private investment in the project. Further, the Authority has made several improvements to its previous business plan. In particular, the total cost of the first portion of the program—the Initial Construction Section (construction section)—is secured. Additionally, as we note in the Introduction, the Authority is now proposing a phased implementation approach that divides the program into smaller, discrete sections that can operate independently so that the Authority can match work to available funding. However, we still have significant concerns about the Authority's 2012 draft business plan. In particular, while the Authority did make some attempts to present alternatives in the event that its planned funding sources do not materialize, we do not believe viable alternatives are identified. As a result, the program's funding situation has become increasingly risky.

The Authority's 2012 draft business plan does not fully address these risks. The Authority admits that the success or failure of the program depends on its ability to secure tens of billions of dollars of federal funding, and yet the plan fails to present specific steps for acquiring these or alternative funds. Further, the plan's lack of detail in its presentation of certain costs and revenues compromises the Authority's transparency. Finally, the reasonableness of the Authority's business plan hinges largely on the accuracy of its ridership projections, yet the Authority could have done more to ensure the credibility of its ridership model. In isolation, any one of these issues could pose a threat to the program; together, they raise concerns about the program's future.

The Authority Has Not Identified Viable Alternatives in the Event That Its Planned Funding Does Not Materialize

As the Authority's cost estimates for the program have risen, the program's success has become increasingly dependent on the Authority's ability to secure tens of billions of dollars of federal funds. Our prior report concluded that the Authority's 2009 business plan

The Authority estimates that phase one of the program will cost between \$98.1 billion and \$117.6 billion but has only secured about \$12.5 billion to date.

lacked details regarding how it proposed to finance the program and that the program risked significant delays if the Authority did not develop a strategy for obtaining or replacing federal funds. As the federal government continues to be by far the largest funding source in the Authority's 2012 draft business plan, we expected the plan to provide specific details indicating how the Authority intends to secure this money, as well as viable alternatives in the event that it does not receive federal funds in the amount envisioned. However, we found that the 2012 draft business plan continues to lack this information. Although it is possible that the Authority may obtain the necessary funding to move forward with the program, it risks significant delays or the inability to proceed if it does not.

The Authority's cost estimates for the program have increased significantly since its last estimate; however, it has not finalized its funding plans. State law requires the Authority to prepare a business plan by January 1, 2012, and to submit a draft of the plan to various legislative committees 60 days before that date. To meet this requirement, the Authority released its 2012 draft business plan on November 1, 2011; however, as of December 2011, according to the chief deputy director, the Authority was taking in comments from the public, legislative hearings, and other stakeholders, and it will likely make adjustments or edits based on the feedback it receives during this comment period. The Authority anticipates releasing the business plan by approximately February 1, 2012. The Authority estimates in its 2012 draft business plan that phase one of the program will cost between \$98.1 billion and \$117.6 billion.² Of this amount, the Authority has secured³ about \$12.5 billion to date: \$9 billion in Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century (Proposition 1A) funds and \$3.5 billion in federal funds. The federal funds consist of \$2.55 billion from the American Recovery and Reinvestment Act of 2009 (Recovery Act) and about \$930 million in another federal appropriation that, according to the 2012 draft business plan, includes funds redistributed from the cancellation of high-speed rail projects by Florida, Ohio, and Wisconsin. Therefore, to complete phase one of the program, the Authority will need to secure between \$85.6 billion and \$105.1 billion in additional funding—an amount comparable to the State's entire annual General Fund budget.

Although the total cost of the first portion of the operating section—the construction section—is secured, the cost of the remainder of the Initial Operating Section (operating section) is not. To fund the \$6 billion cost of the construction section, the Authority plans to use \$3.3 billion of

² Given the long-term nature of the program, the Authority used the year-of-expenditure dollars in its 2012 draft business plan estimates, which the Authority calculated assuming a 3 percent inflation rate. We use these same estimates throughout this report.

³ Throughout our report we refer to the Authority's secured funding. This includes the federal funding authorized under the Recovery Act and Omnibus Appropriations Act of 2010, as well as the \$9.95 billion in bond funds authorized by Proposition 1A in 2008. However, the Legislature must appropriate the Proposition 1A bond funds before the Authority can use them.

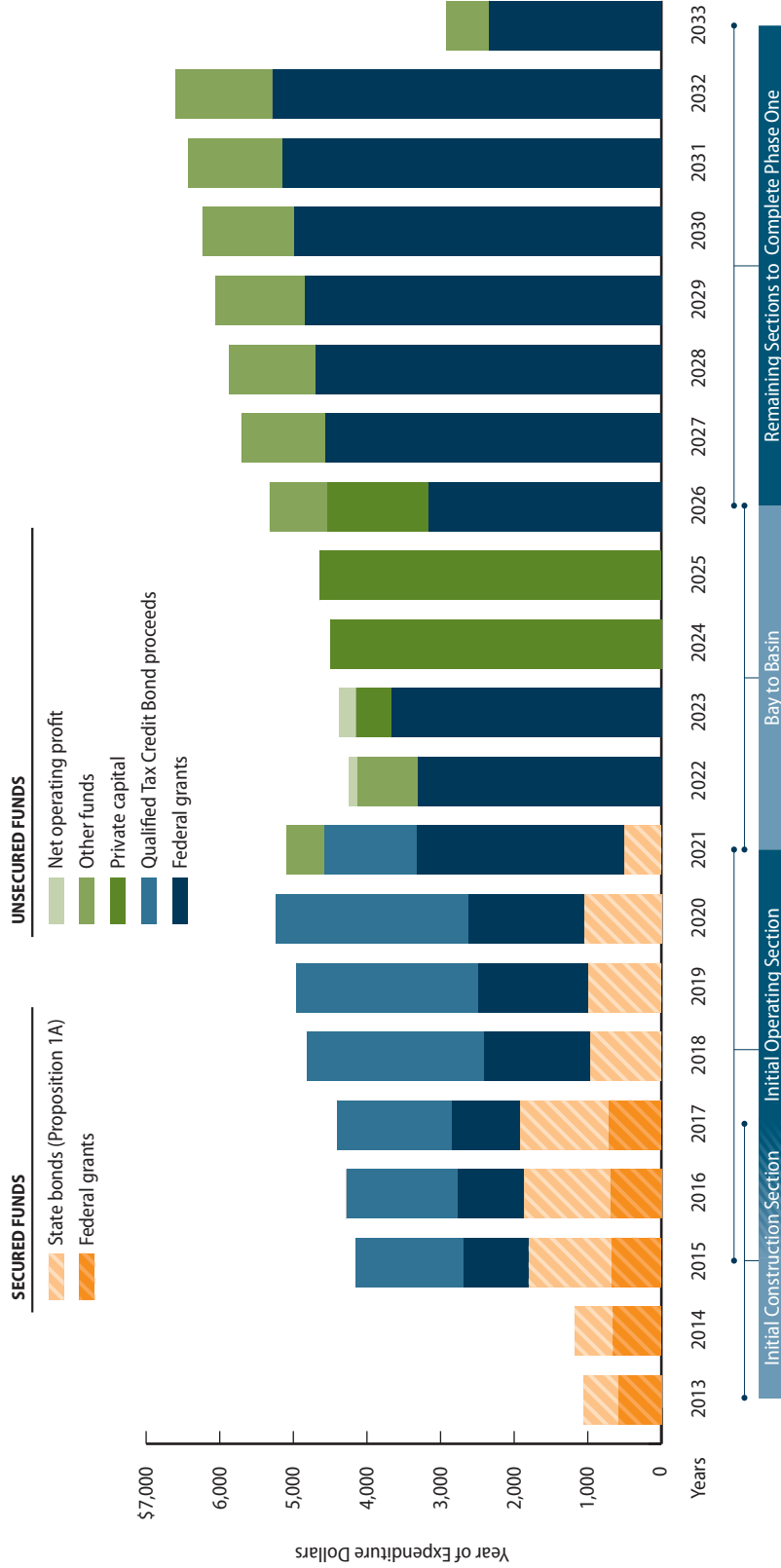
the aforementioned \$3.5 billion in federal funds as well as \$2.7 billion of Proposition 1A proceeds. The Authority estimates in its 2012 draft business plan that the remainder of the operating section will cost between \$24.7 billion and \$27.2 billion as depicted in Table 1 in the Introduction. After paying for administration and preconstruction tasks, only \$5.3 billion of Proposition 1A funding would be left to cover the remaining \$24.7 billion to \$27.2 billion, resulting in a shortfall of at least \$19.4 billion. Figure 3 on the following page details the projected costs and planned funding sources for each of the sections of the program.

The 2012 draft business plan includes a funding plan that assumes that federal funds must cover 80 percent of the operating section's cost. According to the financial consultant who assisted in preparing the Authority's 2012 draft business plan, the project requires that 80 percent come from federal funding through the completion of the operating section because of the fixed amount committed by the State and the revenue guarantee prohibition that limits the amount of early private participation. The 2012 draft business plan indicates that the Authority based its estimate of federal participation in the program on the fact that the federal government has historically provided 50 percent to 80 percent of the funding for major transportation investments, including highway, transit, and aviation sector-related projects. However, a significant portion of the funds for highway and transit programs has typically come from the Highway Trust Fund, which has a dedicated revenue source—the federal tax on motor fuels. As the U.S. Government Accountability Office (GAO) noted in a March 2009 report on the future development of high-speed rail, the federal government has historically provided funding for high-speed rail from general revenues rather than from a dedicated funding source. The GAO stated that high-speed rail projects must consequently compete with other kinds of demands on federal funds such as national defense, education, and health care.

In addition to continuing to rely heavily on federal funds, as indicated in the 2012 draft business plan, the Authority has failed to provide sufficient detail as to how it intends to obtain those funds and did not report viable alternative funding options if it does not receive them, despite our prior recommendation as well as a state law requiring it to do so before spending some of its 2011 Budget Act appropriation. The Authority did make some attempts to present funding alternatives in its 2012 draft business plan. However, Qualified Tax Credit Bonds (QTCBs)—a funding option the Authority described as an alternative—does not seem to be an actual alternative because the Authority has also included it as a critical part of its primary funding plan. In other words, the Authority based its primary funding plan on this alternative, making it difficult to determine how the Authority would proceed with the program should it fail to secure these funds. Moreover, QTCBs are not yet approved for use on high-speed rail projects.

The Authority estimates that the operating section will cost between \$24.7 billion and \$27.2 billion, of which \$5.3 billion is secured—leaving a shortfall of at least \$19.4 billion.

Figure 3
The High-Speed Rail Authority's Projected Sources of Funding and Construction Timeline
2013 Through 2033 (Phase One)
(Dollars in Millions)



Source: The High-Speed Rail Authority's (Authority) 2012 draft business plan assumes a scenario where extension of Initial Operating Section South occurs first and private sector investment in 2023.
Note: Although the 2012 draft business plan begins its financial projections in 2013, the Authority estimates that construction on the Initial Construction Section will start in 2012, as reflected in Figure 2 on page 11.

The Authority plans to use \$13.3 billion in net proceeds from issuing QTCBs, as illustrated in Figure 4 on the following page, to construct the program. According to the director of the public finance division at the State Treasurer's Office (director of public finance), QTCBs are bonds in which the federal government subsidizes the issuer's—in this case, the Authority's—borrowing costs through tax credits or direct payments from the federal government. Further, he explained that in its 2012 draft business plan, the Authority plans to issue QTCBs and use a portion of the proceeds to purchase—and therefore invest in—Proposition 1A bonds. The Authority plans to use the principal and interest payments it would receive from the State as the holder of Proposition 1A bonds, as well as the interest generated from investing those payments over 30 years, to repay the principal on the QTCBs. The director of public finance also stated that investors would be unlikely to accept the risk that future earnings would be sufficient to meet the debt service requirements on the QTCBs, and they would therefore not purchase QTCBs that relied on these types of future interest earnings for repayment. He also stated that a number of the QTCB characteristics that are assumed in the Authority's 2012 draft business plan, which are necessary to generate construction proceeds, have not been features of earlier federal QTCB programs.

Although the QTCBs may be a potential funding source for the program, we are concerned that they may be difficult for the Authority to obtain. In particular, while Congress has authorized QTCB programs for projects related to education, energy conservation, and renewable energy, it has not authorized QTCBs for high-speed rail projects. Finally, according to the director of public finance, there is no current or proposed federal law that would authorize direct payment of QTCBs for high-speed rail as proposed by the Authority, and state law would need to be amended to allow the Authority to both issue QTCBs and to purchase Proposition 1A bonds.

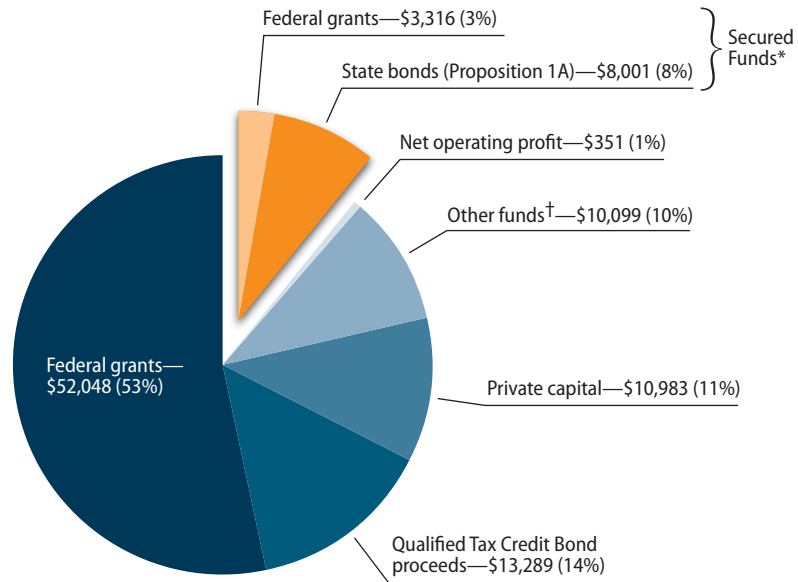
One other possible source of future federal funding that the Authority presents in its 2012 draft business plan also appears unlikely. While the plan mentions the federal Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU) as a potential source of funds for the program, the plan also notes that SAFETEA-LU is struggling to maintain its current spending levels and may not be a viable option for high-speed rail.

The Authority included some nonfederal funding sources in its 2012 draft business plan, yet its lack of detail about these funding sources makes adequately assessing the accuracy of its projections difficult. For phase one, the Authority hopes to obtain more than \$10 billion from what it calls "other funds" that it estimates will

One possible source of future federal funding that the Authority presents in its 2012 draft business plan appears unlikely.

come from state, local, and private development. The plan does not give any detail as to what the other state fund sources are or how the Authority plans to obtain them, but the plan mentions the Authority’s strategy for obtaining local and privately generated revenues by seeking opportunities with local and private partners, such as targeting private revenues from parking fees. The Authority’s financial consultant stated that it reached its estimate of \$10 billion by subtracting the federal funds it still needs and the federal funds and Proposition 1A funds it has already secured from the total cost of the program; however, the Authority does not offer alternatives should it fail to receive these funds, which may further increase its reliance on federal funds.

Figure 4
The High Speed Rail Authority’s Funding by Source: 2013 Through 2033
(Phase One)
(Dollars In Millions)



Source: The High-Speed Rail Authority’s (Authority) 2012 draft business plan assumes a scenario where extension of Initial Operating Section South occurs first.

* Secured funds include the federal funding authorized under the American Reinvestment and Recovery Act of 2009 and Omnibus Appropriations Act of 2010, as well as the bond funds authorized by Proposition 1A in 2008. However, the Legislature must appropriate the Proposition 1A bond funds before the Authority can use them.

† For phase one, the Authority hopes to obtain more than \$10 billion from what it calls “other funds” that it estimates will come from state, local, and private development. The plan does not give any detail as to what the other state fund sources are or how the Authority plans to obtain them, but mentions its strategy for obtaining local and privately generated revenues by seeking opportunities with local and private partners, such as targeting private revenues from parking fees.

Finally, to the extent the Authority does not receive the federal funds that its 2012 draft business plan estimates it needs to complete the operating section, the Authority will likely increase its difficulty in attracting private investments for subsequent sections of the program. Without private investments, it will be forced to rely even more on federal funds that it has not yet either identified or secured. According to the 2012 draft business plan, the operating section will begin generating profits immediately after its completion in 2022. As described in the plan, the Authority believes those profits will attract \$11 billion in private investment that the plan states can contribute significantly toward completing the Bay-to-Basin section. However, the Authority includes in the plan a scenario in which it obtains no private sector investments until after it completes construction of the Bay-to-Basin section. In this scenario, federal and state resources would need to cover the program's construction costs, although the Authority believes it could offset the costs in part with the profits from the operating section.

Many large transportation projects require significant federal funding, and it is possible that the Authority will be able to obtain the funds outlined in its plan. However, given that the federal government is one of the few entities with the amount of capital available to fund a program of this size and scope, the Authority may find that it cannot identify any viable alternative sources of funding. If it cannot present such viable funding alternatives, the Authority has a responsibility to California's taxpayers to acknowledge that no such alternatives exist and that the program cannot proceed if it cannot secure the amount of federal funds it needs.

The 2012 Draft Business Plan Continues to Lack Some Key Details Regarding Costs and Revenues

The Authority does not clearly present the full cost of the program in its 2012 draft business plan. Only within the business plan's eighth chapter about funding and financing—more than 100 pages into the plan—does the Authority mention that phase one could cost as much as \$117.6 billion. Instead, it uses one of its lower cost estimates of \$98.5 billion throughout the plan.⁴ In addition, state law requires the business plan to contain, among other things, a forecast of the anticipated operating and maintenance and capital

Without private investments, the Authority will be forced to rely even more on federal funds that it has not yet either identified or secured.

⁴ The 2012 draft business plan generally refers to \$98.5 billion as the low-capital cost scenario for phase one. It bases this figure on the assumption that it will construct the program following the route it has described as Initial Operating Section North. However, its cost estimate for an alternative route, which it describes as Initial Operating Section South, is \$98.1 billion. We therefore use \$98.1 billion as the lowest cost estimate for phase one.

costs for the system; however, few of the Authority's phase-one cost estimates do so sufficiently. For example, cost estimates for the operating section, the Bay-to-Basin section, as well as the remaining

sections that will complete phase one, do not include operating and maintenance costs as described in the text box. In fact, the plan does not present the total operating and maintenance costs, which, based on data included in the plan, we estimate could total as much as \$96.9 billion from 2025 through 2060. Moreover, the \$6 billion estimated cost for the construction section does not include the cost to make that track ready for high-speed rail. Thus, if the Authority is not able to obtain the funding for the remainder of the operating section according to its schedule, it will only be able to use the construction section of track for traditional rail service.

Operating and maintenance costs include:

- Train operations including train operators, station personnel, and administrative staff
- Maintenance of infrastructure
- System power and operator insurance
- Capital asset renewal expenditures reflecting the need to renew or replace assets over time

Source: The High-Speed Rail Authority's 2012 draft business plan.

We also noted several problems with the way the Authority presents its estimates of revenues in its 2012 draft business plan. In the plan, the Authority projects that all costs associated with operating and maintenance will be paid for out of revenues from ridership. This projection is based on the Authority's assumption that the revenues generated by the program will yield net operating profits beginning in 2022—the year in which the operating section is scheduled to open for passenger service. However, the plan does not address how the Authority will pay for operating and maintenance costs should the program's revenues not cover such costs. Moreover, the Authority has not received any commitments for funding from potential investors, but projects that it will secure private sector investments of almost \$11 billion over four years beginning in 2023.

In addition, although the 2012 draft business plan assumes that the State will receive all of the net operating profit generated by the operating section during 2022 and 2023, the plan does not present phase one's total net operating profit projected from 2025 to 2060. The 2012 draft business plan does not contain any information regarding the estimated net operating profit for 2024. Using the same methodology that we used to calculate operating and maintenance costs, we estimated that the net operating profit would be approximately \$115 billion from 2025 through 2060. In exchange for their nearly \$11 billion investment, private investors will receive some portion of the \$115 billion net operating profit; however, the 2012 draft business plan does not explicitly articulate the number of years or for which sections of the program that private sector investors will receive the net operating profit. Both the Authority's chief deputy director and the financial consultant who prepared the financial sections of the business plan confirmed that, while not

specified anywhere in the 2012 draft business plan, the financial projections are based on the concession that the private sector would receive all the net operating profit from 2024 through 2060.

Finally, the 2012 draft business plan does not include a schedule or cost estimate for phase two of the program. According to the Authority’s chief deputy director, the Authority did not present timelines or cost estimates for phase two because it is too far in the future and planning it would be too speculative at this time.

The Authority’s Process for Overseeing the Development of Its Ridership Model May Raise Concerns About the Credibility of Its Projections

The program’s success relies on the accuracy of the Authority’s ridership model, which is fundamental to the Authority’s revenue projections and thus to private investors’ interest in the program. The ridership model the Authority presents in its 2012 draft business plan assumes an average one-way ticket price of \$81 from San Francisco to Los Angeles and the model projects that passengers will take a total of 29 to 43 million annual trips by the completion of phase one, as noted in the text box. The Authority used this model to estimate the program’s expected operating and maintenance costs, revenues, and net operating profits as well as to project the number of jobs the program will create and the overall economic benefits that will result. However, the Authority’s process for overseeing the development of the model lacked transparency, which may raise investor concern about the model’s credibility. Moreover, the Authority has yet to fully address questions about the accuracy of the model’s long-term projections.

Highlights From the Ridership Model	
<u>Assumptions</u>	
Average ticket price between San Francisco and Los Angeles (one way)	\$81 (2010 dollars)
High-speed rail ticket price as percentage of airline ticket price	83 percent
Population of California, in 2035	44 to 49 million
<u>Projections</u>	
Annual number of trips for Phase One, in 2035	28.9 to 42.9 million
Annual revenue for Phase One, in 2035	\$1.8 to \$2.6 billion (2010 dollars)
Source: The High-Speed Rail Authority’s 2012 draft business plan.	

The ridership model the Authority used in its 2009 business plan received significant criticism for being both overly optimistic and based on unreasonable assumptions. The ridership projections in the 2012 draft business plan offer considerably more detail than those in the 2009 business plan. Most notably, the 2012 draft business plan presents a range of ridership projections from low to high, unlike the 2009 business plan, which included only one ridership projection figure. In addition, the current model adjusts for the price of a gallon of gas as well as projected airfare prices. Finally, the updated model takes into account the economic recession and the subsequent changes in population projections and shifts in consumer behavior.

Although the Authority's chief executive officer created a ridership review group to validate the ridership model, we are concerned that this group may not be truly independent because he personally chose the group's members.

However, the Authority may have missed an opportunity to increase stakeholders' confidence in the ridership model's accuracy once Cambridge Systematics—the subcontractor engaged to develop the model—had completed it. Although the Authority's chief executive officer created a ridership review group to validate the ridership model, we are concerned that this group may not be truly independent because he personally chose the group's members. According to the chief executive officer, after he arrived in May 2010, he created the ridership review group to validate the model and ensure that it did not receive the same level of public criticism that the 2009 business plan's ridership projections—also developed by Cambridge Systematics—had received. To choose the group's members, the chief executive officer selected five of the 20 to 30 ridership experts worldwide of whom he was aware. From January 2011 through July 2011, the ridership review group evaluated the ridership model and worked with Cambridge Systematics to improve it for use in the 2012 draft business plan.

According to the chief executive officer, he wanted to create a ridership review group to ensure that the Authority had better oversight of the program. He further stated that although he was not required to, he informed the Senate Transportation Committee of his intentions to create a ridership review group in an effort to remain as transparent as possible. While we acknowledge the important role that the ridership review group played in validating the ridership model and the chief executive officer's effort to increase transparency, the ridership projections are critical to both the Authority's business plan and the public's perception of the program's viability; therefore, it is essential that stakeholders have confidence in these projections. We believe it is imperative that the Authority take any steps necessary to increase stakeholders' confidence that the ridership model's projections are both reasonable and accurate. By handpicking the ridership review group, the chief executive officer may have inadvertently raised concerns about the objectivity of the members. As an alternative, the chief executive officer could have requested that the Legislature appoint the ridership review group members using a process similar to the one it uses to appoint members of the independent peer review panel required by law to assess the Authority's business plans.

Further supporting the need for an independent review is the fact that the ridership review group expressed concerns regarding the model's long-term projections that the Authority has yet to resolve. Specifically, although the ridership review group determined that the ridership model was suitable for use in the 2012 draft business plan, the group presented several long-term concerns, such as potential biases in the survey data Cambridge Systematics used in the model's development. The ridership review group stated

in its August 2011 report on the model that the Authority must address these long-term issues in order for the group to determine whether the model is suitable for future applications. In other words, the report implies that if the Authority does not address these long-term concerns, the model may only be useful to project ridership for the operating section and not the program's remaining sections. The Authority failed to disclose these important concerns in its 2012 draft business plan, and as a result, stakeholders may not be fully informed about the usefulness of the model.

If the Authority does not address these long-term concerns, the model may only be useful to project ridership for the operating section and not the program's remaining sections.

Recommendations

The Authority should fully implement the recommendations we made in our prior audit, which we list in Appendix B.

To add clarification to the first recommendation we made in our prior report that stated, "To ensure that it can respond adequately to funding levels that may vary from its business plan, the Authority should develop and publish alternative funding scenarios that reflect the possibility of reduced or delayed funding from the planned sources. These scenarios should detail the implications of variations in the level or timing of funding on the program and its schedule," the Authority should also present viable alternative funding scenarios for phase one in its entirety that do not assume an increase in the federal funding levels already identified in the 2012 draft business plan. If the Authority does not believe that such alternatives exist, it should publicly disclose this in its 2012 final business plan.

To ensure that the public and the Legislature are aware of the full cost of the program, the Authority should clearly report total costs, including projected operating and maintenance for the program. Additionally, the Authority should clearly disclose that the 2012 draft business plan assumes that the State will only be receiving profits for the first two years of operation in 2022 and 2023, and potentially not again until 2060 in exchange for the almost \$11 billion the Authority assumes it will receive from the private sector over a four-year period.

To assure independence and instill public confidence in the process regarding the Authority's ridership model, the Legislature should draft legislation that establishes an independent ridership review group. For example, the Legislature could use a similar process to the one used to establish the independent peer review panel that the law requires to assess the Authority's business plans.

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Chapter 2

THE HIGH-SPEED RAIL AUTHORITY'S OVERSIGHT OF THE PROGRAM REMAINS WEAK

Chapter Summary

As the state entity charged with implementing California's high-speed rail network (program), the High-Speed Rail Authority (Authority) is responsible for administering and overseeing the program. Nonetheless, in our April 2010 report, we expressed concern that the Authority's processes for monitoring the performance and accountability of its contractors were inadequate, and our current review suggests that these problems persist. Despite the increased cost estimates for the program (as discussed in Chapter 1), the Authority's staffing levels have remained low; as of August 1, 2011, it had fewer than two dozen employees. Without sufficient staffing, the Authority has struggled to oversee its contractors and subcontractors, who outnumber its employees by about 25 to one. The potential problems inherent in this situation are exacerbated by the fact that the Authority has not ensured that all of its contractors and subcontractors disclose potential conflicts of interest.

As a consequence of its staffing shortages, the Authority has ceded significant control over the program to its Program Manager, the primary contractor with whom it works. The Program Manager communicates the program's progress to the Authority through monthly progress reports, yet we found those reports inaccurate and misleading. We also noted a lack of detail in the reports that regional contractors submit to the Program Manager. This lack of detail makes it difficult to confirm that the regional contractors have performed the work for which they are billing the Authority. In addition, although the Authority improved the risk-management section of its 2012 draft business plan, it has failed to take an active role in identifying and mitigating those factors that might delay or halt the program, instead leaving this responsibility to the Program Manager.

We also noted additional areas of concern in the Authority's administration of the program. Specifically, the Authority has poorly managed its information technology (IT) contracts, resulting in at least one instance in which it failed to follow the policies outlined in the *State Contracting Manual*. In addition, it continues to lack a mechanism for tracking its Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century (Proposition 1A) bond expenditures.

The Authority has struggled to fill positions and has experienced a persistent gap between its filled and authorized positions from June 2010 to August 2011.

The Authority's Profound Staffing Shortages Have Compromised Its Ability to Provide Effective Oversight

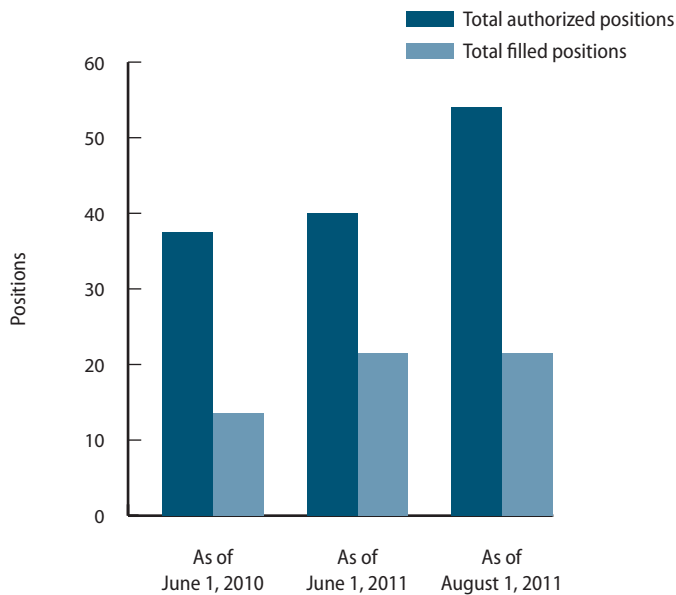
The Authority's current organizational structure places the largest portion of the program's planning, construction, and most importantly, oversight in the hands of contractors who may not have the best interests of the State as their primary motivation. As a result, the Authority lacks assurance that the program is implemented in a way that best serves the public.

According to the Authority's records, as of August 1, 2011, it had only 21.5 filled positions to oversee this statewide multibillion-dollar program. It had an additional 32.5 authorized positions that it has struggled to fill, which is consistent with the persistent gap that has existed between its filled and authorized positions from June 2010 to August 2011, as shown in Figure 5. According to the chief deputy director, a multitude of factors have contributed to this gap. He explained that both the prior and current administrations implemented hiring freezes. To attempt to fill some of the positions that were subject to the hiring freeze, the Authority submitted freeze exemption requests for 30 positions between April 2011 and August 2011 and received approval for 17 positions. Further, according to the chief deputy director, the most recent hiring freeze was not lifted until September 2011 and the Authority did not have a full-time human resources staff member to focus on the hiring process until July 2011. Since that time, the Authority has advertised for 23 of its vacant authorized positions, and according to the chief deputy director, processed over 550 applications and filled 10 positions. Finally, the chief deputy director stated that positions have been difficult to fill as candidates have expressed concern about the stability of the program, among other concerns, and thus have been reluctant to accept a position.

The Authority has found it particularly challenging to fill the high-level positions that might provide it with the leadership it needs to oversee a program of this magnitude. The chief deputy director stated that exempt positions have been difficult to fill because the complexity of the program requires highly specialized and qualified staff; thus, the hiring pool is limited. In fact, the Authority has yet to fill six of its exempt positions. According to the chief deputy director, the private sector generally pays employees higher salaries than the public sector, and qualified candidates may not be willing to accept a decrease in salary. As an example of the salary disparity, according to the chief deputy director, the Authority has budgeted \$98,500 annually for its chief financial officer position; however, according to the salary statistics maintained by the Bureau of Labor Statistics, a similar position in the private sector would receive about \$205,000 annually. In another example, the Program Manager estimated that it could

pay between \$177,000 and \$250,000 annually for a chief program director’s position, while the Authority is currently budgeted to pay \$98,500 for the same position. According to the chief deputy director, although the Authority has some flexibility to pay its exempt positions up to \$217,000, this is not the norm and the Authority is not able to do so in all circumstances due to budget restrictions. Nonetheless, to effectively oversee and manage this program, the Authority needs to make every effort to fill its vacant positions or it risks continuing to have to rely on contractors to perform the functions that it should perform.

Figure 5
The High-Speed Rail Authority’s Authorized and Filled Positions



Source: The High-Speed Rail Authority’s staffing reports.

In contrast to the Authority’s 21.5 filled positions, according to documentation provided by the Authority, the Program Manager, oversight consultant, and regional contractors employed a total of approximately 545 full-time equivalents during fiscal year 2010–11—about a 25-to-one ratio of consultants to state employees. We believe that this relatively low number of staff compared to consultants may have far-reaching consequences for the Authority’s ability to effectively oversee the program. For example, as we describe later in this chapter, because of the Authority’s lack of staff, it is not sufficiently involved in the program’s risk-management process.

Several entities tasked with reviewing the Authority's practices have raised concerns about its heavy reliance on contractors and the increased risks that such reliance poses to the State.

The Authority acknowledges in its 2012 draft business plan that it might not have the number of experienced staff necessary to meet the demands of the program from an internal management perspective. In the plan, the Authority further explains that without the additional staff to manage the financial, funding, procurement, legal, and risk functions associated with the program, it may not be able to adequately perform work related to these roles. The Authority also states that it recognizes the need to build up its management and support teams because consultants should not establish strategy and make management decisions on behalf of the State. However, given that consultants significantly outnumber Authority staff and are directly involved in the day-to-day operations of the program, we question how they could not be establishing strategies and making management decisions.

Several other entities tasked with reviewing the Authority's practices have raised concerns about its heavy reliance on contractors and the increased risks that such reliance poses to the State. Specifically, in May 2011 the Legislative Analyst's Office questioned whether the current number of state employees at the Authority could effectively manage such a large team of contractors. Further, the independent peer review panel that state law established to review the Authority's plans stated in a May 2011 letter to the Authority's chief executive officer that the Authority's staff at that time was not at all adequate for the job at hand and that the Authority was only going to fall further and further behind, especially after construction began. The panel also stated that the Authority could not rectify the problem by hiring more contractors because state leadership and state oversight are paramount to the success of the program.

Finally, the Authority is not maximizing the value of its contractors because it uses their staff to perform duties that state employees could perform. In fact, we reviewed three of the oversight consultant's recent invoices and found that nearly half of its charges were related to its staff performing supplemental support services at the Authority's request. For example, one of the oversight consultant's transportation engineers worked with staff at the Department of General Services (General Services)—the Authority's accounting contractor—regarding the Authority's internal accounting issues. Because this transportation engineer spent time performing an administrative function, he had less time to spend performing his other functions, including oversight of the Program Manager.

The chief deputy director acknowledged that both the Program Manager and oversight consultant's staff perform work that state employees could perform. He provided an example in which the oversight consultant entered into a subcontract with a temporary

agency for staff to help build the Authority's new expenditure tracking database. He stated that he was not familiar with any workload analyses that the Authority might have performed before his arrival in May 2011 that would have determined which functions contractors were currently performing that state employees could perform or whether the 54 positions that the Legislature has currently authorized the Authority to fill will be adequate. He explained that once the Authority fills all its vacant positions, it will evaluate contractors' staff activities to determine whether state employees can perform the same functions. He also acknowledged that replacing contracted employees with state employees could result in significant savings to the State in many instances. Until the Authority can determine the number and type of staff it needs to meet its current workload, it risks compromising its contractors' efficiency and productivity.

The Authority Did Not Ensure That Its Contractors and Subcontractors Disclosed Potential Conflicts of Interest

The Authority has failed to ensure that it and the public are aware of the potential conflicts of interest of its contractors and subcontractors. The Political Reform Act of 1974 (political reform act) requires specified state and local officials and employees with decision-making authority to file with its designated filing officer statements of economic interests that identify any financial interests that these individuals might have. The political reform act also requires that every agency adopt a conflict-of-interest code that specifies any additional individuals who are required to file statements of economic interests. Although the Authority's conflict-of-interest code specifically states that contractors must provide statements of economic interest, we found that six out of 58 contractors failed to do so for the filing period covering 2010. After we notified Authority staff that six statements were missing, they located one of the six; however, the Authority's failure to accurately track and collect these statements of economic interests is troubling for several reasons. When designated individuals do not file statements of economic interests, the public may not be aware of potential conflicts. In addition, if the Authority cannot identify potential conflicts, it increases the risk that it will make ill-informed decisions that leave it open to criticism.

When we asked the Authority how it ensures that it meets the requirements of the political reform act, such as ensuring that employees and contractors submit statements of economic interests, we found that the Authority has no written policies and procedures regarding collecting or tracking the statements of economic interests; this likely contributed to its inconsistent tracking of these statements. For example, when the Authority

Although the Authority's conflict-of-interest code specifically states that contractors must provide statements of economic interest, we found that six out of 58 contractors failed to do so for the filing period covering 2010.

By not effectively tracking and collecting the statements of economic interests, the Authority may be unaware of potential conflicts of interest.

provided the spreadsheet it asserted it uses to track filings of statements of economic interests, we noted that the spreadsheet had only been used sporadically for the filing period covering 2010 and did not include all of the designated employees and contractors required to file such statements of economic interests. By not effectively tracking and collecting the statements of economic interests, the Authority may be unaware of potential conflicts of interest. For example, one board member disclosed on his statement of economic interests that he was a consultant for Parsons Transportation Company—the regional contractor responsible for the San Jose-to-Merced portion of the program—and was paid between \$10,000 and \$100,000 annually. Although this board member appropriately reported this economic interest, if he were to take part in a decision involving the Authority and Parsons Transportation Company while he had this financial interest, and if certain other conditions were met, he could be in violation of the political reform act, which bars public officials from using their positions to influence government decisions in which they have a financial interest.

Further, although the Authority's conflict-of-interest code does not address the issue of subcontractors filing statements of economic interests, the Authority's contract with the Program Manager specifically requires all of its subcontractors to follow the Authority's conflict-of-interest code. However, the Authority has not required or collected statements of economic interests from any of the Program Manager's subcontractors, including Cambridge Systematics, the company that performed the ridership projections for the Authority's 2012 draft business plan. As a result, the Authority has no way to verify whether subcontractors have real or perceived conflicts of interest. Further, the political reform act requires agencies to amend their conflict-of-interest codes whenever significant changes to those agencies occur, yet we found the Authority has not updated its conflict-of-interest code since 2001. Although the Authority finally amended its conflict-of-interest code in 2010, the Fair Political Practices Commission has not yet approved it, which is required to make the amended code effective. This is particularly problematic because the Authority changed significantly as a result of the passage of Proposition 1A in 2008. For example, between fiscal years 2000–01 and 2006–07, the Authority operated with only three to five staff members, but as mentioned previously, as of August 1, 2011, it employed 21.5.

By Relinquishing Significant Control to the Program Manager, the Authority May Be Jeopardizing Its Ability to Make Informed, Thoughtful Decisions

In part because of the staffing shortages that we discussed earlier in this chapter, the Authority has relinquished a significant amount of control to the Program Manager. As a result, the Authority may not be receiving the information it needs to make thoughtful decisions about the program's future. Specifically, the Authority relies on the Program Manager to provide accurate, consistent, and useful information in its monthly progress reports. However, we found that these reports were often inaccurate and that at times the Program Manager misinformed the Authority about the speed with which contractors for each region—called *regional contractors*—performed tasks. In addition, the Authority assumes that the Program Manager ensures the accuracy of the regional contractors' reports, yet the Program Manager has not consistently done so. Finally, the Authority depends on the Program Manager to effectively identify and manage all of the risks related to the program. Consequently, the Authority may not be aware of or have addressed areas of significant concern that could impact the program.

The Program Manager's Monthly Progress Reports Lack Usefulness Because They Contain Some Inaccurate and Misleading Information

The Authority's contract with the Program Manager requires it to submit to the Authority at least once a month progress reports that are sufficiently detailed for the Authority's chief executive officer to determine, among other things, if the Program Manager and regional contractors are on schedule and have performed to expectations. According to the Program Manager's director, these reports are a valuable tool for the Program Manager to formally manage the program's progress. To create the progress reports, the Program Manager is supposed to compile the status of each regional contractor's current work, scheduled and actual work progress, budgeted and actual costs, and budgeted and actual labor hours. The Program Manager is to also include any critical issues that the regional contractors have identified that might affect the program's progress and any remediation measures the contractors have taken to address such areas of concern. After consolidating this information, the Program Manager adds a summary of its own activities and submits the report to the Authority.

In our April 2010 audit we noted problems involving the accuracy and consistency of these reports. During our follow-up audit, we determined that these problems persist. Specifically, we

We found over 50 errors and inconsistencies of various types in three of the Program Manager's monthly progress reports we reviewed.

found over 50 errors and inconsistencies of various types in three of the Program Manager's monthly progress reports we reviewed—December 2010, June 2011, and July 2011. Additionally, we chose progress reports for three regional contractors from June 2011 and used them to compare to the information included in the June 2011 Program Manager's monthly progress reports. Some of the errors were fairly minor and involved issues such as transpositions and typos; however, we also found several significant discrepancies between the regional contractors' reports and those of the Program Manager. In some cases, the Program Manager altered dates to make it appear that the regional contractors would perform work either more or less quickly than they estimated they could in their progress reports. Specifically, we found that the Program Manager had changed completion dates and the progress status of important environmental milestones from those reported by the respective regional contractors. For example, a regional contractor listed the delivery date of a particular task as December 2010 and the Program Manager listed the date as September 2010. In another example, we traced one critical environmental task for the Merced-to-Fresno portion of the construction section—preparation of final environmental impact studies—and found that the Program Manager had changed the regional contractor's estimated milestones 30 times—18 date changes and 12 percentage-of-progress changes—between July 2010 and August 2011. Of the 12 percentages the Program Manager changed, three made it appear that the regional contractor had completed more than it reported and nine made it appear that the regional contractor completed less than it reported in its progress report.

When we asked the Authority's chief executive officer about these changes, he stated that while he discusses these types of changes with the Program Manager and there are some valid reasons that the Program Manager's reported information might not correspond to the regional contractors' reports, this should not be the norm. Nevertheless, the number and frequency of the changes that we noted suggest that the Program Manager misinformed the Authority about the actual status and progress of the construction section. When we asked the Program Manager's operations manager about the inconsistencies in dates, he stated that the Program Manager may purposefully include a date in its monthly progress report that does not match the regional contractor's date because the Program Manager maintains its own schedule as to when certain tasks and duties must be completed. He also stated that sometimes the regional contractors do not agree with the target dates the Program Manager has established in conjunction with the Authority and that this may be a reason that the regional contractors reported different dates. The Authority's chief deputy director stated that the Authority currently has no process in place to compare the Program Manager's reports for accuracy against

the regional contractors' reports and conceded that this procedural gap is a potential problem because the Authority may not be fully informed about possible delays.

We also found that the Program Manager's progress reports lack usefulness because they are not always complete. For example, in response to a recommendation in our prior report, the Authority stated that the Program Manager revised its progress report format to ensure that its reports accurately reflect the program's status. Specifically, the Program Manager had begun including in its monthly progress reports a list summarizing the status of all of its promised goods and services—in other words, its deliverables. However, we found that the Program Manager has not consistently included this list in its reports. For fiscal year 2010–11, the Program Manager only included deliverables status reports for five of the 12 months. As a result, the Authority was not kept consistently informed of the status of the Program Manager's deliverables.

Finally, the Program Manager often submits its reports late, thus making their content less useful to the Authority because the information may be outdated. According to the Program Manager's guidelines, once it receives the regional contractors' monthly reports, it must submit its progress report between the 20th and 22nd of the following month. Our review of the reports for August 2010 through September 2011 found that the Program Manager submitted all of its progress reports late. The reports were late by an average of 13 days, resulting in the Authority receiving them an average of more than 34 days after the last day of the previous month. The fact that we found the progress reports to be inaccurate and frequently misleading combined with such delays, limits the usefulness of the information the Program Manager submits to the Authority.

Despite the critical nature of the Program Manager's progress reports, the Authority has not effectively ensured their accuracy, consistency, and timeliness. To address the deficiencies we found in our previous audit, we recommended that the Authority engage its oversight consultant to perform a critical review of the progress reports for accuracy and consistency. Soon after our audit, the Authority followed our recommendation and amended the oversight consultant's scope of work to include performing reviews of the progress reports and summarizing its findings in monthly memos. However, in December 2011 the Authority's chief executive officer stated that he had reconsidered the value of the oversight consultant performing these monthly reviews and decided to instead have the oversight consultant concentrate on monitoring the formal progress the Program Manager achieved each quarter. We are very concerned by this decision because in our review of the oversight consultant's memos—covering issues

In our review of the reports for August 2010 through September 2011, we found that the Program Manager submitted all progress reports late—the Authority received them an average of more than 34 days after the last day of the previous month.

such as budget and schedule—from May 2010 through June 2011, we found that the Program Manager did not address some of the oversight consultant's concerns, even though the memos raised the same issues month after month. For example, in 11 of the 14 memos we reviewed, the oversight consultant cited the Program Manager's lack of explanation for variations in the budget or schedule.

The chief executive officer's decision regarding the oversight consultant's role is of further concern because it may deprive the Authority's operations committee (operations committee) of valuable information regarding the program's progress and the Program Manager's performance. Even prior to the chief executive officer's decision, we noted significant problems in the oversight consultant's communication with the operations committee. Although the oversight consultant made quarterly presentations to the operations committee, we found that it did not present to the committee all of the key issues it identified in its memos regarding the Program Manager's progress reports. For example, in its May 2011 memo, the oversight consultant mentioned for the third month in a row that the Program Manager continued to omit a key detail from its monthly progress report. However, the oversight consultant did not present this information to the operations committee. In addition, the oversight consultant did not present detailed comments about the Program Manager's reporting practices or failure to correct issues the oversight consultant identified as needing to be addressed.

Although the oversight consultant also submitted quarterly reports to the operations committee in addition to its oral presentation, it did not include all the errors it found in the Program Manager's monthly progress reports or mention the Program Manager's failure to follow the recommendations the oversight consultant made in its previous monthly memos. Therefore, even before this decision, the oversight consultant did not fully inform the operations committee about potentially important issues related to the program and its progress and about aspects of the Program Manager's performance. In light of the chief executive officer's decision, the operations committee risks having even less information because the oversight consultant will no longer prepare memos to serve as a written record of its critical review.

If the Authority staff cannot ensure that its key means for monitoring the program provides accurate and consistent information, it may not have the information it needs to make well-informed and thoughtful decisions about the future of the program.

If the Authority staff cannot ensure that its key means for monitoring the program provides accurate and consistent information, it may not have the information it needs to make well-informed and thoughtful decisions about the future of the program. The Program Manager's failure to consistently provide complete, timely, and accurate monthly progress reports has compromised the quality of the information the Authority relies on.

The Program Manager Did Not Appropriately Identify Differences Between the Regional Contractors' Monthly Progress Reports When Approving Their Corresponding Invoices

In our prior audit, we concluded that the Authority had not implemented effective controls over invoice processing, and in some cases it had paid for work that was not part of its contracts or work plans. In response to our recommendation to strengthen its controls, the Authority amended its *Contract Administration Manual* (contract manual) to include detailed procedures for both Authority staff and the Program Manager to follow when reviewing, verifying, and approving invoices. One of those procedures requires review and written approval from the Program Manager that the regional contractors have performed the work specified in their invoices before Authority staff can approve payment. Our review of 10 monthly invoices the Authority received from regional contractors indicated that the Authority had followed its new procedures by performing a detailed review and by not processing the invoices until after it received the Program Manager's confirmation indicating its review and approval of each invoice.

The contract manual also requires the Program Manager to ensure the work billed by the regional contractors matches the work they performed. We therefore expected that the monthly progress reports the regional contractors submitted would provide sufficient detail to support the charges included in their corresponding monthly invoices; however, this was not always the case. In fact, in three instances, we noted that the Program Manager had approved invoices from regional contractors even though the corresponding regional progress reports indicated the contractors had performed no work in the billed areas during those periods. For example, the Program Manager approved an invoice for roughly \$280,000 by stating that the expenses fairly represented the work the contractor performed during December 2010. However, the invoice included nearly \$12,000 for right-of-way preservation and acquisition services even though the regional contractor reported in its December 2010 progress report that it had not performed any work in this area. According to the Program Manager, the contractor performed this work during the period of November 16 through December 15. While we confirmed that the regional contractor had included this work in its November 2010 progress report, it should have also been included in the December 2010 report; however, the Program Manager did not identify this inconsistency.

The employee of the Program Manager who reviews the regional contractors' invoices explained that he bases his determination that the expenses invoiced fairly represent the work performed on several factors besides the monthly progress reports. In particular, he explained that his daily contact with the regional contractors

The Program Manager had approved some invoices from regional contractors even though the corresponding progress reports indicated the contractors had not performed work in the billed areas during those periods.

allows him to understand the detail of the work being performed while the progress reports indicate a higher-level description of the activities performed. He told us that greater detail should be, and will be, provided in future progress reports to ensure better linkage between the work accomplished and invoices. Without accurate or sufficiently detailed monthly regional progress reports and invoices, the Authority may be misinformed about the status of the program or whether contractors have actually performed the work for which they have billed the Authority.

The Authority Has Not Been Actively Engaged in the Process of Identifying and Mitigating the Many Risks Confronting the Program

In our prior report, we concluded that the Authority's 2009 business plan identified a number of risks associated with the program but provided little detail on how the Authority would manage those risks. During our follow-up review, we found that although the Authority improved the risk section of the 2012 draft business plan by including risk mitigation and allocation strategies as well as a risk-management plan and processes, significant weaknesses remain. Most importantly, the Authority continues to be only minimally involved in the risk-management process and instead relies almost completely on its Program Manager to both identify and mitigate risks.

According to the chief deputy director, the Program Manager is currently more engaged than the Authority in risk management because the Authority has not been able to hire a risk manager. In response to our prior audit report's recommendation that it implement planned actions relating to managing risk, the Authority stated that on July 7, 2010, the Legislature approved a request for an additional management position for the Authority—designated as a deputy director, risk management. The Authority is currently advertising for this position and, according to the chief deputy director, had received six applications and interviewed two candidates as of November 2011 but has been unable to fill the position because finding a candidate with the right level of experience who has compatible salary expectations has been difficult.

In the absence of an individual to fill the position for the risk manager, the Authority has done little to ensure that it is aware of and actively engaged in mitigating the risks confronting the program.

In the absence of an individual to fill this position, the Authority has done little to ensure that it is aware of and actively engaged in mitigating the risks confronting the program. The 2012 draft business plan states that the Authority will regularly attend the risk workshops conducted by the Program Manager to assess identified risks and develop mitigation strategies and management plans. However, according to the Program Manager's risk manager and the Authority's chief deputy director, no Authority representative

attends the risk-management meetings or workshops the Program Manager holds. Instead, the Program Manager provides a high-level summary of risk issues to the Authority through its monthly progress reports and, according to the Authority's chief deputy director, during regular meetings between the Authority's chief executive officer and the Program Manager's project manager. Because the Program Manager generally handles the risk identification and management process exclusively, it could potentially filter critical information regarding risks to the program's progress from the information it ultimately shares with the Authority.

Moreover, although we acknowledged in our prior report that the Authority had taken steps toward improving its risk-management approach by having the Program Manager complete a major revision to its risk-management process in March of 2010, we found that its current risk-management plan is incomplete, does not fully reflect the Program Manager's risk-management practices, and does not adequately identify the Authority's role in addressing risk. For example, the plan does not define the roles of any Authority staff in assessing or managing risks but instead states that addressing these risks is the responsibility of a team composed solely of the Program Manager's staff and regional contractors. Further, the plan is missing a number of details related to issues like the Program Manager's risk-mitigation approach. According to the Program Manager's risk manager, the Program Manager is working on an update to the March 2010 version of the risk-management plan; the Program Manager's operations manager was reviewing this update as of December 2011.

In our review of the Program Manager's risk registers for July through October 2011, we also found several causes of concern. Specifically, the Program Manager has not followed its practices or those in the risk-management plan. We identified numerous action items that were past due, instances where no one was designated as responsible for addressing a risk, and delays in addressing newly identified risks. For example, the Program Manager identified the absence of a finalized agreement with Union Pacific Railroad (Union Pacific) as a very high risk. When we asked the Program Manager's risk manager about this issue, he explained that areas of the program may be affected by Union Pacific or are dependent on having at least temporary access to Union Pacific's right of way. He stated that the Authority has had to make certain assumptions about what, how, and where it will build based on what it believes Union Pacific will agree to; if Union Pacific does not agree, it may impact the program's cost and schedule. In the risk register, the Program Manager has identified several actions that it and the Authority must take to mitigate this risk; however, the Authority and the Program Manager are more than a year late in completing

The Authority's current risk-management plan is incomplete, does not fully reflect the Program Manager's risk-management practices, and does not adequately identify the Authority's role in addressing risk.

By relying almost entirely on the Program Manager for information about risks to the program's progress, the Authority may not respond effectively to circumstances that could significantly delay or even halt the program.

these actions. The Program Manager's risk manager attributes these delays, in part, to the Authority's absence of staff devoted to risk management. These deficiencies indicate that the Authority and Program Manager are not consistently addressing risks to the program promptly and effectively.

While the oversight consultant does some monitoring of the risk-management process, its role in this area is limited per its scope of work. According to the oversight consultant's senior vice president, in January 2010 the oversight consultant began working with the Program Manager to develop and establish its risk-management practices, including developing risk registers. However, the senior vice president acknowledged that he was neither aware of nor involved in the Program Manager's revisions to the March 2010 risk-management plan. Further, the oversight consultant does not attend risk meetings and workshops. Therefore, the oversight consultant does not comprehensively monitor the Program Manager's risk-management practices, nor does the oversight consultant's work plan require it to do so.

By relying almost entirely on the Program Manager for information about risks to the program's progress, the Authority has failed to ensure that it can respond effectively to circumstances that could significantly delay or even halt the program. Further, without its own risk manager, the Authority lacks objective insights into the risks that could threaten the program.

The Authority Poorly Managed Its IT Contracts

The primary role of the Authority in administering the program involves managing contracts. Nonetheless, during the course of our work, we discovered that the Authority had engaged in inappropriate contracting practices involving IT services. The nature of the problems we discovered suggests that the Authority needs to significantly improve its internal controls to ensure that it manages its contracts in ways that comply with state laws.

The Authority may not be promoting open, fair, and equal competition among prospective suppliers for its IT services and, as a result, it cannot ensure the State is getting the best value for these services. In particular, the Authority split its IT services into multiple contracts when it renewed its IT services beginning in March 2010 and then in May 2011.⁵ The *State Contracting Manual* prohibits agencies from splitting contracts to avoid competitive

⁵ The most recent renewal of IT services includes contracts covering the period from June 2011 through June 2013.

bidding requirements and purchasing thresholds for any series of related services that would normally be combined and bid as one job. Nonetheless, in addition to the initial contract, the Authority used 13 individual contracts for IT services over a roughly 15-month period that ranged from \$105,655 to \$249,999.99 for similar services with one vendor, as shown in Table 3 on the following page. Instead of executing multiple contracts generally having aggregate values of just under \$250,000 with one vendor for similar services, the Authority should have combined the services into one contract and solicited competitive bids or obtained approval to noncompetitively bid the contract.

The Authority also failed to satisfy a statutory requirement to obtain two price quotations when using the small business/disabled veteran business enterprise option. According to state law, a state agency may award a contract for IT services that has an estimated value of less than \$250,000 to a certified small business or to a disabled veteran business enterprise, as long as the agency obtains price quotations from two or more businesses of this type. As shown in Table 3, in addition to the initial contract, the Authority entered into four contracts for IT services during 2010 and another three contracts for IT services in February 2011. According to the documentation provided by the Authority, each of these contracts was awarded using the small business/disabled veteran business enterprise option. As such, state law required the Authority to obtain at least two price quotations from other small business/disabled veteran business enterprises, which it failed to do. According to an analyst within the Authority's contracts and finance unit, four of the contracts were extensions of a prior contract with the supplier. She explained that the Authority did not obtain two price quotations from other suppliers because a General Services' contract manager stated it was unnecessary since the cost was below the \$250,000 threshold and the supplier was a small business/disabled veteran business enterprise. However, the Authority could not provide compelling evidence that the four contracts were extensions of prior contracts, nor could it provide support for the statements from General Services' contract manager.

Regardless, the Authority failed to comply with state law by not obtaining at least two price quotations from other small businesses or disabled veteran business enterprises. Further, according to the analyst within the Authority's contracts and finance unit, two of the remaining contracts were related to proprietary software. Although the *State Contracting Manual* allows departments to noncompetitively bid a purchase of proprietary software by requiring that they obtain a signed letter from the supplier stating that the product or service being provided is not available from any other source, the Authority could provide no such evidence that

In addition to the initial contract, the Authority used 13 noncompetitively bid individual contracts for IT services over a roughly 15-month period that ranged from \$105,655 to \$249,999.99 for similar services with one vendor.

these letters were obtained. Finally, the Authority entered into the third contract in early 2011 for the relocation of office headquarters, but did not provide an explanation for why it did not obtain two price quotations for the relocation services.

Table 3
The High-Speed Rail Authority's Past and Current Information Technology Contracts

CONTRACTED SERVICES	AMOUNT	SUPPLIER	DATE AUTHORIZED	CONTRACT START DATE	CONTRACT END DATE
Initial Contract -Information technology (IT) services and consulting	\$406,041.25	Paperless Knowledge	December 16, 2008	December 16, 2008	June 30, 2010
Past Contracts					
IT technology consulting services	249,999.99	Paperless Knowledge	March 15, 2010	March 15, 2010	June 30, 2011
IT maintenance and technical services	249,999.99	Paperless Knowledge	March 15, 2010	March 26, 2010	June 30, 2011
Monthly IT expenditures, including one-time database set up and training	105,655.00	Paperless Knowledge	June 1, 2010	June 1, 2010	Not Specified
IT maintenance and technical services	249,999.99	Paperless Knowledge	February 15, 2011	February 15, 2011	June, 30 2011
Relocation of office headquarters	249,999.99	Paperless Knowledge	February 15, 2011	February 15, 2011	End of Relocation
IT technology consulting services	249,999.99	Paperless Knowledge	February 15, 2011	February 15, 2011	June 30, 2011
Current Contracts					
Development electronic document management solution	249,999.99	Paperless Knowledge	May 3, 2010	June 1, 2010	May 31, 2012
Operate the High-Speed Rail Authority (Authority) IT intranet	249,600.00	Paperless Knowledge	May 18, 2011	June 28, 2011	June 28, 2013
Host the Authority IT servers	249,270.00	Paperless Knowledge	May 18, 2011	June 28, 2011	June 28, 2013
All IT maintenance and technical services desktop for the authority	245,440.00	Paperless Knowledge	May 18, 2011	June 28, 2011	June 28, 2013
IT Web maintenance	245,440.00	Paperless Knowledge	May 18, 2011	June 28, 2011	June 28, 2013
IT database administration	243,360.00	Paperless Knowledge	May 18, 2011	June 28, 2011	June 28, 2013
IT network administration	249,600.00	Paperless Knowledge	May 18, 2011	June 28, 2011	June 28, 2013
Total IT contracts, excluding the initial contract	\$3,088,364.94				

Source: The Authority's past and current IT services contracts.

General Services allowed the Authority to noncompetitively bid the six IT services contracts authorized in May 2011 rather than working with the Authority to ensure that competitive bidding requirements were satisfied. Near the end of March 2011, three months before some of its IT contracts were set to expire, the

Authority submitted six requests to General Services to contract with one IT service provider without soliciting competitive bids for IT services. On May 31, 2011, General Services approved the Authority's six requests and cited the rationale supporting its decision to authorize the Authority to contract with the IT service provider. According to the chief procurement officer at General Services, the IT supplier was the only supplier that could meet the needs of the Authority given its time constraints and lack of staffing. He further stated that had the request not been granted, the Authority's previous contracts with the supplier would have lapsed and the Authority's IT systems would have risked being shut down. However, based on our review of the relevant documents, we disagree with this approach. Although General Services helps to better serve the public by providing a variety of services to state agencies through innovative procurement and acquisition solutions, in this circumstance, we believe General Services could have done more to assist the Authority. Given the time constraints and lack of staffing at the Authority, we believe it would have been more appropriate for General Services to have approved a noncompetitive bid contract for an additional six-month period. During that six months, General Services could have worked directly with staff at the Authority to use a competitive bidding process for future IT services.

As indicated in Table 3, the Authority entered into multiple contracts for similar IT services, each with the same service provider. When we expressed our concern to the chief procurement officer at General Services that the Authority appeared to be splitting these contracts to avoid the purchasing thresholds that would have required using the competitive bidding process, the chief procurement officer stated that the six contracts did not constitute contract splitting. He told us our concerns were unfounded because these were separate and distinct services. Additionally, he explained that there are also certain advantages to separating contracts, such as being able to terminate services more easily than in large contracts. However, we believe that the Authority was attempting to split the contracts. Based on our review of the contracts, the services do not all appear to be separate and distinct. Additionally, we would expect that the provisions within a contract would provide the circumstances for terminating it and that its size would not dictate the ease with which such a contract could be terminated.

Even though the Authority eventually received approval to noncompetitively award its six contracts for IT services to the same provider, thus relieving it of the duty to at least obtain two bids, the Authority entered into these contracts before it received approval from General Services and it agreed to terms longer than were approved by General Services. On May 18, 2011,

We believe that the Authority was attempting to split the contracts because the services do not all appear to be separate and distinct.

the Authority's chief executive officer signed six purchase orders with the same IT service provider even though it had not yet obtained General Services' approval. Nearly two weeks after the Authority signed the six contracts, the chief procurement officer with General Services made a one-time exception to approve the requests with the requirement that the Authority use a competitive procurement process to acquire those same IT services within 12 months following General Services' approval. Despite this one-year stipulation as the term for each of the six contracts, all the Authority's IT contracts are for a two-year period. When we informed General Services, its chief procurement officer told us the contracts would be void after one year because General Services only approved the noncompetitive bid requests for one year. Although the Authority provided a draft of its request for proposal for IT services, because six months have already elapsed on the terms for these contracts, we question whether it can acquire IT services by General Services' one-year deadline.

The Authority Lacks a System to Track Bond Fund Expenditures

In our April 2010 report, we concluded that the Authority did not have a system in place to track expenditures funded by Proposition 1A that would ensure compliance with statutory limitations on administrative and preconstruction task costs. During our follow-up review, we found that although the Authority has made some improvements in its process, it still has not completed its expenditure-tracking system.

As noted in the Introduction, the Authority can use only 2.5 percent (\$225 million) of its portion of Proposition 1A bond funds for administration (the Legislature can increase this up to 5 percent) and only 10 percent (\$900 million) for preconstruction tasks. We previously reported that until the Authority had an expenditure-tracking system in place, it cannot accurately report on its expenditures in each category, cannot create an accurate long-term spending plan, and risks not knowing when or whether it has run out of bond funds available for administration or preconstruction task costs. In our prior report, we also explained that this was of particular concern because at that time the Authority anticipated spending about \$168 million in bond proceeds by the end of fiscal year 2009–10, and the proposed 2010–11 Governor's Budget estimated spending an additional \$583 million on the program, for a total of about \$751 million. We cautioned that if these amounts were all spent on administration and preconstruction task costs, the Authority would use about two-thirds of all the money authorized by Proposition 1A for these cost categories. However, during our follow-up review, we noted that the Authority received a smaller appropriation

Although the Authority has made some improvements in its process, it still has not completed its expenditure-tracking system as noted in our April 2010 report.

for fiscal year 2010–11 and, as of June 30, 2011, ultimately spent \$237 million, or 21 percent, of all the money authorized by Proposition 1A for administration and preconstruction—substantially less than what we previously estimated in our April 2010 report.

According to the chief deputy director, the Authority had been developing a system to track its expenditures but it halted further development in November 2011 because of current staff vacancies as well as a lack of clarity as to how to categorize its program costs. He stated that although the Authority does not currently have clearly documented definitions of how expenditures should be classified by cost category, such as administration and preconstruction tasks, it is working to develop a process and database to track its expenditures. Despite the lack of a system, we observed that the Authority is making attempts to categorize its expenditures. Specifically, the Authority worked with the Program Manager and the oversight consultant to develop a rough draft of a forecasted spending plan through June 30, 2018, that shows how expenditures would be categorized. Nevertheless, without an expenditure-tracking system in place, the concerns we raised in our previous report persist, including that the Authority risks not being able to create an accurate long-term spending plan.

Without an expenditure-tracking system in place, the Authority risks not being able to create an accurate long-term spending plan.

The Authority Has Not Determined Whether the Independent Peer Review Panel Is Subject to the Bagley-Keene Open Meeting Act

As mentioned in the Introduction, state law required the Authority to establish an independent peer review panel to perform a variety of review-related tasks, including assessing the different plans the Authority may develop and reporting its analysis to the Legislature. The Bagley-Keene Open Meeting Act (Meeting Act)⁶ prohibits a majority of members of a state body from discussing, deliberating, or taking action on items of business outside of an open meeting and allows courts to void actions taken by a state body that violates this prohibition. Thus, according to our legal counsel, when the peer review panel analyzes and evaluates the Authority's plans, it must properly announce its meetings and open them to the public. In our earlier report, we recommended that to avert possible legal challenges, the Authority should either ensure that the peer review panel adheres to the Meeting Act or seek a formal opinion from the Office of the Attorney General (attorney general) regarding whether the review panel is subject to this act.

⁶ The Meeting Act establishes open-meeting requirements for every state board, commission, or similar multimember body. It generally requires such bodies to publicly announce their meetings, prepare agendas, accept public testimony, and conduct their meetings in public unless specifically authorized by the Meeting Act to meet in closed session.

Although we made our recommendation nearly two years ago, the Authority did not request a formal opinion until January 5, 2012. At the time of our prior report, the Authority had not sought a formal opinion from the attorney general because it received informal advice from its own former legal counsel, an attorney with the attorney general, stating that the peer review panel was not subject to the Meeting Act. In its six-month and one-year responses to our audit, the Authority stated that it agreed that this topic merited further clarity and that it would continue to work on the issue. Although the Authority sought formal guidance from the attorney general, the results of the opinion are not yet known. Without clarity on whether it is subject to the Meeting Act, the Authority continues to risk having the peer review panel violate state law and potentially having its analyses voided.

Recommendations

The Authority should fully implement the recommendations we made in our prior audit, which we list in Appendix B.

To ensure that it has adequate staff to effectively oversee the program, the Authority should continue to fill its vacant positions. Additionally, the Authority should conduct a workload analysis to determine the total number of staff it needs as well as the functions those staff should perform.

To comply with the political reform act, the Authority should establish written policies and procedures for tracking whether all designated employees and consultants have completed and filed their statements of economic interests on time, thereby identifying any potential conflicts of interest.

To increase transparency and to ensure that it is aware of any financial interest that a subcontractor may have in the program, the Authority should require subcontractors to file statements of economic interest.

To ensure that the Program Manager's monthly progress reports are accurate, consistent, and useful, the Authority should do the following:

- Reinstating the oversight consultant's review of the progress reports. Once it does so, the Authority should hold the Program Manager accountable for implementing the oversight consultant's recommendations. For example, the Authority could withhold partial payment of invoices to the Program Manager until it fully addresses these recommendations.

- Conduct monthly comparisons of the Program Manager's and the regional contractors' progress reports to verify that they are consistent with one another and to ensure that the reports include an accurate status of promised deliverables.

To ensure that the regional contractors' monthly progress reports provide sufficient detail to support the monthly invoices, the Authority should perform a monthly comparison of the regional contractors' invoices with the corresponding progress reports. Specifically, the Authority should ensure that the regional contractors' monthly progress reports describe the work they performed in those areas for which they claimed costs in the corresponding invoices. The Authority should discuss with the Program Manager any areas that lack sufficient detail in the progress reports to make such determinations.

To be aware of and respond effectively to circumstances that could significantly delay or halt the program, the Authority should hire a risk manager as soon as possible. Until then, it should designate and require Authority staff to attend risk-management meetings and workshops. Further, it needs to be involved in the development and implementation of the Program Manager's risk-management plan and ensure that Authority staff have roles and responsibilities defined in the plan, such as identifying and mitigating risks in the risk register. Finally, the Authority should monitor the Program Manager's risk-management practices to ensure that either it or the Program Manager identifies and promptly and appropriately addresses risks.

To effectively manage its contracts, the Authority should do the following:

- Develop procedures to detect and prevent contract splitting.
- Begin awarding contracts with a sufficient amount of lead time.
- Immediately begin the process of soliciting competitive bids for its IT services.

To ensure that the Authority is complying with state contracting rules and is following the guidelines of the *State Contracting Manual*, General Services should conduct a procurement audit of the Authority by January 1, 2013.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the scope section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

Date: January 24, 2012

Staff: Laura G. Boll, Project Manager
Kathleen Klein Fullerton, MPA
Vance W. Cable
Scilla Outcault, MBA

Legal Counsel: Scott A. Baxter, JD

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

Appendix A

SCOPE AND METHODOLOGY

The Bureau of State Audits (bureau) conducted an audit of the High-Speed Rail Authority (Authority) and, in April 2010, publicly reported the results in *High-Speed Rail Authority: It Risks Delays or an Incomplete System Because of Inadequate Planning, Weak Oversight, and Lax Contract Management*, Report 2009-106. Under the bureau's authority to conduct follow-up audits, we examined the Authority and its efforts to implement our recommendations. In addition, the bureau is responsible for conducting audits as directed by statute. Therefore, in accordance with Streets and Highways Code, Section 2704.04 (e), we examined the Authority's expenditure of the bond funds authorized by the Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century (Proposition 1A). Specifically, we set out to do the following:

- Determine whether the Authority has met the requirement in Chapter 38, Statutes of 2011, that it develop and publish alternative funding scenarios that reflect the possibility that the high-speed rail network (program) might receive reduced or delayed funding from the planned sources.
- Review the Authority's funding, business plans, and other documents to assess whether it adequately discussed revenue guarantees, their potential costs, and who would pay for them.
- Determine whether the Authority has implemented its planned actions related to managing risk to ensure that it identifies and addresses circumstances that could significantly delay or halt the program.
- Determine whether the Authority has requested a legal opinion from the Attorney General's Office (attorney general) and assess whether the Authority's peer review group adheres to the Bagley-Keene Open Meeting Act (Meeting Act).⁷
- Evaluate if the Authority tracks expenditures for certain cost categories including administrative and preconstruction tasks and if it has developed a long-term spending plan.

⁷ The Meeting Act establishes open-meeting requirements for every state board, commission, or similar multimember body. It generally requires such bodies to publicly announce their meetings, prepare agendas, accept public testimony, and conduct their meetings in public unless specifically authorized by the act to meet in closed session.

- Determine the Authority's level of participation in the development of its key policy documents, such as its business and strategic plans. Further, assess whether the Authority's board members adhere to policies and procedures regarding communication with contractors.
- Verify that the Authority amended the oversight consultant's work plan to include a critical review of the Program Manager's progress reports for accuracy and consistency. Further, assess the Program Manager's monthly progress reports to ensure that they include information on the status of promised deliverables.
- Determine whether the Authority has implemented and follows procedures for invoice processing and payment control.
- Determine if the Authority adheres to the conditions of its contracts and work plans and that it makes any amendments and modifications to contracts and work plans in writing.

To determine whether the Authority developed and published alternative funding scenarios that reflect the possibility that it could receive reduced or delayed funding from its planned sources as required by Chapter 38, Statutes of 2011, we reviewed the Authority's 2012 draft business plan. We interviewed the Authority's chief deputy director to discuss the business plan and how the Authority developed it. Further, we interviewed the financial consultant who contributed to the financial sections of the business plan. In addition, to assess the operating and maintenance costs of the program, we used the data in the Authority's 2012 draft business plan to estimate these total costs. Similarly, to assess the net operating profit generated from phase one, we used data from the 2012 draft business plan to estimate this total figure. Finally, as it relates to the 2012 draft business plan, we reviewed the ridership model's projections as well as the ridership review group's reports. We also interviewed the Authority's chief executive officer to discuss the ridership model and the ridership review group.

To examine the potential costs of the Authority's planned revenue guarantees and assess who would pay for them, we reviewed the 2012 draft business plan and interviewed the Authority's chief deputy director. To determine whether the Authority has implemented its planned actions related to managing risk, we assessed the Program Manager's risk-management plan as of March 2010 and the risk register on which it identifies and tracks all program risks. Further, to evaluate other risk-management practices associated with the program, we interviewed the Program Manager's risk manager, the oversight consultant's senior vice president, and the Authority's chief deputy director.

To assess whether the Authority implemented our recommendation to either ensure that the independent peer review panel adheres to the Meeting Act or seek a formal opinion from the attorney general regarding whether that group is subject to that act, we reviewed the Authority's responses to our prior audit, interviewed key staff at the Authority, and examined the peer review panel's Web site.

To evaluate whether the Authority established systems to comply with state law and federal grant requirements, we interviewed Authority staff and the chief deputy director of the Authority. The chief deputy director stated that the Authority had placed the development of such systems on hold but that it was developing a draft of a long-term spending plan. During our review of this draft spending plan, we noted the Authority did not include the consultant costs for its Program Manager or any of its oversight consultant's costs as part of the administration category. To verify whether other state entities classify such expenditures in a similar manner, we contacted a chief in the Office of Capital and Finance at the California Department of Transportation (chief). According to the chief, her agency classifies both project management and project oversight costs as part of the capital outlay support program budget and therefore does not classify these costs as administrative expenditures. Thus, we believe the Authority's categorization of its project management and oversight costs appears reasonable. Further, based on interviews with the Authority's interim grant administrator and our review of some federal reports, the Authority appears to be satisfying its federal reporting requirements; however, because the Authority does not have an expenditure-tracking system, as we describe in Chapter 2, we did not verify the accuracy of these reports.

To determine the Authority's level of participation in the development of key policy documents and to assess whether the Authority's board adheres to communication policies and procedures, including those outlining how the board members may communicate with contractors, we reviewed the Authority's policies and procedures. In addition, we interviewed the Authority's chief deputy director, the Program Manager, and the Authority's financial consultant to evaluate whether the Authority has implemented these procedures.

To verify that the Authority amended the oversight consultant's work plan to include a critical review of the Program Manager's monthly progress reports for accuracy and consistency, we reviewed the oversight consultant's annual work plans for fiscal years 2010–11 and 2011–12. Further, to assess whether the Program Manager's progress reports include the status of promised deliverables, we reviewed the available progress reports.

In our prior report, we recommended that the Authority ensure that its written policies and procedures reflect its intended controls over invoice processing, that they offer sufficient detail to guide staff, and that they include steps for documenting staff's compliance with the controls. To assess the Authority's implementation of these recommendations, we reviewed its *Contract Administration Manual* to determine whether it included sufficient controls over invoice processing. Subsequently, to ensure that the Authority's staff adhered to these controls, we examined documentation of its reviews for 10 monthly invoices from regional contractors for fiscal year 2010–11. Specifically, we verified that the Authority had received written notification from the Program Manager that the amounts that the regional contractors had billed were appropriate for the work they performed. Additionally, using the regional contractors' corresponding monthly progress reports, we verified that the regional contractors actually performed work in areas for which they had invoiced amounts to the Authority and that those areas were included in their annual work plans. We also looked at one invoice each from the Program Manager and the oversight consultant and interviewed key staff charged with invoice review to determine whether their procedures and controls seemed reasonable and whether they are being followed.

To evaluate whether the Authority adhered to the conditions of its contracts and work plans and that amendments and modifications were in writing, we examined the two contracts we had previously identified as problematic—one with a regional contractor and one with the Program Manager—to verify whether the Authority had corrected them. In addition, we interviewed the Authority's chief deputy director and reviewed the Authority's proposed change control process, which it has not yet formally implemented.

To ensure the Authority engaged in appropriate contracting practices for its information technology (IT) contracts and adhered to the requirements outlined in the *State Contracting Manual*, we examined the Authority's contracts with its IT supplier, Paperless Knowledge. In addition, we interviewed the Authority's chief deputy director, an analyst within the Authority's contracts and finance unit, as well as the chief procurement officer at the Department of General Services.

To determine the total amount of bond proceeds the Authority has spent, we reviewed and reconciled its accounting records with the accounting records the State Controller's Office maintains. We used the State Treasurer's *Authorized and Outstanding General Obligation Bonds* report as of June 30, 2011, to determine the total amount of bonds issued.

Appendix B

STATUS OF RECOMMENDATIONS

In 2009 the Joint Legislative Audit Committee (audit committee) asked the Bureau of State Audits (bureau) to assess the High-Speed Rail Authority's (Authority) readiness to manage the funds that the Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century had authorized for building the high-speed rail network (program) in California. In April 2010 we issued a report titled *High-Speed Rail Authority: It Risks Delays or an Incomplete System Because of Inadequate Planning, Weak Oversight, and Lax Contract Management*, Report 2009-106. This report concluded that the Authority had not adequately planned for the future development of the program.

In that report, we made 10 recommendations to the Authority. Before our current follow-up audit, we used the information the Authority provided to us in response to our April 2010 audit to assess its implementation of these recommendations. We presented these assessments in our March 2011 report titled *Implementation of State Auditor's Recommendations, Audits Released in January 2009 Through December 2010*, Report 2011-406 (subcommittee report). Table B on the following pages depicts our determinations regarding the Authority's implementation of our recommendations indicated in our subcommittee report as well as our current findings. We concluded that the Authority has fully implemented four recommendations, partially implemented five, and taken no action on one.

Table B
Status of Recommendations

	RECOMMENDATION	BASED ON THE AUTHORITY'S SIX-MONTH RESPONSE AS OF OCTOBER 2010*	THE BUREAU'S RATIONALE FOR ITS DETERMINATION*	THE BUREAU'S CURRENT FINDING(S)	STATUS OF RECOMMENDATION AS OF DECEMBER 2011	RELATED TEXT IN CURRENT REPORT (PAGE #)
1	To ensure that it can respond adequately to funding levels that may vary from its business plan, the High-Speed Rail Authority (Authority) should develop and publish alternative funding scenarios that reflect the possibility of reduced or delayed funding from the planned sources. These scenarios should detail the implications of variations in the level or timing of funding on the high-speed rail network (program) and its schedule.	Pending	The Authority stated that it was in the process of hiring financial consultants to assist it in developing alternative funding scenarios and that it planned to provide a full set of funding scenarios in its one-year response.	The 2012 draft business plan continues to rely extensively on federal funding and does not contain viable alternative funding scenarios.	No Action Taken	15
2	In order to plan adequately for private investment, the Authority should further specify the potential costs of planned revenue guarantees and who would pay for them.	Pending	The Authority stated that it continued to work with financial and legal consultants to address revenue guarantees.	The 2012 draft business plan no longer includes revenue guarantees.	Fully Implemented	15
3	In order to respond effectively to circumstances that could significantly delay or halt the program, the Authority should ensure that it implements planned actions related to managing risk.	Pending	The Authority stated that it planned to hire a risk manager and fill two audit staff positions. However, due to the hiring freeze in place at the time, the Authority had not yet filled the positions.	The 2012 draft business plan contains more detail regarding risk than the 2009 business plan. However, the business plan does not completely address funding delays and, as of December 2011, the Authority has not yet filled the risk manager position.	Partially Implemented	38
4	To avert possible legal challenges, the Authority should ensure that the independent peer review panel adheres to the Bagley-Keene Open Meeting Act or seek a formal opinion from the Office of the Attorney General (attorney general) regarding whether the panel is subject to this act.	Pending	The Authority stated that it was working with legislative contacts to obtain clarification of the law. It asserted that it will obtain adequate clarification in time for the final response.	On January 5, 2012, the Authority sought a formal opinion from the attorney general, but the results of this opinion are not yet known.	Partially Implemented	45
5	To ensure that it does not run out of funds for administrative and preconstruction tasks prematurely, the Authority should track expenditures for these activities and develop a long-term spending plan for them. It also should develop procedures and systems to ensure that it complies with American Recovery and Reinvestment Act of 2009 requirements.	Pending	The Authority stated that it enhanced its computer system for tracking administrative versus project expenditures and that it expected the system enhancements would be online by May 2010. However, the Authority stated it continues to work with the contractor to resolve issues with the system and that it expects full system operability by April 2011.	Although it has developed a draft long-term spending plan, it has not determined how to categorize its expenditures and has not completed its expenditure tracking system.	Partially Implemented	44
6	The Authority should participate in the development of key policy documents, such as its business and strategic plans. Further, Authority members should adhere to their policies and procedures, including those outlining how they may communicate with contractors.	Complete	The Authority added language to its policies and procedures stating that it is responsible for developing key policy documents, including approving the business plan. The Authority also added language to its policies and procedures requiring that its members communicate with contractors through the Authority's chief executive officer.	In spring 2010, the Authority completed a strategic plan, which its board formally adopted. In compliance with its new policies, the Authority was actively involved in creating its 2012 draft business plan.	Fully Implemented	51

RECOMMENDATION	BASED ON THE AUTHORITY'S SIX-MONTH RESPONSE AS OF OCTOBER 2010*	THE BUREAU'S RATIONALE FOR ITS DETERMINATION*	THE BUREAU'S CURRENT FINDING(S)	STATUS OF RECOMMENDATION AS OF DECEMBER 2011	RELATED TEXT IN CURRENT REPORT (PAGE #)
7 In order to ensure that staff receive relevant information on the program's status, the Authority should amend the oversight consultant's work plan to include a critical review of the progress reports for accuracy and consistency. Authority staff should also request that the entity that manages the program (Program Manager) revise its progress reports to include information on the status of contract products and services in relationship to what was promised.	Partially Implemented	The Authority stated that the Program Manager revised its progress reports to ensure that they accurately reflected project status. However, the oversight consultant said that it did not have sufficient information to assess certain analyses in the progress reports. The consultant said that it would prefer to focus on physical deliverables and their actual level of completion.	The oversight consultant's work plan now includes a critical review of the progress reports; however, errors in the reports persist because the Authority does not have a process in place to ensure the problems are addressed. Additionally, the Program Manager does not produce deliverable reports on a timely basis.	Partially Implemented	35
8 To determine if it is paying invoices that accurately reflect work performed, the Authority should ensure that staff adhere to controls for processing invoices. For example, staff should not pay invoices from regional contractors until they receive written notification from the Program Manager that the work billed has been performed, or until they have conducted an independent verification.	Fully Implemented	The Authority asserted that it developed an invoice review, verification, and approval process, which includes approval from both Authority and Program Manager staff.	The Authority does not process payments before it receives written notification from the Program Manager.	Fully Implemented	37
9 To ensure that it does not misuse public funds and can hold contractors accountable, the Authority should adhere to the conditions of its contracts and work plans, and make any amendments and modifications in writing.	Fully Implemented	The Authority amended its contract with the Program Manager to require the use of an audit-adjusted field rate—a discounted overhead rate used when consultants use client facilities. Further, the Authority amended its contract with a regional contractor to include work that was not part of the original contract.	Although the Authority corrected two specific issues we identified in our prior report, it has yet to finalize its change control process.	Partially Implemented	52
10 To better determine if payment controls are implemented, the Authority should ensure that its written policies and procedures reflect intended controls over invoice processing and offer sufficient detail to guide staff. These procedures should include steps for documenting implementation of invoice controls.	Fully Implemented	The Authority amended its contract manual to include detailed procedures for implementation of invoice review and documentation of invoice controls.	The Authority updated its <i>Contract Administration Manual</i> to include invoice processing procedures. Relevant staff are aware of the changes and are adhering to the new process.	Fully Implemented	37

* Our determination was published in our March 2011 report titled: *Implementation of State Auditor's Recommendations, Audits Released in January 2009 Through December 2010* (Report 2011-406).

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(Agency response provided as text only.)

California High-Speed Rail Authority
770 L Street Suite 800
Sacramento, CA 95814

January 11, 2012

Elaine M. Howle*
State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

Attached please find the Authority's response to the Bureau of State Audits report 2011-504, dated January 2012, titled: *High-Speed Rail Authority Follow-Up: Although the Authority Addressed Some of Our Prior Concerns, its Funding Situation Has Become Risky and The Authority's Weak Oversight Persists*,

To ensure full disclosure, I would like you to understand that the task of managing, controlling and oversight of this project remain a huge challenge for the Authority due to a lack of sufficient qualified staff. As the project continues to evolve, the ability to hire additional competent and experienced staff must remain a priority for the Authority and the Governor.

You will notice that the Authority has respectfully pointed out various areas of disagreement concerning comments made in the audit report. These fall mainly into two categories, namely the Draft Business Plan and project reports. Our comments to these two categories are the following: ①

- We believe that the comments on the Draft Business Plan which lead to the conclusion that *"The High Speed Rail's Funding Situation Has Become Increasingly Risky"* are purely speculative and should not form part of an audit response. ②
- Regarding project reporting, we believe the BSA has not understood the role of the Program Management Team [PMT] on this project. The PMT are Program Managers, working together with, and on behalf of the Authority. Therefore during this planning and environmental phase of the program, it is obvious and necessary that the PMT manage and challenge the Regional Consultant's [RC's] reports and inputs. ③

If you have any questions about the actions noted in the response, please contact Chris Ryan, Chief Deputy Director, at 324-1541.

Sincerely,

(Signed by: Thomas Umberg)

Thomas Umberg
Chairman

* California State Auditor's comments begin on page 67.

Note: The Authority also provided us copies of documents relating to the independent peer review panel and the Bagley-Keene Open Meeting Act that we did not include with the Authority's response. These documents are available for inspection at our office during business hours upon request.

Elaine M. Howle
January 11, 2012

(Final)

ATTACHMENT

General Response

BSA Recommendations and Authority Responses

Appendix B

Recommendation: *The Authority should fully implement the recommendations we made in our prior audit, which we list in Appendix B.*

Response: The Authority has taken significant steps in recent months to address the findings reported in the last audit. Specifically, this audit report indicates four of the previous audit findings have been implemented, four findings as partially implemented, one pending implementation and one no action.

Of the four partially implemented findings, two (filling risk manager position and change control process) are being implemented and two (completing expenditure tracking system and discrepancies between the oversight consultant and program manager are reconciled by Authority staff) are being prioritized and implemented to fit within existing staff resources.

- ④ The recommendation indicated as pending relates to a legal interpretation whether of the Legislative Peer Review Group is subject to the Bagley-Keene Act as it relates to the Legislative Peer Review Group and should be changed as having been implemented since and the Authority has requested a formal legal opinion from the Attorney General as recommended in the audit report.

- ① ② Regarding the finding which the Bureau of State Audits (BSA) indicates the Authority has taken no action as it relates to "...presenting viable alternative funding scenarios for Phase One..." the Authority disagrees with this conclusion as it has presented what it believes to be viable funding options throughout the Draft Business Plan.

The Draft Business Plan Continues to Lack Some Key Details Regarding Costs and Revenues

Recommendation: *To ensure the public and the Legislature are aware of the full costs of the program, the Authority should clearly report total costs, including projected maintenance and operations for the program. Additionally, the authority should clearly disclose that the 2012 draft business plan assumes that the State will only be receiving profits for the first two years of operation in 2022 and 2023, and potentially not again until 2060.*

- ⑤ Response: The Draft Business Plan includes projected maintenance and operation costs in Chapters 7 and 8 (between pages 7-3 and 7-5 and again on 8-19 and 8-20) in a table format and illustrates such costs for the period of 2025 to 2060. The tables in the Draft Business Plan do not sum the information as the costs are for illustrative purposes only and would not be borne by the state but would be the responsibility of the concessionaire operating the system. The costs are included for the purpose of being transparent. In addition, the costs associated with maintenance and operation would be offset by revenues associated with the concessionaire commitment agreement associated with operating the high-speed train system. The period of this concession is provided in the Draft Business Plan on page 8-31 and graphically Exhibit 8-27 on the same page and indicates the period from 2022 to 2060.
- ⑥

Operation and maintenance costs are the subject of a detailed discussion in chapter 7 of the Draft Business Plan. Operations and maintenance cost assumptions are described and projections are shown in tables and in line graphs through 2060 in 2010 dollars. The Draft Business Plan also indicates on page 7-1 the support

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document at following link: www.cahighspeedrail.ca.gov/business_plan_reports.aspx. This attachment is part of the Draft Business Plan and provides the detail the auditors appear to be seeking. ⑦

We have also provided tables in Chapter 8 that illustrate revenues, operating and maintenance costs and net operating profits in the same format. Net operating profits are projected under each of the revenue scenarios analyzed (high, medium and low) beginning with IOS operations. The project also illustrates positive net cash flow in each year (net operating profits less amounts required for capital maintenance). The choice of what to do with net cash flows will be made by the State of California as the owner of the system. To date, the intent and direction of the Authority and legislature has been to use net cash flows generated by the project to attract private capital to assist with reducing government funds required to build the system. The Draft Business Plan illustrates how the project's positive cash flows can both cover its operating commitments and contribute to fund capital development. ⑧

The Authority believes that it has been transparent in the presentation of its Draft Business Plan with respect to costs and revenues. The Draft Business Plan has been structured into well-defined chapters and the Authority has clearly described all its assumptions, which it believes are rather conservative but realistic. It went to great extremes to reduce the possibility of confusion with regard to figures as had happened in the past, and in particular as the aspects such as escalation have a large impact on the costs. ⑨

Consistent with standard project financing analysis, the Draft Business Plan assesses the net cash flows that would be generated by the project and estimates the amount of financing that would support. Page 8-32 of the Draft Business Plan discusses the assumptions and a range of discount factors which illustrate that the State could raise a projected \$8.1 billion to \$15.7 billion in funds based on the future cash flows two years after an IOS begins operations. Were the State to commit the future net cash flows of the project to raise capital for the project, such future net cash flows (e.g. net operating profits less capital replacement) would not also be available as a reimbursement to the State. We will review the language in the Draft Business Plan to further clarify that funds from net operating profits cannot be used twice. ⑩

In regards to the statement that "The High-Speed Rail's Funding Situation Has Become Increasingly Risky," we have significant concerns. While the report accurately notes that the Authority has been awarded approximately \$3.5 billion in federal funds, it should also be noted that these funds were secured since the prior audit was conducted in April 2010. Since that time, the Authority signed the following funding / cooperative agreements with the federal governments/FRA: ⑪

FR-HSR-009-10-01	signed 09/22/2010	for \$194,000,000-
Amendment 1	signed 12/22/2010	for \$2,272,176,231-
Amendment 2	signed 08/01/2011	for \$86,380,000-
FR-HSR-0037-11-01	signed 06/17/2011	for \$16,000,000-
FR-HSR-0118-12-01	signed 11/18/2011	for \$928,620,000-

Thus in the past 20 months the Authority has received a total of \$3.5 billion in grant fund commitments from the Federal Railroad Authority for the high-speed rail project in California, while the Transbay Terminal in San Francisco received an additional \$400 million in HSR funding commitments with the FRA.

The report states that "...the Authority has failed to provide sufficient detail on how it intends to obtain those funds and to report alternative funding options if it does not receive them, despite our previous recommendation as well as state law requiring it to do so prior to spending some of its 2011 budget act appropriations." In so stating, the BSA appears to set a standard that is not used for other transportation programs. No project in our experience has fully identified funding sources for the entire project at ⑫

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this stage. Furthermore, the mere existence of a dedicated funding stream is no guarantee that any specific project or program will ultimately be funded. By this metric, Interstate 5 would not have commenced construction, despite the presence of the Highway Trust Fund. Nowhere in the Act is there a requirement that any particular amount of non-state matching funds be committed prior to the initiation of the start of the high-speed rail project.

Moreover, although Proposition 1A requires the Authority in its funding plan request for eligible capital costs on each usable segment to identify all sources of funds to be invested in the usable segment and the anticipated time of receipt of those funds based upon expected commitments, authorizations, agreements, allocations, or other means, it does not require that the usable segment be fully funded prior to the initiation of the start of the usable segment using those eligible capital costs. In fact, Proposition 1A only requires the identification of funds based upon expected commitments or other means.

The Authority has been frank about which commitments have been made and which have not. At this point the commitments are for those funds adequate to construct the Initial Construction Section. Other means beyond the funding for the Initial Construction Section include various funding mechanisms addressed in the Draft Business Plan.

- ⑫ The report ignores the fact that the High Speed Rail project has funding in hand for the Initial Construction Segment, which will have independent utility if constructed. Thus the statement "The Authority has not identified viable alternatives in the event that its planned funding does not materialize" is unclear to us, as the complete phasing concept discussed throughout the Draft Business Plan addresses this issue, and reduces the risk to the state.

- ⑬ Most importantly, the report does not discuss the clear mandate of the Legislature and the people of the State of California pursuant to the provisions in the Act. Under the Act, \$9 billion of bond proceeds were approved to initiate the construction of a high-speed rail system using these state bond monies as matching funds with other private or public funds, including federal funds. Nowhere in the Act is there a requirement that the project must be funded using a "dedicated funding source." Future non-state match funding will be pursued by the CHSRA to progress the project beyond the Initial Construction Section in the Central Valley. Any delay in proceeding with the Initial Construction Section at this time will result in the loss of the existing \$3.5 billion in federal funding and will likely jeopardize the possibility of any future federal funding for a California high-speed rail system.

- ⑭ The report does not assess the risks of not proceeding with the program at this juncture. Those risks include the irretrievable loss of \$3.5 billion of federal funds, the potential elimination of state funds, the impact on regional rail systems of the loss of \$950 million in funding for "interconnectivity" which are tied to progress on the high speed rail development, the inevitable increase in costs of eventual high speed rail connection through California as a result of inflation, population growth, the potential requirement for rework of preliminary engineering and environmental work already completed by the Authority and the loss of economic opportunity and technology development. These risks are present and real and represent lost opportunity of enormous cost and lasting consequence.

As a matter of clarification, the Business Plan indicates that private investment will be used to support the construction from the "IOS segment" to ensure completion of the "Bay to Basin", thus private sector investments will be available just after the first IOS is completed.

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The Authority's Process for Overseeing the Development of Its Ridership Model May Raise Concerns About the Credibility of Its Projections

Response: The Authority's Ridership Peer Review Group will in future report directly to the Authority Board. The Ridership Peer Review Panel members include a variety of areas of expertise so they can review all aspects of the project. These areas of expertise include model development, demand forecasting at statewide and regional levels, ridership forecasting of new modes of travel, travel survey design and analysis, railroad operations (especially for high-speed or near high-speed rail systems), revenue forecasting, demand for air travel, and socio-economic forecasting. During this selection process it is important to:

- Ensure identification of scientific expertise necessary to address key issues;
- Search for appropriate candidates, evaluate credentials;
- Contact the most promising candidates for interest and availability and query them on conflicts of interest and biases; and
- Select a panel of independent experts that is balanced with regard to necessary disciplines and has a diversity of perspectives.

Instead of waiting for the ridership peer review group to be formed by others outside the Authority or by some Legislative Act, the Authority was proactive and transparent in forming such a group itself in an effort to obtain expert advice, ensure validity of the modeling work conducted and welcome critique.

It is not clear what the BSA means to express with the statement "In other words, the report implies that if the Authority does not address these long-term concerns, the model may only be useful to project ridership for the operating section and not the program's remaining sections." Further clarification would be appreciated and as the Authority fully intends to implement the recommendations made by the Peer Review Group, this comment would not be necessary.

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The Authority's Profound Staffing Shortages Have Compromised Its Ability to Provide Effective Oversight

Recommendation: *To ensure it has adequate staff to effectively oversee the program, the Authority should continue trying to fill its vacant positions. Additionally, the Authority should conduct a workload analysis to determine the total number of staff it needs as well as the functions those staff should perform.*

Response: Without doubt the shortage of staff and in particular skilled staff in various positions at the Authority is compromising the Authority's ability to offer the necessary oversight it would like to have on this project, however the following points need to be noted:

- The PMT has been hired in a Program Management role on this project and thus is responsible for such activities as development of a project implementation strategy, master plan, management of the project level environmental work through a series of Regional Consultants, as well as development and management of the technical aspects of the program.
- The Authority hired a Program Management Oversight (PMO) organization to work on the Authority's behalf, to offer program oversight and in particular oversight of the PMT activities.

Neither the PMT nor the PMO are making any strategic management decisions without the participation of the Authority, and policies and procedures generated by the PMT are approved by the PMO and the Authority.

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The Authority understands the importance and concerns related to its vacant positions. As of June 30, 2011 the Authority had 19.5 of 39 positions filled (50 percent filled). On July 1st the Authority received 15 more positions through the Budget Act. As of July 2011 the Authority had filled 19.5 of the 54 (36 percent filled) positions authorized. Since then the Authority has taken a proactive approach to fill the remaining vacant positions. Specifically, the Authority has processed 596 applications, conducted 67 interviews and hired 12 candidates since July 2011. Although there have been several new hires the Authority has lost 6 staff members since July for various reasons. As of January 1, 2012 the Authority has hired 3 additional staff for a total of 15 new hires within the last 6 months. Given the new hires and departures discussed above, the Authority currently stands at 28.5 out of 54 filled (53 percent filled) or an increase of 17 percent since July 1, 2011.

The Authority continues to recruit and hire additional staff to support the project and address the issue of vacancies. In addition, workload analyses will be conducted to ensure the sufficient staffing and classifications are appropriate for this project.

The Authority Has Failed to Ensure That Its Contractors and Subcontractors Disclose Potential Conflicts of Interest

Recommendation: To comply with the political reform act, the Authority should establish written policies and procedures for tracking whether all designated employees and consultants have completed and filed their statements of economic interests on time, thereby identifying any potential conflicts of interest.

Response: As the Authority has noted to the Bureau of State Audits, the chief executive officer, via Internal Instruction No 2010/13 dated November 8, 2010, has established the policy regarding the coordination and filing of Form 700's. This has been communicated with the FPPC and was found to be acceptable. This instruction was updated by means of Internal Instruction No 2011/18 dated December 19, 2011 (updating the list of staff and consultants needing to file). Via Internal Instruction No. 2011/21, dated December 20, 2011, the Authority has designated a filing officer who will have responsibility for accurately tracking Form 700 filings from Authority staff and consultants. The chief deputy director will ensure that staff develops procedures for tracking filings and the Authority will provide a copy of the procedures in follow-up responses to the audit.

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The Authority Has Failed to Ensure That Its Contractors and Subcontractors Disclose Potential Conflicts of Interest

Recommendation: To increase transparency and to ensure that it is aware of any financial interest that a subcontractor may have in the program, the Authority should require subcontractors to file statements of interest.

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Response: The Authority agrees that it is critically important that the Authority and the public be aware of any conflicts or potential conflicts of interest that its contractors or subcontractors may have. To ensure sufficient transparency regarding subcontractors, the Authority confirms that it did identify those subcontractors, who meet the criteria of consultants under the provisions of the Political Reform Act of 1974 and the Fair Political Practices Commission rules and regulations and require them to file Form 700 and such sub-contractors are required to file. The Authority will however again review its conflict-of-interest code and, if it determines it is necessary, will amend it. The Authority will apprise the BSA of the results of its process of identifying any additional subcontractors who are required to file and the results of its review of the Authority's conflict of interest code as part of the 60 day follow-up reporting to the BSA.

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By Relinquishing Significant Control to the Program Manager, the Authority May Be Jeopardized Its Ability to Make Informed, Thoughtful Decisions.

Response: Although the Authority is negatively affected by a shortage of skilled management and staff all strategic direction on this project is given by the Authority's management team.

The Program Manager's Monthly Progress Reports Lack Usefulness Because They Contain Some Inaccurate and Misleading Information

Recommendation: *To ensure that the Program Manager's monthly progress reports are accurate, consistent, and useful, the Authority should do the following:*

- *Reinstate the oversight consultant's review of the progress reports. Once it does so, the Authority should hold the Program Manager accountable for implementing the oversight consultant's recommendations. For example, the Authority could withhold partial payment of invoices to the Program Manager until it fully addresses these recommendations.*
- *Conduct monthly comparisons of the Program Manager's and the regional contractors' progress reports to verify they are consistent with one another and to ensure the reports include an accurate status of the promised deliverables.*

Response: The Authority will reinstate the oversight consultant's review of the progress reports and establish a monthly meeting to coordinate reconciliation of issues between the oversight consultant (PMO) and the Program Manager (PMT). In addition, the authority will establish a process for reviewing monthly progress reports between the Program Manager and the regional contractors using Authority staff from internal audits and contract managers.

Progress reports are prepared and submitted by all parties on a regular monthly basis to ensure a proactive cycle of project control and to communicate project status and existing/or potential problems to all concerned parties as well as the actions either being taken or planned to be taken to maintain the project according to its planned schedule and budget. Further, these documents serve as record of the evolution of the work, particularly with respect to trends in both costs and schedule. While time consuming, these reports are necessary to communicate the status/progress of the work to all stakeholders.

With respect to the PMT Monthly Progress Reports and the PMT Invoice submittals, it was established that the PMO's comments had been submitted to the Authority and were not regularly forwarded to the PMT for their information and comment. A process change has been implemented, so that from the October 2011 reports onwards, the PMO has been instructed to send their comments to the PMT directly, with a copy to the Authority, thereby ensuring that the PMT can consider the PMO's comments during finalization of their reports.

With respect we would like to clarify that there are many reasons why discrepancies between the RC and PMT reports are to be expected and should not to be interpreted as being errors:

1. Initially (and at the time the April 2010 audit was conducted) the HSR project had 4 pre-qualified ARRA sections. These 4 sections were all being developed to an accelerated schedule with the aim to meet the ARRA deadlines (completion of construction by September 2017). Once the FRA and the Authority decided that the Initial Construction Section would be in the Central Valley (November 2010) the overall program had to be re-scheduled, to ensure that the Central Valley

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sections would get priority, the sections adjacent to the Central Valley sections were accelerated and the remaining sections (particularly the previously pre-qualified, but not selected, end sections) were slowed down [referred to as phasing, and later incorporated into the Draft Business Plan]. This resulted in discrepancies between what the RC's had been accustomed to plan, and the top down (Authority prescribed/PMT implemented) schedules. Thus some PMT schedules would clearly overrule the RC schedules.

2. Just after the above mentioned decision, the Authority decided to implement phasing into the "bookends" [later referred to as "Blended solutions" and also included into the Business Plan]. Once again the PMT had to overrule the RC's (on request of the Authority) to adjust their schedules/reports so as to accommodate these changes.
3. Furthermore it is the responsibility of the PMT to manage the RC's (on behalf of the Authority) and thus in some instances the PMT would challenge dates which are submitted by the RC's, thereby aligning the RC program development to the overall goals. This is standard practice in such large projects, and is not necessarily a modification to the performance of the RC's but a request to the RC to adjust their staffing to meet new dates.
4. In some instances budget restrictions necessitated the Authority, through the PMT, to modify the delivery dates/schedules.

It is therefore not unexpected, especially in a project in this relatively early environmental clearance phase, to have such changes. For projects on a firm delivery schedule, such as construction contracts, such changes would not be acceptable. The PMT was always in consultation with the Authority when the aforementioned changes were made, and such changes should not be referred to as errors.

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Chapter 2- The Program Manager Did Not Appropriately Identify Differences Between the Regional Contractor's Monthly Progress Reports When Approving Their Corresponding Invoices

Recommendation: To ensure the regional contractor's monthly progress reports provide sufficient detail to support the monthly invoices, the Authority should perform a monthly comparison of the regional contractors' invoices to the corresponding progress reports. Specifically, the Authority should ensure that the regional contractors' monthly progress reports describe the work they performed in areas in which they claimed costs in the corresponding invoices. The Authority should discuss with the Program Manager any areas that lack sufficient detail in the progress reports to make such determinations.

Response: The Authority will develop procedures to ensure that review and oversight activities include a monthly comparison of the regional contractors' invoices to the corresponding progress reports. These procedures will include a reconciliation and discussion of areas that lack sufficient detail in the progress reports.

Chapter 2- The Authority Has Not Been Actively Engaged in the Process of Identifying and Mitigating the Many Risks Confronting the Program

Recommendation: To be aware of and respond effectively to circumstances that could significantly delay or halt the program, the Authority should hire a risk manager as soon as possible. Until it hires a risk manager, it should designate and require Authority staff to attend risk management meetings and workshops. Further, it needs to be involved in the development and implementation of the Program Manager's risk management plan and ensure that Authority staff have roles and responsibilities defined in the plan, such as identifying and mitigating risks in the risk register. Finally, the Authority should monitor the Program Manager's risk management practices to ensure that either it or the Program Manager identifies and promptly and appropriately addresses risks.

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Response: The Authority agrees with the importance and immediate need to fill the risk manager position and has made an offer of employment to a risk manager candidate. The risk manager will be responsible for addressing the recommendation and implementing strategies to mitigate the risk as discussed in the audit report.

In addition, the PMT has developed and is implementing a Risk Management Plan (RMP) for the program. This is being done in accordance with the Draft RMP document which is being finalized. The basic premises of the risk management program have been reviewed by the FRA.

Several risk workshops have already been conducted with focus on the Central Valley sections, and a Program-wide session is being planned for February to include Authority staff. Each MPR includes information on the risk management status with more detailed information posted on ProjectSolve2.

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Chapter 2- The Authority Poorly Managed Its Information Technology Contracts

Recommendation: *To effectively manage its contracts, the Authority should do the following:*

- *Develop procedures to detect and prevent contract splitting.*
- *Begin its process of awarding contracts with a sufficient amount of lead time.*
- *Immediately begin the process of soliciting competitive bids for its IT services.*

Response: The Authority agrees with the recommendations and will develop procedures to detect and prevent contract splitting. Since the prior audit, Authority staff has significantly revised the contract administration manual to ensure more effective management of the contract management process. Authority staff is working on policies and procedures to specify that contract managers will track the contract development and execution from initiation of the draft contract through implementation of the contract. The contract manual will also be amended to specify that sufficient lead time is built into the contract draft and approval processes.

To ensure sufficient lead time in developing, renewing and executing contracts, the contracts unit will maintain a listing of critical contract dates and notify contract managers at 90, 60 and 30 days prior to the expiration of contracts.

The Authority has drafted statements of work associated with needed information technology services and is in discussion with California Technology Agency representatives regarding service options. To the extent that services cannot be obtained through the California Technology Agency the Authority will obtain needed services through the appropriate procurement process. In addition, the Authority is reviewing current IT agreements to determine what if any can be canceled immediately.

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Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE CALIFORNIA HIGH-SPEED RAIL AUTHORITY

We stand by our audit conclusions and recommendations. We conducted our follow-up audit of the High-Speed Rail Authority (Authority) in accordance with generally accepted government auditing standards, which require that we obtain sufficient and appropriate evidence to support our audit conclusions.

①

As we discuss on pages 15 and 16 of the report, because the program's total cost has risen significantly since the Authority's 2009 business plan and because the Authority failed to provide viable alternatives in the event that its planned funding does not materialize, we believe our conclusion that the Authority's funding situation has become increasingly risky is accurate.

②

Contrary to the Authority's assertion, we do understand the role of the program management team on this project. We interviewed several key members of the program management team (Program Manager), including the Program Manager's program director and principal project manager, to ensure we had sufficient understanding of the various roles. While we agree that the Program Manager should manage or challenge the regional contractors' reports and inputs, the program management team has not been forthcoming in communicating these changes, and fails to provide sufficient explanation for doing so in the related monthly progress reports. Further, as we state on page 28, the Authority's current organizational structure places the largest portion of the program's planning, construction and, most importantly, oversight in the hands of contractors who may not have the best interests of the State as their primary motivation. As a result, the Authority lacks assurance that the program is implemented in a way that best serves the public.

③

Although we initially assessed the status of this recommendation as pending because the Authority had not sent the request letter to the Office of the Attorney General (attorney general), we changed our assessment to partially implemented after the Authority submitted its request to the attorney general for a formal legal opinion on January 5, 2012. We believe the recommendation should remain partially implemented until the Authority receives a formal opinion from the attorney general.

④

State law requires the Authority to include operating and maintenance costs in its business plan, and we do not believe that the Authority should be absolved from its responsibility to

⑤

present total costs because it believes operating and maintenance costs are presented for illustrative purposes only. If the Authority truly wants to increase transparency and comply with state law, it should take the additional step to present the total operating and maintenance costs.

- ⑥ We are perplexed as to how the text in the 2012 draft business plan as well as the exhibit the Authority refers to in its response provide the period of the concession as 2022 to 2060. While we agree that the exhibit shows the net operating profit by section for 2022 to 2060, it does not state that this is the period of the concession; in other words, the agreement that delineates what the private sector would receive in exchange for its investments. Further, the text in the plan to which the Authority refers in its response provides different information that states “the analysis was based on the assumption that private investment occurs close to the end of 2023.” The financial consultant who helped prepare the 2012 draft business plan confirmed that our understanding regarding concessions and private investment was correct. He stated that “after the private sector invests upfront capital in 2023, beginning in 2024, the private sector investors will receive all of the net operating profit for the 30-year term of the arrangement.” As a result of these conflicting pieces of information, we believe that our conclusion is correct that the term of the private sector concession is not clear within the 2012 draft business plan. If the Authority believes that its financial consultant is incorrect and that the concessions begin in 2022, then it should more clearly state the terms of the arrangement in its business plan, as we recommend.
- ⑦ The Authority is incorrect that the attachment to the 2012 draft business plan provides the detail that we are seeking—the total amount of operating and maintenance costs of the program.
- ⑧ We agree that as the owner of the program it is up to the State to decide what to do with the net cash flows resulting from operations. Further, while we understand that no concession has yet been made and thus the exact terms regarding net cash flows have not yet been decided, it is unclear what terms the Authority is assuming within the 2012 draft business plan regarding its financial projections. For example, the business plan does not explicitly state whether the private sector investment valuation is based on the cash flows for the Initial Operating Section (operating section) only or the operating section and Bay-to-Basin.
- ⑨ While the Authority has stated its desire to be transparent in the presentation of its business plan, we disagree that the Authority has clearly described all of its assumptions. For example, as we state on pages 22 and 23, the plan assumes, but does not explicitly articulate, that the State will not receive profits between 2024 and 2060.

Although the Authority’s projections may be “consistent with standard project financing analysis,” the Authority does not clearly disclose the period of its proposed private sector investment nor does it state the sections of the program for which the investors will be receiving the net operating cash flows. While we realize that such an agreement with a private sector investor has not yet been made, we believe that it is critical to clearly outline the assumptions on which the projections were made in the spirit of transparency.

⑩

The Authority is mischaracterizing our conclusion and reacting to its mischaracterization. We do not suggest that the Authority should secure all the funds necessary to complete the program before it begins construction. Further, contrary to the Authority’s assertion, this standard is not ours, but rather it is one established by the Legislature through Chapter 38, Statutes of 2011. This law requires the Authority to report on alternative funding options if no significant federal funds are received. In addition, our prior audit report recommended that the authority identify funding alternatives. While the Authority lists some potential funding sources, as we describe on pages 17 through 19, these alternatives do not appear to be viable solutions. For example, as we state on page 17, Qualified Tax Credit Bonds (QTCBs)—a funding option the Authority described as an alternative—are not yet approved for use on high-speed rail projects, and is not really an alternative as it represents a substantial portion of its primary funding plan as shown in Figure 4 on page 20.

⑪

The Authority is incorrect that our report ignores the fact that the program has funding in hand for the Initial Construction Section (construction section). We describe on page 16 that although the total cost of the first portion of the operating section—the construction section—is secured, the cost of the remainder of the operating section is not. However, to ensure we clearly and fairly present this information, we added information to the Results in Brief and the summary for Chapter 1.

⑫

It is unclear to us why the Authority thought it necessary to explain that Proposition 1A does not include a requirement that the program be funded using a dedicated funding source, because we do not suggest in our report that a dedicated funding source is required to complete the program.

⑬

The Authority misunderstands the scope of our audit. We did not assess, nor were we asked to assess, the risks associated with not pursuing the program. Further, nowhere in our report do we state that the Authority should take any action that would jeopardize these federal funds.

⑭

- ⑮ As we state on pages 24 and 25 in our report, the ridership review group raised some long-term concerns about the model that remain unaddressed and noted that these issues need to be addressed to determine whether the model is suitable for future applications beyond construction of the operating section. Our statements are based on text within the ridership review group's reports dated August 1, 2011 and July 22, 2011.
- ⑯ As we state on page 30, given that consultants significantly outnumber Authority staff and are directly involved in the day-to-day operations of the program, we question how they could not be establishing strategies and making management decisions. For example, on page 38, we state that the Authority continues to be only minimally involved in the risk-management process and instead relies almost completely on its Program Manager to both identify and mitigate risks.
- ⑰ We are not clear as to which document the Authority refers. We state on page 32 that although the Authority finally amended its conflict-of-interest code in 2010, the Fair Political Practices Commission has not yet approved it, which is required to make the amended code effective. We asked the Authority for evidence that it received approval from the Fair Political Practices Commission for its amended conflict-of-interest code; however, as of December 1, 2011, the Authority's chief counsel was still attempting to locate the approval.
- ⑱ The Authority did not use the word "subcontractor" in either its January 20, 2011 list or its January 2, 2012 list that contains the individuals required to file statements of economic interests. Therefore, we do not believe that the Authority has adequately demonstrated its inclusion of relevant subcontractors in its conflict-of-interest practices. Further, we believe the Authority should require all of its subcontractors to file statements of economic interests. Our recommendation would increase transparency and provide awareness to the Authority of any potential conflicts of interests among its subcontractors.
- ⑲ While we acknowledge that informal meetings may take place to discuss such matters, the Authority was unable to provide documentation that the Program Manager was always in consultation with the Authority about the schedule changes. As a result, we have no assurance that the Authority is fully informed about the status of the program.
- ⑳ Although we acknowledge the Program Manager has held several risk workshops, as we state on pages 38 and 39, the Authority stated that it has not attended any of them.

(Agency response provided as text only.)

State and Consumer Services Agency
915 Capitol Mall, Suite 200
Sacramento, CA 95814

January 9, 2012

Elaine Howle
California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Re: Bureau of State Audit's Report No. 2011-504

Pursuant to the Bureau of State Audit's (BSA) Report No. 2011-504, enclosed are the Department of General Services' comments pertaining to the results of the audit.

The State and Consumer Services Agency would like to thank the BSA for its comprehensive review. The results provide us with the opportunity to better serve our clients and protect the public.

(Signed by: Anna M. Caballero)

Anna M. Caballero, Secretary
State and Consumer Services Agency

Date: January 9, 2012

To: Anna M. Caballero, Secretary
State and Consumer Services Agency
915 Capitol Mall, Suite 200
Sacramento, CA 95814

From: Fred Klass, Director
Department of General Services

Subject: RESPONSE TO BUREAU OF STATE AUDITS' REPORT NO. 2011-504

Thank you for the opportunity to respond to the Bureau of State Audits' (BSA) Report No. 2011-504 which addresses a recommendation to the Department of General Services' (DGS) resulting from the BSA's audit of the High-Speed Rail Authority (Authority). The BSA's current audit is a follow-up to its previous audit of the Authority's operations that was completed in April 2010.

During its current audit of the Authority, the BSA developed concerns with the adequacy of the Authority's systems of internal control over contracting for information technology (IT) services. Consequently, due to the DGS having oversight responsibilities for IT procurements, the BSA is recommending that the DGS conduct an audit of the Authority's procurement program.

In its report, the BSA concludes that the Authority over the period March 2010 through February 2011 entered into six contracts for IT services through the use of the small business/disabled veteran business enterprise option. However, the Authority failed to satisfy a statutory requirement to obtain two price quotations from those types of businesses. The appropriate use of the small business/disabled veteran business enterprise option program will be included in the DGS' audit referenced below.

The BSA also expresses concerns that in May 2011 the DGS allowed the Authority to non-competitively bid (NCB) six IT service contracts rather than working with the Authority to ensure that competitive bidding requirements were satisfied. In brief, the BSA concluded that the DGS should have approved one NCB contract for an additional six month period rather than the six NCB contracts for a twelve-month period. As noted in the report, the DGS approved the Authority's NCB's with the provision that the services be put out to competitive bid and that additional NCB's would not be granted for the services. The DGS will contact the Authority to confirm that appropriate actions are being taken to competitively bid the services. As part of this process, the DGS will ensure that all services that cannot be fully justified as separate and distinct will be combined into one contract.

RECOMMENDATION

RECOMMENDATION:

To ensure the Authority is complying with state contracting rules and is following the guidelines of the State Contracting Manual, the Department of General Services (General Services) should conduct a procurement audit of the Authority by January 1, 2013.

DGS RESPONSE:

The DGS' Office of Audit Services will conduct the requested audit by January 1, 2013. The audit's scope will include a review of the Authority's systems of internal control for the procurement of non-IT goods and IT

Anna M. Caballero

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January 9, 2012

goods and services. The objective will be to determine that procurement transactions are being conducted in accordance with the terms and conditions of the Authority's purchasing authority delegation agreements with the DGS. The State's delegated purchasing requirements are primarily contained in State Contracting Manual Volumes 2 (non-IT) and 3 (IT).

The DGS is firmly committed to effectively and efficiently overseeing the State's procurement program. As part of its continuing efforts to improve this process, the DGS will take appropriate actions to address the recommendation presented in the report.

If you need further information or assistance on this issue, please contact me at (916) 376-5012.

(Signed by: Fred Klass)

Fred Klass
Director

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press