

**WHY THE CALIFORNIA HIGH-SPEED RAIL PROJECT IN THE
CENTRAL VALLEY IS INELIGIBLE FOR
PROPOSITION 1A /AB3034 BOND FUNDS**

A Legal Analysis Prepared for the California High-Speed Rail Peer Review Group

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ABOUT THE AUTHOR

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INTRODUCTION

The peer review group is a creation of Proposition 1A and AB3034. No bond funds (\$9 billion) are to be released under Proposition 1A until the peer review group has CERTIFIED that various requirements have been met under STATE law. Stated another way, the Authority cannot obtain access to bond funds under Proposition 1A unless the peer review group signs off and certifies that various requirements of law have been met; following that, other government officials and the Legislature itself must do likewise.

The principal theme of this legal memorandum is that the corridor of the California High Speed Rail Project which is proposed to be built in the Central Valley IS AND WILL BE INELIGIBLE TO RECEIVE PROPOSITION 1A BOND FUNDS UNDER STATE LAW. This, indeed, is the central function of the peer review group. It is not to determine whether the Central Valley Project and its funding/financing comply with the Federal law (ARRA), but simply to determine whether Proposition 1A state bond funds can be used to help finance the project.

THE DIFFERENCES BETWEEN STATE AND FEDERAL LAW

The state law is Proposition 1A and AB 3034. The Federal law is ARRA. The state law became effective in 2008, predating the Federal law. The state law is much more retrospective as to how the state bonds can be accessed and utilized. The Federal law is much more flexible as to how FEDERAL FUNDS can be utilized. The 2 laws are NOT complementary. Indeed, they are fundamentally in conflict, since Federal funds can be used for railroad projects that would be ineligible for state bond funds. This is the heart of the problem: the Central Valley corridor may be permissible under ARRA, but the Central Valley corridor is flatly prohibited from being financed under Proposition 1A,

and therefore no state bond money can be used for this corridor, and the peer review group must so certify.

THE CENTRAL VALLEY PROJECT IS NOT A HIGH-SPEED RAIL PROJECT, AS SUCH

Nothing could be clearer than the fact that Proposition 1A and AB3034 approved \$9 billion bond funds FOR A HIGH-SPEED RAIL PROJECT AND NOTHING ELSE. The voters were not asked to approve \$9 billion in bond funds for general railroad improvements, or new inner city railroad commuter lines, for Amtrak, or anything other than a statewide High Speed Rail Project including trains that would run at more than 200 mph. Any effort to use state bond funds for anything other than a High Speed Rail Project is simply illegal.

When we examine the Federal scheme, however, under ARRA, although it is denominated as a high-speed rail plan, the Department of Transportation and the Federal Railway Administration, which have the authority to dispense the funds and designate their use, have exhibited much more flexibility as to how these Federal funds can be utilized. For example, Federal funds can be used for a portion of a project that has "independent utility", even though the project does not qualify as a High Speed Rail Project, as such. This, therefore, is the stark difference between State law and Federal law. Simply because the Authority may be authorized to proceed with the Central Valley Project under Federal law does not mean that the project can utilize state bond funds under Proposition 1A and AB 3034.

The project, as proposed by the authority and approved by the Federal authorities, is not a High Speed Project. For example, funds for ELECTRIFICATION are not even requested, and no High Speed Rail Project can run without electrification. The documents submitted by the Authority since October 2009, and the corresponding response from the DOT and the FRA, demonstrate that the Central Valley Project is viewed simply as an interim stage and that operation of a high-speed rail system will NOT be the first operating system. The Authority and the feds even contemplate that once the tracks are laid, Amtrak will run diesel trains over these tracts -- scarcely a high-speed rail system. Yet, such a plan might well comply with the "independent utility" concept under ARRA.

Another reason why the Central Valley Project cannot be classified as a High Speed Rail Project, as such, is because no funding is contemplated to be used for a positive train control (PTC) system. This PTC system is very expensive and it was always contemplated that a PTC system running and controlling the entire statewide HSR project would be installed in the Central Valley. And yet no Federal funds are contemplated to be used to construct any such system; without a PTC system, you simply cannot have a high-speed rail system -- another reason why the contemplated Central Valley Project cannot be classified as a High Speed Rail Project.

Nor have Federal funds been requested or allocated for HSR rolling stock. Instead, as part of the "independent utility" concept, it is contemplated that Amtrak will run diesel trains along the tracks, until "some day" a High Speed Rail Project is installed. But, Amtrak's rolling stock is much heavier and different from what a High Speed Rail Project would utilize¹ -- another reason why the Central Valley Project is not HSR qualified.

What is the explanation for all this? It could be that only limited Federal funding was available and that all of these prerequisites for a HSR project could not be afforded, and that the Authority and the feds were anxious to get started, and decided to do so under the "independent utility" concept.

THE PEER REVIEW GROUP MUST CERTIFY THAT THE FUNDING AND FINANCING FOR THE CENTRAL VALLEY PROJECT ARE INADEQUATE.

PROPOSITION 1A BOND FUNDS CANNOT BE UTILIZED BECAUSE THE FEDERAL FUNDS CANNOT BE CONSTRUED TO BE "MATCHING FUNDS", AS REQUIRED BY AB3034

It is an absolute requirement of State law that no bond funds can be accessed unless there is an equal amount in federal or private financing. This is the concept of "matching funds."

But, the Federal funds have to be for a high-speed rail system, since that is the only type of project authorized by the State with respect to the \$9 billion in bonds. In other words, the Federal funds, in order to be classified as "matching funds", must be of like kind and quality and for the same purpose. As the above discussion demonstrates, the Federal funds are not for a high-speed rail project, but are designed for some type of interim project along the lines of local railroad commuter service, not even utilizing high-speed rail locomotives, rolling stock, tracks, or positive train control systems, or any of the other infrastructure (including electrification) essential to the operation of a high-speed rail system. The Legislature and the voters would never have intended that the \$9 million in high-speed rail bond funds would be used to assist in building such local high-speed rail projects.

Therefore, the Federal funds cannot be construed to be "matching funds," and, that being true, proposition 1A Bond funds cannot be accessed to finance the Central Valley Project.

THE CRITICAL STATUTE WHICH IS TO GUIDE THE DELIBERATIONS OF THE PEER REVIEW GROUP

¹ Indeed, once the tracks are laid, and the heavier Amtrak trains start running on them, these tracks will have to be torn up and replaced once, many years in the future, a lighter high-speed rail rolling stock and system come into being.

The statute is Streets and Highways Code, section 2704.08 (d). This sets forth the areas which the peer review group must analyze and sign off on.

The peer review group must certify the adequacy of the funding and financing plan for the corridor in question.

The peer review group must analyze the ridership issue.

The peer review group must analyze the issue of construction costs, including issues of cost escalation during construction and appropriate reserves for contingencies.

Related issues under Proposition 1A include: the fact that California law requires that the project operate at an annual profit; the prohibition on any state subsidies for the project's operating expenses; whether the private sector's insistence on a guarantee of revenue is legal under Proposition 1A; and whether or not funding is in the bank to assure completion of a "usable segment" of the Central Valley corridor (meaning a segment of the corridor operating as a high-speed rail segment and including 2 stations).

We now proceed to analyze those issues under Proposition 1A.

THE ISSUE OF COSTS OF CONSTRUCTION

The Authority's cost estimates from the macro point of view are suspect. When this matter was placed before the voters in 2008, the "first stage" of the project was estimated to cost \$33 billion. This then went up to \$43 billion and is now estimated to be in excess of \$45 billion.

With respect to the Central Valley corridor, this project has also evolved in scope and costs. Originally, it was supposed to be from Merced to Fresno, at a cost of \$3 billion. Then, and with great controversy (the train to nowhere), it was changed: it will start near Merced (but not in Merced) in a small town called Borden; it would then go to Fresno and would end in a small town called Corcoran, near Bakersfield, but not in Bakersfield. This was originally estimated to cost \$4.15 billion, but the most recent cost estimate is \$5.67 billion. As will be shown, this is considerably in excess of the Federal funds available, and if Proposition 1A funds are not available, this corridor should never be started.

The peer review group has to be diligent and exacting in its cost analysis. The history of public works projects in the United States is permeated with scandals and under estimated costs. For example, look at the Bay Bridge Project, currently underway, and with current cost estimates 7 times greater than the original estimates. Or, look at the recently completed Boston "big dig" which was originally estimated to cost approximately \$3 billion, but which wound up costing \$22 billion! Similarly, many credible experts have said that the California high-speed rail project will cost greatly in excess of what the authority estimates. The peer review group should therefore consult

these sources carefully in analyzing what the true cost of the Central Valley corridor will be.

THE STATUS OF FEDERAL FUNDING; THE RELIANCE BY THE AUTHORITY ON FUTURE FEDERAL FUNDING; THE LIKELIHOOD OF FUTURE FEDERAL FUNDING.

A central task of the peer review committee is to certify that the funding/financing for the project is adequate. This requires an analysis of the current Federal funding plus a meaningful examination of whether future Federal funding is going to be provided.

The original Federal grant was \$2.25 million. By the middle of 2010, this had been reduced to \$1.65 million through allocations to complementary rail projects. In October and December 2010, there were 3 additional grants: \$715 million; \$16 million; and \$616 million. This brings the total Federal money to \$2.987 billion, or approximately \$3 billion.

The Authority has indicated that it "expects" \$17-\$19 billion from the Federal government for the project. Yet, there is little likelihood that any new Federal money AT ALL will be granted. The present Congress has introduced statutes to RESCIND even the \$3 billion already granted; politically, there is little likelihood that this present Congress will grant any new money for the California high-speed rail project.

As the analysis above demonstrates, legally, no Proposition 1A Bond funds will be available to supplement the \$3 billion in Federal funds. Therefore, the Central Valley corridor will only have about 50% of what it will cost to construct.

Therefore, the peer review group is in no position to certify that the funding and the financing are in place and adequate for the proposed Central Valley corridor.

THE RIDERSHIP ISSUE

All experts agree that ridership is a key to profitability of a rail project. This issue with respect to the California high-speed rail project is highly controversial. Currently, the Authority is relying upon a study by the Cambridge Institute. But, that study has been severely undermined by an analysis from the prestigious Institute for Transportation Studies (I.T.S.) at UC Berkeley, which said that the Cambridge study was unreliable. Currently, Cambridge refuses to redo its analysis, and the matter remains in limbo. The peer review group must come to concrete and reliable conclusions on this ridership issue before this project can be allowed to proceed. It would be grossly improper to rely upon the Cambridge study without having all the questions raised by ITS answered fully.

Indeed, the importance of accuracy on ridership is especially critical in light of the incredible discrepancies in the history of the Authority's own figures on this issue. When the issue was placed before the voters in November 2008, the Authority represented that it would have 117 million riders per year; after the election, this was first dropped to

63 million riders; the latest figure from the authority is 39 million riders per year -- one third of the original estimate of 117 million riders!

THE PEER REVIEW GROUP MUST ANALYZE AND CERTIFY THAT THERE WILL BE NO STATE SUBSIDIES FOR OPERATING EXPENSES; THAT THE PROJECT WILL OPERATE AT AN ANNUAL PROFIT; AND THAT THE STATE CANNOT GUARANTEE THE REVENUES OF THE PROJECT.

This is also a critical issue related to funding and financing and operation. Proposition 1A forbids the State from subsidizing the high-speed rail project's operating expenses; the proposition also requires that the project operate in an annual profit.

An important legal issue is the demand from private investors that the State guarantee the revenues of the project. This is obviously understandable, since if the revenues are guaranteed, this reduces the risk for the private investor. But, it greatly increases the risk for the State and will completely undermine the intent of the Legislature when it placed the proposition on the ballot. The Legislature was absolutely clear that it wanted to avoid any financial risk to the State. Hence, the requirement that the project operate in an annual profit and the prohibition on State subsidies for operating expenses.

The peer review group must analyze these questions and certify that the Central Valley Project will indeed operate at a profit and that no State subsidies will be required and that any guarantee of revenue would violate proposition 1A and AB 3034. On the subject of operating at a profit, as difficult as it may be, the critical statute, Streets and Highways Code section 2704.08 (d), requires the peer review committee to analyze whether THIS CORRIDOR will operate at a profit. This will be especially difficult, given the fact that the Central Valley corridor runs through a largely rural area and there is no connection between 2 large cities (no station in Bakersfield).

THE PEER REVIEW GROUP CANNOT CERTIFY THAT THE AUTHORITY HAS ENOUGH FUNDS ON HAND TO "COMPLETE" A USABLE SEGMENT OF THE CENTRAL VALLEY CORRIDOR, AS THOSE TERMS ARE UNDERSTOOD UNDER PROPOSITION 1A.

Another requirement of law is that the peer review group must certify that the Authority has enough cash on hand to complete a usable segment of a HSR corridor. Proposition 1A and AB 3034 state that a "usable segment" means a segment of a high-speed rail corridor that connects 2 stations.

Apparently, the 2 stations contemplated in the Central Valley are Fresno and Hanford.

This will be impossible for the Authority to demonstrate since the entire Central Valley Project, as set forth above, is not even a High Speed Rail Project. Therefore, under Proposition 1A and AB 3034, it is legally impossible for the Authority to demonstrate that it has the finances on hand to "complete" a "usable segment" (meaning a segment including 2 stations and ready to operate as a HSR system) in the Central Valley.

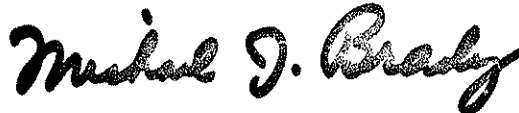
Indeed, there was an interesting exchange on this issue between the Authority Board and its advisors, 2 attorneys from the Attorney General's office when the Board recently met to give its final approval for the Borden to Corcoran corridor. Board member Diridon (now off the Board) specifically asked counsel whether the proposed corridor complied with Proposition 1A; they replied that they were unable to say, but they did say that the corridor did not comply with the "usable segment" concept of Proposition 1A. Interestingly, both representatives from the Attorney General's office resigned shortly after that.

In short, even if the Authority had enough money to complete the segment between the Fresno Station and the Hanford Station, the project would still be INELIGIBLE for Proposition 1A bond funds because that segment is contemplated to be for ordinary rail service , and not a high-speed rail system.

CONCLUSION

The sole task of the peer review group is to decide whether the Central Valley Project is ELIGIBLE to receive Proposition 1A state bond funds. For the above reasons, the peer review group must decide this question in the negative. If the Central Valley Project is to be built at all, it will have to be financed by Federal funds and private sources alone.

Dated: January 12, 2011

A handwritten signature in black ink that reads "Michael J. Brady". The signature is written in a cursive, slightly slanted style.

Michael J. Brady, Esq.