

## 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

#### REPORT NUMBER 2011-504, ISSUED JANUARY 2012

In January 2012 we issued a report that presents the results of a follow-up review the California State Auditor (state auditor) 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 state auditor'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 as of January 2012. 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 their assigned 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.

In the follow-up report, the state auditor made the following recommendations to the Authority, one to the Legislature, and one to the Department of General Services (General Services). The state auditor's determination regarding the current status of recommendations is based on the Authority's and General Services' response to the state auditor as of August 2012.

#### **Recommendation 1.1.a—See page 54 of the follow-up audit report for information on the related finding.**

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.

#### ***Authority's Action: Partially implemented.***

The Authority stated that it continues to work with stakeholders to define alternative delivery scenarios on blended system operations. Additionally, the Authority asserted that in the spring of 2012, the Department of Finance and the Administration identified cap-and-trade revenues as a

potential funding source for the program. Further, the Authority stated that it will work with the Department of Finance to define a specific plan for the use of cap-and-trade funds, which it claims will be presented in detail in the next business plan to be issued in draft in the fall of 2013. However, although the Authority's business plan includes three alternative funding scenarios, all three assume a similar or increased level of federal funding compared to the Authority's primary plan—which the federal government has not indicated will occur.

**Recommendation 1.1.b—See page 54 of the follow-up audit report for information on the related finding.**

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.

***Authority's Action: Fully implemented.***

The Authority hired a risk manager in August 2012. The Authority asserts that the risk manager will attend the risk management meetings related to updating the risk register, identifying new risks, performing qualitative risk analyses, and coordinating and tracking risk responses.

**Recommendation 1.1.c—See page 54 of the follow-up audit report for information on the related finding.**

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.

***Authority's Action: No action taken.***

- ➔ The Authority originally addressed our recommendation by requesting an opinion from the attorney general on January 5, 2012. Subsequently, on October 16, 2012, it withdrew its request for a legal opinion stating that it did so because the independent peer review group is appointed by the State Treasurer, the State Controller, the Director of Finance, and the Secretary of Business, Transportation and Housing. The Authority explained that although it provides information requested by the peer review group, it believes that it does not have the legal authority to direct how the peer review group conducts its meetings including providing legal advice to the group about open meeting law requirements. Nevertheless, while the Authority does not appoint the members of the peer review group, state law requires the Authority to "establish" the independent peer review group and, as such, we believe the Authority would be an appropriate entity to request the opinion. In addition, the peer review group informed us that it believes its actions are not covered by the Bagley-Keene Open Meeting Act when it conducts its meetings. The peer group bases its belief on the advice of the authority's former counsel when it explained to us why it does not comply with the Bagley-Keene Open Meeting Act. Therefore, the Authority has not implemented our recommendation.

**Recommendation 1.1.d—See page 54 of the follow-up audit report for information on the related finding.**

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.

***Authority's Action: Fully implemented.***

The Authority implemented monthly control procedures and a supporting spreadsheet that utilizes cost data from CalStars to report cumulative information for administrative and preconstruction costs. The spreadsheet provides a breakdown of administrative and preconstruction expenditures by fiscal year and the percentage these expenditures represent of the total allowable expenditures authorized in Proposition 1A. The Authority stated that the

spreadsheet will be combined with Program Manager information to project administrative and preconstruction expenditures. The Authority also asserts the spreadsheet may be used for future cost projections.

**Recommendation 1.1.e—See page 55 of the follow-up audit report for information on the related finding.**

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 Program Manager revise its progress reports to include information on the status of contract products and services in relationship to what was promised.

***Authority's Action: Fully implemented.***

The Authority amended the oversight consultant's work plan to include a critical review of the progress reports. In addition, the Authority provided four recent copies of the Program Manager's progress reports that included information on the status of contract products and services in relationship to what was promised.

**Recommendation 1.1.f—See page 55 of the follow-up audit report for information on the related finding.**

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.

***Authority's Action: Fully implemented.***

As published in our March 2011 report titled *Implementation of State Auditor's Recommendations, Audits Released in January 2009 Through December 2010* (Report 2011-406), 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. Finally, the Authority implemented a change control process, which includes making any amendments and modifications to contracts and work plans in writing.

**Recommendation 1.2—See page 15 of the follow-up audit report for information on the related finding.**

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.

***Authority's Action: Partially implemented.***

The Authority stated that it continues to work with stakeholders to define alternative delivery scenarios on blended system operations. Additionally, the Authority asserted that in the spring of 2012, the Department of Finance and the Administration identified cap-and-trade revenues as a potential funding source for the program. Further, the Authority stated that it will work with the Department of Finance to define a specific plan for the use of cap-and-trade funds, which it claims will be presented in detail in the next business plan to be issued in draft in the fall of 2013. However, although the Authority's business plan includes three alternative funding scenarios, all three assume a similar or increased level of federal funding compared to the Authority's primary plan—which the federal government has not indicated will occur.

**Recommendation 1.3.a—See page 21 of the follow-up audit report for information on the related finding.**

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 costs for the program.

***Authority's Action: Fully implemented.***

The Authority's 2012 revised business plan discusses total capital costs including operating and maintenance costs. The Authority believes that capital costs and operating and maintenance costs, including costs by year, have been accurately and thoroughly discussed in an open manner through a range of communication media, including through board meetings that are open to the public.

**Recommendation 1.3.b—See page 21 of the follow-up audit report for information on the related finding.**

To ensure that the public and the Legislature are aware of the full cost of the program, 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.

***Authority's Action: Pending.***

The Authority stated that it would clarify in its next business plan the decision by the State to raise financing from the private sector based on the net cash flows of the project, which means the State will not be able to use those cash flows for other purposes during the term of the financing.

**Recommendation 1.4—See page 23 of the follow-up audit report for information on the related finding.**

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.

***Legislative Action: Unknown.***

The state auditor is not aware of any action taken by the Legislature as of December 18, 2012.

**Recommendation 2.1.a—See page 28 of the follow-up audit report for information on the related finding.**

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

***Authority's Action: Partially implemented.***

As of October 2012 the Authority filled all but one of its high-level vacant positions; the position of chief financial officer remains vacant.

**Recommendation 2.1.b—See page 31 of the follow-up audit report for information on the related finding.**

To ensure that it has adequate staff to effectively oversee the program, 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.

***Authority's Action: Pending.***

The Authority stated that it will explore available options for conducting a workload analysis once it has filled its high-level positions.

**Recommendation 2.2—See page 31 of the follow-up audit report for information on the related finding.**

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.

***Authority's Action: Fully implemented.***

The Authority has written policies and procedures in place to collect, follow up, and retain statements of economic interest. Those policies and procedures include sections on annual statements, assuming office statements, leaving office statements, and retention. The procedures were approved by the chief executive officer on July 17, 2012.

**Recommendation 2.3—See page 31 of the follow-up audit report for information on the related finding.**

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.

***Authority's Action: Partially implemented.***

The Authority asserts that it has put a process in place for determining which contractors and subcontractors should file statements of economic interest. However, not all subcontractors will be required to file. In addition, the Authority's policies state that prime contractors, not Authority staff, are responsible for determining which subcontractors are subject to the conflict-of-interest policy.

**Recommendation 2.4.a—See page 35 of the follow-up audit report for information on the related finding.**

To ensure that the Program Manager's monthly progress reports are accurate, consistent, and useful, the Authority should reinstate the oversight consultant's review of the progress reports.

***Authority's Action: Fully implemented.***

The Authority asserted that the oversight consultant reviews the Program Manager's monthly progress reports and makes observations and recommendations to the Program Manager.

**Recommendation 2.4.b—See page 35 of the follow-up audit report for information on the related finding.**

To ensure that the Program Manager's monthly progress reports are accurate, consistent, and useful, 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.

***Authority's Action: Fully implemented.***

The Authority stated that the Program Manager discusses, reviews, and incorporates the observations and recommendations of the oversight consultant into a written response to the Authority. The Authority also asserted that its contract managers have the ability to withhold payments in order to deal with nonperformance issues. Additionally, the Authority stated that it continues to add resources to its team to augment its oversight responsibility.

**Recommendation 2.4.c—See page 34 of the follow-up audit report for information on the related finding.**

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

***Authority's Action: Fully implemented.***

The Authority stated that the oversight consultant, acting as an extension of the Authority, reviews the Program Manager's monthly progress reports and makes observations and recommendations. Those observations and recommendations are reviewed by the program director and are discussed, reviewed, and incorporated into a written response to the Authority. In addition, the Authority indicated that its audit office's work plan includes scheduled audits of the regional contractors' progress reports and invoices, as well as comparisons on a sample of the Program Manager's and the regional contractors' progress reports. It also stated that the audit office will review the Program Manager's and oversight consultant's activities.

**Recommendation 2.5—See page 37 of the follow-up audit report for information on the related finding.**

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.

***Authority's Action: Fully implemented.***

According to the Authority, to ensure that sufficient detail is provided in the regional contractors' monthly progress reports and that the program director adequately documents any reporting deficiencies noted in the review of the progress reports and invoices, the audit office's work plan includes scheduled audits of the regional contractors' monthly progress reports and invoices and the Program Manager's and oversight consultant's activities. The audit office reports directly to the Audit and Finance Committee of the Authority's board and administratively to the chief executive officer.

**Recommendation 2.6.a—See page 38 of the follow-up audit report for information on the related finding.**

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.

***Authority's Action: Fully implemented.***

The Authority hired a risk manager in August 2012. According to the Authority, the risk manager will attend the risk management meetings related to updating the risk register, identifying new risks, performing qualitative risk analyses, and coordinating and tracking risk responses.

**Recommendation 2.6.b—See page 38 of the follow-up audit report for information on the related finding.**

To be aware of and respond effectively to circumstances that could significantly delay or halt the program, the Authority 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.

***Authority's Action: Fully implemented.***

The Authority stated that the new risk management program includes four general types of risk management workshops and meetings that involve Authority staff. The first type of risk management meeting serves to regularly update the risk register, identify new risks, perform qualitative risk analysis, and coordinate and track risk responses—this includes a review of all program and project risks. In addition, the Authority stated that its risk manager is assessing the current risk meeting process and will be making recommendations for enhancements that will be implemented under the Authority's updated risk management plan.

**Recommendation 2.6.c—See page 38 of the follow-up audit report for information on the related finding.**

To be aware of and respond effectively to circumstances that could significantly delay or halt the program, 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.

***Authority's Action: Fully implemented.***

The Authority indicated that its risk manager plans to regularly meet with risk management staff, including the Program Manager, to provide necessary Authority control, direction, oversight, and information sharing.

**Recommendation 2.7.a—See page 40 of the follow-up audit report for information on the related finding.**

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

***Authority's Action: Fully implemented.***

According to the Authority, all staff with responsibility for preparing contracts have completed the General Services' training on proper state contracting procedures, including the prohibition against contract splitting. The Authority's contract manual has been updated and provided to Authority employees who have responsibility for preparing contracts. To detect contract splitting, all non-state agency contracts are reviewed prior to execution by the contract specialist within the Authority's contracts and procurement department.

**Recommendation 2.7.b—See page 40 of the follow-up audit report for information on the related finding.**

To effectively manage its contracts, the Authority should begin awarding contracts with a sufficient amount of lead time.

***Authority's Action: Fully implemented.***

The Authority provided a schedule of contract expiration dates to ensure that contract managers receive timely notifications from the contract unit of contract expiration dates. Additionally, the Authority asserted that its contract manual contains language ensuring adequate lead time in the contract award process.

**Recommendation 2.7.c—See page 40 of the follow-up audit report for information on the related finding.**

To effectively manage its contracts, the Authority should immediately begin the process of soliciting competitive bids for its IT services.

***Authority's Action: Partially implemented.***

The Authority asserted that it is moving toward in-house IT support rather than contractors. Specifically, the Authority stated that it hired a DPM II on March 5, 2012. According to the Authority's response, the new DPM II has moved the Authority's network connection from the cloud to the California Technology Agency (CTA) and has implemented the movement of the exchange services from its previous contractor—PK Inc.—to CTA-California Email Service (CES) mail. The Authority claims the process of migrating the electronic mail system to CES will be approximately six to 13 months. Additionally, the Authority stated that desktop support has been transitioned in-house with the support of one full-time associate information systems analyst and a student intern. The Authority further indicated that two retired annuitants have been hired to support the server and network administration, and application development.

**Recommendation 2.8—See page 40 of the follow-up audit report for information on the related finding.**

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.

***General Services' Action: Fully implemented.***

Effective May 1, 2012, General Services indicated that the Authority lacks sufficiently trained staff to conduct procurements and subsequently decreased the Authority's purchasing authority to the minimum level of \$4,999.99. Thus, General Services now conducts all of the Authority's purchases above \$4,999.99. As a result of decreasing the Authority's purchasing authority, it is not necessary for General Services to conduct a procurement audit.