BRIEFING: OCTOBER 11, 2016 BOARD MEETING AGENDA ITEM #8

TO: Chairman Richard and Board Members

FROM: Boris Lipkin, Deputy Director of Business Analytics and Strategic Planning

DATE: October 11, 2016

RE: Informational Presentation Regarding Early Operator Input and Development of and Policies on Fares and Schedules

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Background

The California High-Speed Rail Authority (Authority) is delivering a transformative high-speed rail system for California. This system will be delivered largely by the private sector with oversight from the Authority and ownership of the asset being retained by the State. The business model and implementation strategy for the initial Silicon Valley to Central Valley Line operating segment is set out in the 2016 Business Plan. An important part of that strategy is the early procurement of the train operator.

Early procurement of the eventual train operator will assist the Authority as it makes a range of system development and design decisions related to safety, operations, and systems integration, including ensuring a commercially viable system. The eventual train operator will almost certainly want to inform the operational parameters of the system, such as fares and schedules, and all commercially driven decisions that will impact the business model because, at a future point in time, the operator will be required to cover system operational costs at their own risk. In addition, it is in the Authority's interest that the revenues from operations exceed operational costs so that those revenues can help fund system expansion.

In accordance with the business model laid out in the 2016 Business Plan, the purpose of this memorandum is to inform the Board on the current plans to establish future principles within which the fares and fees paid by passengers to ride the system, and the train service schedules, will be managed. These principles, and more specific guidelines, will be incorporated into the contract awarded to the successful bidder of the train operator procurement. While there will be other requirements that the operator procurement will need to set out, fare and schedule policies are two of the most critical elements that will need to be addressed so that potential bidders will fully understand the framework within which it will have autonomy to establish fares and schedules. It is also important that the Board begin considering the policy implications associated with governance of operations.

While formal procurement of the early operator has not yet started, staff is working on establishing the parameters within which the early operator would work, as part of implementing the 2016 Business Plan.

Discussion

Principles for Fare Setting and Schedules

All rail system owners must determine and establish a number of key policies, informed by governance and institutional arrangements. These policies will reflect and support other relevant federal and state policies and take into account the need for public projects to balance social, environmental, and financial goals. For the high-speed rail system this would translate as a service that is widely available to the public and integrated with other rail and transit services resulting in modal shift, in particular from auto, with consequential greenhouse gas emissions reductions.

Policy decisions will be required regarding the type(s) of schedule and service that are to be provided, and what fares will be charged. These decisions often have to balance the provision of transportation services as a public good against more commercially driven considerations.

Broadly speaking, there is a continuum of approaches taken, with maximization of ridership at one end and maximization of revenues at the other. The challenge for public agencies is to find the right place along the continuum to balance social and economic goals. For urban transit, these tradeoffs typically result in services that are subsidized to serve more riders and achieve other objectives such as alleviating congestion. In contrast, for high-speed rail systems, much like airlines, these decisions are often more commercially oriented and are focused on recouping the cost of running and maintaining the system from fares. Similarly, schedules must balance serving more communities by running more trains or having them stop in more places against the benefits provided by running faster service (with fewer stops) or the cost of providing additional services.

Domestic and International Examples

Traditionally, railroads all over the world were managed as integrated businesses where one owner is responsible for managing and maintaining all railroad infrastructure as well as directly operating the train service. Over the last 25 years, this traditional structure has evolved, for a variety of reasons, including the desire to increase competition and reduce operational costs.

In Europe, a ‘horizontally’ integrated business model has developed which separates train operation from infrastructure delivery and maintenance. For example, in the United Kingdom one publicly-owned company (Network Rail) manages all rail infrastructure and a number of independently owned train operating companies compete to run train services which are packaged into geographically organized contracts. These contracts are let and regulated by the central government, with the longer distance inter-city contracts generally paying a premium back to government, and shorter distance commuter contracts generally requiring a subsidy. This business model is highly regulated with regulation of track access (fair access for operators to use the rail network and to ensure best use is made of capacity), the performance of Network

Rail (the infrastructure provider), and for the train operators to adhere to performance standards that include reliability and punctuality, and a minimum number of services that must be operated. Fares are set by the private sector operators according to their commercial strategies, but if those commercial strategies run contrary to the broader public interest the government can intervene and ensure that its fare policy is being adhered to. Certain fares are regulated, for example 'standard class' fares are capped by the increase in the retail price index plus a maximum (variable) percentage increase. Operators are given the flexibility to run additional services and offer promotional and premium fares, at the operator's risk. Commercial risk is also off-set by the introduction of other revenue sources including car parking facilities, yield management systems, leasing retail space within stations, renting marketing space on trains and at stations, and working with other transport modes to introduce start to end ticketing Aspects of this model are seen in other European and Asian countries.

In the United States, Amtrak, a federally supported, for-profit corporation operates the majority of inter-city rail service. Amtrak's 7 voting Board members (appointed by the President and including the Secretary of Transportation) consider matters of policy, with the Federal Railroad Administration available to provide analytical support. Aside from the Northeast Corridor and shorter corridor segments in Indiana, Michigan and New York, Amtrak does not have a responsibility for the rail infrastructure. Instead it pays the freight railroads to utilize their infrastructure. Amtrak's policy is to balance revenues, costs, and grant requirements with social needs such as the requirement for one service per day on most long distance routes. Within this context fares are market driven, taking into account the competitiveness of other modes, congestion and demand. Amtrak's premium Northeast Corridor Acela is an all Business and First Class service, charging a relatively high fare as the corridor experiences very heavy demand for travel and capacity constraints, with the competing modes of road and air heavily congested and prone to poor reliability and performance. Acela services cover all of their operating costs and return a revenue surplus that is used to offset the costs of other, less economic services. A lower cost, slightly slower regional service is also operated in the corridor to provide a variety of services to customers. The Northeast Regional carries about three-fourths of the riders in the corridor and also operates a profit, albeit a smaller one than the Acela service.

In California, the State gives overall policy direction that is implemented by the joint powers authorities (JPAs) that oversee the Capitol Corridor, San Joaquin, and Pacific Surfliner rail services in conjunction with the contract operator, Amtrak. Within the overall state uniform performance standards (e.g. on-time performance, farebox recovery ratios, ridership growth targets), the JPAs have the ability to make decisions with regard to the specifics of the services they are running. Each joint powers authority submits an annual business plan to the Secretary of Transportation which details service levels and associated costs, capital expenditure, and revenues, subject to the Secretary's approval. Fares are developed in conjunction with Amtrak to ensure the rail service is competitive with other modes, with fare modifications used selectively to maximize revenue and ridership while still working toward the State's fare box recovery ratio of at least 50% for the Capitol Corridor and San Joaquin (and 55% for the Pacific Surfliner). Modifications to fares are generally recommended by staff for approval by the respective JPA Board.

California commuter rail and urban transit services are operated either directly by the owner of the system or by a contracted operator providing a service that the public sector agency pays them for. For example, in Los Angeles, L.A. Metro directly operates the urban Metro Rail system whereas the Coaster commuter rail service in San Diego County is contracted by the owning agency (North County Transit District) to a private sector operator, currently Bombardier Transportation. Fares and schedule changes are recommended by staff and approved by the appropriate Board.

In many instances, if the public agency that awards a train operating contract has a particular policy on fares that impacts the economics of operating the system, the private operator can be compensated accordingly. For example, many agencies use discount fares for seniors, and the operator may in turn receive a 'top- up' payment to reflect the full fare.

Internationally, inter-city and high-speed rail services are usually operated by either a national train operator, for example in France, SNCF, or by a private sector operator under contract. The particular arrangements vary from country to country and are dependent on a range of political and economic factors that will drive the degree of liberalization in the market.

Authority's Powers and Plans

In establishing the Authority, the Legislature gave it broad powers on how to develop and operate the high-speed rail system in California. In particular, the Legislature gave the Authority the power to set fares and schedules and to enter into contracts to design, construct, and operate the system.[1] At the same time, in passing Proposition 1A, the voters required the Authority to submit funding plans that show that the service that the Authority plans to run does not require an operating subsidy.

Since its earliest Business Plans, the Authority has always maintained that a private sector operator would run the system as a business in order to ensure that a public subsidy would not be needed and that operating profits could be monetized to pay for expansions to the system. This is reiterated in the Authority's 2016 Business Plan, where the business model and financial plans for the system are detailed extensively.

For the appointed train operator to run the system as a successful business, they will require a high degree of flexibility to set commercially viable fares and schedules commensurate with the objective of establishing an operational profit. Fare and schedule constraints imposed by the Authority will have the effect of reducing the operator's ability to make an operating profit, which is necessary to ensuring that a subsidy is not required. At the same time, the Authority needs to make sure that the public investment in the system achieves other broad public policy objectives including providing safe access and mobility to Californians, facilitating mode shift to reduce vehicle miles traveled, improving air quality, and ensuring that high-speed rail is part of California low-carbon future. These principles are reflected in the 2016 Business Plan which states that:

> "To increase the attractiveness of the operating concession, the private sector needs to have the ability to make key decisions on issues including schedules and

1 Public Utilities Code Section 185036

> fares in order to meet its market goals. At the same time, we will develop guidelines for the concessionaire to operate within to protect the public interest."

Vision and Principles

Based upon this model, the Board would assume the role of the regulating body for the high-speed rail system when it becomes operational. Authority staff would advise the Board and would ensure that all contracts put in place with the private sector to deliver and operate the system conform to the vision and principles of the Board. The contract with the train operator would set out the processes by which fares, schedules, performance levels, and other customer facing and commercial decisions are set, with suitable checks and balances for the Board to intervene. The intention is that there would not be an overly hands on approach, but that broad parameters would be agreed to and then monitored, with penalties and remedial measures available as a last resort.

Based on the guidance provided by the voters when they approved Proposition 1A and the Legislature as well as the Board through its business plans, the vision and principles for the setting of fares, fees for other service and amenities, and schedules on the high-speed rail system are as follows:

1. Fares, fees, and schedules must comply with all of the Authority's obligations under all environmental approvals and must meet any requirements of the Federal Railroad Administration's and Surface Transportation Board's oversight.

2. The Authority will give a private sector operator maximum flexibility to set fares and fees and design schedules to allow it to optimize the service to be provided to passengers and to operate without a subsidy.

3. The Authority will set out any restrictions or minimum service requirements that will be necessary to protect the public interest.

4. Fares on the high-speed rail system should be, to the extent feasible, integrated with other services in the state including intercity rail, connecting commuter rail, transit, and other services that passengers will use to get to or from the stations.

5. Schedules on the high-speed rail system should be, to the extent feasible, integrated with other rail and transit services in the state to allow for easy transfers for passengers and increased ridership and revenue for all services.

6. Every station should have, at a minimum, sufficient service to provide access and mobility for Californians in every community served by the system.

7. Fares, fees, and associated service levels should be set commercially with a range of fare options that are widely affordable.

8. The operator, in setting commercial fares, fees, and service levels (that meet the Authority's conditions) may elect to offer different classes of service with a variety of amenities offered to customers.

9. If an operator would set fares, fees, or schedules that substantially diminish the public benefits derived from the public investment in the high-speed rail system, the Authority must have the ability to intervene and correct the situation.

10. Such interventions should not be common practice in the course of business and should be reserved for limited and uncommon situations. Interventions would be in accordance with the provisions of the contract and could, ultimately, result in early termination. However, careful selection of the operating partner, carefully considered criteria by which changes to fares and schedules can be made, and a continuous process of dialogue through the life of the contract should negate the need for direct intervention.

Implementation

Based on the vision and principles set out in this memorandum, the Authority will develop a set of Train Operator policies that will inform specific guidelines that will be included as part of the eventual operator procurement. The entire operator procurement, including those guidelines, will be brought to the Board for approval.

Recommendations

This item is informational only; staff does not recommend any Board action at this time.

Attachments

N/A