

California carbon funds are an uncertain benefit for high-speed rail

By David Siders
dsiders@sacbee.com

It was a major lift for high-speed rail when Gov. Jerry Brown and the Legislature this summer pledged future proceeds from California's carbon-reduction program to help underwrite the state's \$68 billion project.

The bill included not only one-time funding of \$250 million, a relatively small sum, but also 25 percent of future revenue from California's cap-and-trade program, the money industries pay to offset their air emissions. Long-term funding, rail officials said, could be leveraged to secure private investment in the project.

Even before the funding was approved, several infrastructure development firms wrote letters expressing interest, encouraged by the prospect of cap and trade. Yet as rail officials began talking with potential investors about cap and trade in recent months, the funding source has proved not only to be alluring, but also problematic.

The Brown administration projected generating about \$550 million from cap-and-trade auctions in the current fiscal year, but the Department of Finance refuses to estimate future revenue, arguing doing so might influence the market. For investors looking for a reliable return, the uncertainty of future proceeds is concerning.

"Cap and trade is a potential good solution, but it's still not quite certain," said Michael Liikala, a consultant who advises foreign companies on infrastructure projects in the United States and who has been involved in high-speed rail talks. "It's like if you went to the bank for a mortgage and promised to give them 25 percent of your income, but you didn't know what the income would be."

Still, Liikala is optimistic. He said companies "see the potential here and are looking at it."

Talks between the rail authority and prospective private investors have picked up in recent months, benefiting both from the cap-and-trade announcement and a series of favorable legal rulings.

The California Supreme Court in October declined to review a lawsuit challenging the issuance of bonds for construction of the rail line. This month, the U.S. Surface Transportation Board ruled several lawsuits challenging the rail authority's plans on environmental grounds were barred by federal law.

Crews this summer began work on the first construction segment of the project, near Fresno, and a ceremonial groundbreaking has been scheduled for early January, one day after Gov. Jerry Brown's inaugural festivities.

But private investment is significant to the rail project. The Legislature in 2012 authorized \$5.8 billion to start construction, including \$2.6 billion in state rail bond funds and \$3.2 billion in federal aid. That money is a fraction of the \$68 billion total needed to connect Los Angeles and San Francisco through the Central Valley. And with Republicans now firmly in control of Congress, the prospect of future federal funding is dim.

Jeff Morales, chief executive officer of the California High-Speed Rail Authority, said discussions with private investors are "still at a very early stage." But he said the decision to dedicate cap-and-trade funds demonstrated ongoing political commitment to the project in Sacramento, bringing about a "material change in our discussions with private parties."

Among companies that contacted the state when cap and trade materialized was Sener Engineering and Systems Inc. which called cap and trade "a turning point" for high-speed rail.

Spain's Sacyr USA said in a letter that ongoing funding represented "the signal the private sector has been waiting for as it shows the state is committed to getting this project done and moving it forward now," and ACS Infrastructure Development Inc. predicted "this commitment by the state will in turn motivate private-sector involvement in the financing and development of the program."

The project is a priority for Brown, a Democrat entering his fourth term. Dan Richard, chairman of the rail authority board, said Brown wants project construction to accelerate. Richard, who piloted the private aircraft that flew Brown around the state in the final days of his re-election campaign, said "cap and trade was a tremendous thing for us because it gives us a long-term revenue stream."

However, he said, "it's not automatic."

Because the state is unwilling to estimate future revenue, Richard said, "I think it's up to the private sector, maybe with some ideas from us, to try to take a stream that is variable and somewhat hard to predict, and try to turn it in to a financing mechanism. ... Everybody's still quite enthusiastic about the prospect of it."

In February, the state's nonpartisan Legislative Analyst's Office said that while the cap-and-trade program is expected to raise billions of dollars through 2020, "the actual amount of revenue that will be raised is difficult to predict, particularly because of the uncertainty about future allowance prices."

It estimated potential total revenue ranging from \$12 billion to \$45 billion through 2020.

Brad Williams, the former chief economist for the Legislative Analyst's Office, compared potential borrowing against future cap-and-trade revenue to financing arrangements following the 1998 settlement between tobacco companies, in which California and many other states sold bonds to be repaid from proceeds from the settlement.

In the case of cap and trade, he said, "If you had kind of some sort of estimate that was deemed to be fairly reliable, yes, you would have people that would buy those bonds."

However, he said, "the greater perceived risk, the higher the interest rate" the state would pay.

John Barna, an infrastructure consultant and former executive director of the California Transportation Commission, called cap and trade a "great source of funding" but said "we don't have any experience with it yet."

"The marketplace, if you talk to a variety of bankers, will tell you that it's an interesting source," he said, "But when you get down to it, nobody's done it yet."

In the rail authority's Sacramento offices one day this month, Morales and the authority's chief financial officer, Russell Fong, said they are considering a range of financing options and that any investment deal, or deals, could take two or three years to materialize.

Morales and Fong said revenue is likely to become more certain as the cap-and-trade program matures. Also, some investors may be willing to assume increased risk in exchange for gaining a toehold in the high-speed rail market in the United States. Rail officials have met with representatives of the Chinese Investment Corporation, a major sovereign wealth fund.

"The private sector is very creative, and again, I think that you've got the potential for some of these sovereign (wealth) funds, whether it's China or Japan or Spanish or others, who may be looking for a strategic move, and so may be willing to take on certain risks just because of the strategic value of being part of America's first high-speed rail system," Richard said.

Mike Genest, who was former Republican Gov. Arnold Schwarzenegger's finance director, said cap and trade will be "a pretty tough one" for investment firms because of its uncertainties.

“There are large chunks, very large chunks of the financial markets that would not be allowed by their own conditions laid out in their prospectuses to invest in something like this,” he said.

Genest, who opposes the rail project, said the Department of Finance during Schwarzenegger’s tenure repeatedly advised the governor against it.

Schwarzenegger didn’t waver.

As for the current administration’s ability to execute a financing deal involving cap and trade, Genest said, “I wouldn’t put it past Finance to come up with a creative way to make it work.”

Call David Siders, Bee Capitol Bureau, (916) 321-1215. Follow him on Twitter [@davidsiders](https://twitter.com/davidsiders).