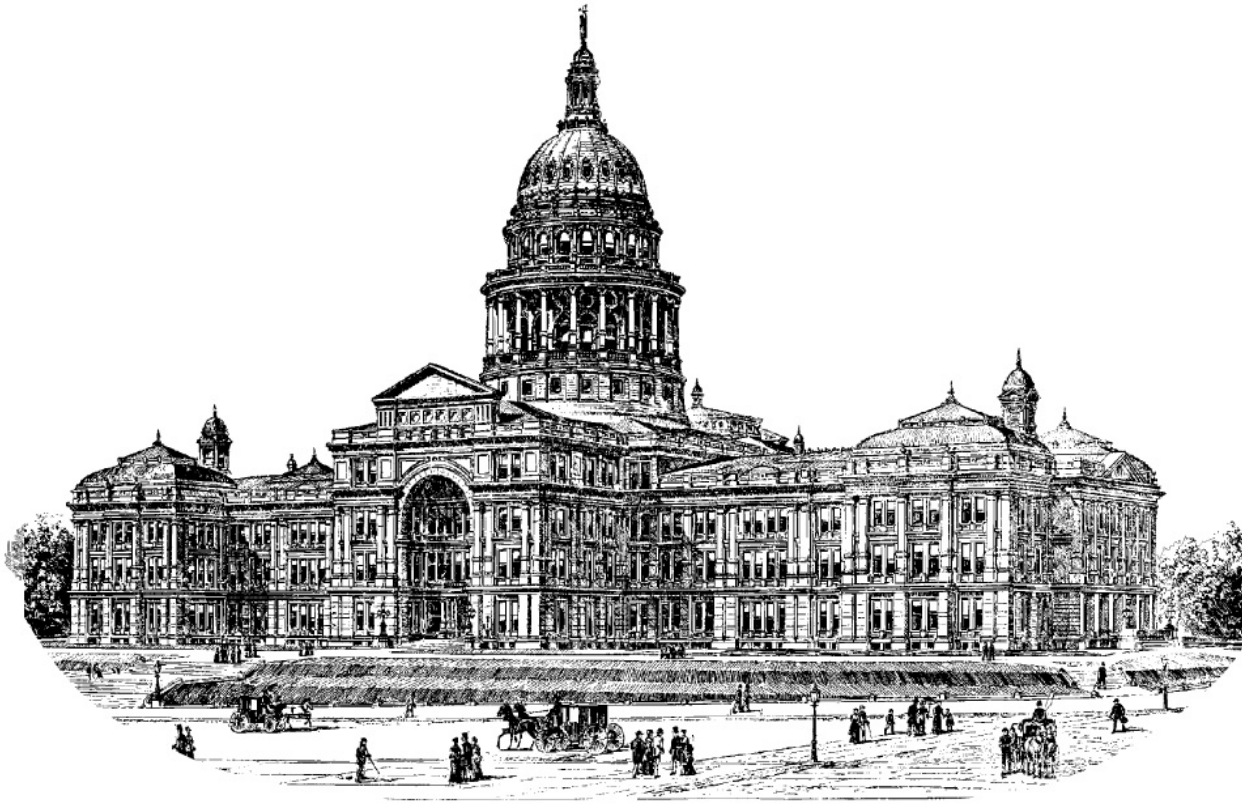
Interim Report

to the 83rd Texas Legislature



House Committee on

State Affairs

December 2012

HOUSE COMMITTEE ON STATE AFFAIRS
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2012

A REPORT TO THE
HOUSE OF REPRESENTATIVES
83RD TEXAS LEGISLATURE

BYRON COOK
CHAIRMAN

COMMITTEE CLERK
TONI BARCELLONA

Committee On
State Affairs

December 13, 2012

Byron Cook
Chairman

P.O. Box 2910
Austin, Texas 78768-2910

The Honorable Joe Straus
Speaker, Texas House of Representatives
Members of the Texas House of Representatives
Texas State Capitol, Rm. 2W.13
Austin, Texas 78701

Dear Mr. Speaker and Fellow Members:

The Committee on State Affairs of the 82nd Legislature hereby submits its interim report for consideration by the 83rd Legislature.

Respectfully submitted,

Byron Cook, Chairman

Jose Menendez, Vice-Chairman

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SYLVESTER TURNER
STATE REPRESENTATIVE

December 10, 2012

The Honorable Chairman Byron Cook
Chairman, State Affairs Committee
P.O. Box 2910
Austin, TX 78768-2910

Dear Chairman Cook:

I would like to thank you for the opportunity to provide my review of the House Committee on State Affairs Interim Report for 2012.

At this time, I would like to note my serious concerns with the regulatory initiatives taken by the Texas Public Utility Commission (PUC) and the Electric Reliability Council of Texas (ERCOT) which are reflected in the "Resource Adequacy" portion of the report.

I am troubled by the PUC rule changes that will raise the system wide cap to $9,000.00 per megawatt hour. I expressed my concerns to the PUC prior to its vote and asked the Commissioners to state the impact on the costs to consumers. I am also troubled that in a deregulatory environment, the PUC is now regulating the market which is antithetical to what was represented by the industry and the PUC in 1999.

While I am providing my signature to this final report, I would like to ensure that my comments regarding my objections to certain sections of this report are duly noted.

Sincerely,

Sylvester Turner

Sylvester Turner
State Representative, District 139

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INTRODUCTION

On February 9, 2011, Texas House Speaker Joe Straus appointed 13 members to the House Committee on State Affairs (the Committee): Byron Cook, Chairman; Jose Menendez, Vice-Chairman; Tom Craddick; John Frullo; Pete Gallego; Charlie Geren; Patricia Harless; Harvey Hilderbran; Dan Huberty; Rene Oliveira; John Smithee; Burt Solomons; and Sylvester Turner.[1]

Under House Rule 3, Section 32, the Committee has jurisdiction over matters pertaining to:

1) questions and matters of state policy;
2) the administration of state government;
3) the organization, operation, powers, regulation and management of state departments, agencies and institutions;
4) the operation and regulation of public lands and state buildings;
5) the duties and conduct of officers and employees of the state government;
6) the operation of state government and its agencies and departments; all of above except where jurisdiction is specifically granted to some other standing committee;
7) access of the state agencies to scientific and technological information;
8) the regulation and deregulation of electric utilities and the electric industry;
9) the regulation and deregulation of telecommunications utilities and the telecommunications industry;
10) electric utility regulation as it relates to energy production and consumption;
11) pipelines, pipeline companies, and all others operating as common carriers in the state;
12) the regulation and deregulation of other industries jurisdiction of which is not specifically assigned to another committee under these rules; and
13) the following state agencies: the Council of State Governments, the National Conference of State Legislatures, the Office of the Governor, the Texas Facilities Commission, the Department of Information Resources, the Inaugural Endowment Fund Committee, the Sunset Advisory Commission, the Public Utility Commission of Texas and the Office of Public Utility Counsel.[2]

On September 22, 2011, the Committee held a hearing focusing on the effects the United States Environmental Protection Agency's Cross State Air Pollution Rule would have on the state's energy supply. A number of witnesses representing generators, regulators, consumers and various advocacy groups testified that the finalized rule could have devastating consequences on the Texas economy.

In October 2011 and March 2012, Speaker Straus released interim charges, which list specific topics for the Committee to study prior to the start of the 83rd Legislative Session. Several public hearings were held throughout the interim to give experts the opportunity to provide the Committee with information related to the charges.[3, 4]

The first of two hearings on resource adequacy was held on February 9, 2012. Thirteen invited witnesses with expertise related to the state's deregulated electricity market provided information and proposed a number of ideas for ensuring that Texas' supply of energy is sufficient to meet current and future demand.

The Committee also held hearings on several joint charges. On July 10, 2012, the House Committee on State Affairs met with the House Committee on Technology in a public hearing to discuss potential cost-effective uses for cloud computing that could streamline state agency operations, while maintaining the security of private information. A public hearing with the House Committee on Government Efficiency and Reform was held on July 11, 2012, providing the opportunity for witnesses to testify about two joint charges. Interested parties discussed possible uses for privatization that could increase the quality and cost effectiveness of state services as well as ways to improve agency rulemaking.

A public hearing was convened on July 10, 2012, giving House State Affairs members the opportunity to hear information about the implementation of Senate Bill (SB) 1048, the Public and Private Facilities and Infrastructure Act. Nine witnesses provided input about how the process for developing public-private partnerships has changed since the passage of SB 1048.

A number of state agencies and two private entities testified at a September 27, 2012 hearing about the state's procurement practices. Witnesses provided valuable insight about how separate agencies have different contracting procedures, and offered recommendations for how the process could be improved in the future.

The final interim hearing was on October 24, 2012. It served as a follow-up to the February 9th resource adequacy hearing and provided participants the opportunity to comment on potential changes to improve the Texas electricity market and meet the growing demand. The Committee also heard from witnesses regarding inefficiencies related to public utility regulation.

Having completed its study on the charges assigned by the speaker, the Committee has adopted the following report.

INTERIM CHARGES

- Examine the issue of resource adequacy in the Texas electricity market, federal and state interventions in the marketplace that may be negatively impacting future adequacy, and the best way to maintain resource adequacy.

- Examine whether current law ensures broadband provider access to an electric cooperative's utility poles and facilities pursuant to reasonable, cost-based, and nondiscriminatory rates, terms, and conditions. Study methods for improving access to electric cooperative utility poles to reduce unnecessary costs and delays for the delivery of broadband service to Texas consumers.

- Examine areas of potential privatization of state services in an effort to achieve a higher level of service and greater efficiency for Texas taxpayers. (*Joint with the House Committee on Government Efficiency & Reform*)

- Identify inefficiencies in the regulation of public utilities in order to minimize the cost of regulation to consumers.

- Examine methods of cloud computing technology to streamline agency operations and generate greater efficiencies for more cost-effective operations. (*Joint with the House Committee on Technology*)

- Examine state agency rulemaking and consider ways to improve procedural efficiencies and public transparency, and to better inform policymakers as to their use, purpose, and cost-effectiveness, including an examination of the financial and other impacts such regulations have on both the license holder and the public. (*Joint with the House Committee on Government Efficiency & Reform*)

- Monitor the agencies and programs under the committee's jurisdiction, including the implementation of SB 1048 regarding public-private partnerships on state-owned property.[5]

- Study how businesses seeking to provide goods or services to the state interact with state agencies. Consider whether additional procedures are needed to ensure that goods and services obtained by the state are the best value. Determine whether additional disclosure and reporting requirements are necessary to ensure transparency, accountability and to promote ethical business practices.[6]

RESOURCE ADEQUACY

Interim Charge: Examine the issue of resource adequacy in the Texas electricity market, federal and state interventions in the marketplace that may be negatively impacting future adequacy, and the best way to maintain resource adequacy.

Background

Resource adequacy is the electric system's ability to provide the energy demanded by customers at all times.[7] The issue of maintaining a sufficient supply of electricity in Texas has become more serious and will require policymakers, government agencies and industry leaders to work together to develop and implement thoughtful solutions.

The demand for electricity in Texas has been increasing dramatically due to robust expansion in the population and the economy. Between 2000 and 2010 the state's population rose by over 20 percent, going from almost 21M to over 25M, which has been a contributing factor for the amount of electricity needed to meet customer demand and avoid interruptions on days when it is needed most. The growth in the Texas economy, particularly in manufacturing and industrial sectors, has also resulted in increased demand. Despite declining reserves, investment in new generation has slowed. To ensure that the state's prosperity continues, as the demand for energy increases, additional capacity will be necessary.[8, 9, 10]

Reserve margin is defined as the percentage by which the electricity supply is expected to exceed demand at a given point in time. To guarantee adequate energy is accessible at all times, reserves must be available to protect against unexpected shortages during peak times, or when demand is higher than forecasted.[11] The state's current reserve margin target is 13.75 percent, but the Electric Reliability Council of Texas (ERCOT) is reevaluating the target. If the current reliability standard is maintained, it is likely that the reserve margin target will increase once the anomalous 2011 weather data are considered.[12, 13]

The situation described by ERCOT in the December 2011 Capacity, Demand and Reserves (CDR) report was bleak. It included predictions that the reserve margin would fall below the target as early as 2012 without significant intervention. However, subsequent projections show a more optimistic outlook. The May 2012 CDR report showed the reserve margin staying above the target for the 2013 peak season, but dropping to 9.8 percent by 2014, 6.9 percent by 2015 and becoming negative by 2022. The CDR report released in December 2012 concluded that the 2013 peak season reserve margin will fall slightly below the target, but the forecasted reserve margin for 2014 is higher than the two previous reports. The reserve margin data from ERCOT have complicated the task of evaluating the state's options and deciding on a definitive course of action. In order to make the best decisions for the state, possible solutions must be carefully evaluated; however, this has been extremely difficult because utility regulators and lawmakers are working with ever-changing projections.[14, 15, 16]

Without enough energy to meet demand, residents could experience involuntary load shedding (rolling blackouts) and a dramatic increase in wholesale electricity prices. The entire state's economy would feel negative affects if inadequate energy supplies prevent companies from

functioning properly. Moreover, any uncertainty related to the cost or availability of electricity could hinder business activities and discourage new economic growth.

Developing new generation before there is a significant drop in reserve margin is essential, but it is necessary that Texas remain mindful that changes to the energy market can have a meaningful impact on utility prices. It is vital that solutions to address resource adequacy maintain a competitive market structure, while balancing the need for more electricity with the desire to keep costs as consistent as possible.

A number of factors have complicated the resource adequacy issue, including additional federal regulations, weather conditions and the current economic environment.

Regulatory Factors Affecting Resource Adequacy

The United States Environmental Protection Agency (EPA) has adopted two rules that could have a significant impact on resource adequacy: the Cross State Air Pollution Rule (CSAPR) and the Mercury and Air Toxics Rule (MATS).[17] Compliance with new regulations often requires power plants to modify their operations or install new equipment, which can be very costly and time consuming. Facilities are sometimes retired or mothballed because it is not cost effective for generators to make the necessary changes.[18]

CSAPR requires 27 states to reduce emissions from power plants because of the predicted effect the chemicals have when they travel from upwind states to downwind states. According to the EPA, emissions from the states included in the rule impact other states' ability to comply with National Ambient Air Quality Standards. The final adopted version of CSAPR, which was signed by the EPA on July 6, 2011, included Texas in portions of the rule that had not been anticipated. Because the rule was scheduled for implementation on January 1, 2012, there was less than six months between adoption and implementation, which could have caused serious repercussions for the state's energy market. It was announced that the rule would have required at least 1300 MWs of generation to shut down immediately. The Texas Attorney General filed suit in federal court to halt the enforcement of the rule. Two days before the rule's effective date, the court issued a stay, delaying the implementation until a decision could be made about the legal basis for the rule.[19]

The willingness of the United States Court of Appeals to institute a stay prior to the scheduled implementation of CSAPR had an almost immediate positive effect on resource adequacy. Generation units that were previously planning to be mothballed because of an inability to comply with the rule were able to stay online.

On August 21, 2012, the federal appeals court vacated CSAPR. While the ruling to revoke CSAPR was a victory for Texas, the EPA filed a petition on October 5, 2012, requesting an en banc rehearing of the August 21st decision.[20] Subsequently, there is still uncertainty regarding whether Texas will have to implement CSAPR, and what affect it may have on the state's electricity market.

MATS, which was released by the EPA on December 16, 2011, sets hazardous air pollutant

emission standards for mercury, non-mercury metals and acid gases for coal- and oil-fired power plants.[21] MATS requires compliance by 2015 and could affect as many as 1,100 existing coal-fired and 300 oil-fired units at 600 power plants around the country. It is estimated that 56 power plants in Texas will be required to comply with the new standards, more than any other state.[22] It is still unclear exactly how Texas will be impacted, but based on a preliminary analysis of the final rule, the Texas Commission on Environmental Quality and the Public Utility Commission of Texas (PUC) continue to have significant concerns about the basis for the standards, achievability, compliance dates and potential impact on electric reliability.[23]

MATS could have a dramatic effect on resource adequacy by implementing onerous emissions standards, which may result in the retirement of existing coal-fired generators. It may also result in new generation projects being delayed or cancelled because the emissions requirements under MATS could be more stringent than those included in finalized air permits. This discrepancy could result in facilities being required to reapply for air permits, which would be resource intensive.

Weather Related Factors Affecting Resource Adequacy

Certain weather related factors have affected resource adequacy in Texas, by increasing the demand for electricity and potentially hindering generators' ability to produce energy at their full capacity. In 2011, Texas experienced extreme weather patterns that highlighted the importance of having sufficient reserves. Freezing temperatures in February adversely effected equipment and forced a number of generators offline. The decrease in supply, combined with an increase in the amount of energy needed to properly heat buildings forced ERCOT to shed load, resulting in consumers experiencing outages.[24] The summer of 2011 was the hottest on record in Texas, and the intense heat caused an increase in energy consumption, which resulted in the reserve margin dropping below the target a number of times.[25, 26] On several occasions during the summer, ERCOT was forced to issue warnings and request that individuals and businesses conserve electricity, but the shortages never resulted in outages.

Because electricity production often requires using water for cooling, drought conditions could also contribute to reliability issues. In 2011, Texas had the worst one-year drought in the state's history. Many regions received less than half of the normal amount of rain, lowering lake levels, stream flow and water tables to alarming levels.[27] Drought conditions in areas of Texas have moderately improved since the release of the December 2011 CDR report. In September 2011, over 96 percent of the state was in either extreme or exceptional drought. One year later, it had dropped to 24.9 percent. ERCOT has reported that Texas has not experienced electricity shortages because of the water shortages; however, if the current conditions continue or worsen it could result in severe consequences for generators.[28, 29]

Market Factors Affecting Resource Adequacy

The construction of new capacity has not been sufficient to maintain long-term resource adequacy because demand for electricity has been increasing, while current economic conditions have stifled investment in capital projects. Texas has an energy-only wholesale electric market -- which means that generators bear the financial risk of building new facilities. In an energy-

only market, operations and investments are driven primarily by energy prices. In other states, mechanisms like market-based payments are used to incentivize development, transferring some of the risk to the ratepayers.[30, 31]

In recent years, it has been more challenging to secure financing for generation projects because profitability is uncertain, and investors are more conservative and risk adverse than they have been previously. Natural gas prices set wholesale electricity prices for most of the day, and are currently low and stable; therefore, it is difficult for electricity producers to realize a return on their investment. Low and stable prices also discourage retail and industrial consumers from signing long-term energy contracts because a significant increase in price is not a foreseeable concern. Without contracts, generators do not have a guaranteed customer base to incentivize the construction of new facilities.[32, 33]

Some companies have decided not to build new capacity because federal subsidies for wind energy have distorted the electricity market.[34] The Production Tax Credit (PTC), which is set to expire on December 31, 2012, only pays generators when wind energy is sold. They receive $22 for every megawatt hour of electricity purchased, creating an incentive for wind generators to sell electricity for less than it costs to produce. The PTC allows wind generators to make up for negative prices, but price signals in the wholesale electricity market are distorted, making it difficult for other types of generation to recover their costs.[35]

Findings

To ensure long-term resource adequacy in Texas, while maintaining a competitive market, rules and policies must be established that strike a balance between the needs of consumers and the needs of the generators. Electricity customers expect access to reliable power at an affordable and fair price. Generators need appropriate market signals that allow them to get a return on their investment. Recognizing the importance of maintaining an adequate supply of electricity, lawmakers, the PUC, ERCOT, generators, consumers and other stakeholders have been working together to address resource adequacy.

Regulatory Initiatives to Improve Resource Adequacy

The PUC and ERCOT have implemented a number of regulatory changes to address resource adequacy by improving market signals and increasing capacity. The PUC initiated rulemaking projects to encourage the development of new technology and provide greater flexibility for conducting pilot projects. Significant changes were made to the Emergency Response Service, formerly known as the Emergency Interruptible Load Service, to increase participation in the program, resulting in more demand response.[36]

The PUC also approved rule changes that will incrementally raise the system wide offer cap to $9,000 per megawatt hour. The new provisions are an economically efficient way to support resource adequacy by increasing incentives for both demand response and the construction of new generation.[37]

To examine the issue of resource adequacy in Texas, ERCOT hired an independent consulting

firm, the Brattle Group. In June 2012, the Brattle Group released a report that confirms maintaining sufficient reliability will be a major challenge. The report asserted that there are fundamental problems with the current market design and changes will be necessary to maintain an appropriate reserve margin to prevent reliability related outages. It also provided several options for changes to the electricity market that could encourage new capacity and protect resource adequacy.[38]

At a PUC hearing on October 25, 2012, the commissioners considered two options for changes to the current market design that would address the fundamental issues identified by the Brattle Group. The meeting was adjourned without taking action to adopt a specific market design.

Some experts have suggested that additional action should be taken, regardless of the market structure, to improve scarcity pricing. An operating reserve demand curve could be used to help achieve the energy prices needed to incentivize new generation. The demand curve could allow energy price increases to correspond to the level of scarcity. It could also result in more efficient load and generation response at different price points along the curve.[39]

Improvements to the Market Design

The recent changes made by the PUC and ERCOT to enhance scarcity pricing will likely attract new generation and improve resource adequacy, but additional action will probably be necessary. Reserve margin projections have been improving; however, problems with the market structure persist, and the current levels of reliability may not be sustainable without significant changes to the market design.[40]

According to the Brattle Group, if the current energy-only market is maintained, the reserve margin is expected to fall to eight percent before energy prices could support significant investment in new plants. If Texas experiences extreme heat like 2011, almost 20 events are anticipated at an eight percent reserve margin; only 2.4 events are expected at a reserve margin of 14 percent. The public is intolerant of reliability related outages because they are often perceived as planning failures, but accepts the occasional outage caused by adverse weather. An eight percent reserve margin would likely result in an unacceptable number of involuntary load shedding events.[41]

Recognizing the importance of implementing a market design that will maintain long-term reliability, two composite models have been developed based on extensive stakeholder feedback: an energy-only market with administrative supports and a Texas capacity market. Both designs are currently being carefully evaluated to determine which will more effectively provide enhanced reliability at the lowest possible cost. Most resource developers need two to three years for planning and construction. Making a decision with enough time to develop additional capacity is critical, but because reserve margin projections in ERCOT's CDR reports have been improving, regulators have the time needed to continue to thoughtfully explore all of the state's options.[42]

Energy-only Market with Administrative Support

An energy-only market with administrative support would maintain the wholesale energy price structure of our current energy-only market, and would attempt to achieve adequate reliability by using administrative support mechanisms. To successfully build enough capacity, energy prices need to be sufficient to encourage the development of additional capacity. The scarcity pricing reforms that are already being implemented by the PUC and ERCOT will help, but additional changes may be needed to achieve the necessary energy prices.

Demand response could provide additional electricity resources without suppressing energy prices or displacing investment. To achieve the desired level of reliability, substantial demand response would need to be developed quickly. It is unlikely that the market alone would be able to expand demand response soon enough to meet the growth in load. The PUC and ERCOT could use administrative supports to strengthen demand response for all customer segments, from residential to large commercial and industrial. Currently, residential customers account for 53 percent of peak load, but provide very little demand response because residential and small commercial demand response programs are more complicated and more difficult to implement than programs that focus on large industrial customers. Several innovative ideas for encouraging growth in residential demand response have been developed and could be administered if this market design is adopted.

Existing demand response initiatives focus primarily on large industrial customers, but more participation from this sector will probably be necessary. A capacity auction could be used to encourage more industrial demand response. Before setting up a capacity market for demand response, there are significant risks that need to be carefully evaluated. A capacity market that only focuses on demand response creates a less efficient market because a demand response-only capacity market is discriminatory against other resources. This design also has many of the same complicated issues associated with a broader capacity market. To incentivize enough demand response to sustain adequate reliability, capacity payments may be needed for many years. Moreover, regulators would need to resolve potential issues with price formation because the deployment of demand response can depress the price below the strike price, known as price reversal.

If demand response is insufficient to achieve enough reliability in an energy-only market, another administrative tool could be used. The quantity of operating reserves could be increased through an administrative withholding proceeding, but determining the proper amount of operating reserves is complicated. A commitment to support administrative withholdings would be necessary two to three years before the additional generation is needed.

Some stakeholders have supported the implementation of this market design because they contend it would be easier, faster and less complicated to administer than a broader capacity market. They argue it would be better at maintaining the integrity of a competitive energy market and would have less of an impact on energy prices. Other interested parties have expressed hesitation about implementing this model because it would create a discriminatory capacity market and it is uncertain whether enough demand response could be developed to achieve the desired reliability.

Texas Capacity Market

Under a Texas capacity market design, a specific resource adequacy requirement would be established and generators would compete to meet the obligation through a capacity auction. This structure could improve resource adequacy because it allows competition between existing participants and new entrants into the market. It could provide some additional predictability because the boom and bust cycles present in the current market would be stabilized. Another beneficial design element would be an elastic forward supply curve, which may improve price formation. If implemented, this market design could also respond effectively and efficiently to supply challenges like new EPA regulations or extreme weather conditions.

Unlike other capacity markets, the Texas capacity market would be a single region-wide market, which would be easier and more stable. A single market would avoid the complexity of a locational market, and would be less susceptible to price volatility and market manipulation. A minimum offer price rule (MOPR) is necessary in other capacity markets to prevent market manipulation, but because there is a one-state regional transmission organization regulated by a single entity, MOPR is less meaningful in Texas. While establishing a MOPR is unnecessary, adopting a statement of principles could provide stakeholders with additional regulatory certainty. To further protect the integrity of the market, the Independent Market Monitor could be given the discretion to identify manipulation and recommend mitigating measures to the PUC.

In order to successfully implement a capacity market in Texas, it would be necessary to carefully balance the use of capacity payments and penalties with the continued use of scarcity pricing in the energy market. Deliberate planning during the transition period would be critical to mitigate some of the potential problems.[43, 44, 45]

Supporters of the Texas capacity market have argued that it is the best option for ensuring the state has an acceptable level of long-term reliability because it establishes a specific resource adequacy requirement. However, other industry participants are concerned that developing a capacity market would be too costly and complicated. Opponents contend it would be difficult to adopt all of the necessary rules in time to incentivize capacity growth before reserve margins drop. There have also been concerns expressed that a capacity market would undermine the fundamental structure of a competitive market and result in higher prices for consumers.

Conclusion

Because resource adequacy affects the state's economy and every facet of Texans' lives, it is imperative that any changes made to the electricity market ensure there will be a sufficient supply of energy now and in the future. The decisions made could have a significant impact for generations to come, and the latest information indicates that the outlook for resource adequacy, while still challenging, has improved. Utility regulators and legislators should take the time necessary to carefully assess market design options before deciding on a definitive course of action.

POLE ATTACHMENTS

<u>Interim Charge</u>: Examine whether current law ensures broadband provider access to an electric cooperative's utility poles and facilities pursuant to reasonable, cost-based and nondiscriminatory rates, terms and conditions. Study methods for improving access to electric cooperative utility poles to reduce unnecessary costs and delays for the delivery of broadband service to Texas consumers.

Background

Utilities require a physical infrastructure to carry the wires that move resources from the provider to the customer. Telecommunications and electric utilities have established a system of poles to carry their wires; however, cable companies rarely have their own poles. Creating a separate system specifically for cable would be expensive and redundant; therefore, most cable companies negotiate with existing pole owners to lease space on their poles. Reaching contract agreements for attachments can be difficult and can create economic and legal issues.[46]

The federal code exempts electric cooperative and municipally owned utility (MOU) poles from regulation, and specifies that the Federal Communications Commission (FCC) has the responsibility to oversee the rates, terms and conditions of cable television attachments to investor owned utility poles. The statute requires utilities to charge just and reasonable rates and provide non-discriminatory access to their poles. It also directs the FCC to develop a standard method for determining rates and gives the agency the authority to resolve disputes related to pole attachment agreements.[47]

Federal statutes give states the ability to adopt their own standards, and specify that any provision adopted by a state preempts the federal regulations. The FCC is required to periodically publish a list of states that have elected to adopt their own pole attachment guidelines. The most recent list, which was released in May 2010, includes 20 states (Arkansas, Alaska, California, Connecticut, Delaware, Idaho, Illinois, Kentucky, Louisiana, Maine, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Oregon, Utah, Vermont and Washington).[48]

Texas has not been certified by the FCC as a pole attachment regulator, but the state passed legislation in 2005 affecting attachments to poles owned by municipally owned utilities. MOUs agreed to an amendment in 2005 to The Public Utility Regulatory Act as part of the effort to increase competition amongst telecommunications providers. It set clear guidelines for antidiscrimination and pole rental uniformity for attachments to poles owned by MOUs. It also gave the Public Utility Commission of Texas authority to regulate disputes related to MOUs' poles.[49]

Excluded from both federal and Texas statutes are regulations addressing pole attachment agreements between cable companies and electric cooperatives. Rather, the terms, conditions and rates for attachments on cooperative poles in Texas are established in private contracts between cooperatives and attachers. The rationale for omitting cooperatives from federal regulation was outlined in the federal Senate Report on the Pole Attachment Act of 1978. It

specifies that rates charged by cooperatives are already subject to a decision making process that is based on the needs of the public; therefore, the rates presumably reflect an equitable distribution of pole costs.[50] Furthermore, in order to maintain their tax-exempt status, cooperatives are required to charge cost-based rates for their services, including pole attachments.[51] Congress concluded that it is in cooperatives' best interest to establish reasonable pole attachment agreements with cable providers, and consequently does not require government intervention.

There was an unsuccessful attempt to have state government regulate pole attachments for electric cooperatives during the 82nd Legislative Session. House Bill (HB) 2710 would have established state regulation of pole attachments for cooperatives. The House State Affairs Committee heard testimony related to the bill, but due to concerns about the legislation members opted not to vote on the measure, and the legislative session ended with HB 2710 left pending in committee. There was no senate companion bill.[52]

Findings

While codifying explicit guidelines for agreements between cable companies and cooperatives is not essential, it could create a more predictable and efficient system, but reaching a consensus has been difficult. Specifically, differences between cable companies and cooperatives can relate to unauthorized attachments, unsafe or abandoned attachments, access, timeliness, rent calculations, private property easements and the dispute resolution process.[53]

Cable companies argue that they could be prevented from expanding service if they are unable to attach to cooperatives' poles. They want to avoid any future complications by statutorily prohibiting cooperatives from denying access. Cooperatives assert that access is not an issue because there has never been a situation where a cable provider has been barred from attaching their equipment to a cooperative's poles.[54]

Claims have been made by cable companies that broadband expansion projects could potentially be stalled because cooperatives are not required to take action within a specific timeframe. While there are no statutorily established deadlines, delays have not historically been issues in Texas because cooperatives already accommodate cable's strict timelines in most instances. The contract and construction process can be resource intensive, and cooperatives attempt to complete the process as quickly as possible. Pole owners must process the permit application, conduct a pre-construction survey, provide an estimate for the cost to prepare (make-ready) the poles and then perform the preparation work. The procedure can be particularly difficult if a large number of attachments are requested at one time. If numerous permit applications are received simultaneously, they need additional time for processing and construction.[55]

Broadband providers have expressed concern that because rates are not regulated, cooperatives can charge amounts that make expansion cost prohibitive. Conversely, cooperatives argue that the fees are set at an extremely reasonable level. The average cost in Texas is lower than the national average, and rural areas, where broadband services are most limited, charge some of the lowest rates in the state.[56]

Establishing an appropriate method for calculating pole attachment rates has been a challenge. Cooperatives want to ensure that they can charge an amount sufficient to cover the costs associated with the attachment, including maintenance. Cable companies want to keep their rent costs as low as possible. The FCC has developed formulas for determining rates, which cable companies would like to be used for cooperatively owned poles; however, cooperatives have argued that the federal formulas set rates at artificially low levels that would not allow them to recoup all their costs.[57]

Cooperative utilities work diligently to establish attachment agreements and have expressed frustration with cable providers that attach to cooperative poles without authorization. Under the current regulatory framework, there are very few consequences for companies that fail to notify pole owners prior to attachment. Cooperatives would like to establish penalties for cable providers that do not go through the appropriate permit process.[58]

Cooperatives are also concerned about attachments that are abandoned or create safety concerns. Presently, pole owners can request that the cable providers fix their attachments and clear their abandoned wire, but if companies do not comply with the request, cooperatives have few options except to use their resources to resolve the problem. Cooperatives would like enforcement provisions that hold attachers financially responsible for any situation attachers cause.[59]

Cable companies that add equipment to utility poles are required to get authorization from private property owners to attach in a particular easement or right-of-way. Unlike most municipally owned or investor owned utilities, many cooperative poles are on private land. There are instances where cable companies fail to get the necessary approval. Cooperatives want cable companies to indemnify them from liability resulting from the cable company's failure to obtain a necessary easement for its attachments.[60]

Finally, under the current system, if a cooperative and cable provider are unable to reach an agreement, it can result in lengthy and expensive litigation. Such litigation has been extremely rare. It could improve efficiency if a specific dispute resolution process was developed. Historically, the two groups have disagreed on how that process should be structured and who should have the authority to resolve issues related to pole attachment agreements.

Conclusion

Representatives from the state's electric cooperative association, the telecommunications industry and the cable association have been actively working toward resolving their contract disputes. They have been meeting to negotiate an agreement, which may be introduced legislatively during the 83rd Legislative Session; however, this conflict remains a disagreement between private entities over contract provisions, and therefore, statutory intervention is not essential.

PRIVATIZATION OF SERVICES

<u>Interim Charge</u>: Examine areas of potential privatization of state services in an effort to achieve higher level of service and greater efficiency for Texas taxpayers. (*Joint with the House Committee on Government Efficiency & Reform*)

Testimony

The House Committee on State Affairs, in a joint hearing with the House Committee on Government Efficiency and Reform, heard testimony regarding this charge on July 11, 2012. The hearing included invited testimony from the following persons:

- Albert Cortez, private citizen
- Leonard Gilroy, Director of Government Reform, Reason Foundation
- Shar Habibi, Resource Center Director, In The Public Interest
- Terri Hall, Founder, Texans Uniting for Reform & Freedom
- Talmadge Heflin, Director of Center for Fiscal Policy, Texas Public Policy Foundation
- Richard Jackson, President, SpeakWrite
- Todd Kimbriel, Director of eGovernment, Department of Informational Resources
- Neal Oliver, American Federation of State, County & Municipal Employees
- Brian Olson, American Federation of State, County & Municipal Employees
- Karen Robinson, Executive Director, Department of Informational Resources
- Tom "Smitty" Smith, Texas Director, Public Citizen
- Thomas Suehs, Executive Commissioner, Texas Health and Human Services Commission
- Wayne Wilson, Executive Director of Enterprise Contract and Procurement Services, Texas Health and Human Services Commission.

Background

Privatization, also known as contracting out, outsourcing, competitive sourcing or public-private partnerships, contemplates the transfer of government responsibility to the private sector.[61] There exists innumerable ways government may bring the private sector into the process of provisioning a government good or service. In fact, the state in 2005 had approximately 21,664 contracts for the purchase or provision of approximately $59.8B worth of goods and services, each representing a form of privatization.[62] By 2012, the State of Texas had contracts or provisions worth approximately $82.08B.[63]

The term privatization can be ambiguous, the meaning of which can change by degrees depending on the user and the context. For example, the Congressional Budget Office (CBO) states, "true privatization involves a genuine sale of assets and termination of a federal activity."[64] The CBO's definition appears limiting in light of the interim charge by Speaker Joe Straus that emphasizes the need to achieve a higher level of service and greater efficiency, which requires a more elegant solution then simply selling state lands or assets. A working definition more suitable to policy makers of the legislature may be that of the "use of the private sector in the provision of a governmental good or service, the components of which include the supplying,

production, delivery and quality control."[65]

The privatization of governmental goods and services in the United States dates back to the founding of the country. The first U.S. Congress approved an act that essentially privatized the operation of the nation's lighthouses, beacons, buoys and public piers.[66]

A century and a half later, the Tennessee Valley Authority (TVA) was established by the U.S. government to provide electricity for 9M people across seven southeastern states. The TVA also provides flood control, navigation and land management for the Tennessee River system and assists utilities, state and local governments with economic development.[67]

Since the 1970s, the practice of privatization has increasingly grown at all levels of government.[68] The trend stems from the common belief that private companies can help governments save or make money by doing jobs faster and cheaper, or managing a public asset more efficiently. In fact, a recent review of more than 100 privatization studies found savings ranging from 20 percent to 50 percent.[69]

In 1992, the book *Reinventing Government* noted this revolutionary restructuring of the public sector by documenting a comprehensive compilation of the ideas and experiences of market forces in government. The book set forth ten operating principles that distinguish a new entrepreneurial form of government, and spurred on the privatization growth of government.[70]

Due to the potential for savings and increased efficiency in providing services to taxpayers, the issue of privatization is non-partisan. The Texas Public Policy Foundation stated that public policy in Texas should favor private production whenever possible "because government preempts competition, stifles entrepreneurial opportunity, destroys economic growth, and raises the price of doing business."[71] Likewise, the Center for Public Policy Priorities, noted the benefits of Strengthening Families, a privatization program implemented by Texas in 2008. During the first 20 months of the program, approximately 1,300 families and 4,500 children participated in the program. An evaluation of the program estimated that the program prevented 248 children from becoming wards of the state, resulting in a savings in both federal and state dollars of $8.2 M.[72]

The issue of privatization is not limited to Texas. In April of 2012, the City Council of Chicago, Illinois overwhelmingly approved a public-private partnership worth over $7B to build new runways at O'Hare Airport; replace 1,650 miles of water and sewer pipes; create special routes for bus transit; modernize schools, transit stations, and city buildings; as well as build 12 new parks and 20 new playgrounds. [73] The City of Sandy Springs, Georgia, is a "contract city" that effectively privatized the large majority of the municipal services by entering into a public-private partnership with CH2M HILL in 2005, a full-service operations company that now controls nearly all of the once-public sector, from road maintenance to cleaning up trash in the park. The city, a suburb of Atlanta with a 2010 population of 93,853, wanted to separate from what it saw as wasteful government spending in surrounding communities. However, not all of Sandy Spring's public services were privatized. Public safety continues to be handled by government police officers and firefighters, and the Fulton County School System still operates public schools within the city.[74]

While Texas has largely experienced success in privatization, the state has also experienced some failure. One often cited example is the Texas Health and Human Services Commission (HHSC) $900M contract with the Texas Access Alliance (TAA) led by Accenture, signed on June 29, 2005. HHSC's analyses estimated that outsourcing this function would achieve a five-year cost savings as high as $21.7M when compared with its optimized in-house model.

A State Auditor's report of the program indicated that HHSC had not achieved any cost savings from outsourcing this function and that their existed significant errors and omissions in the commission's cost data for both the outsourced and optimized in-house models. As such, auditors were not able to determine whether the commission's decision to outsource was cost-effective.[75] Call centers were jammed, HHSC improperly cut people from benefits and it took months for services to begin once Texans applied.[76] On March 13, 2007, HHSC terminated its contract with TAA. Other private providers now offer the services that HHSC privatized formally under the contract with TAA.[77]

Another negative experience of state privatization occurred in the past year with Texas' Department of Informational Resources (DIR), which provides the oversight for management of government information and communications technology for the state. In November of 2007, DIR entered into an $863M contract with IBM for statewide data center consolidation and services. In August of 2010, DIR cut short its seven-year contract with IBM citing among other issues, the failure to perform computer back-ups properly, resulting in data loss; not providing qualified staff to perform services, causing severe backlogs; and failing to transfer all 27 agencies into "consolidated data centers" -- only five have been completed at the time of contract termination.[78]

As the interim charge language suggests, privatization of government goods and services can be an effective way to achieve a higher level of service and greater efficiency for Texas taxpayers. The challenge for the legislature will be to learn from past inefficient privatization efforts and to establish a system to help ensure the delivery of cheaper and better governmental goods and services that are often promised by privatization.

Findings

The State of Texas has a procurement problem <u>not</u> a contracting problem.

One may cite the DIR and the HHSC as negative examples of privatization. However, closer examination of the contracting process shows that HHSC and DIR still successfully privatized the services of the contracts in question. While DIR and HHSC learned certain contracting lessons, the issue was not whether to privatize services, but what best practices and processes to use in privatizing certain governmental services.

<u>Texas Health and Human Services Commission Contract</u>

The mission of the HHSC is to provide the leadership, direction and foster the spirit of innovation needed to achieve an efficient and effective health and human services system for

Texans. The state's health and human services agencies spend more than $30B a year to administer more than 200 programs, employ 56,000 state workers and operate from more than 1,000 locations across the state. [79]

In 2003, as a result of a budget shortfall and rising caseloads at state eligibility offices, HHSC was directed to evaluate whether call centers would be cost effective for the eligibility and enrollment process, and to contract with a private vendor to operate the call center unless it was determined not to be cost-effective. HHSC evaluated the addition of state-run call centers and an outsourced arrangement. The agency concluded that both options would save the state money, but the outsourced model saved more with a projected five-year cost savings as high as $646M.[80]

After establishing the business case, HHSC issued a request for proposals. At the time, Children's Health Insurance Program (CHIP) eligibility determinations, Medicaid and CHIP enrollments into a health plan (managed care enrollment broker services) and maintenance of the state's computer system for eligibility services -- TIERS, were already outsourced under three separate contracts. The request for proposals included these functions in a single procurement and added integrated eligibility services for the Supplemental Nutrition Assistance Program (SNAP food benefits), Medicaid and Temporary Assistance for Needy Families (TANF cash assistance) programs as new functions within the same procurement.[81]

Following a competitive procurement, HHSC entered into a contract in June 2005 with the TAA, which was comprised of Accenture as the prime contractor and a consortium of vendors including MAXIMUS, Image API and eleven other companies. TAA would provide integrated eligibility services for SNAP, Medicaid, and TANF (including call center and document imaging services), CHIP processing and eligibility determination, TIERS maintenance, and enrollment broker services. The critical new elements in the contract included establishing call centers, document imaging and moving some application support work, which state eligibility workers had performed previously, to the private sector.[82]

At the end of 2005, TAA assumed responsibility from the previous vendors for enrollment broker, TIERS maintenance, and CHIP eligibility. TAA planned a staggered roll-out of call and document processing centers in Midland, Austin, Athens and San Antonio. On January 20, 2006, the Integrated Eligibility and Enrollment pilot began in Travis and Hays counties, allowing potential clients to apply for services by phone, fax, over the Internet or in person.[83]

The initial plan called for a full transition to the new system across the state through a series of geographic roll-outs over a 12-month period, which was largely driven by HHSC's need to reduce staffing by 4,000. The first planned roll-out into 20 additional counties was scheduled for April 2006, contingent on the results of the pilot. HHSC postponed expansion of the pilot when it was determined that improvements were needed in call center and processing center operations and technical performance. HHSC put expansion on hold until the issues identified in the pilot could be resolved.[84]

HHSC worked with TAA to develop an improvement plan and scheduled another review for May 2006. The improvement plan included improved training for customer service representatives in the call centers, a process to more quickly escalate and resolve complicated

cases, better reporting tools to track cases and workload and improved data collection. Social service advocates critical of the initial contract claim that the number of kids on CHIP dropped from about 500,000 in 2003 to 330,000 last summer, when the decline began to level off. As proof, they point to the percentage of families renewing CHIP or children's Medicaid coverage. Prior to December, the CHIP renewal rate was about 80 percent each month. After Accenture took over in December, the rate dropped to 50 percent. Children's Medicaid, which covers 1.1M kids and shrinking, has experienced a similar trend. Although it is unclear how much the decrease in enrollment can be contributed to administrative barriers from privatization and how much may be due to budget cuts that also went into effect due to state budgetary restraints.[85]

In May 2006, HHSC suspended the pilot indefinitely because they determined satisfactory progress was not been made toward the goals of the improvement plan. Ongoing evaluation of the new eligibility system and CHIP operations identified several additional problems in the vendor's performance:

- Processing times were too slow, leading to a backlog in the pilot area.
- Unnecessary letters were sent to CHIP applicants requesting more information. A review found that, in some of the cases, the requested information was either on the original application or had been received by the subcontractor and not attached to the case properly or within required timeframes. This issue led the state to implement additional quality control processes that ensured families were not inappropriately de-enrolled.
- Errors on SNAP, Medicaid and TANF cases were too high and resulted in too many cases being returned to the vendor for corrections.
- The quality of information provided to callers involving complex cases was unacceptable. The cases should have been escalated to state staff sooner.

Based on lessons learned in the pilot, HHSC and TAA announced a plan to restructure the contract in December 2006. The roles of the state and the vendor were to be rebalanced with vendor staff more clearly focused on clerical and support functions. As part of this strategy, the HHSC's eligibility workforce and local office structure were retained and enhanced. Contractor payments and fees were adjusted to reflect the reduced role of TAA in the eligibility system and $30M in state costs were recovered through service credits and discounts. HHSC and TAA agreed to renegotiate the contract under this new direction.[86]

When agreement on specific contract terms could not be reached, HHSC and TAA announced a mutual agreement in March 2007 to end the contract early. All services covered by the contract were transitioned to other vendors or back to the state. By July 2007, HHSC had taken over management of CHIP and TIERS maintenance, and signed interim agreements with MAXIMUS to process CHIP applications, staff the call centers, image documents and perform enrollment broker services to help clients enroll in health plans. In the final agreement reached in December 2008, TAA agreed to forgo $70.9M in payments for services provided to the state, pay $20M in cash and provide $10M credit for future work performed by MAXIMUS.[87]

Following the decision to unwind the contract, HHSC revisited the procurement strategy and

determined that separate procurements would best support the eligibility system going forward. To help minimize any impacts to clients and service delivery, HHSC extended the interim contracts until new procurements could be completed. HHSC has completed new procurements for the services that HHSC had consolidated originally under the single TAA contract.

The functions and current vendors are as follows:

- Document Processing Services Contract: Image API
  - Electronic imaging of applications and other eligibility documents received via mail
- Eligibility Support Services Contract: MAXIMUS
  - CHIP eligibility processing
  - Eligibility support services for Medicaid, SNAP and TANF, including call centers
- TIERS Software Development and Technical Support: Deloitte
  - Maintenance of eligibility automation system
- Enrollment Broker: MAXIMUS
  - Enrollment assistance for Medicaid and CHIP health plans

Today, two contracts provide direct support to HHSC applicants and clients, as well as HHSC staff tasked with determining eligibility for benefit programs: Document Processing Services and Eligibility Support Services. HHSC has focused the eligibility contracts to optimize the state's resources. By focusing vendors on administrative, process-related and routine tasks, HHSC's eligibility staff is better able to focus on the tasks that require their expertise -- such as conducting client interviews, making eligibility decisions and processing changes that can impact eligibility or benefit levels. There have been no significant performance issues and vendors have met or exceeded most of their key performance requirements over the past year.[88]

Throughout the narrative of the HHSC contracting, one can point to some global best practices for privatization that were initiated. HHSC developed performance metrics and goals, and built those goals and benchmarks into the contract. Vendor payment and continuation of the vendor contract were tied to performance. HHSC enforced financial penalties for poor performance and rising costs. HHSC developed strong oversight and monitoring and protocols before entering into new contracts to ensure compliance, the lesson being that government's role does not end with the contract signing; rather, government's role shifts to rigorous monitoring and contract management.[89]

Texas Department of Information Resources Contract

In 1993, the 73rd Texas Legislature directed DIR to enter into a partnership with Angelo State University (ASU) to establish a State Disaster Recovery Facility and Operations Center on ASU's campus.[90] The facility opened for business in January of 1997 under a ten-year contract to a team led by IBM.

In 2005, the 79th Texas Legislature created the Texas Data Center Services (DCS) in order offer mainframe, server, bulk print and mail and co-location services to state agencies. The idea being

to consolidate disparate legacy agency facilities, reduce statewide costs for services, modernize aging equipment and increase security and disaster recovery capability.[91]

In November of 2007, DIR entered into an $863M contract with IBM for statewide data center consolidation and services (DCS). In August of 2010, DIR cut short its seven-year contract with IBM citing among other issues, the failure to perform computer back-ups properly, resulting in data loss; not providing qualified staff to perform services, causing severe backlogs; and failing to transfer all 27 agencies into "consolidated data centers" — only five have been completed at time of the contract being terminated.[92]

Nevertheless, there were a number of gains from the original contract, including the construction of the 15,000 square foot Austin Data Center, physical security systems, dual grid power distribution system, centralized SAN data storage and centralized print/mail facilities. All mainframe operations for nine agencies were consolidated into seven mainframes at the two consolidated data centers. Print and mail services were consolidated, totaling 228M print pages and 42M mailings per year. The consolidated centers now support over 3,000 terabytes of data capacity on the centralized SAN storage, over 75 times the size of the Library of Congress. The enterprise also supports 38,000 terabytes of data capacity on tape media, which is over 950 times the size of the Library of Congress.[93]

The difficulty in privatizing technological services is not unique to Texas. Virginia state auditors released a critical report of Virginia's Department of Information Resource ten-year, $2.3B IT contract with Northrop Grumman to run the state's computers, servers, e-mail systems and help desk services. The audit cited missed deadlines, cost overruns, technical failures and poor service.[94]

The current DCS contracts are structured to reduce service delivery timelines to customers, achieve the expected consolidation levels and expand the service offerings available to the participating state agencies. There are a number of key design changes which have already improved the DCS program.

DIR established an owner-operator contract governance model, engaging DCS customers at key organizational levels in governance decision making to ensure agencies have a voice in the vendor's delivery of services to their agencies. The model focuses on establishing program guidance at the lowest possible level and driving for consensus-based solutions involving service providers. When stakeholders cannot reach a consensus, there are escalation processes in place.[95]

A key element of this governance model is the Business Executive Leadership Council (BELC). The BELC is comprised of executive directors or their designees from data center partner state agencies. The BELC oversees an IT leadership committee established to define enterprise technology strategic goals for data center services. This committee includes customer members from partner agencies and focuses on service delivery, technology, transformation and contracts/finance areas. This improved governance model utilized one of the best practices of privatization, which is to communicate early and often with stakeholders. It enables service providers to standardize across agencies, thus improving the speed and cost of services

delivered.[96]

During the re-procurement of the contract, DIR and these governance bodies worked together to develop requirements and to select the vendors offering the best value for the enterprise. Objectives of the new awards included improved service delivery; increased agency customer satisfaction; stabilized IT infrastructure environment to deliver secure, reliable services to state agencies; increase server consolidation to the state data centers to reduce costs, as well as efficiency and security.

In addition, DIR restructured the single-vendor DCS contract model, creating a Multi-Sourcing Integrator (MSI) role to deliver the industry's best tools, processes and program management. DIR solicited individual bids for each of these specialized functional components as well as soliciting separate bids for the MSI function. This sourcing model drew greater competition from the market, rather than limiting competition solely to the very large corporations with the capability to provide all services. DIR and the BELC then selected the top provider within each technical competency.[97]

In the DCS program, as well as all other DIR programs, DIR has focused on improving the customer experience and making it easy to do business with DIR. The DCS contract model offers greater flexibility, opportunities for efficiency and access to the best of the new technologies that the industry has to offer.

Again, one can see through the narrative of the DIR contract process that the agency held contractors accountable through proper contract management and oversight. It is well documented that government entities that fail to provide adequate oversight and watch contractors closely increase the chances that they will experience cost overruns, missed deadlines and costly mistakes that impact service quality and program integrity. Contracting public services requires greater agency management capacity. Agencies that do not properly staff contract management functions make the mistake of under-resourcing the oversight and management of contracts.[98]

Successful State Privatization

Last fiscal year, state agencies of Texas had over 100,000 contracts worth approximately $82B, many of which agencies executed successfully.[99] DIR's contract to administer Texas.gov is one example of many successful and profitable public-private partnerships that exist in Texas.

Texas.gov is the official web site for the state of Texas, providing the state with efficient, cost-effective ways to develop and maintain online services for its citizenry. The portal offers over 1,000 services including occupational and facility licenses and permits; utility, fee or fine payments; enrollment in state programs and services; obtaining vital records (birth, death and marriage certificates); renewing driver licenses, specialty license plates, vehicle registrations; and applying for drilling permits.[100]

The Texas.gov model is sustainable and effective through contractually defined and established roles, processes and governance. In this model, DIR provides contract management, strategic

guidance and operational oversight, enterprise-level coordination and advocacy. The private partner provides all other aspects of program management.

The success of Texas.gov relies on strong, flexible governance that involves the state agencies, municipalities and counties whose applications and services comprise the portal. The Texas.gov governance model supports DIR's oversight authority of Texas.gov and provides ongoing opportunities for customer agency involvement in program governance. The governance model includes a Project Review Board, Change Control Board, Customer Advisory Council, Veterans Portal Advisory Council, Payment Engine Users Group and an Executive Steering Committee.[101]

Since its inception in 2000, Texas.gov has (as of August 31, 2012) received over 200M site visits; processed over 179M financial transactions; collected and processed over $26B in revenue; and contributed over $131B to the Texas State Treasury General Revenue fund.[102] In sum, Texas.gov is just one example of many public-private partnerships that state agencies executed successfully without objection from the public.

State agencies have demonstrated a propensity to enter into public-private partnerships on a regular basis, and in the future, state agencies will have many opportunities to execute public-private partnerships.[103, 104] Agencies have also shown their willingness to diligently manage privatized contracts to protect the taxpayer from potential long-term negative consequences.

The issue is not if Texas can privatize services successfully, nor if Texas fails to privatize services when the opportunity presents itself.[105] Rather, the question is whether there exists a tool to better help state agencies procure privatized services, even though each agency and each procurement opportunity has its own unique circumstances.[106]

A Single eProcurement

A single source eProcurement system takes disparate procurement functions and combines them to create an online, easy-to-access, easy-to-use, one-stop-shop for government users and vendors alike. A system of eProcurement would help the state's privatization by providing transparency and systematically tracking vendor performance. An eProcurement system integrates functionality like vendor registration, solicitation management, contract management, requisitions, purchase orders, electronic invoice, workflow and business intelligence into one online system. An eProcurement system creates uniformity and efficiency across state government, makes it easier for all vendors, regardless of size, to do business with the state and creates detailed visibility into all state spending.[107]

Transparency is the key to spending accountability. According to some public advocacy groups, spend data belongs to the people, and should not be guarded by government officials. Taxpayers should be able to see exactly where and how state funds are spent.[108] Because eProcurement systems track all spending under management, it is easy to post all state contracts with corresponding spend-to-date information online in real-time. The general public can access this information 24/7 via a website without having to jump through hoops or submitting open record requests. Currently, a taxpayer has to submit a costly open records request to obtain this information. The act of transparency alone would help insure competitive contracting, remove

red tape obstacles to public sector innovation and improve public access to information.[109]

With an eProcurement system, a purchasing official can pull reports quickly, identify areas of improvement and have improved audit trails. For example, within seconds a procurement official can run reports to determine where off-contract spending occurs. With this intelligence readily available, procurement officials can determine where they have purchasing gaps and can take the necessary steps to strategically solicit contracts for commodities or services where gaps might exist, thereby identifying new areas or improve existing areas of public-private partnerships.[110]

The State of Texas is an economic engine pumping millions of dollars into businesses across the state through privatization. All suppliers, regardless of business size or classification (minority, women, veteran owned, etc.), should receive an equal opportunity to compete for business. An eProcurement system could help achieve this by posting all state contracts in one, easily accessible location. This prevents smaller vendors from being overlooked by their larger counterparts, and increases market competition to the benefit of the state.[111]

Furthermore, conducting business with the state becomes easier using eProcurement because you provide a single location for suppliers to register, view solicitations, submit bids, process purchase orders and submit invoices. State agencies can even certify and track small business participation at the time of vendor registration. Likewise, performance metrics and contact goals can be tracked systematically, which is an important best practice for successful public-private partnerships.[112]

Facing a $1.4B budget shortfall, the State of Arizona replaced its multiple procurement systems with a "one-stop-shop" implementation of BuySpeed eProcurement. The transition to the new statewide purchasing gateway, branded "ProcureAZ" began in 2008. This single, web-based procurement and sourcing portal brought significant cost and manpower efficiencies not only to the state, but to local governments and schools as well.[113]

Arizona implemented a one percent administrative fee for vendors on purchases made by local government entities. The administrative fee covered the entire cost for implementing the system within 18 months and has since maintained an average 15 percent increase in revenue annually.[114]

Currently, more than 4,500 active catalogs and 25,000 vendors are registered in ProcureAZ. Arizona has used the system to manage more than 1,200 solicitations, including 12 reverse auctions. The State has seen a 26 percent reduction on pricing in a representative sample of new solicitations for various commodities and services. Participation in Arizona's cooperative purchasing program has increased by 51 percent; this program allows local governments to leverage the state's cost savings by purchasing off statewide contracts through ProcureAZ.[115]

Michigan is embarking on the eProcurement implementation process and plans to mirror Arizona's innovative procurement paradigm, making its eProcurement investment available to all local agencies. "We're looking at the whole procurement system, from A to Z" said Michigan Budget Director, John Nixon. The state chose to move forward with a single source statewide

eProcurement system, envisioned to benefit state agencies and all other public procurement entities across the state, to provide a solution for better data tracking and to help the state know how and when to get the best deals.[116]

Speaking to the significant value added by eProcurement, Kurt Weiss, a spokesman for Michigan's Department of Technology, Management and Budget stated, "It also will allow for quicker turnarounds on bids and easier communication between state purchasing office officials and vendors, which will increase efficiency."[117]

The State of Texas is potentially losing millions of dollars in savings each year by providing disparate procurement functions across its multiple agencies. For example, state contracts (statewide agreements, agency contracts, multi-agency contracts, technology contracts, "go to" cooperative contracts, etc.) are not posted in one central location. The state runs multiple different systems, has its own TxSmartBuy catalog, and also provides a catalog for state agencies to purchase technology through DIR.[118]

Although Texas agencies are governed by the same procurement code and the business processes are similar, the differences (an agency's organizational structure, purpose and requirements) can be significant. The state's current procurement systems do not take these important baseline differences into account and therefore create more work for agencies. For example, an agency user can find a contract and an item in TxSmartBuy but then will need to go through the approval process (funds checking, department approval, pre-encumbrance, etc.) that is needed according to that agency's policies. This scenario makes the agency user interact with multiple systems and therefore increases workload and frustration at the agency level.

In sum, where the state continues to fail is in the procurement process, not the contracting process.[119] The state needs to establish an eProcurement system to capture the entire procurement process from the issuance of requisitions, to processing contract/purchase orders and assembling files - all in a paperless environment.[120]

Conclusion

The State of Texas should consider initiating a pilot comprehensive eProcurment system and study its feasibility for statewide deployment.

PUBLIC UTILITY REGULATION

Interim Charge: Identify inefficiencies in the regulation of public utilities in order to minimize the cost of regulation to consumers.

Background

The responsibility of regulating Texas public utilities is divided between multiple governmental entities. The Public Utility Commission of Texas (PUC) oversees the activities of electric and telecommunication utility companies. The Railroad Commission of Texas (RRC) has the authority to regulate gas utilities.[121, 122]

Each regulatory agency has expertise related to the specific utilities they are responsible for managing and has developed unique regulatory frameworks to reflect the distinct structure of each utility market. Because the regulation of public utilities has a direct impact on the prices of services, it is imperative that inefficiencies are identified and eliminated to minimize the cost to consumers.

The Public Utility Commission of Texas (PUC)

The PUC was created to regulate the rates and services of monopolistic electric and telecommunications utility providers. In 1995, Texas passed legislation to deregulate the wholesale electricity market, and in 1999, the retail electricity market was deregulated. As a result, there was a transition to a system that allows competition and market forces to replace traditional rate regulation. The new market design has changed the responsibilities and scope of the PUC.

The restructuring of the electricity market primarily affected investor owned utilities (IOUs) within the Electric Reliability Council of Texas (ERCOT) region. For IOUs inside of ERCOT, the PUC is only responsible for regulating rates for transmission and distribution service. Because competition has been delayed outside of ERCOT, IOUs in these areas remain fully regulated by the PUC for all aspects of utility service. Municipally and cooperatively owned utilities may opt into the competitive market, but they are not required to do so. Municipally owned utilities' (MOUs) retail rates are established through the traditional rate setting process in which the municipalities' governing bodies have control over rates, operations and services. The PUC is only involved in MOU retail rate cases if a decision is appealed, and the PUC's appellate jurisdiction only applies to ratepayers of the MOU that live outside of the municipality.[123]

For IOUs (both transmission and distribution utilities inside ERCOT and bundled utilities outside ERCOT), the PUC has original jurisdiction over rates in areas outside of municipalities and where a municipality has surrendered its original jurisdiction to the PUC (see PURA Section 32.001). In areas where cities have retained their original jurisdiction over the rates of IOUs, the PUC has appellate jurisdiction. However, because all electric IOUs have service areas that cover a number of municipalities and unincorporated areas, virtually all electric rate matters are ultimately decided at the PUC.

The PUC's role in utility regulation has evolved with the restructuring of the market; however, the current statutory foundation is a mix of old and new provisions, which has created some inefficiency. Costs paid by consumers could be reduced if statutes were amended to streamline and update regulatory requirements.

The Railroad Commission of Texas (RRC)

The RRC was originally responsible for the regulation of the state's railroads, but today serves as the primary regulator of the oil and gas industry.[124] Their main focus is on the efficient production and safe transportation of energy resources, as well as the regulation of gas utilities.[125]

The agency protects customers' access to reasonably priced natural gas by overseeing rates for both investor and municipally owned gas utilities in Texas. While some municipalities operate MOUs, the majority of Texas cities use IOUs for gas service. Municipalities that use IOUs grant a franchise to a specific utility company that is then responsible for providing services to consumers within the city. Because most of these companies operate as monopolies, the state has an interest in ensuring the rates are fair. Original jurisdiction over rates within cities is given to the municipalities' governing bodies, but the RRC has appellate jurisdiction. The RRC is solely responsible for rates of gas utilities operating outside municipalities.[126]

Findings

The Public Utility Commission of Texas (PUC)

The deregulation of the electricity market has resulted in a large portion of the Texas market no longer being subject to rate regulation by a governmental entity. However, the PUC is still involved in rate regulation for transmission and distribution service and for IOUS in areas of the state outside of the ERCOT region. The PUC also has limited appellate authority over the retail rates of MOUs.

The Texas Utilities Code gives municipalities exclusive original jurisdiction over the rates, operations and services provided by IOUs and establishes that the PUC has jurisdiction over any appeals related to rate setting.[127] While this may have been the most efficient regulatory system when it was established, it currently creates some inefficiencies and increases regulatory costs, which are ultimately passed onto consumers.

Virtually all of the rate proceedings that originate at the municipal level are ultimately appealed and transferred to the PUC because of the desire of utilities to maintain system wide rates. When cases are transferred, the rate process often starts at the beginning again, which results in more time and money being spent on rate regulation than is necessary. These costs get folded into the rate base, increasing electricity costs.[128]

Witnesses testified at the October 24th House Committee on State Affairs hearing that original jurisdiction for IOU rate cases could be transferred legislatively from the municipalities to the state. The PUC already has the expertise and a regulatory system in place to appropriately

handle rate regulation. Municipalities interested in maintaining their role as an advocate could still participate as a party to the rate setting process. However, municipal involvement would not be essential because other entities, such as the Office of Public Utility Counsel and the PUC have a responsibility to ensure customers have access to adequate and efficient services at fair, just and reasonable rates.[129]

Additional regulatory cost savings may be achieved if portions of the Texas Utilities Code were amended. The statute allows municipalities participating in the ratemaking process to hire attorneys, accountants, engineers, rate consultants and auditors. The provision requires the utility, and ultimately the customer, to reimburse the municipality for the cost of these professional services. If original jurisdiction was transferred to the PUC it would not be necessary for cities to participate, and the additional costs for professional services would not be passed to the consumer, unnecessarily increasing their electricity bills.[130] Cities could still participate in the rate proceeding in the same manner as any other affected customer, but would bear their own legal expenses, just like other customers.

Several regulatory inefficiencies that are not related to rate setting have also been identified by the Sunset Advisory Commission. The PUC lacks some of the tools needed to provide efficient oversight of electric utilities, specifically: sufficient power to prevent wholesale market power abuses, the ability to administer penalties sufficient to deter certain violations and the authority to immediately stop harmful activities.[131]

While the PUC does not directly regulate generation in the ERCOT region, it is tasked with preventing market power abuse. Appropriately defining and preventing market power abuses is critical because companies can profit greatly by manipulating the wholesale electric market to increase prices. This market manipulation is harmful to consumers because they must bear the burden of inflated prices. Victims are left with few options other than going to court, which has an uncertain outcome and can be expensive. Allowing restitution in cases of wholesale market power abuses would provide a mechanism for recouping overpayments, as well as create a disincentive for violating the law.[132] House Bill (HB) 2133, passed by the 82nd Legislature provided the PUC with the authority to order the disgorgement of improper excess revenue from abuse.

The maximum allowable administrative penalty may not be sufficient for violations that could affect grid reliability. Many reliability related offenses are categorized as a single violation, and because most penalties are assessed on a per violation basis, the ability to impose a meaningful penalty is limited. Enforcement should be severe enough to overcome a company's potential monetary gains from ignoring ERCOT's reliability related orders.[133]

The PUC does not have the power to issue cease-and-desist orders when companies are engaged in unlicensed activities, and no other method exists to immediately halt harmful actions. The current system for stopping adverse behavior is time consuming; the PUC is required to issue a notice to the violator and have a hearing on the matter before a company can be compelled to change its practices. In cases when violations could result in reliability issues or harm to the consumer, it is critical that the PUC has the ability to take immediate action.[134]

The PUC's licensing provisions hinder efficiency and flexibility, increasing oversight costs. Most licensing agencies collect fees from applicants to recover some of the costs associated with issuing licenses, but because the PUC does not have the authority to charge a fee, licensing activities are supported using the agency's finite resources. Additionally, the PUC does not have the ability to require renewal of registrations, certifications or permits. This has created an inefficient regulatory system because resources are being wasted tracking entities that have gone out of business or changed their contact information. Giving the PUC statutory authority to establish fees and require renewal could improve the flexibility and efficiency of licensing-related activities.[135]

The Railroad Commission of Texas (RRC)

During the October 24th House State Affairs hearing, leaders in the natural gas industry identified the RRC as an innovator at the forefront of many trends toward efficient regulation. However, some inefficiency related to rate regulation exists, which if appropriately addressed, could decrease the regulatory costs paid by consumers.[136]

The Texas Utilities Code outlines the process for setting gas utility rates. Municipalities have jurisdiction over utilities operating within cities, but they can opt to pass their regulatory responsibilities to the RRC. The RRC is responsible for establishing rates for gas utilities operating outside a municipality or within a municipality if it has surrendered their regulatory authority to the RRC.[137, 138]

When the system for gas utility regulation was established, it was reasonable to give each individual municipality the responsibility for regulating their own rates and services. Over the years, the market has changed and the current framework is no longer the most efficient option. Because each city regulates their own utility, there are effectively over a thousand gas utility regulators in Texas. Working with many city regulators is a complicated process that is resource intensive and time consuming. More efficient regulation could be achieved if a single entity was responsible for gas utility regulation.[139]

While some, mostly rural, cities have voluntarily transferred their ratemaking authority to the RRC, the majority continues to oversee local rate setting procedures. Current statutes could be amended to shift the authority for establishing all gas utility rates to the RRC. The agency already has the expertise and regulatory framework needed to streamline the ratemaking process, which would result in cost savings for consumers. Under a revised regulatory structure, cities could still advocate for their residents in many of the same ways they are doing now. Currently, many of the rate cases are eventually appealed to the RRC, and cities often become parties to the cases, which could still happen in a restructured system.

Additional regulatory cost savings could be achieved by transitioning from a ratemaking process that is focused on litigation to one that emphasizes the use of auditing. The traditional rate regulation method is lawyer driven, which can be very time and resource intensive for all of the parties involved. Adopting a system that focuses on setting policy upfront and then relies on accountants to calculate rates based on predetermined formulas could potentially reduce complexity by creating a transparent and predicable ratemaking process. A gas company

testified at the House Committee on State Affairs hearing that rate regulation is much less expensive in states that have transitioned to an audit based process.[140]

Conclusion

The legislature should continue to streamline the regulatory process for public utilities by identifying and eliminating inefficiencies. Lawmakers could consider making the statutory changes necessary to move the original jurisdiction for investor owned utility rate cases from municipalities to the Railroad Commission of Texas, for gas, and the Public Utility Commission of Texas, for electricity. Additionally, other policy changes that may simplify the process and reduce regulatory costs could be explored.

CLOUD COMPUTING

Interim Charge: Examine methods of cloud computing technology to streamline agency operations and generate greater efficiencies for more cost-effective operations. (*Joint with the House Committee on Technology*)

Background

Cloud computing is an on-demand model for network access to a shared pool of computing resources that can be provisioned and released with minimal management effort or service provider interaction.[141] Cloud computing is an attractive model for state and local governments because it allows for a large capacity of storage and access to information without increasing data center space. Additionally, users have the benefit of increasing or decreasing capacity in real-time, only paying for what they use and access to up-to-date software without having to invest in infrastructure upgrades. As part of the Department of Information Resources (DIR) strategic plan, cloud computing is identified as one of the state's top technology priorities over the next five years.[142]

Cloud Services

Cloud providers offer three delivery models:

- *Software as a Service (SaaS)* -- Cloud providers operate and install software in the cloud where users have access but do not manage the infrastructure or platform (Google Apps, Quickbooks online).
- *Platform as a Service (PaaS)* -- Key components are provided, such as an operating system and programmable languages, allowing users to develop, build and deploy web applications on a hosted infrastructure (database management).
- *Infrastructure as a Service (IaaS)* -- Providers offer physical or virtual computers, firewalls, storage and infrastructure space, while users are responsible for installing operating systems and software (Rackspace Cloud Hosting).[143]

In addition to a delivery model, users determine the type of cloud that would serve their needs, known as their deployment model. There are three basic cloud deployment models:

- *Public Cloud* -- the provider delivers a common information technology (IT) capability in a shared environment. Data are pooled together to optimize resources, but the user has little control on how resources are used or allocated.
- *Private Cloud* -- the provider dedicates and customizes the capabilities and resources of a defined environment for each organization, which provides the user with control over access to information.
- *Hybrid Cloud* -- A blended model with both public and private cloud features.[144]

Considerations for Utilizing Cloud Services

Using cloud computing technology can have a number of benefits as well as potential

drawbacks. There is a reduced cost associated with utilizing cloud technology, as agencies can scale back on infrastructure upgrades and IT maintenance. For example, Colorado's migration to cloud services for email is expected to take 122 existing email servers out of production and have an estimated annual savings of $ 8M in IT infrastructure and operation costs.[145]

Implementing cloud technology has the added advantages of utilizing private industry resources, while increasing storage capacity. Companies such as Rackspace Cloud Hosting, headquartered in San Antonio, are at the forefront of cloud hosting, and have data centers throughout the state. Additionally, cloud platforms allow for the access of information across state agencies through public or hybrid clouds, as well as remote accessibility. Clouds can be accessed wherever there is an internet connection.

While there are many benefits to transitioning to cloud services, several matters should be examined such as issues with connectivity, data center location and security concerns. Rural areas of Texas have limited access to computers and internet service, which are essential components for using a cloud.[146] Federal and state governments have faced the challenges of the jurisdiction of data hosting centers across state and national boundaries, and Texas would need to verify where information is being stored to comply with state and federal statutes. Because information and IT resources are maintained outside the firewall organizations, utilizing cloud services can become more vulnerable to external threats, making security a primary concern.

Federal and State Agencies' Implementation

A number of state and federal agencies have implemented clouds into their technology resources. In addition to the aforementioned public cloud for email, Colorado has implemented a hybrid model, using a private, off-site cloud for redundant storage of vital records (taxes, Medicaid, law enforcement), increasing disaster recovery capabilities at a reduced cost. Utah is moving its platform of about 1,800 physical servers to a virtual platform of 400, a consolidation from 35 locations. With a state IT budget of only $150M, they are expected to save $4M annually.[147] Virginia, Michigan, New Jersey and Wisconsin have implemented similar cloud resources, with savings varying, depending on the extent of cloud services provided.

At a federal level, agencies have implemented cloud technologies as an efficient, cost-cutting strategy. www.apps.gov is an IaaS cloud intended to be a single source for locating potential cloud services. The Department of Veteran Affairs deployed an internal cloud that serves as an early warning system for infectious diseases. More than 100 clinics input data into the cloud, which the software, built into the platform, analyzes to spot outbreaks. One of the biggest cloud initiatives in government has been the Defense Information System Agency (DISA), which has been virtualizing servers since 2008. As of 2010, 20 percent of the 6,000 operating environments had been virtualized.[148]

In Texas, cloud services have been utilized by agencies including the Department of Motor Vehicles (DMV) and the Office of Court Administration (OCA). During the July 2012 joint hearing, members of the House Committees on State Affairs and Technology heard testimony from the DMV that they are currently moving their email system to a private cloud using an SaaS model, consolidating their 127 servers down to three. At the same hearing, the OCA

informed legislators that they have been using cloud technology for e-filing for the past ten years.[149]

Findings

There are a number of factors that affect successful transition to cloud computing for a state. Clouds can be an efficient way to store and access information, but not all data should be stored in a cloud, and different cloud models need to be used for storage of certain data.[150] Regulatory applications for sensitive information, such as that which is subject to the Health Insurance Portability and Accountability Act (HIPAA) provisions, are not able to function within public clouds; therefore, they would need the higher security available in private clouds. In addition to security, fiscal matters, state policies, electricity supply and accessibility need to be reviewed before transitioning to cloud services.

The primary concern for virtualization of information is security. Issues concerning encryption, email and data transmission, physical location of storage and other regulatory requirements necessitate consideration and analysis. Implementation of cloud technology requires the provider to be vigilant to cyber security threats. Providers need to have intrusion detection and prevention mechanisms, as well as ensure that data has sufficient and effective encryption. On-site, single tenancy clouds are the most expensive to operate, but provide the most secure environment for information.

Providers that undergo the Department of Defense's Information Assurance Certification and Accreditation Process (DIACAP) are certified at the highest level for securing information resources. This type of security would be necessary for clouds housing sensitive information.[151] Consulting DIR, and state and federal statutes, agencies may determine the level of security that would be required when deciding the cloud delivery and deployment models.

Fiscally, cloud computing has the potential to save money in server storage space, system upgrades and procurement of equipment. However, estimated cost savings vary depending on what cloud services are used. Private clouds and PaaS models cost more to operate and maintain than a public cloud and SaaS. Furthermore, DIR testified at the September 2012 joint hearing that within the government data center, IT support staff with advanced skills in cloud management would need to be retained, requiring an educated workforce and salaries competitive with private industry.[152] Additional appropriations for technology services may be necessary for successful implementation, although the additional costs would likely be offset by the efficiency gains from cloud services.

Sound policies are essential for practical implementation of cloud services. Policies that address the security concerns related to transitioning to virtualization should be adopted before moving forward with a comprehensive cloud strategy. Prioritization of agency needs and collaborations between agencies for redundant services can be analyzed through a strong program management office (PMO) within the current data center, DIR. The PMO should establish policy that clearly outlines basic characteristics of cloud use, when and how it should be implemented. Industry leaders testified during the September 2012 joint hearing that in order to attract the expertise in cloud enterprises to the state, it is necessary to have policies that allow for tax breaks on

computer equipment purchased for data centers, and ensures a reliable source of electricity.[153] The constant, reliable electricity supply is essential to transitioning to a broader use of cloud technology. Rolling blackouts associated with electricity shortages would hinder access to information stored or shared in a cloud.

Access to cloud will also be obstructed by a lack of accessibility to the internet. In a study by the National Telecommunications and Information Administration, access to the internet is significantly lower in rural and low-income communities. Only 47 percent of households in these communities have a computer, with only 28 percent having access to broadband service.[154] Seventeen Texas counties are considered rural, low-income communities, eight of which are located along the Texas/Mexico border. Agencies' ability to share information from law enforcement, health and social services has the potential to significantly improve the quality of life of Texans living in this region. Continued expansion of broadband services to these areas and computer literacy training for governmental entities will help to transition to a broad application of cloud services.

Conclusion

The Texas Legislature should continue to examine how using cloud technology could provide a secure environment for data storage, and support agencies expansion of cloud computing services where usage will incur cost savings and efficiencies in government operations. As security is paramount, minimizing the risks associated with virtualizing sensitive material is necessary before the state can move toward a broader use of cloud technology.

AGENCY RULEMAKING

<u>Interim Charge:</u> Examine state agency rulemaking and consider ways to improve procedural efficiencies and public transparency, and to better inform policymakers as to their use, purpose, and cost-effectiveness, including an examination of the financial and other impacts such regulations have on both the license holder and the public (*Joint with the House Committee on Government Efficiency & Reform*).

Testimony

The House State Affairs Committee, in a joint hearing with the House Government Efficiency and Reform Committee, heard testimony regarding this charge on July 11, 2012. The hearing included invited testimony from the following persons:

- Cary Austin, Technical Salesmen, Cycle Stop Valves, Inc.
- Linda Battles, Associate Commissioner, Texas Higher Education Coordinating Board
- Linda Brookins, Director of Water Supply Division, Texas Commission on Environmental Quality
- Katherine Minter Cary, Division Chief of General Counsel, Office of Attorney General
- Kathleen Hartnett White, Distinguished Senior Fellow-in-Residence & Director, Armstrong Center for Energy & the Environment, Texas Public Policy Foundation
- Wesley Hottot, Staff Attorney, Institute for Justice
- Bob Jackson, General Counsel, Texas Department of Transportation
- William H. Kuntz Jr., Executive Director, Texas Department of Licensing and Registration
- Caroline Sweeney, Deputy Director, Texas Commission on Environmental Quality
- Richard Viktorin, Director, Audits in the Public Interest

Background

Statutes are created or amended by the legislature; whereas rules are adopted by state agencies (executive branch), usually with specific rulemaking authority from the legislature. The legislature creates administrative agencies and empowers these agencies to achieve important governmental objectives. The basic purpose of allowing agencies to impose regulation is to implement the laws enacted by popularly elected representatives of the state legislature. These administrative agencies receive their power or authority from Title II, III, and IV of the Texas Government Code. Responsibilities for the administration of government and enforcement of governmental policies and procedures are delegated largely to a wide range of these administrative agencies.

Texas Administrative Law embodies the rules and decisions of state agencies that carry out the work of the executive, judicial, and legislative branches of government. Before 1975, Texas had no comprehensive, unified body of administrative law. Each agency determined for itself the proper requirements for hearings, proposed rules and adopted rules. Texas also had no central journal in which agencies published their rules and notices.

In 1975, the 64th Legislature passed Senate Bill (SB) 41, known as the Administrative Procedure and Texas Register Act (APA), which established minimum standards of uniform practice and procedure for state agencies. The bill also provided minimums for public participation in the rulemaking process, provided for notice of agency rules and actions through newspaper publication, laid provisions for judicial review and required agencies to give notice and current information on various actions.[155]

Today, the APA is codified Chapter 2001 of the Texas Government Code. Subchapter B describes the rulemaking procedures for all state agencies. These procedures detail the requirements for public posting, legislative and state agency review, emergency rulemaking, as well as any studies that need to be completed before rule adoption. Subchapter B does not describe when state agencies should adopt new rules; rather, it establishes guidelines by which agencies should adopt new rules, when they so choose.

Before a state agency adopts any new rules, the agency must perform the following actions:

- Allow for public comment, with a public hearing required when a governmental agency or any group of or association representing a minimum of 25 people requests one.[156]
- Be ready to provide a statement containing the reasons for and against a new rule, including the agency rational for overruling any reasons against adoption.[157]
- Provide at least 30 days' notice before the implementation of a new rule. The notice must provide an explanation of the new rule, as well as any fiscal costs or gains to state or local governments, and economic costs to affected persons and public benefits resulting from the new rule.[158]
- Perform an employment impact statement for any local economies impacted by a proposed rule for the first five years after adoption of the rule. However, failure to comply with this requirement does not inviolate an adopted rule.[159]
- Any environmental rule exceeding standards set by federal law, and not required by state law, must contain a cost-benefit analysis of the rule as well as the rationale and scientific evidence supporting its adoption.[160]

Agency rules are subject to both legislative and agency review. The appropriate standing committee in each house of the legislature possesses the authority to review every agency rule before agency adoption. Furthermore, state agencies are required to review existing rules every four years. This reassessment must include whether the reasons for adopting the original rule still exist.

In 1977, the Texas Legislature created the Texas Administrative Code (TAC).[161] In the Administrative Code Act, the legislature directed the Office of the Secretary of State to compile, index and publish the Texas Administrative Code. TAC is a compilation of all of the state agency rules in Texas. There are 16 titles in the TAC; gaps are left in the numbering of the titles, chapters and sections of the code to allow for future expansion. Each title represents a category and relating agencies are assigned to the appropriate title. The TAC is updated annually; whereas the *Texas Register* is quarterly and annually, follows the publication date of the TAC's

main volume or supplement and provides references to rules that have been affected by the particular issue.

Finding

Open government through public participation in the rulemaking process is not applied consistently across state agencies.

Texas government is made up of many diverse agencies with different missions, different challenges, different populations of employees and different public constituencies. Agencies have broad discretion to craft rules that are related reasonably to their statutory mandates. Without slighting the importance of agency staff expertise in the rulemaking process, the more fundamental determinations in rulemaking will change in ways that are consistent with public comments. Therefore, agencies must take public comments seriously if rulemaking procedures are to have their intended effects.

Public comment is governed within the general parameters of the Administrative Procedure and Texas Register Act (APA); however, agencies vary in the handling of public input during the notice-and-comment process. Some agencies have established a culture of public inclusion in the rulemaking process, such as the Texas Department of Licensing and Regulation, while other agencies have been criticized for having too little public input.

The Texas Department of Licensing and Regulation's (TDLR) rulemaking process complies with state law requirements for administrative rulemaking, yet provides additional opportunities for the public and stakeholders to give input beyond what is legally required through the use of 19 advisory boards (also known as advisory committees).[162]

TDLR is the state's umbrella occupational and regulatory agency, responsible for the regulation of 29 occupations and industries. TDLR drafts proposed rules in response to statutory changes enacted by the legislature, or in response to proposals from the advisory boards, members of the regulated industry, members of the public, or TDLR staff. The rule draft is then presented to the appropriate advisory board at a public meeting for feedback and recommendations. The public and the regulated industry have an opportunity to comment at these advisory board meetings.[163]

*An **advisory committee** is defined as a committee, board, council, commission, task force, or other entity with multiple members that has as its primary function advising a state agency in the executive branch of state government. Typically, advisory committees are standing committees with broad-based jurisdiction that can be created in statute or by a state agency. Advisory committees are subject to requirements in Chapter 2110 of the Texas Government Code* (Sunset Advisory Commission, *Texas Higher Education Coordinating Board: Staff Report,* (June 2012) at 13).

Based on the recommendation of the advisory board, TDLR files the proposed rules, along with a detailed preamble explaining the proposal, with the *Texas Register*.[164] After the public comment period ends, the advisory board will often hold another public meeting to consider the comments and make a final recommendation to the commission. The public and the regulated industry also have an opportunity to comment at this public meeting.

Finally, the TDLR Commission adopts the rules at a public meeting. The commission will consider the

public comments, the advisory board's recommendation and any recommendations from staff in making its decision and may make limited changes to the rules based on the comments received. The public and the regulated industry have yet another opportunity to comment at this public meeting. The impact of advisory boards results in real savings and efficiency within the agency. In fiscal year 2012, the TDLR lowered fees for 17 license types, which is projected to save $200,535 annually and benefit more than 24,654 licensees.[165]

Texas Department of Transportation (TxDOT) also has used advisory boards but in limited cases. A majority of TxDOT's rules are not regulatory in function or purpose and as such, tend to be non-controversial and therefore generate little public interest or participation during the notice-and-comment period. However, in 2010, the TxDOT initiated a major transportation planning and development rulemaking project that would affect many of the transportation agencies around the state. Additionally, in 2011 the department went through a major rulemaking project regarding the regulation and licensing off-premise outdoor advertising signs affecting many business, local governments and advocacy organizations.

TxDOT recognized there would be significant public interest, as both rules would affect many outside stakeholders. Therefore, the department found it appropriate and necessary to utilize some additional procedures permitted under the APA to ensure wide stakeholder participation and a full vetting of the issues during the rulemaking process.

In 2010 and 2011, TxDOT formed an advisory committee of experts, interested persons and representatives of the public to advise the agency about contemplated rulemaking.[166] TxDOT developed a process to assure that there were representatives from as many of the interested stakeholders groups on the committee as possible.[167] This allows TxDOT to analyze how the rule would affect each stakeholder group and attempt, through negotiations, to build the largest consensus possible when drafting the rule.

Once the advisory committee was formed and appointed, TxDOT published all dates and times of the meetings of the advisory committee in the *Texas* Register and opened them to the public. During these meetings, the committee discussed, debated, took public input and drafted the actual language of the rule. The committee shared publicly all drafts and edits. When the committee was finished drafting, they held a vote on the actual language of the proposed rule. Upon approval of the committee, TxDOT staff then proposed the rule to the commission for public notice and comment.

TxDOT testified that the utilization of early notice-and-comment, and an advisory committee for each of the above mentioned rulemaking projects, allowed TxDOT to reach a consensus for adoption of advisory committee rules. TxDOT and the commission viewed these rulemakings as a success for TxDOT and found the advisory committee process to be a practical tool for consensus building in the rulemaking process.

The Texas Higher Education Coordinating Board (THECB) provides leadership and coordination for the Texas higher education system. The THECB recently underwent review by the Sunset Advisory Commission (Sunset Commission). The Sunset Commission found that *the structure of the agency's advisory committees does not meet standard operating criteria and fails to provide*

the direct input and expertise needed to aid the governing board in setting policy and making decisions.[168] THECB testified before the committee to agreeing with the Sunset Commission's recommendation. THECB also testified to implementing cures that currently allow advisory committees to report their recommendations directly to the board without filtering or dilution by agency staff.[169]

Often the objective of agency rules is not only to ensure compliance with a statute, but also to clearly articulate and lay out the objective of the applicable law, which often times is highly technical in nature. So even when agencies follow APA throughout the rulemaking process with opportunities for the public to both obtain information about and to comment on rulemaking, there is opportunity for public misunderstanding of the process and for the agency to forgo free and expert advice of the public.

The committee heard testimony from citizens who were frustrated with agency responses to proposed rulemaking and operational changes, even when agencies were working through the rulemaking process in good faith.[170] As the TDLR advisory board system illustrates and the Sunset Commission report confirms, advisory boards can provide an understanding and expertise to relevant agency rulemaking issues, as well as create stakeholder support for final agency rulemaking decisions.

Advisory committees could also potentially aid agencies in conflicts that sometimes arise between the legislative branch, which creates policy, and the executive branch, which implements the policy. Legislatures have handled such conflicts by being reactionary and passing legislation after the creation of agency rules.

The United States House of Representatives has passed multiple bills to restrain regulatory excess.[171] One example is the REINS Act (Regulations from the Executive in Need of Scrutiny Act) that would have reclaimed congressional authority to make the final decision about major regulations.[172] Under the 1996 Congressional Review Act, Congress already has the power to override proposed regulations by passing a joint "resolution of disapproval." The REINS Act would change the process so that major regulations would be contingent on congressional approval -- if a majority in each chamber does not vote "yes," the agency is unable to enact the regulation.[173]

An example of the struggle between the legislative and executives branches in Texas and their contending interests is the passage of SB 1134 by the 82nd Legislature in 2011. The bill was in response to an adopted state regulation, which significantly expanded regulatory requirements for thousands of oil and gas production facilities.[174] The bill prohibited the Texas Commission on Environmental Quality (TCEQ) from promulgating new or amending existing authorizations [Permits by Rule (PBR) or Standard Permits (SP)] for the oil and gas industry without performing a regulatory impact analysis (RIA), extensive monitoring and correlated modeling. The bill also limited the use of worst-case modeling inputs and required actual credible air quality monitoring data. Air quality monitoring data and the evaluation of that data would be required to be scientifically credible and could be generated by an ambient air monitoring program conducted by or on behalf of the TCEQ or by a local or federal government entity, or a private organization.[175]

This assumes the legislature even has the broad will to act. Congress has only successfully wielded its power under the Congressional Review Act once before, in 2001, when it voted to do away with a Department of Labor ergonomics regulation. The 82nd Texas House passed HB 125 in 2011 with the intent to provide additional regulatory transparency by requiring a simple, concrete Regulatory Analysis of Major Environmental Rules in rules promulgated by TCEQ.[176] The Texas Senate never considered the bill.

The legislature has other means of providing checks on rulemaking besides the passage of legislation. The committees of Texas' Legislature are empowered to review agency rules before adoption.[177] Agencies are required to review a rule not later than the fourth anniversary of the date on which the rule takes effect and every four years after that date. Current law also requires state agencies' review of a rule to include an assessment of whether the reasons for initially adopting the rule continue to exist. Similarly, some states require the legislature's approval of select agency regulations.[178] Again, these legislative measures tend to be reactionary and taken after an agency has created a regulation.

Some critics want to ensure proper agency rulemaking by making more prescriptive the cost-effectiveness analysis, particularly in regards to measuring the fiscal impacts of agency rules on the private sector in the ARA.[179] However, even if the legislature could enhance the ARA perfectly to clearly denote specific systems of measurements with pragmatic data points, and even if such data could enlighten the legislature of the true positive or negative influences of agency rules, the legislature would still likely act after the fact. Meanwhile, such enhancements to the ARA could have the effect of slowing an already burdensome rules process with additional bureaucratic requirements.

When agency rulemaking utilizes advisory committees, the process permits broader participation by stakeholders and encourages comprehensive solutions to problems that go beyond the facts of individual cases that agency staff would be unable to measure precisely with pragmatic data points. Moreover, advisory committees' activities are ongoing and occur in real-time with the rulemaking process and are not reactionary, unlike legislative acts passed after the creation of an agency rule.

Having advisory committees assist with agency rulemaking would maintain rulemaking as an advantageous approach, both in terms of its fairness to individual citizens and in terms of democratic and effective policy development. Advisory committees would also address the concerns raised by the Government Efficiency and Reform Committee's Texas Red Tap Challenge and discussion regarding agency rulemaking, which centered on improving public participation and knowledge of agency rules.[180]

Advisory committees would likely limit rules from being arbitrary and capricious in the application of policy in individual cases and also prevent retroactive sanctions against individuals for actions taken before the establishment of clear standards. Advisory committees would arguably make the process more transparent and more accountable under the ARA than an undefined ad hoc approach. Advisory committees would enable agencies to accomplish their statutory objectives more expeditiously than they could through additional incremental policy

developments imposed by the legislature.[181] The process of advisory committees would continue to grant the discretion to agencies to be the technical experts whose specialized knowledge is necessary to translate general statutory provisions into specific regulatory standards.

Conclusion

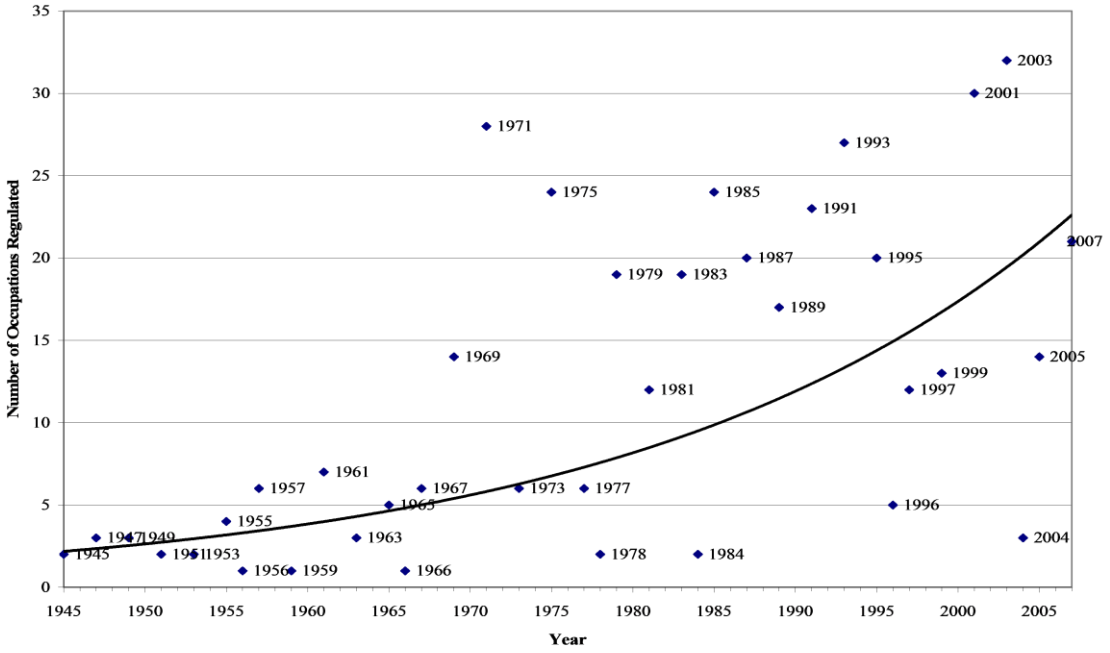
The Legislature should formalize, standardize and require the process of advisory committees in the agency rulemaking process.

Finding

Occupational licensing programs administered by the State of Texas have grown to affect a significant portion of the state's workforce.

Much of the testimony before the committee noted Texas, whose population and economy is larger than many countries, and whose regulatory purview is vast, is known for regulating with a lighter hand than most states.[182] One major exception to this generally accepted sentiment is the continued expansion of occupational licensing by the State of Texas.[183]

Since the regulation of medical physicians by the Republic of Texas in 1837, the State of Texas has expanded its regulatory oversight over its workforce. With the exception of the broad regulation of the alcohol industry at end of the Prohibition Era in the mid-1930's[184], before the end of World War II the Texas Legislature rarely regulated occupations and businesses in Texas. In fact, during the 19th century, the legislature approved the state regulation of only medical physicians (1837) and dentists (1889). In 2007, the legislature approved state oversight for 21 types of jobs and businesses, including property tax lenders, residential fire alarm technicians, professional land surveying firms, air conditioning and refrigeration technicians, hair braiders and weavers, combative sports event coordinators, residential appliance installers, tow truck operators and vehicle storage facility employees. At the beginning of the 2009 legislative session, 514 occupations were regulated.



Source: Data compiled from Texas Legislative Council's report, Occupational Regulation in Texas, prepared for Representative Callegari's Office, 2007.

The chart, *Texas Occupational Licensing Trends (1945 - 2007)*, depicts the number of occupations placed under regulation for each year since 1945. Each point within the chart represents the number of occupations regulated during a given year. The trend line inserted within the chart indicates a trend towards more occupational licensing programs in Texas.

Currently, the State of Texas regulates over 514 types of occupations. These occupations represent the jobs held by nearly 2,715,000 individuals and businesses in this state.[185] Nearly one out of every three working Texans labors in a business or an occupation regulated by the state program. In other words, nearly one-third of the Texas workforce is state-regulated, when measured against a workforce of nearly 8,631,000 non-government jobs in 2007 – a proportion higher than the national trend.[186] This statistic does not account for federal or local occupational licensing programs.

The proliferation of occupational licensing by the State of Texas can be detrimental to the very consumer the licensing is professing to protect. First, occupational licensing programs, by nature, limit the number of participants within an occupation. While such limitations may serve the public interest in certain instances, they may also limit job growth and consumer choices in others. Second, some occupational licensing programs offer clear advantages to members of the licensed profession, such as reduced competition and increased earnings.

Studies of the effects of occupational licensing programs demonstrate that they may increase licensed practitioners' earnings by as much as ten to 12 percent.[187] Given these advantages, occupational licensing programs are typically advocated for and defended by members of the

profession. In fact, consumers and consumer advocacy groups rarely advocate for the establishment of occupational licensing programs.[188] Of the 21 types of jobs and businesses regulated during the 80th Session, support for many of these proposed measures came from members of that industry.[189] The landscape irrigation industry's drive to enhance its own regulation is another example of this type of behavior. In 2005, irrigators petitioned TCEQ for stronger rules regulating their industry. The industry subsequently helped pass legislation requiring cities with a population of 20,000 or more to adopt an ordinance requiring that only licensed landscape irrigation installers install irrigation systems within city limits.[190]

The concern is that licensed members of a regulated occupation enjoy several advantages from the state's regulation of their trade. These advantages include less competition, improved job security and greater profitability. This suggests that state regulatory policy may work to benefit a certain segment of a labor market to the detriment of job growth and consumer choice.

Likewise, implementing new occupational licensing programs requires more state spending and larger bureaucracies, while advocates for these programs frequently tout that they are revenue neutral or increase revenues for the state. To be sure, while many of the licensing programs charge fees that cover the costs of regulation, others actually pay more in fees than the cost of regulation. Although these licensing programs may be revenue neutral, or may even earn the state extra revenue, they still require more state spending and bureaucracy than would be required in the absence of regulation. The costs to the licensed practitioner for the licensure fees are, in turn, passed on to the consumer.

Critics of occupational licensing programs label them as "new unions" or "modern day guilds" that shield existing licensees from competition.[191] These critics contend that established members within a regulated industry rely upon licensing programs to erect barriers to entry for newcomers, thereby protecting their practices from competition. Statutory requirements for barbering and cosmetology schools are illustrative of this practice. State law requires that a barber school be no less than 2,800 square feet, have 20 modern barber chairs, and 20 instructional chairs and at least seven specific areas within the school.[192] Cosmetology schools must, by law, have no less than 3,500 square feet, certain instruction areas and equipment to educate a minimum of 50 students.[193] These requirements reflect a clear preference for larger schools -- which require greater start-up costs -- to the exclusion of smaller schools. Even though state law provides for the licensing of barbering and cosmetology-related specialties, such as hair braiding, hair weaving and manicuring, the law precludes the creation of smaller, specialty schools to provide the instruction necessary for these licenses. More critically, the law prevents the creation of smaller barbering or cosmetology schools that may be able to serve a significant portion of the student population, including students that prefer a smaller, more intimate learning environment, or students in rural areas where the lesser population density precludes the creation of larger schools in their areas.

Judging from historic trends, Texas appears heading towards more and greater occupational licensing programs. Other states have implemented "sunrise" processes as a way to curb the growth of occupational licensing programs. Currently Colorado, Washington, West Virginia and Arizona have "sunrise" processes to evaluate the need for new occupational or business licenses. In general, each sunrise process requires an industry or consumer group to submit an application for an occupational regulation to the agency that conducts the sunrise review. The application must specify the actual harms to public safety in the absence of regulation, and demonstrate how those problems may be cured through regulation. Hypothetical or tenuous arguments regarding problems associated with the absence of regulation, such as "bad actors" or "fly-by-nights", are not acceptable. The agency or commission responsible for the review must evaluate the application, and conduct its own field research on the proposed regulation. The text box, *Sunrise Criteria Used in Other States*, describes the criteria employed by several agencies in other states when conducting sunrise reviews. Like a Texas Sunset Advisory Commission report, each state's sunrise review agency publishes its findings and recommendations regarding the proposed regulation. The legislatures of each state with a sunrise process are not bound by their sunrise recommendations. These recommendations do, however, offer legislators the opportunity to be better informed about proposed licensing programs before passing them into law.

Sunrise Criteria Used in Other States

The sunrise review processes employed in the states of Arizona, Washington, and Colorado use the following criteria for evaluating proposed occupational licensing programs:

1. Whether the unregulated practice of an occupation can clearly harm or endanger the health, safety, or welfare of the public, and the potential for the harm is easily recognizable and not remote or dependent upon tenuous argument;

2. Whether the public needs and can reasonably be expected to benefit from an assurance of initial and continuing professional ability; and

3. Whether the public cannot be effectively protected by other means in a more cost-beneficial manner.

Sources: Colorado Department of Regulatory Activities; Arizona Joint Legislative Audit Committee; Washington State Department of Licensing.

The use of sunrise processes in other states has helped curb the growth in occupational licensing programs in the states that employ them. For example, the Colorado Department of Regulatory Agencies recommended against the regulation of landscape architects, interior designers and sign-language interpreters, all currently regulated in Texas, because the unregulated practice of each profession failed to demonstrate a significant harm to consumers. [194, 195, 196] The West Virginia Legislature's Performance Evaluation and Research Division recommended against regulating athletic trainers and court reporters. The division did, however, recommend regulating elevator workers and assisted living administrators.[197] The State of Washington's Department of Licensing has conducted 17 sunrise reviews since 1990. Recently, the department recommended against regulating interior designers, while it recommended in favor of regulating soil scientists and home inspectors.

The Sunset Advisory Commission does have the authority to make recommendations regarding

the continuation or structure of occupational licensing programs administered by the state. The Sunset Advisory Commission's statute limits the agency's review to "whether a public need exists for the continuation of a state agency or its advisory committees or for the performance of the functions of the agency or its advisory committees."[198] The commission's statute also specifies the criteria that must be used when evaluating the need for an agency's continuation. While the Sunset Commission has made recommendations regarding the discontinuation of certain occupational licensing programs, the commission's statute does not specifically require the evaluation of occupational licensing programs. Nor does the Sunset Act prescribe any standards for the commission's review of occupational licensing programs.

Conclusion

The Legislature should implement a process to review proposals to regulate new occupations, as well as existing occupational licensing programs, based on real and documented harm to the public.

PUBLIC-PRIVATE PARTNERSHIPS

Interim Charge: Monitor the agencies and programs under the committee's jurisdiction, including the implementation of SB 1048 regarding public-private partnerships on state-owned property.

Background

Senate Bill (SB) 1048 was passed during the 82nd Legislative Session in response to the need for statutory guidelines and transparency in the process of creating public-private partnerships (P3s) for Texas.[199] Modeled after successful legislation in Virginia, SB 1048 attempts to address the state's growing needs for new facilities and maintenance of existing infrastructure, by using the innovation and resources from the private sector. Through this bill, also known as the Public and Private Facilities and Infrastructure Act, private industry has a statutory avenue to submit solicited or unsolicited proposals for development on government-owned land.

While a statewide, formalized process had not been established previously, P3s are not a new concept in Texas. Successful P3s include the Triangle, a complex of retail stores, apartments and restaurants located on state land in central Austin, and construction of the Cowboy Stadium with the City of Arlington.[200]

SB 1048

The 82nd Legislature identified several specific reasons for passing SB 1048.

- Government facilities need to be acquired, designed, constructed, improved and installed in a timely manner.
- The public may not be satisfied with existing methods of procurement for these services.
- Governmental entities in Texas have inadequate resources to independently develop facilities necessary to meet the needs of citizens, and there is demonstrated evidence that P3s can meet these needs.
- State and federal tax provisions provide financial incentives for establishing P3s.
- Authorizing private entities to develop qualifying projects may address the needs of the public in a more timely, less costly fashion. [201]

The bill authorizes governmental entities to enter into comprehensive agreements for the construction of qualified projects, including office buildings, hospitals, schools, public works and recreational facilities. This legislation creates statutes for implementing a process for solicited and unsolicited proposals. Having these provisions in place provides structure and incentives to private companies that wish to do business with state, county and municipal governments. A state agency or other governmental entity that elects to operate under this statute must adopt guidelines for proposals based on the criteria outlined in the bill. Upon submission, proposals would be evaluated to determine if the project addresses a public need or results in a public benefit; estimated costs are reasonable compared to similar facilities; and the plans would result in timely development or operation.

SB 1048 also establishes the Partnership Advisory Commission (PAC) to advise state agencies that are implementing this statute. The PAC can examine proposals that exceed $5M, if the proposed project does not receive appropriations from the state's general revenue. Any project, regardless of appropriations, exceeding $50M can be subject to review. The 11-member commission, which is obligated to meet at least once per quarter, is made up of appointees from the speaker, lieutenant governor and governor, as well as the chairs of the House Appropriations and Senate Finance Committees.

Before a governmental entity can begin negotiations, the PAC must assess the project information, and determine whether it will review the proposal. The PAC has ten days from the time a proposal is submitted to decide if they will review it to make recommendations. If a proposal is reviewed, the PAC will post recommendations within 45 days of its receipt. Formal negotiations cannot begin until the commission has submitted its recommendations. The entity must then submit a report outlining how it will address the recommendations at least 30 days before entering into an agreement. This process is intended to provide legislative oversight by giving elected officials the opportunity to scrutinize projects. The PAC has begun holding hearings, taking testimony from P3 experts, which have focused on the P3 process and efficient strategies for implementation.[202]

The Texas Facilities Commission (TFC), which manages the bulk of state-owned and leased land, are currently the first and only agency to implement SB 1048 since going into effect on September 1, 2011. They published the "Public-Private Partnerships Guidelines", a 26-page document outlining comprehensive procedures for submitting, evaluating and reviewing proposals. SB 1048 did not provide for any additional appropriations to maintain a specific P3 program office; therefore, when the TFC opted to adopt this statute, they did so with limited resources. A current staff of three is dedicated to analyzing, negotiating and monitoring the P3 projects, identified in their most recent Sunset report as being insufficient for P3s' complexity.[203]

At the June 14, 2012 PAC hearing, the TFC reported they had received six unsolicited proposals since implementing SB 1048, and are presently looking at five of them as potential projects.[204] In an interim hearing of the House Committee on State Affairs, the TFC testified that they are currently looking at the 21 acres of underdeveloped land in the capitol complex as part of their master plan for development, as well as working with the Health and Human Services Commission to examine possible P3 proposals for hospital facilities on state property.[205]

Potential Benefits and Risks of P3s

P3s are beneficial to the state because they can result in efficiency gains, namely cost, time and maintenance savings. Cost savings are realized by private financing of infrastructure projects and transferring risk to private partners.[206] Private financing, with payment upon delivery, motivates private industry to ensure timely completion within contractual obligations. Private partners take on the risk of timely completion, and are penalized for delays. Payment upon delivery, or when certain benchmarks are met, requires private industry to make a significant investment in the up-front costs.

Transferring risk to private partners can provide additional savings, but it is essential to

determine what specific risks to transfer. The optimal risk allocation process should involve identifying and assigning a value to project risk during an up-front assessment, which can be broken down into three categories:

- Risks transferred to private partners -- value can be gained by transferring risks to the public sector, such as financing, construction costs, scheduling, design coordination and operation maintenance. Private partners have control over how to best achieve the desired outcomes.
- Risks maintained by the state -- risks that the private partner will have little control over, or outcomes are uncertain, therefore will be reflected by higher costs in the contract. Risks such as undocumented soil contamination prior to construction may be better addressed and monitored by the public partner.
- Shared risks -- risks that both partners can influence the outcome.[207]

To ensure that desired spending reductions are realized, it is essential to diligently evaluate and determine risk responsibilities. Although it is possible to transfer some risks to private industry, the responsibility for project failure or default would ultimately fall on the state, an issue to carefully consider when allocating taxpayer resources.

P3s have the potential to offer time savings over conventional procurement methods. Traditional procurements can necessitate a lengthy legislative approval process for appropriation of funds to finance projects. Private financing takes out that barrier as the private partner provides the bulk of the up-front investment. Investors recoup their capital through fees, such as usage, commercial and residential rents.

The long-term contracts associated with P3s also lend to innovative design that can be lacking in the conventional procurement. In the more traditional model, short-term obligations are placed on private industry through construction and a limited warranty period. Long-term investment in infrastructure is subject to appropriations, and can be overlooked during periods of austerity or in favor of other essential programs. Conversely, a P3 project will place design, structure and maintenance obligations on the private sector. Private industry has an incentive to invest in advanced, quality infrastructure in up-front costs versus paying for larger maintenance and operational costs over the length of the contract. Additionally, SB 1048 provides an avenue for unsolicited proposals allows governmental entities to benefit from creative ideas in the private sector.

Findings

While the TFC is the only agency that has taken steps to implement SB 1048, P3 projects are often a viable option for state, county and municipal governments to invest in necessary infrastructure without debt financing. The TFC is evaluating projects that will provide state facilities, utilize the private sector, produce tax revenues from business and protect state assets.[208]

For a structured P3 process to achieve these functions, Texas must develop best practices for evaluation, address ambiguities within statute and clarify the responsibilities and duties of the

PAC. It is essential to assess the policies that will ensure a competitive, efficient and cost effective means of procurement, which will ultimately best serve the public interest. The state should evaluate how other governments, like Canada and Virginia, have implemented specific processes for engaging in P3s. Both of these governments have successfully executed statutory guidelines for P3s, with the Canadian government utilizing P3s as one of their primary methods of delivery of public infrastructure projects for almost two decades.

Best Practices for Evaluating P3s

Determining the best method of procurement for a project is essential to achieve the benefits of a public-private partnership. P3 procurement does not always provide benefits that outweigh additional costs, such as the higher cost of monitoring and managing P3 contractual obligations. In the Canadian model, where P3 is the presumptive method of delivery, only 20-25 percent of infrastructure projects result in a P3 procurement.[209] In order for P3s to be the presumptive method of delivery, cost-benefit analysis of conventional and P3 methods of procurement should be conducted to determine if the value-for-money (VFM) exceeds that of customary method of procurement.

The VFM is an amount that can be determined by looking at specific costs associated with infrastructure development and lifecycle costs, while factoring in the benefits gained from transferring risk to the private industry. Under the traditional method, costs are generally associated with the inputs of the design-build. Ongoing lifecycle costs, such as maintenance, operational and technology updates, need to be compared to those costs associated with a P3. Complex projects that will incur high lifecycle operational costs can often be achieved at a lower cost through a P3, where the private industry provides the financing, expertise and assumes the risk responsibility.[210]

Sufficient project complexity, developing output specifications and the competitive market to receive bids need to be evaluated to determine if P3 will generate sufficient VFM. Analysis of these factors has historically been done by an office that houses expertise in P3 procurement. Both the Virginia and Canadian models created offices that provide these specific services. In Canada, provincial governments retain fee based offices of expertise, such as Partnerships BC and Infrastructure Ontario, which can provide the necessary proficiency. Upon passage of the Public-Private Transportation Act in 1995, Virginia expanded the Department of Transportation to oversee these projects, creating the Office of Transportation Public-Private Partnerships.

In the July 14, 2012 PAC hearing, experts from Canada testified that having this "center of expertise" is one of the determining factors for the success of P3s in Canada.[211] SB 1048 did not create an individual office to facilitate these functions. Section 2267.001 (5)(B)(2) requires independent analysis by qualified professionals prior to approval, but does not statutorily require agencies to retain specific P3 project management for the length of the procurement.[212]

Policies requiring the use of P3 project managers to represent the governmental entity could help to ensure that the state receives the maximum benefits from P3 procurement. Many state agencies retain procurement specialists who have the necessary skills and knowledge for conventional procurements; however, expanding these services to include infrastructure

procurement specialists could be a costly and unnecessary long-term expense for most state agencies.

During the September 2012 House Committee on State Affairs hearing, the TFC testified that they intend to be available to provide this expertise on P3s for agencies operating under SB 1048, and are awaiting legislative direction for being a clearinghouse for these services.[213] This would likely require expanding the staff at the TFC to include professionals with these types of expertise. As the implementation of SB 1048 has been minimal, it may be more cost efficient to obtain these services from experts in the private industry before dedicating long-term state resources to expanding an agency.

Housing this expertise within a state agency, in addition to expanding government, would be a significant cost to the state, as competitive salaries and benefits would be necessary to attract strong candidates across multiple fields.[214] A fee based structure for these services could offset costs, but long-term benefits for additional employees, such as retirement and healthcare, would likely increase over time. Contracting these services through independent project managers places a limited, fixed obligation for state resources. Amending the statute to include the requirement of project management, and making statutory requirements for procuring these services based on qualifications would likely help ensure P3 procurements are managed properly.

Statutes

As currently written, the statute has permissive authority over agencies that elect to adopt its provisions.[215] The permissive nature SB 1048 can have the unintended consequence of limiting its effectiveness. Policies that provide predictability in the proposal process and standardized practice are necessary to attract private investment in public projects. As the TFC is currently the only agency that has adopted formal guidelines, private industry may limit their willingness to invest. It may be beneficial to require that VFM for P3s be done before any substantial procurement for infrastructure projects.

P3s in Canada and Virginia have largely been centered on infrastructure development for roads, hospitals, water treatment facilities and similar projects where the services provided can be directly linked to public benefits. Virginia's Education Infrastructure and Investment Act provide the direction for governmental entities:

> "…while substantial private sector involvement is encouraged, qualifying facilities must be devoted primarily to public use, typically involving facilities critical to public health, safety and welfare." [216]

SB 1048 does not limit the scope of projects to those offering specific public services. Benefits derived from employment and tax revenue can be gained from private industry building in underutilized space. The TFC's stated goals indicate that development of office space to lessen the dependence on leases can be accomplished using P3s, but the agency has also been looking at unsolicited proposals that would integrate more commercial ventures.

The General Land Office's P3 at the Triangle in Austin is often cited as a successful example of retail space on public lands. The implementation of this project was subject to Texas' Natural Resources Code Chapter 31, which requires incorporating extensive input from the local government and citizenry, weighing in on potential public benefits and zoning requirements. SB 1048 requires responsible governmental entities to notify affected jurisdictions of proposed projects, allows comments to be submitted for consideration and requires a public hearing to be held no later than 30 days before entering into an interim or comprehensive agreement. It does not stipulate reporting requirements for how these concerns will be addressed.[217] Policies that effectively address and integrate concerns from the local jurisdiction will help to ensure projects chosen are those that are most beneficial to the state and the localities most affected by a development.

In addition to local jurisdiction input, it may be necessary to institute policies that incorporate multiple agencies that share authority over state land. Much of the state's underutilized space in the capitol complex falls under the jurisdiction of the TFC and Texas State Preservation Board (TSPB). Government Code Section 443.0072 requires any proposals for construction on the complex be submitted to the TSPB for its review and comment at the earliest planning stages, but does not define what earliest planning stages are.[218] Whether legislatively or through rulemaking authority within the agencies, examination and clarification of these duties and responsibilities is necessary when implementing SB 1048.

Partnership Advisory Commission

The legislative oversight granted to the PAC can benefit the P3 process by giving elected officials the opportunity to provide input on state infrastructure projects. Since P3 contracts are long-term investments, having oversight is essential to ensure that the agreements entered into are in the best interest of the state. Statutory authority prescribed to the PAC is virtually the same as those found in Virginia's Public-Private Partnership Advisory Commission.[219]

Ambiguities in the statute and time constraints of policymakers could create significant obstacles for effective oversight by the PAC. P3 proposals must be submitted to the presiding officer and the chairs of House Appropriations and Senate Finance Committees prior to entering into any agreements. After submission, the PAC has 10 days to determine if they are going to review and submit recommendations. Statutorily, the PAC is required to meet once per quarter, but there is ambiguity regarding the process for determining whether or not to review a proposal. Convening a quorum for a hearing to decide if they are going to review a proposal within the ten-day timeframe could be a difficult obligation to place on the committee, especially during the 140-day regular legislative session. If there is no response or they decline to review, then the governmental entity can begin finalizing interim and comprehensive agreements. This language creates a liability for the PAC, where the committee could potentially be inundated with proposals if SB 1048 is adopted by multiple agencies, or if an agency begins multiple projects at the same time.

In the 2012 guide to the Open Meetings Act, provided by the Attorney General's Office, governmental bodies must hold a public meeting to exercise their powers, and its powers are vested in a quorum majority vote.[220] In October, the PAC submitted a request for an opinion to

the Attorney General's Office to determine if they are subject to the open meetings law. As a purely advisory committee, lacking authority to enforce any recommendations they may have, there is ambiguity as to the manner in which they are to conduct business.[221] Confidential and proprietary information is protected from public view during this stage of review, and the PAC could be prevented from discussing this aspect of a proposal if subject to open meetings law. Clarification by the Attorney General and revisions in statute to reflect this opinion may be necessary before the PAC can adopt rules and procedures for reviewing proposals.

Conclusion

The legislature should continue to examine best practices of P3 procurements and determine if additional statutes are necessary for effective implementation. Clarification of duties of the PAC is pending an Attorney General opinion, after which the legislature may determine additional changes need to be made.

PROCUREMENT AND STATE CONTRACTING

Interim Charge: Study how businesses seeking to provide goods or services to the state interact with state agencies. Consider whether additional procedures are needed to ensure that goods and services obtained by the state are the best value. Determine whether additional disclosure and reporting requirements are necessary to ensure transparency, accountability, and to promote ethical business practices.

Background

Procurement in the Texas is a largely decentralized system, with guidelines, reporting and oversight taking place internally and through independent reviews, such as the Sunset process and audits by the State Auditor's Office (SAO). Chapter 2155 of the Texas Government Code outlines rules and procedures for state purchasing, and gives general procurement authority to the Office of the Comptroller of Public Accounts (CPA).[222] Through legislation, the following governmental entities also retain procurement authority for state agencies:

- Department of Information Resources (DIR) -- procurement authority for telecommunication and information (IT) resources;
- The Texas Facilities Commission (TFC) -- procurement authority for building, maintenance and lease management of state property;
- Council on Competitive Government (CCG) -- authority to identify, study and determine best method for delivering services, as well as enter into contracts for services and commodities.

According to a 2007 LBB report, only three percent of spending is coordinated by these agencies.[223] Individual agencies have the statutory authority to procure goods under $15,000, and services under $100,000 through agency administered, competitive bid processes. Agencies must adopt procurement guidelines and contract management policies that conform with state statutes, and report purchases, contracts and amendments to the CPA and LBB. Moreover, delegations and exemptions from CPA and DIR purchasing authority are made for some agencies, as well as for specific purchases and under emergency circumstances.[224]

Comptroller of Public Accounts (CPA)

During the 80th Legislative Session, authority to oversee state purchasing was transferred from the Texas Building and Procurement Commission (TBPC) to the CPA.[225] The Texas Procurement and Support Services Division (TPASS) was created within the CPA to develop a cost-effective supply chain for agencies and political subdivisions and improve statewide contracting and procurement processes. Their primary functions are to:

- Establish statewide contracts by obtaining the best valued goods and services;
- Certify Historically Underutilized Businesses and report their use;
- Manage statewide contracts;
- Train and certify state purchasers and contract managers; and
- Manage the Centralized Master Bidders List and TxSmartBuy program.[226]

Core publications for state purchasing are developed and updated through the CPA. The *Contract Management Guide* and the *Statewide Procurement Manual* are both available through TPASS. These publications provide agencies with general guidelines, statutes and best practices for all aspects of the contracting process.

Department of Information Resources (DIR)

During the 79th Legislature, authority for procurement of state IT contracts was transferred from the TBPC to DIR.[227] Making bulk purchases for IT commodities helps save the state money by creating an economy of scale. Unless otherwise exempt, agencies are required to buy IT products through these contracts. In addition, political subdivisions, such as municipalities and school districts, utilize these contracts. DIR manages the IT contract website, which allows agencies to identify products and services the state currently has contracts with, provides contact information and directions on how to order.

Texas Facilities Commission (TFC)

The functions of the TFC primarily focus on authority to oversee the management, purchase or lease of state buildings, grounds and property. Procurement authority extends primarily to statewide leasing and professional services.[228]

The TFC became the first agency to adopt guidelines for procurement through public-private partnerships under the provisions created by the passage of Senate Bill (SB) 1048 during the 82nd Legislative Session. The guidelines created by the TFC provide an avenue for solicited and unsolicited proposals for infrastructure development on state property. Although they are in the initial stages of evaluation, this type of procurement requires expertise across multiple fields that is not currently housed within the agency.

The Council on Competitive Government (CCG)

This seven member council was created in 1993 through the passage of HB 2626.[229] Under this Act, the CCG examines services provided by state agencies, and determines if a competitive process between public and private entities would economically benefit the state. Membership is comprised of the governor, comptroller, lieutenant governor, speaker, Workforce Commission and GLO Commissioners and Executive Director of the TFC. Through feasibility and competitive studies, the CCG is able to apply accelerated procurement processes and establish contracts for government services, such as energy procurement and mail services. The CCG performs extensive contract and performance reviews to determine the efficiency and cost effectiveness of procured state contracts.

Oversight of Procurement and Contract Management

In addition to oversight and delegation of purchasing authority granted to the CPA, review of agency purchases and contract management falls under the authority of the Sunset Advisory Commission (SAC), LBB and SAO. These administrative agencies review the functions and activities of individual agencies, and make recommendations to the agency and legislative bodies

for best practices. Additional procurement oversight is provided by the Quality Assurance Team (QAT) and the Contract Advisory Team (CAT).

Governmental entities subject to the Sunset Act are required to undergo a review every 12 years, unless otherwise designated. As part of the review, the SAC examines the functions of agency operations, its efficiency and effectiveness. Agency procurement and contract management operations are examined and recommendations are made to the legislature for continuation and improvements.

All state agencies and institutions of higher education are required to report contracts and any contract modifications to the LBB no later than 10 days after entering into one, or changes are made to an existing contract.[230] The LBB maintains a major contracts database where the public can access information regarding contract values, specific agency contracts and vendors. Furthermore, LBB staff conducts performance audits for any agency that receives funds from the General Appropriations Act and efficiency reviews of state agencies, reporting the results to the governor and legislature.

The SAO is statutorily authorized to conduct various types of audits of state agencies and institutions of higher education, such as compliance and efficiency audits. An audit plan, based on recommendations from other oversight agencies, specifies the different types of audits to be done on select agencies, including audits of procurement and contract management.[231] Individual agencies house internal auditors who conduct annual reviews and report findings to the SAO. Findings from SAO audits are published online, and reported to the governor and legislature.

The CAT and the QAT were each created to review and make recommendations for procured services. The CAT reviews procurement solicitations for any contract over $1M, though specific agencies, such as the Teachers Retirement System, are exempt from this review. The CAT team is comprised of one member from each from the Office of the Attorney General, CPA, DIR and Office of the Governor. The CAT reviews solicitation documents and provides its recommendations within 20 days of receipt.[232]

Created in 1993, the QAT reviews the status of major information resources projects and makes recommendations to the legislature to reduce risk of project overruns and failures. Major projects are defined as those with development costs greater than $1M and meet one or more of the following criteria: (a) requires a year or more to reach operational status; (b) involves more than one agency or governmental unit; or (c) materially alters the work methods personnel or the delivery of services to agency or university clients. Representatives from the SAO, LBB and DIR comprise the QAT.[233]

After data from projects subject to QAT are analyzed, projects are identified as high, medium or low risk. Low risk projects are sometimes waived from monitoring. The QAT makes recommendations for each project reviewed, as well as more general recommendations for reoccurring issues across all projects.

Findings

Procurement of contracted services has increasingly become the primary method of operation for many services and commodities. From fiscal years 2002 to 2010, the amount of money spent on state contracts, as reported to the LBB, increased from $15B to $59.8B, a 44 percent change.[234] Private, professional service providers are often able to maintain a level of expertise that would be costly, and often times unrealistic, for the state to deliver. Procuring commodities and services allows the state to tap into the innovation and expertise of private industry without placing a permanent, long-term tax burden on the citizens to maintain and staff these services into perpetuity.

Though tapping into these resources can be efficient, a number of factors impact the successful implementation of procured services. First, up-front planning has the biggest impact on successful procurement. Analysis, risk assessment and solicitation are all key variables to planning for success. Second, the actual contract, execution and oversight are essential to ensuring that project goals, timeframe and compliance are observed. Finally, statutes impact governmental entities' ability to plan and execute a procurement, and need to be examined to ensure that they do not hinder the state's ability to obtain the best value for services and commodities.

Procurement Planning and Process

In a 2012 SAO report on major information system projects, 67 percent of the projects analyzed took longer to implement than estimated, and 73 percent went over budget.[235] Examining QAT reports from 2006-2011, it is evident that this is a reoccurring problem.

- In 2006, major information resources investments accounted for $772.1M in spending. By 2011, this number had increased to $1.31B.
- The amount spent on high risk projects has almost doubled, from $608.7M in 2006 to $1.26B in 2011.
- In 2011, implementation and/or deployment of late projects were an average of 18 months behind schedule.
- In 2009, the average cost for a project was $7.9M and projected to take over two years for development.
- Only two of the seven projects completed in 2008 were within the original timeline.
- Between 2006 and 2011, the largest project completed over budget was the TIERS Development-Accenture Project, costing the state $296.6M compared to the $3.4M initial cost estimate.[236]

In virtually all of these QAT reports, agencies underestimated or did not consider all elements of life cycle costs when estimating total project costs. Furthermore, the 2012 SAO report concluded that one of the biggest factors impacting these overruns is poor planning in the initial phases of development.

A needs based assessment, risk assessment, and cost projections all need to be completed and thoroughly analyzed before moving forward with Request for Proposals (RFPs). It is in these

stages that diligent planning can be used to prevent future complications. The SAO's analysis determined that agencies did not consistently involve all stakeholders and internal auditing departments, and treated cost estimates as placeholders when developing major information resources projects.[237]

Further complications come from a lack of input from people with subject matter expertise when doing assessments.[238] Agencies utilize the CAT for their expertise in best practices for procurement, but a gap in expertise on different subjects exists. The GLO testified at the September 2012 House State Affairs hearing that the CAT review, while beneficial, cannot evaluate the planning aspect of procurements, due to the lack of subject matter expertise.[239] During previous sessions, legislation has been introduced that would require procurement specialists with subject matter expertise for large contracts, but none has passed.[240] Information derived from this expertise could provide a thorough needs and risk assessment, and cost projections would likely be more accurate.

A lack of expertise and poor planning will have an impact on the methodology used when examining proposals to determine which would provide the best value for the state. Texas Government Code Section 2155.074(b) identifies best value factors such as installation and life cycle costs, quality and reliability of services, effects of purchase on agency productivity and vendors' anticipated economic impact to the state, all of which are difficult to determine if the proper planning has not been performed.[241]

Diligent adherence to best practices is essential for any agency procuring goods or services, but it is especially significant to agencies with mass purchasing authority, because their contracts impact other agencies' or political subdivisions' operations. In their 2011 Sunset report, staff identified missed opportunities at DIR, such as low-bid and strategic sourcing for telecommunications commodities, which could provide additional savings but are not being implemented. DIR has been delegated the authority to procure IT contracts for agencies and political subdivisions; however, entities that utilize DIR's contracts are encouraged to negotiate for deeper discounts when making their purchases through this program. Political subdivisions such as schools and municipal governments frequently lack personnel and resources necessary to negotiate better prices, and therefore may not be obtaining the best value.[242,243] Though vetoed, the Sunset bill that passed the House and Senate would have instituted a more rigorous use of strategic sourcing. Requests from legislators to the agency for reform are currently being implemented and under evaluation by Sunset staff and members of the legislature.

During ERS' procurement of their most recent HealthSelect contract, allegations of flaws in methodology and lack of input from stakeholders surfaced. The awarded contract was based on the potential for a projected $41M in cost savings over four years ($25M in lower administrative fees and up to $16M in risk sharing payments) on a contract valued at more than $200M.

A protest filed by the competing bidder claims that "ERS incorrectly applied the applicable statutory standards and criteria… the award does not provide the best value to ERS or plan participants." [244] They contend that under the new contract, lack of access to a safety network of doctors, inferior provider agreements and a flawed disruption analysis could cost the state as much as $600M.

The significance of a flawed analysis in the procurement extends further than the cost to the state. The disruption analysis used to determine the impact to participants indicates that almost three percent (10,000 members) would need to change their primary care physician, and did not include specialists in the scope of their final criteria. ERS testified that under the previous contract, 95.4 percent of providers deliver in-network coverage, while under the new plan, at the time of analysis, only 90.4 percent would be in-network.[245]

Furthermore, participants who utilized a safety network available under the previous plan to offset the costs of going to out-of-network doctors do not have access to the same type of benefit under the new contract. This was not a consideration taken into account during the analysis.[246] The competing bidder's protest contends that under their plan, savings to participants would be an estimated $150M to participants over the life of the contract.[247]

ERS testified that a number of additional physicians have opted into the new network since the contract went into effect, and many providers that were out-of-network under the previous contract are now in-network. The competing bidder's official protest has since been withdrawn, but given the potential cost to the state and plan participants, as well as the conflicting data, additional scrutiny of this contract may need to be considered.

An external audit, conducted 14-months after the effective date, could provide legislators with insight into the performance of this contract. ERS staff would have a comprehensive analysis to compare the current performance with its predecessor, which would likely be beneficial during the procurement of the next HealthSelect contract. Furthermore, should the audit indicate that the third-party administrator is not capable of performing the necessary functions, the executive director has the discretion to re-bid prior to the end of the four-year contract.[248]

Contract Management and Oversight

Contract management is a vital part of the procurement process, one that can be overlooked once contracts have been signed and funds released. In DIR's 2011 Sunset Review, Sunset staff contend that controls over major contracts frequently lack the necessary management:

> "…further discussion regarding the State's oversight and controls over major contracts at all state agencies is warranted. Clearly, problems with major contracts, particularly for outsourced services or IT-related projects, are not unique to DIR. Though members of the Legislature, the Comptroller of Public Accounts, and the Legislative Budget Board have all recommended improvements to how agencies enter into and manage major contracts for many years, these efforts have not yet resulted in a consistent approach to oversight and management of these contracts, and agencies such as DIR continue to struggle, putting the State at risk."[249]

Contract management is the final stage of a procurement, and continues until deliverables have been met or the contract is cancelled. Performance monitoring, approval of deliverables and auditing of invoices must be done throughout the length of the project.[250] Agencies can use the *Contract Management Guide,* which provides a framework for best practices in contract

management.

Once contracts have been signed, agencies must engage in ongoing monitoring. This can include site visits, reviews of invoices and performance reports submitted by the contractor and reviews of expenditure documents. Reviewing and auditing performance is a preventative measure against fraud and failure to provide deliverables. Ongoing monitoring also helps identify and address any problems that may arise early on, potentially preventing large scale costs that could mount over time.

Though an essential function of the procurement process, lax or ineffective monitoring frequently occurs. One of the common problems found during QAT reviews of major information resources projects was inefficient contract management, affecting the budget, functionality and time of project completion.[251] While examining ways to reduce the risks associated with contract management, the LBB found that contract management is often delegated to program staff with subject matter knowledge. Having this expertise is an important element of a contract, but experts in a field do not always have the contract management proficiency necessary to oversee a project. [252]

Problems that occur from ineffective procurements and contract management are often identified by oversight agencies such as the SAO, LBB and SAC, but their role is limited to advise and report. Testimony given by State Auditor, John Keel, during the House State Affairs Committee's September hearing provided insight regarding these inefficiencies and changes that could be made, namely an enforcement mechanism and penalties for noncompliance. Regarding major information resources projects, he suggested that yearly appropriations be released by the Comptroller upon the QAT's recommendation. Evidence of projects being on track and within the scope of the contract would need to be provided before this could happen. Having this enforcement mechanism would likely increase compliance with monitoring obligations. Putting penalties in place, such as withholding funds for failing to do a needs assessment, could ensure that agencies are implementing all the necessary steps of a procurement, thereby lowering the risks associated with them.[253]

It is essential that agencies take preventative measures when procuring goods and services as opposed to after the fact compliance from problems identified by oversight agencies. Aside from the fact that poor planning and contract management increases costs and risk to the state, the manpower at oversight agencies has not kept pace with the increase in the amount and number of contracts the state procures. While the amount spent on contracted services has increased by 75 percent, budgets for oversight agencies has increased at a much lower rate, between 20 and 40 percent.

These agencies oversee multiple aspects of state operations, and monitoring the procurement process of state agencies is only one of their many functions. Given the costs associated with poorly planned and executed contracts, the legislature may want to consider if there would be benefits associated with increasing the number of staff with expertise in procurement and contract management to monitor and ensure compliance with state statutes and best practices.

Statutes Impacting Procurement

The House State Affairs Committee heard testimony regarding the challenges faced by agencies when procuring professional services, as well as limitations placed on agencies when using competitive sealed bid processes.

Current statute requires that professional services be procured on a qualifications based selection (QBS).[254] Unlike strategic sourcing, which is primarily used for commodity purchases, QBS are utilized for procuring services in fields such as engineering, architecture and land surveying, where the lowest price may not yield the best value. QBS is generally used for the services provided in infrastructure, building and maintenance projects. Utilizing the most qualified professional may necessitate more up-front costs, but life cycle costs will likely be lower than those associated with poor quality services, such as those associated with change orders and higher construction and maintenance costs. QBS is the standard method of procuring professional services in 44 states as well as for federal agencies.[255]

For professional services, current Texas statute requires the three most qualified candidates to be ranked and negotiations begin, starting with the most qualified. If an agreement cannot be reached, the second most qualified is approached, and so forth. The GLO indicated that this method of procurement limits the state's negotiating capabilities for the best price possible, and proposed implementing a process that would set a minimum qualification while factoring in cost as a variable.[256]

Though QBS is the preferred method of procurement for professional services for the vast majority of state governments, some have instituted qualifiers that could be considered for Texas. First, a number of states have set a dollar threshold for requiring QBS. Texas has no minimum dollar threshold for applying QBS to professional services procurement. States such as Indiana and Nebraska require QBS only if a project is estimated to cost more than a certain amount. State thresholds vary from $25,000 to $200,000.[257]

Second, states place limitations on the type of projects and fields that are subject to QBS. Texas' wide scope includes real estate appraising, professional nursing, accounting, medicine and optometry. Massachusetts and Minnesota limit requiring QBS for procuring professional services associated with vertical construction projects, such as multi-story parking structures and buildings. Other states limit the scope of what QBS can be applied to, usually engineering and architecture fields. It is important to consider the potential impact on the quality of service, as well as provisions that have been successfully implemented in other states.

The 82nd Legislature passed HB 628 relating to contracts by governmental entities and their method of procurement for constructions projects. Though this consolidation and revision of code simplifies the procurement process by housing the provisions under one statute, the process for competitive sealed proposals for public works projects was significantly altered, requiring that agencies receiving RFPs under this method to "receive, publicly open and read aloud the names of the offerors and their bids".[258] Prior to passage, the cost portion was revealed after negotiations were complete.

At the September hearing, representatives from the GLO and the TFC testified that requiring bid amounts to be read aloud severely limits the state's ability to obtain the best value.[259, 260] Agencies are permitted to negotiate prices with potential vendors, and since the bid amounts are read publically, vendors have the advantage of knowing the competing offers. Prior to the passage of HB 628, vendors were not privy to other offers and therefore, motivated to provide their best offer.

Requiring that bid amounts be read aloud is not standard practice for this method of procurement, and may be hindering the state's capacity to obtain the best value, a fact to considered when examining how to strengthen procurement statutes. Other states with similar, consolidated procurement statutes have provisions to prevent disclosing this information.

- Arkansas -- In conducting discussions, there shall be no disclosure of any information derived from proposals submitted by competing offerors; no part of any negotiation plan shall be revealed to bidder(s) or made available for public review until after a contact award.[261]
- Colorado -- Proposals shall be opened so as to avoid disclosure of contents to competing offerors during the process of negotiation.[262]
- New Mexico -- The contents of any proposal shall not be disclosed so as to be available to competing offerors during the negotiation process.[263]

Additional analysis could determine if there is a significant impact on the state's ability to negotiate when disclosing bid amounts from competitive sealed proposals prior to negotiations for public works projects.

Conclusion

Procurement and contract management are essential for the operation of virtually every state agency. The tools for effective procurement and contract management are present, though not always executed. Additional policies may need to be implemented to ensure that best practices and recommendations from oversight agencies are being performed. The legislature should continue to examine how to improve statutes that affect procurement and consider instituting penalties for non-compliance.

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[162] Like other state agencies, TDLR's rulemaking is governed by the Administrative Procedures Act, Chapter 2001 of the Government Code, and the administrative rules for the Texas Register, 1 Texas Administrative Code, Chapter 91.
[163] Examine Agency Rulemaking: Public Hearing before the H. Comm. of Government Efficiency and Reform, 82nd Sess. (Tex. 2012) (William H. Kuntz Jr., Executive Director, Texas Department of Licensing and Registration).
[164] Proposed rules must be filed with the Texas Register on a strict filing deadline (by 12:00 noon on Monday, published in the Texas Register on Friday of the next week – eleven days later).
[165] Study All Existing Occupational Licensing Programs: Public Hearing before the H. Comm. of Licensing & Administrative Procedures, 82nd Sess. (Tex. 2012) (William H. Kuntz Jr., Executive Director, Texas Department of Licensing and Registration).
[166] Tex. Govt. § 2001.031(b)-(c) makes advisory committees permissible but not required.
[167] The department drafted rules to implement the advisory committee process and establish how they would operate, including giving the commission the power by order to appoint the advisory committee members (43 T.A.C. § 1.83).
[168] Sunset Advisory Commission, Texas Higher Education Coordinating Board: Staff Report, (June 2012) at 13.
[169] Examine Agency Rulemaking: Public Hearing before the H. Comm. of Government Efficiency and Reform, 82nd Sess. (Tex. 2012) (Linda Battles, Associate Commissioner, Texas Higher Education Coordinating Board).

[170] Examine Agency Rulemaking: Public Hearing before the H. Comm. of Government Efficiency and Reform, 82nd Sess. (Tex. 2012) (Cary Austin, Technical Salesmen, Cycle Stop Valves, Inc.); see also, Examine Privatization of State Services: Public Hearing before the H. Comm. of Government Efficiency and Reform, 82nd Sess. (Tex. 2012) (Albert Cortez, Public Testimony.)
[171] Examine Agency Rulemaking: Public Hearing before the H. Comm. of Government Efficiency and Reform, 82nd Sess. (Tex. 2012) (Kathleen Hartnett White, PhD, JD, Distinguished Senior Fellow-in-Residence & Director, Armstrong Center for Energy & the Environment, Texas Public Policy Foundation).
[172] The US House approved H.R. 10, 112th Cong. (1st Sess. 2011) but was never considered by the US Senate.
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[177] Tex. Govt. § 2001.032.
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[181] Davis, Kenneth Culp, Discretionary Justice: A Preliminary Inquiry (Baton Rouge: Louisiana State University Press, 1975); see also, Peck, Cornelius, The Atrophied Rulemaking Powers of the National Labor Relations Board (Yale Law Journal 70(5) at 729– 61).
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[185] Data compiled from Texas Legislative Council's report, Occupational Regulation in Texas, prepared for Representative Callegari's Office, 2007.
[186] Morris M. Kleiner, Licensing Occupations, Ensuring Quality or Restricting Competition?, 2006, page 12; see also, Suzanne Hoppough, "The New Unions," Forbes, 25 February 2008, page 100.
[187] Summers, Occupational Licensing: Ranking the State and Exploring Alternatives, page 15.
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[190] Witness List, HB 1656 80th Regular Session, House Committee Report.
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