HOUSE COMMITTEE ON GOVERNMENT REFORM
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2008

A REPORT TO THE
HOUSE OF REPRESENTATIVES
81ST TEXAS LEGISLATURE

WILLIAM "BILL" CALLEGARI
CHAIRMAN

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Committee On
Government Reform

January 13, 2009

William "Bill" Callegari
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P.O. Box 2910
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The Honorable Tom Craddick
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 Government Reform of the Eightieth Legislature hereby submits its interim report including recommendations and drafted legislation for consideration by the Eighty-first Legislature.

Respectfully submitted,

William "Bill" Callegari

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INTRODUCTION

On January 26, 2007, the Honorable Tom Craddick, Speaker of the Texas House of Representatives, appointed seven members to serve on the House Committee on Government Reform for the duration of the 80th Legislature. The following members were named to the committee: Chairman William Callegari, Vice-Chairman Jim Pitts, Leo Berman, Eddie Rodriguez, Wayne Smith, David McQuade Leibowitz, and Borris Miles.

Pursuant to House Rule 3, Section 18 (80th Legislature), the Committee has jurisdiction over all matters pertaining to:

1. the organization, operation, powers, regulations, and management of state departments, agencies, institutions, and advisory committees;
2. elimination of inefficiencies in the provision of state services; and
3. the following state agencies: the Texas Incentive and Productivity Commission and the Sunset Advisory Commission.

Speaker Tom Craddick issued Interim Charges to the committee on November 28, 2007 to study and report back with facts, findings, and recommendations.

The final report is the culmination of the Committee's hearings and investigations. The Committee wishes to express appreciation to the agencies, associations, and members of the public who contributed their time and effort on behalf of the report.

Finally, the Committee would like to extend its sincere appreciation for those state employees, whose time and talent were significantly taxed by the Committee's staff, and without whom this report would not have been possible, Dan Wattles and Anita D'Souza of the State Auditor's Office, Bart Bevers and Deborah Giles of the Health and Human Services Commission, Office of Inspector General, and Debbie Irvine, Tammy Edgerly, Jason Bane, and Chandler Lewis of the Texas Legislative Council, Research Division.

HOUSE COMMITTEE ON GOVERNMENT REFORM

INTERIM STUDY CHARGES

CHARGE: Research, investigate, and make recommendations on how electronic documents can be created, maintained, exchanged, and preserved by the state in a manner that encourages appropriate government control, access, choice, interoperability, and vendor neutrality. The committee shall consider, but not be limited to, public access to information, expected storage life of electronic documents, costs of implementation, and savings.

CHARGE: Research, investigate, and make recommendations regarding litigation brought by school districts receiving state funds under Chapter 46, Education Code, for defective construction of instructional facilities and the state's interest in ensuring the use of such funds for the repair or reconstruction of defective facilities or the return of state funds.

CHARGE: Reviews authorized offices of inspectors general and assess the benefit of having a statewide office of inspector general for all executive branch agencies.

CHARGE: Study and review current laws regarding licensing and regulation of professionals, as well as current laws regarding practice acts, and make recommendations on creating limitations and streamlining of licensure requirements, such as the public policy implications of decriminalization of license-related violations.

CHARGE: Evaluate and make recommendations, if necessary, regarding state contracts with pharmacy benefit managers. Assess the feasibility of combining prescription drug programs of state health insurance programs. All recommendations should take into consideration any budgetary impacts (Joint Interim Charge with the House Committee on Pensions and Investments).

CHARGE: Monitor the agencies and programs under the committee's jurisdiction.

ELECTRONIC DOCUMENTS

Research, investigate, and make recommendations on how electronic documents can be created, maintained, exchanged, and preserved by the state in a manner that encourages appropriate government control, access, choice, interoperability, and vendor neutrality. The committee shall consider, but not be limited to, public access to information, expected storage life of electronic documents, costs of implementation, and savings.

Background on Electronic Documents:

The nature of the government document has changed. Historically, documents were paper based, where they were typed or printed in a manner that could be saved in a library or file cabinet. With the advent of the electronic information age, government documents are frequently created and stored in an electronic format. The widespread use of information technologies by state agencies to create and store documents has focused policymakers on ensuring the effective use of technology, including creating, using and archiving electronic government documents for public access.

Unlike a paper-based document, which may be easily created using paper and ink; most electronic documents are created using computer hardware and software. *Computer hardware* is defined as the mechanical, magnetic, electronic, and electrical components making up a computer system. Hardware commonly refers to objects that you can actually touch, like disks, disk drives, display screens, keyboards, printers, boards, and chips.[1]

In contrast, software is untouchable. Software exists as ideas, concepts, and symbols, but it has no substance. *Software* is a general term used to describe a collection of computer programs, procedures and documentation that perform some tasks on an operating system.[2] S*oftware* (sometimes referred to as computer programs or applications), consists of carefully-organized instructions and code that programmers write in a language computers can understand and act upon. These applications handle a variety of common and specialized tasks a user might want to perform, such as accounting, data processing, word processing, and video communication.[3] It is often bought by the user to address specific needs and is usually the reason people buy computers.

A secondary component of software is the file format employed by the software application. Many electronic documents created by certain software programs, such as a spreadsheet using Microsoft Excel or a letter using WordPerfect, require the information to be stored in a specific file format. A file format (sometimes referred to as a "document format") is a particular way to encode information for storage in a computer file.[4] The format is what enables a software application to interpret the raw data contained in the file. Spreadsheets, such as Microsoft Excel or Lotus 1-2-3, use page layout formats designed to convey numerical based information, such as financial or mathematical data. Word processors, such as Microsoft Word and Open Office Writer, use document preparation formats designed to convey mostly text.

Paper based documents provide a useful analogy. The pages and the ink are the hardware, while the words, sentences, paragraphs, and the overall meaning are the software. A computer without software is like a book full of blank pages - you need software to make the computer useful just as you need words to make a book meaningful.

Despite the evolutionary change of the government document, the basic issues of creating, using

1. Wordnet, definition of hardware (2008), http://wordnetweb.princeton.edu/perl/webwn?s=computer%20hardware.
2. Wordnet, definition of software (2008), http://wordnetweb.princeton.edu/perl/webwn?s=software.
3. Webopedia, definition of software (2008), http://www.webopedia.com/TERM/s/software.html.
4. Webopedia, definition of file format (2008), http://www.webopedia.com/TERM/f/file_format.html.

and archiving government documents still relate. The manufacturing method and materials of works on paper, such as the inks, paints and paper components, can influence the inherent, long-term stability and usability of library, art and archival items. Likewise, the manufacturing method used to create an electronic document, such as the electronic hardware used, the software utilized, and the file format employed, may influence the inherent, long-term stability, usability, and cost of the electronic information.

Issue 1: Electronic information of the State of Texas needs to be produced as economically as possible.

Background on Open v. Proprietary

Some software industry experts claim the problems of long-term stability, usability, and costs of the electronic information are commonly associated with the use of closed software, often referred to as proprietary. *Proprietary software* are programs that are the legal property of one party, the use of which is made available to a second or more parties, usually under contract or licensing agreement and often includes restrictions on use, particularly with regard to the copying or modification of the software.[5] In the computer industry, proprietary often implies that the company has not divulged specifications that would allow other companies to duplicate the product.

Similarly, *proprietary formats* are controlled and defined by private interests. In a proprietary format, only the software produced by the company who owns the specification of the format is able to correctly open and read the data in the file.[6]

A number of software manufactures offer an alternative to proprietary applications; know as *open source software*, applications whose architecture and specifications are commonly made public.[7] This includes officially approved standards as well as privately designed architectures whose specifications are made public by the designers. The opposite of open is closed or proprietary.

Type	Proprietary	Open Source
Operating System	Windows	Red Hat Linux
Office Suite	MS Office	OpenOffice.Org; IBM Lotus Symphony
Image Editor	Adobe Photoshop	GIMP
Internet Browser	Internet Explorer	Mozilla Firefox
E-Mail	MS Outlook	Thunderbird
Web Server	MS IIS	Apache

Likewise, *open format* is a published specification for storing digital data, usually maintained by a standards organization, which basically can be used and implemented by anyone. For example, an open format can be implementable by both proprietary software and open source software, using the typical licenses used by each. [8]

5. Webopedia, definition of proprietary (2008), http://www.webopedia.com/TERM/P/proprietary.htm.
6. Texas Department of Information Resources, Open Standard, Open Source, Open Format: An Introduction 2 (June 2008).
7. Webopedia, definition of open (2008), http://www.webopedia.com/TERM/O/open.html.
8. Texas Department of Information Resources, *Supra* note 6 at 2.

Some industry experts claim that organizations and individuals that create and store their data in an open architecture avoid being locked into a single software vendor, leaving them free to switch software if their current vendor goes out of business, raises its prices, changes its software, or changes its licensing terms to something less economically favorable for the user.[9] Proponents of adopting open formats, such as the ODF Alliance, argue that adopting true open formats could increase compatibility and interoperability and save the state as much as 60 to 90 percent in purchase and support of application software costs.[10]

Providers of open source software and open formats often claim that their products offer better long-term stability and usability, at lower costs. One of open source's most touted benefit is the price. Download the software and install it all for free. They further claim that their open architecture allows anyone to customize the software application to their specific needs and even design add-on products. By making the architecture public, however, a manufacturer allows others to duplicate its product. Linux, for example, is considered open architecture because its source code is available to the public free of charge.[11]

In contrast, DOS, Microsoft (MS) Windows, and Apple's Macintosh architecture and operating systems have been predominantly closed and have historically been fee based. Proponents of proprietary software argue that, unlike open source, proprietary software can offer a single-minded purpose, direction and reliability within an organization's existing design considerations and priorities. Manufactures of proprietary software maintain that their software is more dependable and comes with more comprehensive technical support. They argue that the absence of licensing fees of open source software needs to be offset with the costs of training, support and maintenance of such products.[12]

Proposed Legislation

During the 80th Session, H.B. 1794 and S.B. 446 were introduced, both of which proposed to statutorily mandate the use of an open document format for state created documents. The House Committee on Government Reform heard H.B. 1794, which was left pending in committee, while S.B. 446 was left pending in the Senate Committee on State Affairs. Each bill, if passed, would have carried a total General Revenue cost of $55.8 million for the 2008-09 with a total All Funds cost for the biennium of $121.2 million. [13] Both bills were a result of a certain factions within the information technology marketplace to create and promote the benefits of open

9. ODF Alliance, *Why ODF? The Importance of OpenDocument Format for Governments* (2006).
10. *Benefits of Open Document Formats, Public Hearing on HB 1794 before the H. Comm. of Government Reform, 80th Sess.* (Tex. 2008) (statement of Marino Marcich, ODF Alliance).
11. *Research, investigate and how electronic documents can be created, maintained, exchanged and preserved by the state: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Tom Rabon, Executive Vice President, Red Hat).
12 *Research, investigate and how electronic documents can be created, maintained, exchanged and preserved by the state: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. *(Tex. 2008)* (statement of Stuart Mckee, National Technology Officer, Microsoft).
13 Memorandum from John S. O'Brien, Director, Legislative Budget Board on HB 1794 by Veasey to Honorable Bill Callegari, Chairman, H. Comm. on Government Reform (Mar. 26, 2007); *See also,* Memorandum from John S. O'Brien, Director, Legislative Budget Board on SB 446 by Hinojosa to Honorable Robert Duncan, Chairman, S. Comm. on State Affairs (Mar. 25, 2007).

formats over existing closed or proprietary formats.

H.B. 1794 and S.B. 446 of the 80th Reg. Sess.	
Bill Analysis	Fiscal Note
Each bill would have required each electronic document created, exchanged, or maintained by a state agency to be an open, Extensible Markup Language (XML) based file format, which specified by the Department of Information Resources (DIR), would be interoperable among diverse internal and external platforms and applications; published without restrictions or royalties; fully and independently implemented by multiple software providers on multiple platforms without any intellectual property reservations for necessary technology, and controlled by an open industry organization with a well-defined inclusive process for evolution of the standard.	2008 ($38,410,100) 2009 ($17,374,741) 2010 ($10,055,183) 2011 ($10,063,690) 2012 ($10,072,422)

Findings:

- The terms "open" should not be confused with free software, nor should one assume that "proprietary" means software at an upfront price. [14] Neither of the two terms is specific enough to describe a particular software license. In general, the most important part of the copyright in the issue of software regards the software's copying, distribution and preparation of derived works.[15] *Commercial software* is being developed by businesses which aim to make money from the use of both open and proprietary software.[16] Microsoft is a software company that mutually develops proprietary and open source software.[17]
- Open and proprietary software architectures should be viewed as competing business models. Open source software is a vision where software development and support is a service industry, not a product industry.[18] For example Red Hat is one of the premier Linux and open source providers. While the development process and technology offered by Red Had is open and can be obtained for free, the company generates revenue and profit through a subscription model.[19] The subscription business model is when a company sells periodic (monthly, yearly or seasonal) access or technical support to a product or service, rather than selling products individually at a one time upfront cost.

14. *Freeware has no clear accepted definition, but it is commonly used for a class of software that you can download, pass around, and distribute without payment. Although there are different types of "free licenses", the most widely accepted by the industry is called the General Public License (GPL), first established by Richard Stallman in 1983* (Stallman.org, biography, 2008). *GPL requires that every user should have: the freedom to use the software for any purpose, the freedom to change the software to suit your needs, the freedom to share the software with your friends and neighbors, and the freedom to share the changes you make* (FSF.org, A Quick Guide to GPLv3 (2008)).
15. Donald K. Rosenberg, Open Source: The Unauthorized White Papers (2000).
16. Webopedia, definition of commercial software (2008), http://www.webopedia.com/TERM/c/commercial_software.html.
17. Microsoft, Open Source (2008), http://www.microsoft.com/opensource; *see also,* Barb Mosher, *Microsoft's New Open Source Web CMS*, CMS Wire, Dec. 9, 2008.
18. Joab Jackson, *The Real Cost of Open-Source Software*, Government Computer News, July 5, 2005.
19. RedHat.com, about (2008), http://www.redhat.com/why_red_hat.

Proprietary software commonly generates revenue by selling the customer the right to use the software product as opposed to selling them actual ownership of the product (as they might own a physical object) and in turn provides support and needed updates. In sum, both open and propriety software are businesses models that have different ways of extracting value from a particular piece of software.

- The *total cost of ownership* (TCO) of an electronic document is a complex formula that goes beyond the simplicity of the software being open or proprietary. TCO needs to include the original cost of the computer hardware and software, as well as the hardware and software upgrades, the maintenance, technical support and training.[20] Most estimates place the TCO at about 3 to 4 times the actual purchase of the original hardware or software. [21]
- The TCO can very from one state agency to another depending on the needs of its business. Agencies use different types of software, both open and proprietary that may be used for only one agency, and agencies need a degree of flexibility to fulfill their particular mission.[22] For example, the TCO of the severs and backend computer operations of the Texas State Soil and Water Conservation Board (TSSWCB) were reduced in 2003 by moving to an open source solution, after the Board experienced poor customer service and security issues with its then proprietary system.[23] However not all agencies might be as agile and free from legacy issues, or have the same level of in-house expertise as TSSWCB.[24] The money an agency may spend for technical service, support, training, customization and testing open-source applications may exceed its current known proprietary systems[25], as reflected by the Legislative Budget Board's fiscal notes for H.B. 1794 and S.B. 446.[26] The fact that the costs of integrating new open source software or formats might be mitigated by phasing them in during an agency's natural upgrade cycle to new hardware or new versions of software, only goes to the complexity of determining true TCO.[27]
- The State of Texas has existing infrastructure to help it determine true TCO of an electronic document. The 73rd Legislature in 1989 established the Department of

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20. Webopedia, definition of TCO (2008), http://www.webopedia.com/TERM/T/TCO.html.
21. Id..
22. *Research, investigate and how electronic documents can be created, maintained, exchanged and preserved by the state: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Ginger Salone, Deputy Executive Director, Texas Department of Information Resources).
23. Telephone Interview with Clay Wright ET AL., IT Officer, TSSWCB (Jan. 18, 2008).
24. *TSSWCB was unable to determine any exact dollar amount of savings due to the use of open source software because money saved by free software does not come from reducing current expenses but rather from not having to spend future money on the acquisition of proprietary software. Nevertheless, the agency estimated a specific savings of approximately $10,000, when opting for an open source solution for deploying its statewide area network.*
25. Joab Jackson, *The Real Cost of Open-Source Software*, Government Computer News, July 5, 2005.
26. *The cost of the bills is related to five primary factors: Train agency staff to use the new software ($50.9 million, All Funds); convert existing files to the new protocols ($15.9 million, All Funds); reprogram existing agency applications; increase document storage capacity ($10.2 million, All Funds); and provide technical support for open source software ($44.2 million, All Funds)* (Memorandum from Keith Yawn, Agency Performance Review, Legislative Budget Board on State Electronic Documents to Jonathan Mathers, Committee Clerk, Tex. H. Comm. on Government Reform (March 19, 2008) (on file with author).
27. *Research, investigate and how electronic documents can be created, maintained, exchanged and preserved by the state: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Ginger Salone, Deputy Executive Director, Texas Department of Information Resources).

Information Resources to coordinate and direct the use of information resources technologies by state agencies and provide the most cost-effective and useful retrieval and exchange of information within and among state agencies, and to Texas residents and their elected representatives.[28]

- Any statute that would mandate a specific software or document standard would be out of date in a short period of time due to the rapid pace of change in technology.[29] For example, the State of Texas adopted the OSI network protocol in 1990 and by 1993 had to drop OSI to due market forces that favored the now widely used communications protocol, The Internet Protocol Suite (commonly called TCP/IP).[30] Open Systems Interconnection (OSI) was an effort to standardize networking, in an attempt to get everyone to agree to common network standards that was started in 1982 by the International Organization for Standardization (ISO). Prior to OSI, according to its proponents, networking was largely vendor-developed and proprietary, with protocol standards such as SNA, Appletalk, NetWare and DECnet. It was common for large networks to support multiple network protocol suites, with many devices unable to talk to other devices because of a lack of common protocols between them. However while OSI developed its networking standards, TCP/IP came into widespread use on multivendor networks. So while statutes may not be an appropriate way to direct the State's strategic plan for technology, DIR has the authority and flexibility to promulgate rules and require adherence to new technological standards when deemed appropriate.

Recommendations:

1.1 The Legislature should not mandate in statute the use of any specific software or file format. It is not in the State's best interests to insert itself into any market battle between competing software architectures. Doing so could increase the state's *total cost of ownership* of electronic information, as technologies can easily become outdated.

1.2 The Department of Information Resources (DIR) should continue to move state agency software acquisitions toward achieving the business needs of the State at the lowest *total cost of ownership*. Given the complexity of TCO in regards to open and closed architecture, the committee would encourage DIR to develop a comprehensive buying guide that state agencies could utilize when determining whether to purchase open or proprietary software during natural upgrade cycles.

Issue 2: The State of Texas needs to adapt to ever-changing technology and business processes to ensure its electronic data is accessible and usable to the public.

Background

28. Tex. Govt. § 2054 (2007).
29. *Research, investigate and how electronic documents can be created, maintained, exchanged and preserved by the state: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Ginger Salone, Deputy Executive Director, Texas Department of Information Resources).
30. Texas Department of Information Resources, Meeting Citizen Needs: A Vision for Information and Technologies to Serve Tomorrow's Texans 17, Nov. 1993; *see also* 18 Tex. Reg. (4987).

Whenever someone is writing an article, retouching an image, building a web page, listening to a song or watching a favorite movie on a computer, they are using files. These files need to have a format in order to be opened, read or modified. The format is what enables an application to interpret the raw data contained in the file. File formats are marked in the extension of the file name, the characters after the period in the name of a file. [31] For instance ".wpd" is a document created in WordPerfect and ".doc" is a document created using MS Word. These extensions are used by computers to identify how a file is to be used and what programs can be used to open it.

As previously discussed, a file format can be open or proprietary. An open format is a published specification, usually maintained by a non-proprietary standards organization, and free of legal restrictions on use. Open file formats can be opened by a variety of manufacturers' products. In a proprietary format, only the software produced by the company who owns the specification of the format will be able to correctly open and read the data in the file.[32] The International Organization for Standardization (ISO), an international-standard-setting body that promulgates worldwide industrial and commercial standards[33], has adopted several formats, including the Open Document Format (ODF), Open Office Extensible Markup Language (OOXML), and Portable Document Format (PDF).[34]

Industry supporters of open file formats claim that open formats guarantee long-term access to data without legal or technical barriers. They claim that document produced in an open file format can then be processed by other applications seamlessly, without interference of any proprietary code or any other restrictions. Likewise they claim that a document saved in an open file format naturally has long term access and is never indecipherable because the technical specifications used to produce it are always available.[35]

Manufactures of proprietary software claim that open file formats solve only some of the problems that exist when trying to access electronic documents. Additionally, they assert that open file formats can also create barriers to document access in certain circumstances. They also claim a government policy of using only a single file format is shortsighted and that depending on the specific technological goals of a state agency and the documents in question, proprietary solutions exist that may offer better access to electronic documents.[36]

Other States

Several other states, including Minnesota, Florida, and New York, have considered but ultimately determined not to adopt legislation or rules mandating the use of open document formats. As of the date of the committee's report on this issue, there are no states in the United

31. Texas Department of Information Resources, Open Standard, Open Source, Open Format: An Introduction 2 (June 2008).
32. Id..
33 ISO, About (2008), http://www.iso.org/iso/about.htm.
34. *ODF was approved in May 2006 and OOXML was approved by ISO in March 2008.*
35 ODF Alliance, *Why ODF? - The Importance of Open Document Format for Governments,* Dec 2007 at 2.
36 *Research, investigate and how electronic documents can be created, maintained, exchanged and preserved by the state: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Stuart Mckee, National Technology Officer, Microsoft).

States that require the use of open document format to the exclusion of other formats when creating state documents. The Massachusetts Information Technology Division did adopt a policy requiring state agencies to use an open document format in 2005. Since that time, the Massachusetts division has altered its policy to allow agencies to create and save records in several formats, including, ODF, OOXML, HTML, and PDF.[37]

Open Document Format Proposed Polices by State		
State / Bill	Analysis	Status
California A.B. 1668 February 23, 2007	Would have required "all state agencies, beginning on or after January 1, 2008, to create, exchange, and preserve all documents, as specified, in an open extensible markup language-based, XML-based file format, and to start to become equipped to receive any document in an open, XML-based file format, as specified."	The bill remained in committee.
Connecticut H.B. 5299 January 10, 2007	Would have required each state agency to "consider the availability of open source code software when purchasing, licensing or procuring computer software, as an alternative to proprietary software. Such comparison shall be based upon a comparison of costs and quality standards of such software."	A public hearing was scheduled for February 21, 2007. The bill remained in committee.
Florida S.B. 1974 February 22, 2007	Proposed committee substitute introduced on March 28, 2007 would have required the new Office for Enterprise Information Technology to "develop a plan and a business case analysis for the creation, exchange, and maintenance of documents by state agencies in an open format."	No action was taken by the Committee on adding the proposed language. The bill became law on June 12, 2007 without that language.
Minnesota H.F. 176 January 17, 2007	Preservation of State Documents Act, if passed, would have required that all documents "including text, spreadsheets and presentations" of the state be created in ODF.	The bill language was changed on March 23, 2007 to require an electronic records study be conducted by January 15, 2008, and was enacted into law. The study was published in February 2008.
Oregon H.B. 2920 March 27, 2007	Bill would have required "state agencies to disclose public records in electronic form in certain circumstances and, when practicable, in open formats for which freeware is available."	The bill remained in committee.
New York A8961 June 6, 2007	Directs the Director of the Office of Technology, in consultation with other entities to study electronic document production and preservation in New York, and to make recommendations regarding appropriate	The study was published in May of 2008.

37 Auditor of the Commonwealth of Massachusetts, *Report on the Examination of the Information Technology Division's Policy for Implementing the Open Document Standard*, NO. 2006-0884-4T (Sept. 20, 2007).

	government control, access, choice, interoperability, and vendor neutrality by January 15, 2008.	

Findings:

- Some government documents can be discarded immediately, while others should be saved for years. Most government documents are subject to public information requests. This, along with e-discovery[38], emphasizes the need for a format that allows the public to access state information now and decades from now, regardless of which software product and version was used to create it.[39]
- Thus, interoperable data is a desirable goal as it leads to new and innovative approaches. *Interoperability* is the ability of software and hardware on different machines from different vendors to share data.[40] When interoperability exists there can be enhanced services and efficiencies: better capture, storage and retrieval of critical information, coordination of key activities, and better communication between state agencies and with the public.[41] The most obvious example of interoperable data is the Internet, where data is routinely decoupled from the program that created it and shared across multiple websites, which reinterpret the information in the form of maps, blogs, pictures, et cetera. One tangible example of interoperable data on the internet that benefits citizens is the website USAspending.gov, which provides citizens with easy access to government contracts, grants and other government spending data. The information on USAspending.gov can be searched in several ways to isolate or identify specific transactions and results can be easily manipulated to be displayed in text or graphic rich detail.[42]
- While open file formats are a solid attempt to allow products developed by various vendors to work together, the sole use of open file formats does not guarantee interoperability. For example, OpenDocument Format (ODF) is a popular open standard for office applications, which includes spreadsheets. Theoretically this means that two separate office software programs that use ODF, such as OpenOffice and KOffice, should be able to share spreadsheets. In practice, there are obstacles to sharing spreadsheets among ODF compliant software because ODF currently lacks formula specification for spreadsheets. So while KOffice and OpenOffice can easily open one another's spreadsheets, they often lose the actual formulas that make the spreadsheets useful.[43]

38. *Electronic discovery, or "e-discovery", refers to discovery in legal litigation that deals with information in electronic format also referred to as Electronically Stored Information (ESI).*
39. *Research, investigate and how electronic documents can be created, maintained, exchanged and preserved by the state: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Andrew Updegrove, Attorney and Published Author on Open Standards).
40. Webopedia, definition of interoperability (2008), http://www.webopedia.com/TERM/i/interoperability.html.
41. *Research, investigate and how electronic documents can be created, maintained, exchanged and preserved by the state: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Dr. Gary Chapman, LBJ School of Public Affairs, University of Texas).
42. USAspending.gov (2008), http://www.usaspending.gov/index.php.
43. Marco Fioretti, *OpenDocument office suites lack formula compatibility,* linux.com, Sept. 20, 2005, *available at* http://www.linux.com/articles/47942.

- Open file formats do not guarantee document fidelity among applications. Document fidelity denotes how accurate a copy of a file is to its source.[44] Document fidelity is even hard to ensure among proprietary software using its own proprietary format, such as opening a MS Word 2003 document using MS Word 2007.[45] Nevertheless, document fidelity is key consideration in selecting a standard. Documents can lose meaning and value if the layout or visual emphasis is altered. For example, in the legal or regulated environments, retaining the exact document layout may be required for official communications or legally binding transactions. In sum "present technology does not ensure that a document created by one open-standard-compliant product can be retrieved and read by a document created by a different, yet also compliant product."[46]
- Open file standards do not ensure accessibility for all citizens.[47] Individuals with disabilities that rely on assistive technologies would currently have difficulty utilizing certain open file formats currently in the market place. In 2006 Massachusetts noted that ODF-supporting office suites were "unlikely to be fully supported by assistive technology vendors, or alternatively to include fully functional adaptations in the packaged product," by the time frame slated for its migration to ODF formats.[48]
- Open standards for document formats, which began gaining approval by ISO just a few years ago, are still evolving and may in time resole many of the outstanding technical concerns. Nevertheless, the market is showing a growing preference for open file formats. OpenOffice, which is a free cross-platform office application suite that supports ODF is alleged to have a "10% market share, at least according to IDC, Jupiter and Gartner, while Forrester is even more optimistic about the open-source solution, evaluating its market share at 15%."[49] Likewise, Microsoft Office 2007, which already provides support for 20 different document formats, will support ODF in its upcoming service pack update (SP2).[50] Microsoft Office 2007 currently supports various other open file formats including Office Open XML, which is the default file format of Microsoft Office.
- Ultimately, open file standards are only the beginning of the technical issues facing the state in its attempts to share electronic information. All application programming interfaces (API) would also have to be open.[51] API is a set of functions, procedures, methods, classes or protocols that an operating system, library or service provides to support requests made by computer programs. A good API makes it easier to develop a program by providing all the building blocks.[52]

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44. Telephone Interview with Stuart McKee ET AL., National Technology Director, Microsoft (Oct. 17, 20087).
45. Id.
46 *Research, investigate and how electronic documents can be created, maintained, exchanged and preserved by the state: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Ginger Salone, Deputy Executive Director, Texas Department of Information Resources).
47. Telephone Interview with Dr. Jim Thatcher, Web Accessibility Expert, JimThatcher.com (Apr. 4, 2008).
48. Letter from Louis Gutierrez, Chief Information Officer, Massachusetts Executive Office for Administration and Finance to private citizen (Aug. 23, 2006).
49. Softpeida, *Open-source versus Microsoft in office arena*, June 2, 2005; *available at* http://news.softpedia.com/news/Open-source-versus-Microsoft-in-office-arena-2554.shtml.
50. Press Release, Microsoft Corporation, Microsoft Expands List of Formats Supported in Microsoft Office (May 21, 2008).
51. Interview with Gary Chapman, Professor, LBJ School of Public Affairs at the University of Texas in Austin, Tex. (Feb. 11, 2008).
52. Webopedia, definition of API (2008), http://www.webopedia.com/TERM/A/API.html.

- To date, no single file standard addresses all the needs and goals of the State of Texas. Thus, any choice to use a specific file format must be based solely on the value it would add to the specific agency task at hand. For example, the Texas Legislature, in an attempt to communicate to its citizens, archives House Committee Hearings using both video and audio file formats and posts public documents to the web in three different formats (.html, .doc, .pdf). A move to a single file format, even an open file format, might adversely affect the legislatures attempt to communicate with the public, due to issues of translations between the various formats and programs used by the public. In sum, state agencies use different types of file formats, including proprietary formats that may be used by only one agency. Agencies need a degree of flexibility to fulfill their particular mission.[53]
- The Department of Information Resources (DIR) and the Texas State Library and Archives Commission (TSLAC), with the assistance of the Records Management Interagency Coordinating Council (RMICC), which is an interagency group focused on electronic state record policy, has the authority to promulgate rules and require adherence to file format standards that are deemed appropriate for the State of Texas.[54]
- At legislative direction, in 1998 the State of Texas prepared the "Electronic Records Research Report." This report made recommendations in three areas: Managing records in electronic formats; adopting functional requirements for managing records in electronic formats; and making agency information available to the public in electronic formats.[55]
- Through the authority of DIR and the State Library and Archives Commission, many of the recommendations of the report have been implemented. The report was also used to develop "Electronic Records: Standards and Procedures," which has a provision requiring any electronic system developed or acquired by a state agency to "provide a standard interchange format…to permit the exchange of records on electronic media between agency computers using different software/operating systems and the conversion or migration of records…from one system to another."[56] However, the report and the standards and procedures were written before the issues of open file formats developed.

Recommendations:

2.1 The Department of Information Resources and the Texas State Library and Archives Commission, with the assistance of the Records Management Interagency Coordinating Council, should continue to focus using software and file formats that will achieve the State's business needs but also towards the policy goal of better accessibility and interoperability of the State's

53. *Research, investigate and how electronic documents can be created, maintained, exchanged and preserved by the state: Public Hearing before the H. Comm. of Government Reform, 80th Sess.* (Tex. 2008) (statement of Ginger Salone, Deputy Executive Director, Texas Department of Information Resources).
54. *RMICC was created by the Texas State Library and Archives Commission's 1995 Sunset reauthorization legislation (SB 366) as the successor to the now-abolished Records Management and Preservation Advisory Committee. As identified in the following roster, the council is composed of representatives of seven state agencies with direct authority over policy affecting Texas state government's management of its records.*
55. *Research, investigate and how electronic documents can be created, maintained, exchanged and preserved by the state: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Ginger Salone, Deputy Executive Director, Texas Department of Information Resources).
56 Texas State Library and Archives Commission, Electronic Records: Standards and Procedures (Mar. 2003).

electronic data.

2.2 Given the growing market preference for open file formats, the committee strongly encourages Department of Informational Resources and the State Library and Archives Commission, with the assistance of the Records Management Interagency Coordinating Council, to further examine and make findings on the use of open file formats in its next revision of the State's Electronic Records Standards and Procedures.

Research Methods:

In-depth research interviews were conducted with personnel from several agencies to determine the potential effects of implementing HB 1794, and to better understand their existing information technology infrastructure and needs. These agencies included the University of Texas System (UT), The Texas State Soil and Water Conservation Board (TSSWCB), Texas School for the Blind and Visually Impaired (TSBVI), Texas State Library and Archives Commission (TSLAC) and the Texas Department of Information Resources (DIR). Research interviews were also conducted with various experts and representatives from the software industry including IBM, Microsoft, Red Hat, the Open Document Alliance, and Sun Microsystems. Facts were also derived from the public testimony heard by the committee on April 9, 2008 at the Capitol, which included various experts in technology from both the private and public sector.

DEFECTIVE CONSTRUCTION OF CERTAIN SCHOOLS

Research, investigate, and make recommendations regarding litigation brought by school districts receiving state funds under Chapter 46, Education Code, for defective construction of instructional facilities and the state's interest in ensuring the use of such funds for the repair or reconstruction of defective facilities or the return of state funds.

Background on defective construction of certain schools:

Since 2003 there as been a noticeable rise in certain school districts filing lawsuits against construction contractors, subcontractors, and architects regarding construction defects in their buildings. Many of the school districts involved in these suits are Chapter 46 school districts in Region 1 that receive a portion of their funding for construction from the State of Texas.[57]

The normal process that is followed by a school district that has a construction defect issue should involve a notification to the responsible contractor or contractors. After which, an inspection of the identified issue is conduced by the contractor to determine the validly of the claim. If it is agreed that the identified issue is a defect caused by the work of the contractor, the issue is remedied by the contractor. In some cases there may exist a disagreement between the owner and the contractor regarding responsibility for the alleged defect. This conflict could potentially lead to litigation; whereby financial compensation may be paid to the owner by the contractor or the insurance carrier of the contractor.[58]

Chapter 46 assistance is comprised of two parts. The first is the Instructional Facilities Allotment (IFA), which requires applications for assistance in building proposed new facilities. These applications are approved based on greatest need (determined by per-pupil local property wealth) until allocated funds are expended. The second part consists of the Existing Debt Allotment (EDA) and is used to assist districts with debt retirement requirements on old debt (Tex. Educ. Title 2 § 46 (2008).

In the case of school districts, many cases involve water damage claims, where improper design or workmanship caused leakage or subsequent damage within a building. Other claims have included malfunctioning air conditioning systems and cracked foundation slabs. A majority of the cases filed have been settled through arbitration or mediation, while only a few have gone to trial. Several cases have been settled by the insurance carriers of the contractors, resulting in payments of hundreds of thousands, even millions of dollars in damages.[59]

Several contractors and architects contend that many lawsuits are a systematic attempt by financially strapped school districts to find alternative revenue streams and not about fixing defective construction. These contractors claim that districts often failed to provide any type of previous correspondence on the alleged defects in question. Additionally, they were not made aware of any issues or details surrounding alleged defects, until a lawsuit was filed. They assert that litigation has helped contribute to higher fees for insurance costs to construction companies, which are being passed on to all school districts in the region by the affected contractors. They admit that the while the problem has not become widespread, it has had an impact on both costs and competitiveness for school construction projects in certain districts involved in the lawsuits,

57. *Review of litigation for defective construction of certain schools: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008).
58. Interview with Reynaldo Ortiz, Trial Attorney in Austin, Tex. (Mar. 14, 2008).
59. *Review of litigation for defective construction of certain schools: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008).

as well as surrounding school districts.[60]

Summary of proposed legislation

Critics of the lawsuits argue that a school district that brings an action for recovery of damages for the defective design or construction of an instructional facility, which is financed by bonds paid with state and local funds, should be required to provide a copy of the pleadings or other documents to the commissioner of education. They further claim that the state should share in the recovery of any funds in excess of the amount required to repair damages. Additionally, the commissioner should be authorized to join in an action on behalf of the state to protect the "state's share" of any recovery. In summary, any recovered funds should first be utilized to repair the defective design or construction in accordance with the state standards and that only the remaining funds should be sent to the State Comptroller to replenish public funds.

The plaintiffs to date have included, among others, Donna, Alamo, San Benito, Edinburgh, Somerset, Raymondville, and Progresso independent school districts.

Region 1 school districts counter that that they have experienced damages to real property due to defective construction. The districts explain that while the original cause of action against a contractor may rest on damage to real property (land and buildings),[61] the schools may also suffer collateral damages to personal property (text books and classroom furniture).[62] For example, if a defectively assembled pipe fitting bursts, damaging a school library's book collection, the school has the cost of fixing the pipe and walls of the schools library (real property) but also has the cost to personal property of replacing the books destroyed by water (personal property). Schools contend that compensatory damages and general damages are often not enough to cover collateral damage to personal property. Exemplary damages are frequently used to cover the cost of fixing or replacing personal property.[63]

During the 80th Session House Bill 447 by Callegari was passed by the House but was subject to a substitute by the Senate Committee on Government Organization, which included a provision that would require any Chapter 46 school district that filed a construction defect lawsuit and won a recovery amount, to return to the state any extra proceeds once the attorney's fees and the damage repair costs had been paid. The bill also required that a district apply any settlement monies received to repair stated defects. HB 447 was vetoed by Governor Perry for reasons other than the provisions regarding Chapter 46 district lawsuits.[64]

The Region 1 School District covers the counties of Cameron, Hidalgo, Jim Hogg, Starr, Webb, Willacy, and Zapata.

60. *Review of litigation for defective construction of certain schools: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008).
61. Real property is defined as land and anything growing on, attached to, or erected on it, excluding anything that may be severed without injury to the land. Black's Law Dictionary 1234 (7th ed. 1999).
62. Personal property is defined any movable or intangible thing that is subject to ownership and not classified as real property. Black's Law Dictionary 1235 (7th ed. 1999).
63. *Review of litigation for defective construction of certain schools: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008).
64. H.B. 447, 80th Reg. Sess. (Tex. 2007).

Issue 1: Should restrictions be placed on the ability of Chapter 46 publicly funded schools to recover damages in lawsuits regarding defective construction.

Findings:

- A clear pattern of frivolous lawsuits or poor construction of schools could not be established by the research of committee staff. Many school districts failed to reply to requests for information.[65] Likewise, many general contractors were unable to disclose the exact nature of their settlements entered into with school districts. In cases that were shared openly with committee staff, there was evidence of culpability by both sides - several school districts entering into frivolous lawsuits and poor workmanship by certain contractors.[66]
- Contractors, subcontractors, and architects claim to be subjected to frivolous lawsuits. Anecdotal evidence offered by these groups suggests that some trail attorneys are co-opting school districts in Region 1 with anticipated large settlement amounts to systemically bring legal action against architects, engineers, general contractors, and subcontractors.[67] The strategy generally starts with filing construction defects litigation listing all new building or major renovation projects completed during the previous 10 years. Contractors are seldom given the opportunity to inspect or offer remedies to alleged construction defects by the school districts or their attorneys. Few cases reportedly go to trial, as many cases are settled by the insurance carriers of the contractors, without significant input by the contractors. The settlements range from tens of thousands to hundreds of thousands of dollars.[68]
- In one case a general contractor was named in lawsuits regarding school buildings in which it had no involvement with constructing. The general contractor was named in multiple lawsuits in 1997, when San Benito ISD sued every contractor that worked on a district building during the previous ten years. However, the general contractor only worked on one of the buildings in question. The general contractor has twelve employees, does approximately $6 to $7 million worth of school work each year and wanted to fight the case, believing that their workmanship was above reproach. Despite the general contractor's belief in the merits of the case, the company's insurer sought to settle. San Benito ISD is alleged to have not applied any of the settlement monies to fixing the supposed problem. The operations of the elementary school building in question remained continuously in use, begging the question as to the extent of the damage and its affect on the school's operation.[69]
- In another but similar case conveyed to committee staff, an established commercial plumbing and mechanical contracting firm was sued by Edinburgh ISD. The firm has been in business for over 35 years, with a workforce of between 50 and 60 apprentices and plumbers. The suit involved allegations of mold, and a faulty roof and air

65. *Review of litigation for defective construction of certain schools: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008).
66. Id.
67. Interview with David Lancaster, Et. Al., Executive Vice President, The Texas Society of Architects, in Austin, Tex. (Mar. 8, 2008).
68. *Review of litigation for defective construction of certain schools: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008).
69. Telephone Interview with Bill Peacock, President, Peacock General Contractors, Inc., (Mar. 4, 2008).

conditioning system. The Edinburgh ISD filed suit against approximately 30 contractors and subcontractors involved in the construction of the high school in question. Some of the contractors named in the suit had nothing to do with the construction areas that were alleged to be problematic. The firm offered to fix any construction defects if one was found. The firm claims that Edinburgh ISD never took the company up on its offer. Still, this particular firm was required through mediation to settle for a portion out of the entire $30 million settlement. As part of this issue, smaller contractors were required to pay $10,000 in order to be released from the lawsuit. The commercial plumbing and mechanical contracting firm alleges that the mediation focused less on actual liability and more on who had the greater insurance coverage, even though the contractor in question may have had no part or culpability in the alleged damages. Edinburgh ISD allegedly did not apply the settlement monies to remedy the supposed problem.[70]

- General liability insurance premiums for contractors working for Region 1 school districts have reportedly increased significantly since 2003. According to the Associated General Contractors, general liability insurance rates for the area have increased by over 350 percent.[71] The general contractor, who was sued by San Benito ISD and settled, experienced a 50 percent increase in his contractor's liability insurance premium. Since the settlement the general contractor has avoided doing business with San Benito ISD or other ISDs engaged in the practice of systematically suing general contractors.[72] Since 2003, when Edinburgh ISD began the defective construction lawsuit against the before mentioned commercial plumbing and mechanical contracting firm, the firm's liability insurance has increased from $80,000 to $250,000. The $250,000 was the lower of only two quotes offered to the firm and the other bid was for $350,000.[73]
- While some insurers have increased their premiums for contractors in the Region 1, others have since withdrawn from the market. This contraction in the insurance market for the area, coupled with the rise in premiums, has limited some contractors' and architects' ability to obtain coverage. The rise in insurance premiums for contractors working in Region 1 has increased construction costs for school district building projects. Between 2004 and 2007 construction costs increased from $80 per square foot to over $105 per square foot.[74] Just as contractors have apparently increased their construction prices to reflect their increased liability premiums, some architects have reportedly increase their design fees. These costs are ultimately shouldered by those school districts seeking to build new facilities.[75]
- The rise in insurance premiums, coupled with the perception of a litigious atmosphere, has prompted some contractors to avoid bidding on contracts for school district buildings in Region 1. One school district has bid three separate times for the construction of its fine arts center, and has yet to receive a bid. Another district received only one bid for the construction of a high school. The reluctance of contractors to bid on school districts'

70. Telephone Interview with JoRae Wagner, President, CTO Inc., (Mar. 5, 2008).
71. Interview with Michael Chatron, Et. Al., Executive VP, Associated General Contractor (AGC), in Austin, Tex. (Feb. 22, 2008).
72. Telephone Interview with Bill Peacock, President, Peacock General Contractors, Inc., (Mar. 4, 2008).
73. Telephone Interview with JoRae Wagner, President, CTO Inc., (Mar. 5, 2008).
74. Interview with Michael Chatron, Et. Al., Executive VP, Associated General Contractor (AGC), in Austin, Tex. (Feb. 22, 2008).
75. *Review of litigation for defective construction of certain schools: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008).

building projects has diminished the number of competitive bids available to school districts, and has increased the cost of building new facilities.[76]

- However, there exist reported cases were schools have incurred real damages. In one case a general contractor allegedly walked off the job, leaving the construction completion to the subcontractors. The subcontractors allegedly completed the work without adequate oversight or supervision, which allowed for problems to occur. In other instances, general contractors can be overextended and too preoccupied with chasing new building contracts. This may lead to general contractors leaving an older, unfinished project behind. In one case the general contractor literally walked off the job, leaving the smaller bid project for a larger one. Some cases involve the general contractor's alleged negligence, or failure to abide by a "standard of care".[77]
- Most construction defect litigation relayed to committee staff, involves the problem of water leaks. Most leaks result from workmanship or design, where sloppy work, inadequate supervision, or even improper brick sequencing can cause water problems. Progresso ISD had s problem with bricks falling off of a parapet on one of its buildings. There were also no proper expansion joints, drip edges, or water proofing on the buildings. Donna ISD had significant problems with water leaks in some of its buildings. In the case of Somerset ISD the contractor walked off the job leaving the building unfinished. The school could not occupy the building. Some schools documented the problems they found, even going so far in some cases to film water flowing into school buildings during rainstorms.[78]
- Many school districts claim that they do allow for contractors to repair problems and have records of repair requests. The school districts maintain that despite the fixes, some problems recur. Consequently, the school districts, out of frustration, decide to file suit against the contractors.[79] In a documented case, Rosebud ISD sued its contractor regarding a leaking roof. The school district claims that their expert documented leaks in a school's roof, and the contractor's expert agreed. The case went to court, however, because the contractor claimed that it was frivolous. The school district claimed that through discovery they found that the contractor knew in June of 2001 that the roof would fail within four years and failed to inform the school district. In 2006 the school district informed the contractor of problems with the roof. The school district asked the company to honor the warranty. The contractor showed-up and purportedly made no repairs to the problem area. The roof was classified as hopeless by the school district, although the warranty stipulated that the roof would be leak free. The contractor did not attempt to fix the roof until one week before the trial, when it appeared on site with one maintenance worker and two attorneys. The school district contents that the contractor had full access to the building to fix the problem, although the attorneys tried to argue that the district was impeding the contractor's access to the building. The case settled for actual damages to fix the roof, plus attorney fees, with exemplary damages used to replace personal property.[80]

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76. Id.
77. Interview with Reynaldo Ortiz, Trial Attorney, in Austin, Tex. (Mar. 14, 2008).
78. Telephone Interview with Norman Jolly, Trial Attorney, (Mar. 6, 2008).
79. *Review of litigation for defective construction of certain schools: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008).
80 Interview with David Hansen, Attorney, Schwartz & Eichelbaum, in Austin, Tex. (May 13, 2008).

Recommendations:

1.1 School Districts should be allowed to keep financial awards in construction defects provided the award is spent on fixing the constructive defects in question, along with any collateral damage to personal property caused by the original defect.

1.2 Architects, engineers, general contractors, and subcontractors should be able to protect themselves against bad actors who bring frivols lawsuits. Therefore it may be appropriate to consider legislation to require an engineering report on any alleged construction defects to be provided to the architects, engineers, general contractors, and subcontractors, with time to properly fix the defect, before a lawsuit is allowed to be filled.

Research Methods:

The research method used was less statistically based and more nominative in nature due to the lack of raw data available to committee staff. It would be a herculean task to audit all construction suits; notwithstanding that many settlement details are privileged and unavailable. Committee staff did try to provide some statistical analysis by attempting to compare the reports of new construction defects and that of recites for repairs of new construction by certain school districts. However, the data set was not sufficient due to the failure of many school districts to respond to the request for information.

Committee staff did interview several contractors and subcontractors working in the Rio Grande Valley. Staff also interviewed representatives of the Texas Society of Architects and the Associated General Contractors of America. In addition, several trial lawyers who have represented school districts in defective construction lawsuits were interviewed. Several school districts that have engaged in defective construction lawsuits were contacted by staff, or by the Texas Association of School Boards on behalf of staff, to discuss this issue. Facts were also derived from the public testimony heard by the committee on April 9, 2008 at the Capitol, which included building contractors, architects, attorneys, and school district board members.

INSPECTORS GENERAL

Reviews authorized offices of inspectors general and assess the benefit of having a statewide office of inspector general for all executive branch agencies.

Background on Inspectors General help agencies guard against waste, fraud, and abuse:

Inspector generals are charged with examining the actions and operations of a government agency to ensure compliance with established policies or to discover the possibility of misconduct, waste, fraud, abuse, or certain types of criminal activity by individuals or groups related to the agency's operation, usually involving some misuse of the organization's funds or credit.[81] Inspectors general often seek to recover misused funds through courts and administrative procedures. They also seek prosecution of wrongdoers in cooperation with local district attorneys or state attorney generals. As such, inspectors general frequently employ commissioned peace officers, who are trained investigators and familiar with rules of evidence, conducting investigative interviews, setting up successful surveillance, and how to prepare a prosecution memo for bringing charges against a wrongdoer.[82]

Offices of Inspectors General (OIG) exist in state governments, county and city governments, regional authorities, even US territories and foreign countries. Within the United States government, OIGs may exist as sub-agencies within Cabinet departments and other agencies. The Federal Inspector General Act of 1978 establishes the responsibilities and duties of the federal offices of inspectors general.[83] The Act was amended throughout the 1980s to increase the number of agencies with inspectors general, culminating in 1988 with the establishment of inspectors general in smaller, independent agencies. Currently 64 inspector generals are authorized at the federal level.[84]

A survey of existing statewide inspectors general throughout the 50 states identified little consistency between how they were established, organized, or even the type of work they performed. Only nine states have established, by statute, some type of statewide office of inspector general.[85] Common characteristics of these offices include: appointment by and reporting to the governor, a defined purpose in their authorizing statues, administrative independence from their parent agency, and a demand for integrity. None report to the legislature, and each has a different governance structure.[86]

In Texas, OIGs exist in four state agencies.[87] The OIG for the Health and Human Services Commission (HHSC) was established in statute by the 78th Texas Legislature in 2003 with the

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81. Association of Inspectors General, Principles and Standards for Offices of Inspector General 4-5 (May 2004). *See also,* Presidents Council on Integrity and Efficiency, Executive Council on Integrity and Efficiency, Quality Standards for Federal Offices of Inspector General 4-6 (Oct. 2003).
82. Roland Malan, Certified Government Financial Manager, Certified Fraud Examiner, and a Certified Inspector General, Sandpiper Consulting, Address at the State Auditor's Office: Auditing in an Investigative Environment (July 18, 2008). *See also, Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform, 80th Sess.* (Tex. 2008) (statement of John Moriarty, Inspector General for the Texas Board of Criminal Justice).
83. 5A U.S.C. § 1 (2008).
84. Federal Inspectors General Home Page, http://www.ignet.gov/ (Oct. 3, 2008).
85. The nine states with statewide office of inspectors general are Florida, Illinois, Indiana, Louisiana, Massachusetts, New Jersey, New York, Ohio and Pennsylvania.
86. Memorandum from Tammy Edgerly, Senior Research Associate, Tex. Legislative Council on Survey of Other State Offices of Inspector Generals to Tex. State Rep. William Callegari, Chairman, Tex. H. Comm. of Government Reform (May 13, 2008) (on file with author).
87. Id.

objective to aggressively recover Medicaid overpayments and maximize the referral of cases to the Office of the Attorney General (OAG).[88] The OIG for Texas Department of Criminal Justice (TDCJ) was established in March 1999 by the Texas Board of Criminal Justice TBCJ to be the primary investigative and law enforcement entity for TDCJ, and to ensure coordination and effective communication between TDCJ executive management and the Board.[89] The OIG for Texas Youth Commission (TYC) was established by the 80th Texas legislature in 2007 with investigating crimes committed at a facility operated by or under contract with the commission.[90] The OIG for the Texas Education Agency (TEA) was established by the agency in 2006 under the authority of Executive Order RP36 and is largely guided by the general rules and guidelines of TEA that mandate the OIG to investigate allegations of cheating on the Texas Assessment of Knowledge and Skills.[91]

Background on Issues surrounding the creation of a statewide office of inspector general:

Several state officials have advocated for the establishment of a statewide OIG. These state officials often cite the lack of uniformity among the OIGs, the success of the HHSC OIG in protecting the health and welfare of the Texas Medicaid program, and the establishment of an OIG at TYC to address recent concerns. During the 80th Session, eight bills were introduced relating to the creation or reorganization of state OIGs. Three of the bills proposed creation of a statewide OIG.[92] Advocates for these measures claimed that a statewide OIG would promote standardization within the various agency inspectors general, ensure quality control, promote independence of the office, and create a clear chain of command for reporting fraud, waste, and abuse.[93]

Other state officials claim that the State Auditor's Office already performs many of the audit and investigative duties that would be conducted by a statewide OIG and that the duplication of services would be an unnecessary expenditure of taxpayer money. Similarly, many agencies use internal auditors to evaluate the adequacy and effectiveness of how risks are identified and managed, as well as provide recommendations for improvement in specific areas of opportunities or deficiencies.

88. Tex. Govt. § 531.102 (2007).
89. Texas Department of Criminal Justice, PD-22 (rev. 11) General Rules of Conduct and Disciplinary Action Guidelines for Employees (Oct. 1, 2007). S*ee also*, Texas Department of Criminal Justice, 2007 Annual Review for the Texas Department of Criminal Justice (June 2007).
90. S.B. 103, 80th Reg. Sess. (Tex. 2007). *See also,* 37 Tex. Admin. Code § 93 (2008).
91. Tex. Exec. Order No. RP 36 (July 12, 2004). RP 36 was a sweeping directive to all state agencies from Governor Rick Perry, to establish wide-ranging efforts to detect and eliminate fraud in government programs. The executive order specifically directed state agencies to develop their own anti-fraud measures and report those efforts to his office; designate a staff member to implement fraud prevention and fraud elimination activities; and identify policy and organizational changes to improve fraud detection and prosecution efforts.
92. H.B. 668, 80th Reg. Sess. (Tex. 2007); H.B 914, 80th Reg. Sess. (Tex. 2007); H.B. 2781, 80th Reg. Sess. (Tex. 2007); H.B. 2877, 80th Reg. Sess. (Tex. 2007); HB 3579, 80th Reg. Sess. (Tex. 2007); H.B. 3639, 80th Reg. Sess. (Tex. 2007); HB 3889 80th Reg., Sess. (Tex. 2007); S.B. 750, 80th Reg. Sess. (Tex. 2007); S.B. 103, 80th Reg. Sess. (Tex. 2007).
93. *Office of Inspector General: Hearing on H.B. 668, H.B. 2781, H.B. 2877 and H.B. 3899 Before the H. Comm. of Government Reform,* 80th Reg. Sess. (Tex. 2007).

Issue 1: State agencies with Offices of Inspectors General function under various structures and authorities and may need specific direction from the legislature to ensure appropriate structure and independence.

Background:

Some state agencies currently have inspector generals that function under various structures and authorities. Offices of inspector general exist within four state agencies: Health and Human Services Commission, Department of Criminal Justice, Youth Commission, and Texas Education Agency. This section describes each office in detail.

Office of Inspector General for the Health Human Services Commission

Created by the 78th Texas Legislature in 2003, the Health and Human Services Commission's (HHSC) Office of Inspector General (OIG) works to prevent and reduce waste, abuse and fraud within the Texas health and human services system. The director of the office, known as the inspector general, is appointed by the governor to serve a one year term that expires on February 1.[94]

HHSC's OIG employs approximately 642 fulltime employees, in 27 cities, with an operating budget of approximately $51.5 million dollars.[95] The OIG has four divisions. The Compliance division is responsible for identifying and reducing waste, abuse and fraud and improving efficiency and effectiveness. The Enforcement division works closely with the other divisions and sections to ensure that allegations of waste, abuse and fraud are properly investigated and program rules are followed. The Office of Chief Counsel's responsibilities include imposing administrative sanctions, damages or penalties, negotiating settlements and maintaining an effective third-party liability program. The Operations division directs and guides strategic operations and planning of the Office of Inspector General administrative and budget functions.[96]

HHSC, in consultation with the inspector general, sets clear objectives, priorities, and performance standards for the office. The office is required, by statute, to focus on "coordinating investigative efforts to aggressively recover money" by "allocating resources to cases that have the strongest supportive evidence and the greatest potential for recovery of money," as well as "maximizing opportunities for referral of cases" to local district attorneys or the Attorney General.[97] The result is a $1.9 billion in cost recoveries and a $1.8 billion in cost avoidance for the State of Texas, with over 1,000 cases being referred to the Office of the Attorney General

94. Tex. Govt. § 531.102 (2007).
95. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Bart Bevers, Inspector General for the Health and Human Services Commission of Texas). *See also,* Memorandum from Keith Yawn, Agency Performance Review, Legislative Budget Board on OIG Program Financial Data to Jonathan Mathers, Chief Clerk, Tex. H. Comm. of Government Reform (Aug. 15, 2008) (on file with author).
96. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Bart Bevers, Inspector General for the Health and Human Services Commission of Texas). *See also*, https://oig.hhsc.state.tx.us/AboutOIG/OrgStructure.aspx.
97. Tex. Gov'T. § 531.102 (2008).

since 2004.[98]

Office of Inspector General for the Texas Department of Criminal Justice

The Office of Inspector General (OIG) for the Texas Department of Criminal Justice (TDCJ) was created by the Texas Board of Criminal Justice. The inspector general is appointed by and reports directly to the Board, and can be removed for cause.[99] The OIG is the primary investigative and law enforcement entity for TDCJ. The OIG employs approximately 125 fulltime employees, of whom[92] are investigators and has an operating budget of approximately $8.1 million dollars.[100] The OIG has two major departments, the Investigations Department and Administrative Support and Programs.[101]

The Investigations Department investigates allegations of excessive or unnecessary use of force, harassment, and retaliation of inmates. Investigators pursue allegations of employee misconduct and criminal violations occurring on TDCJ property, including drug and contraband interdiction. All investigators are commissioned Texas peace officers, and are assigned throughout the six TDCJ regions of the state.[102]

TDCJ's OIG performs several functions that go beyond the traditional function of an office of inspector general. The TDCJ OIG oversees investigators assigned to violent crime and fugitive task forces in Texas' largest metropolitan cities. The OIG also maintains the Fuginet Database, which contains information on all parolees, as well as those with outstanding warrants. Similarly, the OIG maintains the Auto Theft Prevention Grant, which allows for the collection and dissemination of information on offenders/parolees involved in the theft of vehicles to local, state, and federal law enforcement agencies. The OIG also supervises a task force in conjunction with federal law enforcement for investigating prison gangs.[103]

Office of Inspector General for the Texas Youth Commission

In 2007 the Office of Inspector General (OIG) was established by the statute as an independent law enforcement division of the Texas Youth Commission (TYC).[104] The inspector general

98. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Bart Bevers, Inspector General for the Health and Human Services Commission of Texas). *See also*, Texas Office of the Attorney General, Joint Semi-Annual Interagency Coordination Report (Sept. 1, 2004 - Aug. 31, 2007).
99. Texas Department of Criminal Justice, Board Policy 1.07 (Jan. 23, 2008).
100.. Memorandum from Keith Yawn, Agency Performance Review, Legislative Budget Board on OIG Program Financial Data to Jonathan Mathers, Chief Clerk, Tex. H. Comm. of Government Reform (Aug. 15, 2008) (on file with author).
101. id. *See also, Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of John Moriarty, Inspector General for the Texas Board of Criminal Justice).
102. id. *See also*, http://www.tdcj.state.tx.us/inspector.general/inspector.gnl-home.htm.
103. id. *See also, Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of John Moriarty, Inspector General for the Texas Board of Criminal Justice).
104. H.B. 914 (Enrolled), 80th Reg. Sess. (Tx. 2007). See also S.B. 103 (Enrolled), 80th Reg. Sess. (Tx. 2007).

reports to the Executive Commissioner of TYC, and is an at-will employee.[105] The OIG has 45 fulltime employees, of which 16 are criminal investigators and 13 are administrative investigators. The office has an operating budget of approximately $2 million.[106]

The OIG was established for the primary duty of investigating crimes committed by commission employees, and crimes committed at a facility operated by the commission. The OIG was also tasked with the operation of the Incident Reporting Center (IRC), which operates a mandated hotline required by the 80th Texas Legislature. The hotline was established in March of 2007, as part of the task force initiative as a means for youth, family, staff, and others to report violations and crimes that occur in relation to TYC. The IRC hotline is answered 24 hours a day, seven days a week.[107] In June of 2008 the OIG was tasked with the responsibility to conduct all administrative investigations involving allegations of abuse and neglect of youth in TYC care.[108]

Office of Inspector General for Texas Education Administration

The Office of Test Monitoring/Inspector General Investigations (OIG) was created by the Texas Commissioner of Education in September 2006. The Office was initially responsible for the agency's Test Monitoring Program, conducting special accreditation investigations of schools believed to have violated requirements of test security, investigating allegations regarding testing violations by an educator, and other investigations as directed by the Commissioner.[109] The director of the office, known as the inspector general, severs at the pleasure of the Commissioner.

In April of 2008 the inspector general of the Texas Education Agency (TEA) left the office to pursue other interests. In the interim, the TEA Internal Auditor and Complaints Manager are overseeing or implementing the duties assigned to the OIG.[110] As of August 2008, the responsibilities of the OIG are carried out by several individuals whose time is equivalent to three full time employees. The OIG is budgeted for approximately $700,000 with six fulltime employees.[111]

In December 2007, TEA expanded the OIG's responsibility to include the investigation of

105. Tex. Hum. Res. § 61.0451 (2008).
106. Memorandum from Keith Yawn, Agency Performance Review, Legislative Budget Board on OIG Program Financial Data to Jonathan Mathers, Chief Clerk, Tex. H. Comm. of Government Reform (Aug. 15, 2008) (on file with author). *See also,* Letter from Bruce W. Tony, Inspector General, Texas Youth Commission, to Jonathan Mathers, Chief Clerk, Tex. H. Comm. of Government Reform (Sept. 15, 2008) (on file with author).
107. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (2008) (statement of Bruce Tony, Inspector General for the Texas Youth Commission). *See also,* http://www.tyc.state.tx.us/oig/index.html.
108. Letter from Bruce W. Tony, Inspector General, Texas Youth Commission, to Jonathan Mathers, Chief Clerk, Tex. H. Comm. of Government Reform (Sept. 15, 2008) (on file with author).
109. Press Release, Texas Education Agency, Inspector General Hired to Oversee Test Irregularity Investigations (Oct 5, 2006), available at http://www.tea.state.tx.us/press/06taskforcerecs.pdf.
110 Interview with Jim Lyde ET AL., Deputy Inspector General, Texas Education Agency in Austin, Tex. (June 23, 2008).
111. Memorandum from Keith Yawn, Agency Performance Review, Legislative Budget Board on OIG Program Financial Data to Jonathan Mathers, Chief Clerk, Tex. H. Comm. of Government Reform (Aug. 15, 2008) (on file with author).

reported fraud, waste, and abuse at the agency. The OIG was also charged with coordinating any investigations with the Internal Auditor, State Auditor's Office, and other law enforcement and prosecutorial agencies in order to minimize duplication of investigatory efforts. The Office is represented on the TEA Fraud Prevention Committee and collaborates with Legal Services to review TEA guidelines for ethical conduct.[112]

In 2006, the Office's priority was to address allegations of widespread cheating on the 2005 TAKS test. The Office issued 14 investigative reports in 2007. During the 2007-08 school year, the Office issued two investigative reports and assisted in 20 educator cases. As a result of these investigations, three districts received sanctions and four educators received disciplinary actions. In 2007, the Office completed one internal investigation regarding TEA contracts. Additionally, the Office monitored approximately 215 schools in the spring of 2008.[113]

Independence and Inspectors General

An OIG must be independent from external influences in order to effectively execute its function. The need for independence is clearly affirmed in the standards for state OIGs, Principles and Standards for Offices of Inspector General, which states that an "inspector general and OIG staff involved in performing or supervising any assignment should be free from personal or external impairments to independence."[114] The standards governing federal OIG also affirm the need for independence.[115] Any impediment to the independence of an OIG may render meaningless the function and work product of the OIG and worse, waste the state's resources. The creation of an OIG may generate an appearance with regard to intent to curb waste, fraud, and abuse, but in the absence of appropriately-defined independence for that office, its effectiveness can be diminished.

An OIG should have autonomy over its own budget. Allowing a parent agency any control over an OIG's budget would trespass upon the office's ability to appropriately exercise its function. An agency that wanted to curb its OIG's investigative reach could simply reduce the amount of funding available to the office. For example, the budget for the OIG for the Smithsonian Institute was cut after its inspector general launched an audit of its top-ranking officials. The audit eventually found excessive spending on travel and other expenses by top officials, leading to the resignation of Smithsonian Secretary.[116] That IGs must seek funding from the very agencies they investigate is contrary to the concept of independence.[117] In order to be effective, an OIG should not be restrained -- or threatened into compliance -- by budgetary controls

112. Interview with Jim Lyde ET AL., Deputy Inspector General, Texas Education Agency in Austin, Tex. (June 23, 2008).
113. Texas Education Agency, List of Schools (Audits Final), (June 2008).
114. Association of Inspectors General, Principles and Standards for Offices of Inspector General 8 (May 2004).
115. Presidents Council on Integrity and Efficiency, Executive Council on Integrity and Efficiency, Quality Standards for Federal Offices of Inspector General 64 (Oct. 2003).
116. James V. Grimaldi and Jacqueline Trescott, *Former IG Says Small Asked Her To Drop Audit,* Washington Post, Mar. 20, 2007 at C1.
117. The Texas Senate Committee on Finance in its recommendations to the 80th Legislature stated that Texas should "clearly establish the independence of the Office of Inspector General (OIG) by providing the funding outside the purview of the Health and Human Services Commission." *See*, Texas Senate Committee on Finance, *Interim Charge Recommendations to the 80th Legislature* 48 (Jan. 2007).

implemented by the parent agency.

An OIG must be assured job security and free from "influences that jeopardize continued employment of the inspector general or individual OIG staff for reasons other than competency."[118] Simply put, an OIG may be unwilling to criticize an agency or its leadership if that agency's executive leadership may terminate the investigator's employment at any time. The inspector general for the US Department of Homeland Security was fired after issuing a series of stinging reports regarding the Department.[119]

In Texas, questions regarding the independence of the TEA's OIG were publicly raised after the dismissal of the office's staff by the Education Commissioner.[120] A former employee of the OIG testified before the Government Reform Committee that they were fired by the Commissioner as retribution for complaining that they were not permitted to do their job. For example, one employee claimed that top agency officials kept him and his colleagues from investigating allegations of possible kickbacks to a superintendent.[121] While this report cannot render judgment regarding the propriety of these actions at TEA, they serve as examples to the problem inherent with a lack of independence for an OIG.

An OIG without appropriate independence cannot be expected to render meaningful investigations or conclusions regarding the agency operations that they are charged with overseeing. Personal, organizational and external impairments to the conduct of work that strives to obtain those objectives, diminishes the independence of the office, which in turn damages the credibility and integrity of the office.[122] The purpose of the inspector general function is to provide objective, fact based investigations and analyses.

The Association of Inspectors General

The Association of Inspectors General is the standard setting body for state and local government offices of inspectors general. The Association of Inspectors General consists of Inspectors General and professional staff in their agencies, as well as other officials responsible for inspection and oversight with respect to public, not-for-profit, and independent sector organizations.[123] The Association seeks to foster and promote public accountability and integrity in the general areas of prevention, examination, investigation, audit, detection, elimination and prosecution of fraud, waste and abuse.[124]

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118. Association of Inspectors General, Principles and Standards for Offices of Inspector General 9 (May 2004).
119. Brian Ross & Rhonda Schwartz, *Official Who Criticized Homeland Security Is Out of a Job*, ABC News, Dec. 9, 2004, available at http://abcnews.go.com/print?id=316582.
120. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (2008).
121. Corrie MacLaggan, *Do inspectors general have free enough rein?,* Austin Statesman, July 16, 2008. *See also,* Editorial, *Watchdogs of state agencies must have autonomy*, Austin Statesman, July 18, 2008.
122. Roland Malan, Certified Government Financial Manager, Certified Fraud Examiner, and a Certified Inspector General, Sandpiper Consulting, Address at the State Auditor's Office: Principles and Standards for Offices of Inspector General (July 17, 2008).
123. The Association of Inspectors General, Dec 15th, 2008, http://www.inspectorsgeneral.org/mc/page.do.
124. Id.

The Association has promulgated these standards in its book, Principles and Standards for Offices of Inspector General, commonly referred to as the "green book." The principles and standards adopted by the Association represent the professional criteria used for the establishment of offices of inspector general.[125] The text box, *Principles and Standards for Offices of Inspectors General*, describes these standards in detail.

Principles and Standards for Offices of Inspectors General

Independence – The inspector general and staff must be independent both in appearance and in fact. The objective of the inspector general function is to provide objective, fact based investigations or analyses. Personal, organizational and external impairments to the conduct of work that strives to obtain those objectives, diminishes the independence of the office, which in turn damages the credibility and integrity of the office.

Planning – The office of an inspector general should establish and maintain a planning system for assessing the nature, scope, trends, vulnerabilities, special problems and inherent risks of agency programs and operations for use in developing office goals, objectives, and tasks to be accomplished by the office.

Organizing – The inspector general should organize the office to assure efficient and effective deployment of resources.

Staff Qualifications – Staff should collectively possess the knowledge, skill, and experience needed to accomplish the office mission.

Direction and Control – The inspector general must ensure that all activities are adequately supervised, performance is consistent with professional standards and that periodic internal assessments of the office are made.

Coordination – The inspector general should coordinate the activities of the office, internally and with other components of government, to assure effective and efficient use of available resources.

Reporting – The inspector general should keep appropriate officials and the public properly informed of the offices' activities, findings, recommendations and accomplishments as consistent with the office mission, legal authority, organizational placement and confidentiality requirements.

Confidentiality – The inspector general should establish and follow procedures for safeguarding the identity of confidential sources and for protecting privileged and confidential information.

Quality Assurance - The inspector general should establish and maintain a quality assurance program to guarantee the work performed adheres to establish polices and procedures, and is carried out economically, efficiently, and effectively.

Source: Association of Inspectors General, Principles and Standards for Offices of Inspector General, May 2004.

Findings:

- The authority and structure for each state agency office of inspector general varies, providing for the dissimilar application of the office's function. The chart, *Comparison of Texas OIGs*, depicts the differences between the agency OIGs. As depicted in the chart, some inspectors general report to their respective commissioner, whereas others report to the parent agency's board. With regard to appointments, some inspectors are selected by agency commissioners, while the TDCJ board selects that agency's inspector, and the Governor appoints the one for HHSC. The legal authority for the agencies' offices of inspector general also varies. The OIGs for the HHSC and the TYC are established by

125. Association of Inspectors General, Principles and Standards for Offices of Inspector General (May 2004).

statute.[126] The other OIGs are established through executive orders or agency rules.[127] The duties and responsibilities of these offices may be changed without cause or legislative approval. The chart further depicts that some agencies are provided law enforcement status, whereas other are not, and that only the HHSC's OIG is furnished with subpoena power.

- Each OIG lacks budgetary independence from their parent agency.[128] All inspectors general are funded by their parent agency, and subject to that agency's instructions regarding appropriations requests.
- The various state OIGs do not have uniform terms of employment. HHSC's inspector general is appointed by the governor for a one year term. The inspector general for TYC is both appointed by the executive commissioner of TYC with no specified term.[129] The TYC inspector general may be removed from office for cause by the commissioner. The inspector general for TDCJ in appointed by and reports to the agency's board.[130] The board, in turn, may dismiss the inspector general for cause. The entire staff of the inspector general at TEA, which has no statutory reference, is subordinate to the Executive Commissioner and can be dismissed at any time by the Executive Commissioner. In fact during the course of the committee's research, several TEA OIG employees were dismissed by the Commissioner.

Comparison of Texas OIGs					
Agency	**Entity to whom OIG reports**	**Basis for Selection of OIG**	**Authoritative Establishment of OIG**	**Law Enforcement Status**	**Subpoena power**
HHSC	Executive Commissioner	Appointed by Governor	Statute in 2003	No	Yes
TDCJ	Texas Board of Criminal Justice	Appointed by the Board	Agency rule in 1999	Yes	No
TYC	Executive Commissioner	Selected by Commissioner	Statute in 2007	Yes	No
TEA	Commissioner of Education	Selected by Commissioner	Governor order in 2006	No	No

- State OIGs have various levels of reporting independence from the agencies they are charged with investigating. The HHSC inspector general routes reports and investigations to the executive commissioner for evaluation and possible changes before being released.[131] The reporting process for the offices of inspector general at TYC and TDCJ prevents administrative interference.[132] Investigations and reports by the TEA

126. Tex. Gov'T § 531 (2008). *See also*, Tex. Hum. Res. § 61.0451 (2008).
127. Tex. Exec. Order No. RP 36 (July 12, 2004).
128. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (2008).
129. Tex. Gov'T § 531.102 (2008). *See also*, Tex. Hum. Res. § 61.0451 (2008).
130. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of John Moriarty, Inspector General for the Texas Board of Criminal Justice).
131. *See Id.* at (statement of Bart Bevers, Inspector General for the Health and Human Services Commission of Texas).
132. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008).

inspector general are submitted to the Executive Commissioner before publicly being disclosed.

- Personnel, organizational and external impairments to the conduct of work toward those objectives, can diminish the independence of the office. This damages the credibility and integrity of the office. Conducting a professional and meaningful investigation or monitoring standards that will stand up to scrutiny requires inspectors general to be independent.

Recommendation:

1.1 Although the establishment of a statewide Inspector General of Texas is not recommended in this report, if an inspector general is established for a specific agency, it should be governed by a uniform statute that properly defines and establishes general powers and clarifies the duties and terms of the office. Any proposed legislation considering the addition of an agency inspector general should specifically address the need for independence, the appointment and removal, term of office, organizational placement, and funding for all state agency OIGs.

Issue 2: Establishing a statewide Office of Inspector General is not necessary and would increase the cost of agency oversight.

Summary of proposed legislation

During the 80th Session, the Government Reform Committee heard several bills that proposed creating a single, state-wide office of inspector general. Those bills are summarized in the chart, *80R Statewide OIG Legislation*. The chart describes each proposed statewide office of inspector general bills heard by the Government Reform Committee. The bills all assume that the current staff, budget, and all other resources allocated to current inspectors general would be transferred to the new statewide OIG.

81R Statewide OIG Legislation	
Bill	**Description**
HB 3889	Created an independent Office of Inspector General (OIG) responsible for the detection, investigation, and prevention of fraud, waste, and abuse in state or federally-funded programs administered by state agencies. Granted Office rulemaking and subpoena authority, and authorized the Office to commission peace officers.
HB 2781	Renamed the State Auditor's Office to the Texas Government Accountability Office (TGAO). The TGAO would be required to recommend policies for the detection of fraud involving state funds and procedures in dealing with that fraud. The Legislative Audit Committee would no longer be required to approve audits planned or conducted by the Office. HB 2781 established on Office of Inspector General within the TGAO. The inspector general would have investigated fraud or abuse in state agencies, and monitor each agency's compliance with the laws relating to that agency's authority. The bill would have transferred all powers, duties, functions, personnel, property and obligations of an inspector general at other departments that relate to the investigation of fraud or abuse to the TGAO.

SB 750	Created a new state agency, the Office of State Inspector General (OSIG), responsible for the detection, investigation, and prevention of fraud, waste, and abuse in the state implementation and administration of all state or federally-funded programs and enforcement of state law relating to those programs. The State Inspector General would have been able to appoint state agency inspectors general in state agencies that implement or administer state or federal programs. The OSIG would be authorized to employ and commission peace officers. All state and federal funding, including funding for overhead, support and lease cost would be transferred and allocated to OSIG. Affected agencies would be required to provide administrative support to the OSIG under the terms of a service level agreement that would be reviewed and executed annually. The bill would have abolished the inspector general that currently resides at the Health and Human Services Commission, and require HHSC to transfer all assets, funding, employees and related costs to the OSIG.

Summary of State Auditors Office

A general provision of the Constitutional of 1876 requiring fiscal accountability by state agencies and institutions was given statutory amplification for the first time in 1929, when the 41st Legislature created the first "State Auditor and Efficiency Expert" position in Texas state government. The State Auditor and Efficiency Expert was authorized to inspect all books and records of all the officers, departments, and institutions of state government and to investigate all custodians of public funds and disbursing officers of the State. The State Auditor and Efficiency Expert was allowed to serve for two years and could be removed or discharged at any time by the Governor. [133]

Between 1929 and 1943, the position of State Auditor and Efficiency Expert was subject to frequent turnover. Dissatisfied by the implementation of the 1929 statute, the 48th Legislature in 1943 amended the enabling legislation to provide for the appointment of the "State Auditor" by the legislative branch instead of by the Governor. The law remained essentially unchanged until 1987, when it was amended by the 70th Legislature to reflect the changing responsibilities of a modern audit organization.[134]

The general enabling legislation for the State Auditor is now codified in Chapter 321 of the Texas Government Code.1 The chapter provides that the State Auditor serves under the general guidance of, is responsible to, and appointed by the six-member Legislative Audit Committee (LAC). The LAC is a permanent standing joint committee of the State Legislature that plays a vital role in the overall audit process by directing and controlling the expenditure of any money appropriated to the office of the State Auditor and must approve the State Auditor's appropriation requests and annual audit plan, as well as review audit requests submitted by members of the Legislature.[135]

Currently the SAO is a nationally recognized auditing program,[136] authorized to perform

133. Terrell Blodgett, Management Study of the Texas State Auditor's Office (1984). *See also,* SAO, History of the State Auditor's Office, (Sept. 15, 2008) at http://www.sao.state.tx.us/aboutsao/historyofsao.html.
134 Id.
135, Tex. Gov'T. § 321.012 (2008).
136. Both the National State Auditors Association (NSAA) and National Legislative Program Evaluation Society

statutorily mandated and risk-based projects that include financial statement opinion audits, financial audits, compliance audits, economy and efficiency audits, effectiveness audits, and other special audits. The SAO for fiscal year 2008 had an Annual Budget of $19,422,786, with 216 fulltime employees, and completed 59 audits, reviews, and investigations, including the State of Texas Financial Portion of the Statewide Single Audit Report.

Findings:

- The cost of establishing a statewide office of inspector general would be redundant given the auditing authority and existing responsibilities of the State Auditor's Office of Texas (SAO). The committee considered three bills during the 80th Session that created a statewide inspector general. The purposed measures would have substantially increased the cost of auditing services for the state. Moreover, none of the bills would have given the statewide OIG significantly greater powers than that currently held by the SAO.
- Establishing a statewide office of inspector general could duplicate, and potentially conflict with, the legislative oversight functions performed by the SAO. The text box, *State Auditor's Office of Texas*, provides a brief description of the history, statutory authority, oversight, and size of the agency. The SAO is authorized to audit all state agencies, as well as local government entities and other entities receiving federal or state funds. In addition, the agency is authorized to perform any related audit work, including agency reviews, requested by the Legislature. Like an office of inspector general, the SAO is authorized to conduct investigations of fraud and abuse of state resources. The SAO maintains a special investigative team to properly handle and investigate matters that may result in criminal or civil penalties.[137]
- The primary auditing authority of the state belongs under the Legislature's purview. As described in the text box, *State Auditor's Office of Texas*, this authority was once reserved for the executive branch.[138] During that time, the state auditor position was subject to frequent turnover as several auditors were dismissed over a short period of time. After 1943, when the auditor's position was transferred to the legislative branch, the position became more stable with terms of office becoming longer. There have been only four State Auditors since then.[139] Not only does the housing of this function within the legislative branch ensure greater stability, it coincides with the Legislature's oversight responsibility regarding all matters relating to state government.
- Of the 50 states surveyed all but two of the primary auditing offices of the state were publicly elected or reported to the legislature.[140] The nine states that have statutorily

(NLPES) have nationally recognized and awarded the State Auditor's Office for its work in 2008. Additionally the David M. Walker Excellence in Government Performance and Accountability Award (May 2008) was awarded to State Auditor John Keel by the National Intergovernmental Audit Forum for his sustained contributions to improve government performance and accountability.

137. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. on Government Reform,* 80th Sess. (Tex. 2008) (statement of John Keel, State Auditor). *See also,* Tex. Gov'T. § 321 (2008).

138. Terrell Blodgett, Management Study of the Texas State Auditor's Office (1984). *See also,* SAO, History of the State Auditor's Office, (Sept. 15, 2008) at http://www.sao.state.tx.us/aboutsao/historyofsao.html

139. Terrell Blodgett, Management Study of the Texas State Auditor's Office (1984). *See also,* SAO, History of the State Auditor's Office, (Sept. 15, 2008) at http://www.sao.state.tx.us/aboutsao/historyofsao.html

140. Indiana State Board of Accounts reports to the Governor and Oregon's Audits Division is housed within the

established a statewide office of inspector general, still consider their state auditor to be the primary auditor of the state.[141]

- A statewide inspector general could jeopardize the federal funding received to operate the OIG at HHSC. Federal funding for all administrative activities relating to Medicaid is conditioned on the filing of a state plan with the federal Centers for Medicare and Medicaid Services (CMS), which CMS must approve. In Texas, the single state Medicaid agency that has filed an approved state plan with CMS is the Health and Human Services Commission (HHSC).[142] This plan must comply with the federal requirement that a single agency must administer or supervise the administration of the Medicaid state plan. In order for an agency to qualify as the Single State agency, the agency "must not delegate, to other than its own officials, authority to exercise administrative discretion in the administration or supervision of the plan."[143] Because the state plan must include fraud and abuse-related program integrity functions, the effect of the single state agency requirement in federal law is that the functions currently performed by the Inspector General for HHSC cannot be delegated to a separate agency, at least not without the risk of losing the current level of federal funding. Consequently, the solution for ensuring preservation of the current level of federal funding is for the OIG to remain imbedded within HHSC, while at the same time maintaining independent of HHSC.

Recommendation:

2.1 The State of Texas does not require a single statewide Office of Inspector General.

Issue 3: Only agencies that meet a defined threshold of merit should maintain an office of inspector general.

Background

Offices of inspector general provide agencies with an enhanced investigative and enforcement arm to curb the problems of waste, fraud and abuse. The recent history of some Texas OIGs highlights their effectiveness with regard to addressing these problems. For example, since its inception HHSC's OIG has saved the state $1.9 billion in cost recoveries, and $1.8 billion in cost avoidances. [144] The particular success of the OIG at HHSC suggests that in some cases an office of inspector general is warranted. While these functions may help some agencies in curbing fraud, waste, and abuse involving taxpayers' dollars, not every agency operates at a level that would necessitate OIG oversight and determination of need should include a thorough cost

Secretary of State.

141. Memorandum from Tammy Edgerly, Senior Research Associate, Tex. Legislative Council on Survey of State Offices of Inspector Generals in Texas to Tex. State Rep. William Callegari, Chairman, Tex. H. Comm. of Government Reform (May 13, 2008) (on file with author).

142. Interview with Bart Beavers ET AL., Inspector General for Health and Human Services Commission, in Austin, Tex. (June 6, 2008).

143. 42 C.F.R. § 431.10 (2008).

144. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (Tex. 2008) (statement of Bart Bevers, Inspector General for the Health and Human Services Commission of Texas).

benefit analysis.

Internal Auditors

Internal auditor is an individual within an organization that provides an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. They help an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.[145]

The Texas Internal Auditing Act requires agencies to have an internal auditor if they have an annual operating budget that exceeds $10 million; has more than 100 full-time equivalent employees as authorized by the General Appropriations Act; or receives and processes more than $10 million in cash in a fiscal year.[146] Thirty six agencies and 58 universities have internal auditors; another 23 agencies contract with outside firms to perform internal auditing functions.

The Act establishes that internal auditors report directly to the agency's governing board or the administrator if the agency does not have a governing board. Internal auditors are required to develop an annual audit plan; conduct audits as specified in the audit plan and document deviations; conduct quality assurance reviews; conduct economy and efficiency audits and program results audits; and send a copy of each completed audit to the state agency's governing board or administrator, the Sunset Advisory Commission, the budget division of the governor's office, the State Auditor of Texas, and the Legislative Budget Board.[147]

The program of internal auditing conducted by an agency must allow the internal auditor access to the administrator and ensure that the auditor is free from all operational and management responsibilities that would impair the auditor's ability to review independently all aspects of the state agency's operation. Auditors are thus not independent from the state agency they audit but are autonomous.[148]

Findings:

- Requiring all state agencies to implement an office of inspector general would unnecessarily expand their size and associated costs, while effectively duplicating the oversight function already provided by the State Auditor's Office. Some agencies, however, may administer programs where the risk of fraud, waste or abuse is such to justify the implementation of OIGs. Those agencies that may have a threshold of merit for the establishment of an office of inspector general include those that process large numbers of claims on state or federal coffers; those that expend substantial portions of the

145. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (2008) (statement of Steve Goodson, Chief Audit Executive for Texas Commission on Environmental Quality). *See also*, University of Texas, Purpose of Internal Auditor (Sept. 2008) at http://www.utexas.edu/admin/audit/mission.html#purpose.
146 Tex. Gov'T § 2102.004 (2008).
147 Tex. Gov'T § 2102 (2008).
148 Tex. Gov'T § 2102.006 (2008).

state budget; those that award substantial contracts; and those that may have a history of fraud, waste or abuse. Nevertheless, most of the time the SAO is already effectively monitoring those organizations.

- The Health and Human Services Commission (HHSC) merits an inspector general on two counts. First, the agency processes a large number of claims on state and federal money in the HHSC Medicaid program and needs an effective method to ensure the accountability of contractors, vendors, and recipients, all of whom may abuse or overuse the benefits of Medicaid. Of the approximate 642 fulltime employees at the OIG of HHSC, 420 of them are engaged in some type of "enforcement" function.[149] Second, the HHSC consumes a large percentage of the state budget. The HHSC was appropriated a total (all funds) of $17.2 billion in 2008 and $14.0 billion in 2009, making HHSC's appropriated budget 20% of the total state budget for 2008 and 17% for 2009.[150]
- The Texas Youth Commission (TYC) and Texas Department of Criminal Justice (TDCJ) merit an inspector general with the Texas Legislature's concern about the recent activities and continued effectiveness of the day to day operations of the State's correctional facilities. Additionally, TYC and TDCJ require internal law enforcement services. During just the fiscal 4th quarter of 2008, the OIG of TYC opened 324 criminal cases and closed172 cases. Of the cases worked by OIG during the quarter, investigators made 21 arrests, obtained 15 indictments, 15 convictions and 24 cases are pending with a Grand Jury.[151] Similarly, in fiscal year 2005, the OIG of TDCJ investigated 3,673 cases; 29 percent involved employee suspects, and 61 percent involved offender suspects. The cases resulted in 636 indictments or convictions for fiscal year 2005.[152]
- Texas Education Agency (TEA) arguably merits an office of inspector general based on agency's large control of state and federal money, which subsequently makes TEA a major consumer of the State's budget. The Texas Education Agency was appropriated a total of $24.3 billion in 2008 and $25.9 billion in 2009 (both numbers represent all funds). Thus TEA's general revenue related appropriations equal 34 percent of the total general revenue related appropriations for 2008 and 39 percent for 2009.[153]
- As an alternative to establishing offices of inspector general within every agency, existing internal auditors already provide a level of independent oversight in order to ensure compliance with the law. The text box, *Internal Auditors*, describes the internal auditing function in greater detail.[154] Internal auditors are trained to look for fraud, waste and abuse, and in most cases can meet the auditing needs of their agency without the added bureaucracy and expense of an office of inspector general. One example of how an internal auditor functions within a large agency is that at the Texas Commission on

149. (31) FTE's in Chief Counsel Division, (325) FTE's in Enforcement Division, and (64) FTE's in Utilization Review Unit (UR) total 420 FTE's. These 420 FTE's equate to 65% of OIG's 642 FTE's. UR makes up approximately 64 FTE's. While UR is in the Compliance Division they are called upon to exercise enforcement related activities when assessing penalties against hospitals and nursing homes. If the 64 FTE's in UR were subtracted, the total enforcement-related positions in OIG would still be 55%.
150. Texas Legislative Budget Board, Fiscal Size-Up 176 (March 2008).
151. Texas Youth Commission OIG, 4th QUARTER REPORT FY – 08 (Aug. 2008).
152. Sunset Advisory Commission, Sunset review of TDCJ, the Board of Pardons and Paroles and the Correctional Managed Health Care Committee 91 (Oct. 2006).
153. Texas Legislative Budget Board, Fiscal Size-Up 191 (March 2008).
154. Interview with Steve Goodson ET AL., Chief Audit Executive for Texas Commission on Environmental Quality, in Austin, Tex. (June 28, 2008).

Environmental Quality. The agency's Chief Auditor's Office (CAO) provides traditional auditing services that provide assurance and advisory services that help the commissioners and management meet agency goals and objectives.[155] The CAO audit activities include compliance audits of third party vendors and fee payers, fraud investigations, and forensic accounting for criminal cases. Often these audits identify not only issues of non-compliance, but have resulted in identifying and recovering $2 million in overpayments from FY 2006 to 2008.[156]

Recommendation:

3.1 Only those agencies that process a large number of claims on state/federal revenues and award large contracts, such as the Texas Health Human Services Commission and the Texas Education Agency, or have a need for internal law enforcement services, such as the Texas Depart of Criminal Justice and the Texas Youth Commission, should be authorized by statute to implement an office of inspector general.

Research Methods:

In-depth research interviews were conducted with personnel from all existing state offices of inspector generals to determine the potential effects of implementing a statewide inspector general and to better understand the functions of each of their offices. These offices included the Office of Inspector General for Health and Human Services (HHSC), Office of Inspector General for the Texas Youth Commission (TYC), Office of Inspector General for the Texas Department of Criminal Justice (TDCJ), and Office of Inspector General for the Texas Education Administration (TEA). Likewise, research interviews were conducted with the State Auditor's Office (SAO), the internal auditor for TYC, and the internal auditor for the Texas Commission on Environmental Quality (TCEQ) to better understand how internal auditors work with but are distinctively different than inspectors general. In addition, committee staff attended a number of formal classes on specific standards and best practices of government auditing offered through the professional development program of the State Auditor's Office. Facts were also derived from the public testimony heard by the committee on July16, 2008 at the Capitol which included current and former inspector general staff of HSSC, TDCJ, TYC, and TEA; as well as internal auditors of TYC and TCEQ; the State Auditor, and staff from the Texas Legislative Budget Board.

155. *Review authorized offices of inspector generals and assess the benefit of having a statewide office of inspector general: Public Hearing before the H. Comm. of Government Reform,* 80th Sess. (2008) (statement of Steve Goodson, Chief Audit Executive for Texas Commission on Environmental Quality).
156. Memorandum from Steve Goodson, Chief Audit Executive, Texas Commission on Environmental Quality on TCEQ and CAO's Monitoring and Oversight Activities to Jonathan Mathers, Committee Clerk, Tex. H. Comm. on Government Reform (Oct. 10, 2008) (on file with author).

LICENSING AND REGULATION OF PROFESSIONALS

Study and review current laws regarding licensing and regulation of professionals, as well as current laws regarding practice acts, and make recommendations on creating limitations and streamlining of licensure requirements, such as the public policy implications of decriminalization of license-related violations.

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

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[157], 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). Between 1900 and 1944, the Legislature approved the licensing and regulation of only 43 non-alcohol-related occupations and industries. The occupations subject to regulation during this era included nurses, pharmacists, combative sports personnel, real estate brokers, food and drug manufacturers, milk sellers, optometrists, engineers, architects, barbers and cosmetologists.

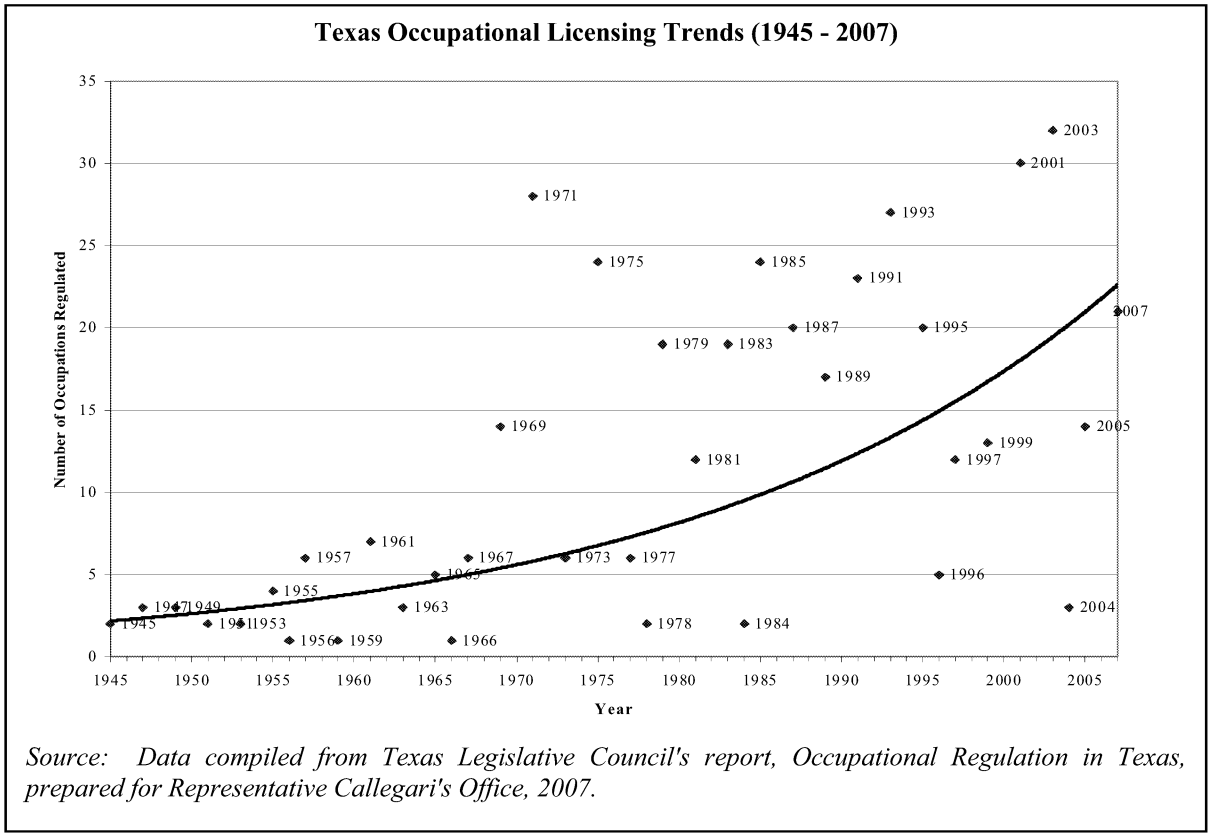
Since 1945 the Legislature has authorized regulation of over 400 additional occupations and businesses. The types of occupations and businesses regulated since 1945 vary. Between 1945 and 1960, the Legislature approved the regulation of egg dealers, plumbers, chiropractors, dental hygienists, and prepaid funeral contract sellers. Between 1960 and 1980 psychologists, auctioneers, land surveyors, pawnshops, irrigators and landscape architects were regulated. Tattoo studios, interior designers, firework operators, social workers, and bottled water operators were regulated between 1980 and year 2000. Since 2001, the Legislature has approved the regulation of geoscientists, food managers, electricians, court interpreters, locksmiths, and service contract providers. 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.

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.

Since 1945 the State of Texas has regulated more professions over time. Between 1945 and the early 1960's, the state approved, on average, the regulation of fewer than five occupations per year. By year 2000 the number of occupations brought under state regulation jumped to an average of over 15 occupations per legislative session. Currently, the State of Texas regulates 514 types of occupations. These occupations represent the jobs held by nearly 2,715,000 individuals and businesses in this state.[158] Nearly one out of every three Texas workers worked in a business or an occupation regulated by the state, when measured against a workforce of

157. The repeal of the 18th Amendment -- the Prohibition Amendment -- in December 1933 inaugurated extensive regulations of the alcoholic beverage industry. In 1935 the Legislature met in special session and passed the Texas Liquor Control Act, which provided for the regulation and licensing of the manufacturing, sale, and distribution of alcoholic beverages.

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



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

nearly 8,631,000 non-government jobs in 2007. In other words, nearly one-third of the Texas workforce is state-regulated. This statistic does not account for federal or local occupational licensing programs.

Texas is not the only state in the Union that has increased implementation of occupational licensing programs. For the past half century most states have trended towards regulating more occupations. During the 1950's approximately 4.5 percent of the American workforce required an occupational license.[159] By 2000, over 20 percent of the nation's workers were regulated by occupational licensing programs. A more recent study indicates that 28 percent of American workers, nearly 43 million individuals, work within a licensed occupation.[160] Texas, however, regulates nearly one-third of its workforce, a proportion higher than the national trend.

Background: Occupational licensing programs restrict individuals' entry into regulated portions of the state workforce.

Individuals wishing to engage in certain occupations must be licensed by the state. Occupational licensing is, "the granting by some competent authority of a right or permission to carry on a business or do an act which otherwise would be illegal."[161] Occupational licenses provide practitioners the exclusive right to engage in a certain practice provided that they meet certain

159 Morris M. Kleiner, Licensing Occupations, Ensuring Quality or Restricting Competition?, 2006, page 12.
160 Suzanne Hoppough, "The New Unions," *Forbes*, 25 February 2008, page 100.
161. Sidney Spector and William Frederick, *Occupational Licensing Legislation in the States*, The Council of State Governments, 1952, page 5.

qualifications defined by law. Just as licensing laws grant practitioners the right to practice a certain occupation; they also explicitly prohibit the unlicensed practice of that occupation.

State law prohibits individuals from engaging in scores of practices without a license. For example, practicing medicine or dentistry without a license is illegal, punishable by a Class A misdemeanor (one year in jail, $4,000 fine).[162] Nor may an individual provide plumbing[163], athletic training[164], engineering[165], massage therapy[166], auctioneering[167], barbering[168], or land surveying[169] services, to name a few, without a license. Engaging in these practices and others without a license is prohibited by law, and may be punishable by fines and imprisonment.

Many occupational licensing programs administered by the State of Texas require that applicants meet several criteria in order to be licensed. These criteria typically include a specified amount of education, experience, and passing an examination administered by a regulatory agency. For example, in order to be a licensed geoscientist, an individual must demonstrate a good moral character as evidenced by letters of reference, have four years of college-level studies in geosciences, five years of qualifying work experience, pass an examination, and meet any other requirement established by the Board of Professional Geoscientists.[170] The qualifications for a licensed massage therapist include a minimum of 500 hours of massage therapy studies by a massage therapy instructor at a massage school, including a minimum of 125 hours learning Swedish massage therapy techniques[171], and pass a written examination.[172] Before 2007, an applicant required only 300 hours of massage therapy instruction. A registered land surveyor must complete two years as a surveyor in training, have a bachelor's degree with 32 hours of specific course work, and pass an examination.[173] In order to receive a hair braiding or hair weaving certificate of registration, an individual must be at least 17 years of age and complete a training program approved by the Texas Commission of Licensing and Regulation.[174]

While some of these requirements may ensure that participants have a minimum skill,

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162. Occupations Code, § 264.151; Occupations Code, § 165.151
163. "A person may not engage in the business of plumbing unless: (1) the person holds a license or endorsement or is registered under this chapter; or (2) the person's work is supervised and controlled by a person licensed." Plumbing License Law, Occupations Code, § 1301.351
164. "A person may not hold the person out as an athletic trainer or perform any activity of an athletic trainer unless the person holds a license." Occupations Code, § 451.151.
165. "A person may not engage in the practice of engineering unless the person holds a license." The Texas Engineering Practice Act, Occupations Code, § 1001.301
166. "A person may not act as a massage therapist, massage school, massage therapy instructor, or massage establishment unless the person holds an appropriate license." Occupations Code, § 455.151
167. "A person may not act as an auctioneer or associate auctioneer in an auction held in this state unless the person is an individual who holds a license." Occupations Code, § 1802.051.
168. "A person may not perform or offer or attempt to perform any act of barbering unless the person holds an appropriate certificate, license, or permit." Occupations Code, § 1601.251.
169. "A person may not engage in the practice of professional surveying unless the person is registered, licensed, or certified" by state law. Professional Land Surveying Practices Act, Occupations Code, § 1071.251.
170. "Texas Geoscience Practice Act, Occupations Code, § 1002.255.
171. "Although Swedish massage therapy is one of over 160 different types of massage therapy, it is the only specific method prescribed by state law that license applicants must study.
172. Occupations Code, § 455.156.
173. Professional Land Surveying Practices Act, Occupations Code, § 1071.254.
174. Occupations Code, § 1601.258 and § 1601.259

competency or knowledge level in order to engage in a profession, many of these requirements also establish barriers to individuals seeking to enter a particular profession. In order to work in those trades an individual must clear several regulatory hurdles in order to obtain the appropriate license. Invariably, these regulatory hurdles impede some citizens from pursuing certain professions in the job market.

Education requirements require applicants to dedicate time and money on coursework or degrees. Attending cosmetology school, a legal requirement for a cosmetology license, may cost between $7,000 and $22,000, and consume nine months to sixteen months of coursework. Graduating from massage therapy school, a prerequisite for a massage license, costs between $4,800 and $6,000.[175] Some work experience requirements place applicants in an indentured status, where they may have suppressed earnings potential, and simply cannot afford to sustain their cost of living while earning less. These requirements disproportionately affect low-income individuals that lack the economic resources to attend school, or complete the necessary experience requirements.[176]

Examination requirements also have an exclusionary effect. Several licenses require examination takers to meet certain education or experience requirements before being allowed to take an examination. For example, in order to take the examination to become a licensed landscape irrigator, an individual must take a 32 hour course approved by the Texas Commission on Environmental Quality (TCEQ). While an individual may have considerable training, or be competent or intelligent enough to pass the examination without the required experience or formal education, they are barred from taking the qualifying examination until these criteria are met. Still, the examination alone may present a barrier to entering an occupation. According to TCEQ, the passage rate for the landscape irrigators' license is less than that for other licenses administered by the agency.[177] Similarly, the passage rate for the landscape architect license examination administered by the Board of Architectural Examiners is lower than that for the architecture license.[178] These examples, albeit anecdotal, illustrate how certain examination requirements may limit some individuals' entry into a given profession.

175. *Tuition data for massage therapy and cosmetology tuition was obtained by surveying a random sample of schools. This survey, conducted by staff, found that several schools offer financial aid for interested students. In one case, the availability of financial aid depended on the applicant's having a minimum credit score. This raised the broader question of whether credit score requirements for financial aid programs for occupational education programs precluded students' access to those programs.*
176. Summers, Occupational Licensing: Ranking the State and Exploring Alternatives, page 29.
177. Interview with Tony Franco, Director, Compliance Support Division, Office of Compliance and Enforcement, Texas Commission on Environmental Quality (TCEQ); Terry Thompson, Operator Licensing Supervisor, TCEQ; Leonard Olsen, TCEQ; Issac Jackson, TCEQ (hereafter: TCEQ interview), 11 June 2008.
178. Interview with Dianne Steinbrueck, Board Member, Texas Board of Architectural Examiners (TBAE); Cathy Hendricks, Executive Director, TBAE; Scott Gibson, General Counsel, TBAE; Priscilla Pipho, Deputy Director, TBAE, 3 June 2008.

No study of the actual effects of occupational licensing programs on Texas' workforce has been completed. Anecdotal evidence suggests, however, that some Texans have been precluded from obtaining jobs due to occupational licensing requirements.[179] One study of national trends found that occupational licensing programs reduce the rate of job growth by 20 percent.[180] This restriction of the labor supply increases the costs of labor and the price of services rendered to consumers.[181] Consequently, Texas consumers may pay more for services rendered by licensed persons within a regulated occupation.

Background: Some occupational licensing programs protect and enhance established members of an occupation, while providing little benefit to the public.

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. Studies of the effects of occupational licensing programs demonstrate that they may increase licensed practitioners' earnings by as much as 10 to 12 percent.[182] 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.[183] 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.[184] 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.[185]

Interior designers have also pushed for enhanced regulation of their industry. Although currently protected by a title act, designers in Texas and elsewhere have lobbied for a practice act that would limit the act of practicing interior design to those that are licensed by the state. Implementing a practice act would not only further limit the number of interior design practitioners, but potentially affect the large number of interior decorators working in Texas.[186]

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179. *Anecdotal evidence includes constituent correspondence received from individuals that were unable to complete certain requirements for obtaining a license. As further evidence of the exclusionary effect of occupational licensing programs, during the Government Reform Committee's hearing on this interim charge, several interior decorators testified that further enhancing the current regulation of interior designers could place them out of a job.*
180. Adam Summers, *Occupational Licensing: Ranking the State and Exploring Alternatives*, Reason Foundation, August 2007, page 15.
181. Morris Kleiner, "Occupational Licensing", *Journal of Economic Perspectives*, Fall 2000, page 192.
182. Summers, *Occupational Licensing: Ranking the State and Exploring Alternatives*, page 15.
183. Id. at 19.
184. *As examples of this trend, legislation to license property tax lenders, land surveying firms, and air conditioning and refrigeration technicians were supported by associations representing practitioners of these occupations.*
185. Witness List, HB 1656 80th Regular Session, House Committee Report.
186. According to the U.S. Department of Labor's Bureau of Labor Statistics, the practice of interior design may be described as follows: *"Traditionally, most interior designers focused on decorating—choosing a style and color palette and then selecting appropriate furniture, floor and window coverings, artwork, and lighting. However, an increasing number of designers are becoming involved in architectural detailing, such as crown molding and built-in bookshelves, and in planning layouts of buildings undergoing renovation, including helping to determine the location of windows, stairways, escalators, and walkways. Interior designers must be able to read blueprints,*

Unlike interior designers, interior decorators do not assist in the placement of windows, stairways, escalators, and walkways, or work with other professionals to ensure that building designs are safe and meet construction requirements. The work of interior designers and decorators intersects with regard to the style, color, lighting, and architectural detailing of a space, however. A practice act for interior designers, where all individuals performing the types of job activities that a designer does must be licensed as an interior designer, could adversely affect thousands of interior decorators in Texas.

Critics of occupational licensing programs label them as "new unions" or "modern day guilds" that shield existing licensees from competition.[187] 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.[188] 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.[189] 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.

The state's regulation of interior designers indicates protectionist practices that favor a certain industry segment to the exclusion of others. Texas currently has a title act regulating interior designers: only a person registered with the state as an interior designer may use the title and term "interior designer" when representing their services.[190] In order to earn the title of interior designer, an individual must pass an examination, graduate from an approved interior design program, and have professional experience in the field of interior design.[191] Advocates for these regulations, notably the American Society of Interior Designers (ASID), claim that such regulation is necessary for public health, safety, and welfare.[192] This same organization also claims that regulation is necessary to "legally recognize [] the profession and protect [] designers'

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understand building and fire codes, and know how to make space accessible to people who are disabled. Designers frequently collaborate with architects, electricians, and building contractors to ensure that designs are safe and meet construction requirements." (See: US Department of Labor Bureau of Labor Statistics, Occupational Outlook Handbook, 2008-2009 edition, http://www.bls.gov/oco/ocos293.htm.)

187. Hoppough, "The New Unions," *Forbes*, 25 February 2008, page 100.

188. Occupations Code, § 1601.353.

189. Occupations Code, § 1602.303.

190 Occupations Code, § 1053.151.

191 Occupations Code, § 1053.155.

192. Dick Carpenter II, *Designing Cartels: How Industry Insiders Cut Out Competition*, The Institute for Justice, November 2007, page 11.

right to practice."[193] Both of these claims ring hollow under close scrutiny. Since 1907 only 52 lawsuits have been filed against interior designers in the entire United States. The majority of these cases involved contract disputes, and not damages that represented a menace to public health, safety, and welfare.[194] Furthermore, several states have rejected proposals to regulate interior designers on ground that such regulation offers no public benefit.[195] In 2007 the State of Indiana found "no compelling public interest" to justify the regulation of interior designers.[196] Earlier this year the Governor of the State of New York vetoed a proposal to regulate interior designers, stating that no evidence has been presented to suggest that any harm was occurring to the public for the unlicensed activity. The claim that legislation is necessary to protect interior designers' right to practice ignores the fact that, but for state regulation, all designers have a natural right to practice.

In light of the shallow arguments used to justify regulation of interior designers, the title act simply benefits the limited number of individuals capable of meeting the Act's requirements. In 2007, 4,962 individuals possessed the legal right, sanctioned and enforced by the State of Texas, to use the title of interior designer. Here, the title act confers two distinct economic advantages to registered interior designers. First, registered designers may advertise that they are interior designers, whereas others may not. Second, registered interior designers are protected from economic encroachment by the Texas Board of Architectural Examiners, the state agency responsible for regulating the occupation. Any individual found advertising interior design services without the appropriate registration risks enforcement by this agency. In fact, over the past three years the majority of enforcement actions taken by the Board of Architectural Examiners regarding interior designers involve unregistered individuals.[197] Similarly, nearly half of the complaints received by the Board regarding interior designers regard unregistered individuals, and not the poor practice of regulated designers.

Background: Alternatives to state regulation exist to ensure the quality, integrity, and safety of services rendered by certain occupations.

The emphasis on occupational licensing programs underscores a presumption that the state is best positioned to identify competent, safe practitioners for certain occupations. To a certain extent, such programs remove qualitative decisions regarding practitioners' competency from the private sector, and places them under the state's authority. Under this paradigm, consumers no longer decide if a practitioner's education, work history, or demonstrated knowledge may qualify them to work on certain tasks. Instead, occupational licensing programs require that the state serve as the arbiter responsible for identifying and approving individuals capable of performing a regulated occupation.

193. American Society of Interior Designers, *Legislation, Politics and the Interior Designer*, www.aisd.org.
194. Interior Design Protection Council, *Rebuttal to AISD Message Guide*, page 8.
195. Id. at 12.
196. Veto Message of Indiana Governor Mitchell Daniels, Jr. on Senate Entrolled Act 490, 2 May 2007, quoted in letter from Edward Nagorsky, General Counsel, National Kitchen and Bath Association, to Chairman William Callegari, House Committee on Government Reform, 10 July 2008, page 4.
197. According to data received from the Texas Board of Architectural Examiners, between October 2005 and October 2008 the agency received 63 complaints, and conducted 28 enforcement actions against *licensed* interior designers. During that same period TBAE received 60 complaints, and conducted 43 enforcement actions against *unlicensed* interior designers.

The state is not the only authority capable of identifying competent practitioners. Some private and industry organizations offer certification and accreditation services to ensure and promote competency and quality for certain professions, as an alternative to state regulation. Interior designers, currently registered by the Texas Board of Architectural Examiners, may be certified by the National Council for Interior Design qualification, the Council for Qualifications of Residential Interior Designers, or even Interior Redesign Industry Specialists. Athletic trainers, currently licensed by the Texas Department of State Health Services, may also be certified by the National Athletic Trainers Board of Certification. Court reporters, currently licensed by Court Reporters Certification Board, may be certified through the National Shorthand Reports Association or the National Court Reporters Association. Similarly, cosmetology schools, which are regulated by the Texas Department of Licensing and Regulation, may be accredited by the National Accrediting Commission of Cosmetology Arts and Sciences (NACCAS). Each of these organizations certifies businesses and practitioners that meet specific criteria, some including education and experience requirements. Some certifying organizations even administer their own examinations to qualify individuals for certification. Just as some practitioners may advertise that they are licensed, registered, or certified by the State of Texas, others promote their credentialing by private organizations.

Some occupational licensing programs are introduced as a way to "professionalize" or further enhance the public or professional credibility for an occupation. Practitioners may use their licensure status to indicate that they have undergone a certain level of education or training, passed an examination, or even undergone a criminal background check, in order to obtain the license. To be sure, occupational licenses allow licensed practitioners to represent to the public that they meet some form of quality, competency, and safety standard enforced by the authority of the State of Texas. These same objectives may be met, however, through the credentialing or certifying services offered by the types of private organizations listed above. In fact, some practitioners note in their advertisements that just as they are state licensed, they are also certified a professional trade organization or other authority such as the Better Business Bureau or Angie's List.

Another common rationale for the introduction of occupational licensing programs is to curb the public harms incurred in the absence of regulation. Several occupational regulations have been introduced as a way to eliminate "bad actors", reduce "fly-by-night" operations, crack-down on charlatans and impostors, and help consumers by ensuring greater accountability within a profession. These policy objectives may be achieved through the enforcement of existing statutes. For example, the chapters of law regarding theft and fraud clearly prohibit these practices, regardless of whether or not they are perpetrated by a licensed professional. Similarly, enforcement of the Texas Free Enterprise and Antitrust Act, and the Identity Theft and Enforcement Act, also protect consumers from certain bad practices. More importantly, enforcement of the Texas Deceptive Trade Practices - Consumer Protection Act could also serve as an appropriate remedy. The text box, *The Texas Deceptive Trade Practices - Consumer Protection Act*, explains the Act's provisions in detail. The Act broadly outlaws many practices employed by bad actors within any profession. For example, under the Act, an athletic trainer could not represent that they were certified by the National Athletic Trainers Board of Certification when, in fact, they are not. Similarly, a massage therapist is prohibited from

offering customers Swedish massages when, in fact, the applied massages are not. Practitioners found in violation of the Act may be sued by consumers, or the Consumer Protection Division of the Attorney General's Office, for economic damages.

Just as the use of private accreditation services or the enforcement of existing statutes may achieve some of the objectives intended by occupational licensing programs, growth in consumer information and awareness regarding service providers may have a similar regulatory effect. With the advent of the Information Age, more information is available to consumers regarding the quality, competency, and even safety of services rendered by a variety of practitioners. The Internet, in particular, has magnified the power of the word of mouth. Many privately-run organizations, including the Better Business Bureau, web-sites such as Yelp.com198 and Angie's List199, and even neighborhood organization web sites200 offer consumers' reviews of services rendered by certain professionals. In addition, consumers concerned with the criminal history of practitioners now have the option to search law enforcement databases for criminal background checks.[201] Now, consumers have more information at their disposal to make informed decisions regarding a variety of services offered by differing practitioners. The enhanced ability of consumers to identify and employ qualified, competent practitioners and avoid bad ones, may mitigate the need for some occupational licensing programs.

The Texas Deceptive Trade Practices - Consumer Protection Act

The Deceptive Trade Practices - Consumer Protection Act broadly prohibits "false, misleading, or deceptive acts or practices in the conduct of any trade or commerce." Some of the types of practices outlawed by the Act include:

- passing off goods or services as those of another;
- causing confusion or misunderstanding as to the source, sponsorship, approval, or certification of goods or services;
- causing confusion or misunderstanding as to affiliation, connection, or association with, or certification by, another;
- representing that goods or services are of a particular standard, quality, or grade, when they are not;
- representing that work or services have been performed on goods when the work or services were not performed;
- failing to disclose information concerning goods or services which was known at the time of the transaction if such failure to disclose such information was intended to induce the consumer into a transaction into which the consumer would not have entered had the information been disclosed;
- knowingly making false or misleading statements of fact concerning the need for parts, replacement, or repair service.

Source: The Deceptive Trade Practices - Consumer Protection Act, Chapter 17 Business and Commerce Code, § 17.46.

198. See www.yelp.com.
199. See www.angieslist.com.
200. *As an example of this, the web-site for the Cherrywood Neighborhood Association in Austin, Texas, includes reviews and recommendations provided by residents regarding a variety of services, including state-regulated occupations such as air conditioning repairmen, architects, electricians, plumbers, home security installers, pest control applicators, doctors, engineers, and veterinarians.* (See: http://www.cherrywood.org/n-recfile.htm.)
201. The Texas Department of Public Safety has an on-line database of all persons arrested and prosecuted for cases involving a Class B misdemeanor or greater violation of Texas' criminal statutes. The database may be accessed at: https://records.txdps.state.tx.us/DPS_WEB/Cch/index.aspx.

Background: Policy issues and concerns surrounding occupational licensing programs.

The proliferation of occupational licensing by the State of Texas raises several policy concerns. 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. In light of the advantages offered to established members within a licensed occupation, propositions -- even suggestions -- to terminate occupational licensing programs are typically met with strong resistance.[202] 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. These economic concerns associated with occupational licensing are compounded by the observation that some licensing programs offer little, if anything, by way of public benefit, while others may persist despite the absence of any necessity for their continuation.

The purpose of this charge is not to categorically condemn all occupational licensing programs. To be sure, the regulation of many professions, including doctors, dentists, and hazardous materials vendors, serves a compelling public interest, particularly with regard to citizens' health and safety. Nor are all of the licensed occupations identified in this report are ready candidates for deregulation. Regulated occupations described here are examples to illustrate certain trends and practices. Any recommendation for deregulation should be accompanied with a more thorough evaluation, using clearly defined criteria.

The purpose of this charge is to highlight some of the problems associated with a policy of increasing occupational licensing programs. The recommendations are intended to encourage the thorough evaluation of existing occupational licensing programs as well as prospective programs to ensure that defined public interests are met.

This charge also contemplates recommendations regarding the Texas Sunset Advisory Commission. The findings and recommendations listed here regarding the Sunset Commission reflect the Committee's work in Interim Charge # 7, to "[m]onitor the agencies and programs under the committee's jurisdiction." [NOTE: Refer to this issue "Monitor the agencies and programs under the committee's jurisdiction" on page 94 of this report.]

Issue 1: The State of Texas should implement a mechanism to review the necessity for continuing existing occupational licensing programs.

Background:

Of the 514 occupational licensing programs administered by the state, several exist that may no

202. As anecdotal evidence of this behavior, when committee staff interviewed personnel at the Texas Board of Architectural Examiners regarding the need for the regulation of landscape architects, word of this interview quickly spread to the licensed landscape architect community. As a result, 15 landscape architects appeared before the Government Reform committee hearing on this interim charge to defend and promote the continued regulation of landscape architects.

longer be necessary. Some programs may have outlived the historical reason for which they were introduced, while others may fail to provide any meaningful oversight over the regulated profession. Other programs are inappropriately structured to render any effective regulatory control over the regulated occupation. The continued existence of these, and other licensing programs, indicates a need for defined criteria for evaluating the public purpose and benefits of occupational licensing programs administered by this state.

Findings:

- Some occupational licenses administered by the state involve no meaningful oversight, or may be easily circumvented. The bottled and vended water operator certification program administered by the Department of State Health Services (DSHS) is one example of an occupational regulatory function that provides no public benefit. During the late 1990's the bottled and vended water operator certification program was initiated at the bottled water industry's request to help "professionalize" the occupation. The program prohibits a bottled or vended water plant from operating in Texas without the supervision of an operator certified by DSHS.[203] Individuals may be certified for this practice by paying a fee and passing an examination. The examination and the certification awarded upon its completion simply ensure that the operator possesses a certain amount of knowledge; the program has no bearing on water quality or safety. State and federal water quality standards enforced by several agencies, including TCEQ, US Environmental Protection Agency, US Food and Drug Administration, and DSHS ensure that bottled and vended water is fit for human consumption. Compliance with the health and safety regulations enforced by these agencies is achieved regardless of if a facility is run by state certified operator. The certification program merely ensures that operators possess the industry knowledge that they otherwise should possess when engaging in their trade.

  The regulation of fish farmers by the Texas Department of Agriculture (TDA) serves as another example of an occupational licensing program that offers no discernable public benefit. During the 1980's the Texas Parks and Wildlife Department (TPWD) began regulating fish farmers as part of a broader effort to control the cultivation of non-native fish species that could damage local ecosystems.[204] The regulation of fish farming was soon transferred from TPWD to Texas Department of Agriculture at the behest of the fish farmers, who perceived that TPWD was hurting the business more than it should have. Today, TDA's regulation of fish farmers involves the collection of a fee and the issuance of a permit. The agency does no other oversight or regulatory activity regarding aquaculture facilities. In fact, the agency's review of aquaculture applications is only to check for compliance with TCEQ and TPWD regulations.[205] The fish farming licenses administered by TDA have no bearing on food safety, species control, or water quality.

203. Health and Safety Code, § 441.002.
204. Telephone interview with Mike Ray, Deputy Director of Coastal Fisheries, Texas Parks and Wildlife Department; 30 June 2008.
205. Interview with David Kostroun, Assistant Commissioner for Regulatory Programs, Texas Department of Agriculture (TDA); Kelly Book, Deputy Assistant Commissioner for Regulatory Programs, TDA; Brian Murray, Assistant Commissioner for External Relations, TDA; 6 June 2008.

Each of these policy concerns are addressed through other regulatory programs. No specific public benefit is apparent in the state's regulation of fish farmers. Just as an individual does not need a license to raise cattle, sheep, pigs or other livestock, fish farmers should not need a license to cultivate fish. Although some members of the fish farming industry recognize that the license is meaningless, they continue to advocate for its continuation at TDA out of concern that, absent any regulation, TPWD may somehow attempt to further regulate their industry.

Just as the regulation of bottled and vended water operators and fish farmers provide little, if any public benefit, the state's regulation of talent agencies fails to protect the public. Talent agents were initially regulated to protect actors from fraudulent agents that would take clients' money and pledge to provide representation, only to disappear. Now, any agency or person that obtains, or attempts to obtain employment for an artist, including counseling or directing the artist in the development of their career, must register with TDLR. In 2007 there were 59 registered agencies. A talent agent typically takes a client's picture portfolio and resume and submits those materials to casting directors looking for certain individuals. State law prohibits agents from charging clients up-front fees. The agent represents their clients for a commission that is paid by a production company once the client is hired. Although state law requires the registration of talent agencies, widespread activity by unregulated parties that offer services similar to a talent agent's while falling short of the definition provided in law, effectively skirt the consumer protections intended under current law. Some agents sell training to compete in a talent contest, whereas others sell "glamour shots" to clients.[206] These services are sold with an implicit message that they may help aspiring actors. Under these arrangements the agents may receive payments up front for certain services rendered, and are not obliged to attempt to obtain employment for the paying artists. A similar problem exists with casting call companies. In particular individuals pay to appear in casting calls for alleged production companies. These productions are essentially a sham, where no genuine representation is ever provided for paying clients.[207] As applied, the regulations for talent agencies are readily circumvented, rendering the regulation ineffective. While other states, such as California, have modified their laws to account for changes within the industry, Texas' regulation of this occupation fails to solve the problem for which it was intended to cure.

- Some occupational regulations persist although the initial rationales for their implementation have expired. Historically, combative sports, such as boxing and wrestling, were illegal in Texas. Opponents of boxing argued that permitting the act would allow for the "weakening of the morals."[208] Proponents for legalizing boxing countered that "[t]he anti-boxing law of this state is an obsolete statute, passed to prevent a particular fight back when boxing was really fighting."[209] In essence, the anti-boxing

206. Interview with Carol Pirie, Deputy Director, Texas Film Commission, 3 July 2008.
207. Interview with Bill Kuntz, Texas Department of Licensing and Regulation; Brian Francis, TDLR; Stephen Bruno, TDLR; 19 May 2008.
208. Bill Van Fleet, "Texas Legislature Going 'Liberal' on Horse Racing and Boxing Bills", *The Galveston Daily News*, 26 May 1933, page 5.
209. Bill Van Fleet, "Stanley Poreda Talked Long and Loud About Ernie Schaaf -- and Then Got His Ears Knocked

laws back then were part of a broad prohibition on fist-fighting and brawling. Boxing proponents at that time also pointed out that just as other states reaped extra tax revenues by legalizing the sport, the "sadly-depleted treasury" of the State of Texas could also stand to benefit. One commentator pointed out that the State of Illinois made over $9.3 million between 1926 and 1933, a considerable sum for the era.[210] In 1933 the Texas Legislature legalized boxing along with fistic combat, wrestling matches, and sparring contests.[211] Like the end of Prohibition, where sales of alcohol were regulated and taxed, the legalization of combative sports prompted the Legislature's regulation and taxation of the occupation. Sports participants, managers, promoters, matchmakers, seconds, and timekeepers were all required to be licensed by the Texas Labor Commissioner. Oversight by the Commissioner's Office focused on whether participants were licensed, if the ring and the round met state requirements, and if the gross receipt taxes were being properly collected. In addition, the Legislature approved a three percent tax on all gross receipts from events. The gross receipts tax, originally implemented in 1933, continues today. In FY 2007 the tax brought in $592,010, and another $250,607in 2008.[212] The initial regulation appears oriented towards expanding the state's revenue base at a time of fiscal crisis, while implementing certain levels of oversight to mitigate the ethical concerns of legislators. Combative sports are the only sports regulated by the State of Texas. The regulations, administered by the Texas Department of Licensing and Regulation, ensure the health and safety of the participants, and that participants, particularly boxers, are paid appropriately.[213] Other contact sports, such as football and, arguably, hockey, are governed by private associations. Even NASCAR, a widely-embraced sport that involves motor vehicles speeding above state limits, and has proven both deadly and dangerous for observers and participants alike, is not subject to state regulation.

The state's regulation of egg brokers and egg dealer-wholesalers may also be more reflective of historic concerns, rather than contemporary markets. Texas is an egg deficit state. Fewer eggs are produced in Texas than the state's consumers demand, necessitating the import of eggs from other states. [214] Before the 1960's Texas was a dumping ground for low-quality eggs.[215] In response to this trend, the Legislature authorized the licensure of egg brokers and dealer-wholesalers to ensure that eggs sold in Texas meet certain quality standards. All eggs sold in Texas must be graded (AA, A, or B grade)[216] and

Down," *The Galveston Daily News*, 8 January 1933, page 14.
210. Id.
211. HB 832, Legalizing Fistic Combat, Wrestling Matches, Boxing, Sparring Contests or Exhibitions for Money, 43rd Texas Legislature (1933).
212. Comptroller of Public Accounts, 2008 Annual Cash Report, page 56.
213. Interview with Bill Kuntz, Texas Department of Licensing and Regulation; Brian Francis, TDLR; Stephen Bruno, TDLR, 19 May 2008.

214. Interview with David Kostroun, Assistant Commissioner for Regulatory Programs, Texas Department of Agriculture (TDA); Kelly Book, Deputy Assistant Commissioner for Regulatory Programs, TDA; Brian Murray, Assistant Commissioner for External Relations, TDA, 6 June 2008.
215. Telephone interview with James Grimm, Texas Poultry Federation, 13 June 2008.
216. *An egg's grade indicates how the egg will look when it is broken out; Grade AA eggs will cover a small area, and appear thick and firm, Grade B eggs will cover a wide area, and appear weak and watery. An egg's grade has no bearing on its nutritive value or edibility.* (Source: American Egg Board, "Basic Egg Facts,

sized (J, XL, L, M, S) by a licensed dealer-wholesaler or broker.[217] While no egg with a grade lower than a Grade B may be sold to Texas consumers, state law requires that eggs imported into Texas for retail sale must be at least Grade A as established by a licensee.[218] This requirement ensures that eggs imported into Texas from other states meet higher quality standards. The licensure or brokers and dealer-wholesalers ensure that those quality controls are enforced; the health and safety regulations governing the sale of eggs apply to all individuals in the production and sale process, regardless of licensure status. While these regulations may have made sense 40 years ago, when the production and processing practices employed allowed for the dumping of lower quality eggs in Texas, they may not reflect the functions of the modern egg industry. Technological breakthroughs in the 1960's led to faster processes where eggs were conveyed directly from laying cases to grading and packing machines.[219] At the same time, the egg industry underwent a transformation from the traditional "farm-to-market" approach, where separate growers sold their eggs to different packers, to a vertically integrated industry where eggs are produced, packed, and distributed from a single facility.[220] This phenomenon grew as the number of producers and processors within the industry shrank, and larger, consolidated operations grew. These widespread changes within the egg industry give rise to the question of whether it is capable of, or even possess the intent, to replicate the egg dumping practices that existed before the implementation of quality regulations nearly 50 years ago. In light of this, the laws regulating egg quality, and the requirement for occupational licenses to ensure that quality, warrant further scrutiny.

Another example of an occupational regulation that exists past its usefulness regards the regulation of the sale or transfer of secondhand watches. Under a law passed in 1941, a person cannot sell or exchange a secondhand watch unless the watch is specifically labeled as "secondhand", and the seller provides the buyer with a written invoice.[221] Persons violating these requirements may be punished with up to 100 days in county jail, or a $500 fine, or both. A cursory review of secondhand watches for sale on Craigslist and eBay, secondhand vending sites on the Internet, found several examples that were not compliant with this requirement. An informal survey of county and district attorneys found that this portion of law is simply not enforced. Although the regulation of the sale of secondhand watches is not an occupational license, the law works nonetheless to regulate a certain occupation. While the regulation of the sale of secondhand watches may have addressed certain circumstances in 1941, today that regulation goes unused and ignored. Still, individuals selling secondhand watches in Texas may risk 100 days imprisonment or a $500 fine for violation of this law.

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www.aeb.org/facts/facts.html (accessed 3 September 2004).)
217. Agricultural Code, § 132.041.
218. Agricultural Code, § 132.046.
219. United States Department of Agriculture Economic Research Service, "Marketing Contracts, Production Contracts, or Vertical Integration?", *Vertical Coordination of Marketing Systems*, page 20.
220. Id.
221. Business and Commerce Code, Chapter 17, Subchapter C.

- In some cases, the population of individuals regulated through occupational licensing may be too small to merit the continuation of the licensing program. There are two reasons to consider discontinuing programs that include a small licensed population. First, the costs of the regulation involved may exceed the amount of revenue generated. Second, if the number of practitioners within a regulated profession is small, then the level of public exposure may be too low to merit regulation on grounds of protecting public health, safety or welfare. The State of Minnesota deregulated the licensing of watchmakers when the number of practitioners dropped below 100.[222] Several occupations regulated by the State of Texas include a small number of licensees. For example, the Texas Department of Licensing and Regulation (TDLR) regulates weather modifiers, otherwise known as rainmakers. There are currently six licensees. The cost of regulating this function does not equal the lesser revenues generated.[223] As another example, the number of certified bottled and vended water operators is relatively small (258). In FY 2007, the bottled and vended water operator's certification program generated $27,938 for the state.

- 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 text box, *A Blurb About the Sunset Advisory Commission*, explains how the agency works. 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."[224] 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.

A Blurb About the Sunset Advisory Commission

The Sunset Advisory Commission is a legislative body consisting of five House members, five senators, and two public members. The Commission oversees the activities of Sunset staff, and the evaluation and recommendations regarding agencies subject to Sunset review. Approximately 130 state agencies are subject to the Texas Sunset Act. Agencies under Sunset typically undergo review once every 12 years. Each review focuses on the continued need for a state agency and its functions, and potential improvements that may be made to an agency's operation. An agency review is summarized in a report that includes a recommendation to abolish or continue the agency and may also contain other recommendations regarding agency functions. If the Commission recommends continuation of an agency, the Commission must provide draft legislation to the Legislature to continue the agency for up to 12 years and correct other problems identified in the Sunset review.

Recommendation:

1.1 Authorize the Sunset Advisory Commission to review the continuing need for

222. Kleiner, Licensing Occupations, Ensuring Quality or Restricting Competition?, page 13.
223. Interview with Bill Kuntz, Texas Department of Licensing and Regulation; Brian Francis, TDLR; Stephen Bruno, TDLR, 19 May 2008.
224. Texas Sunset Act, Government Code, § 325.011.

occupational regulatory programs administered by the state. As part of this recommendation the Sunset Commission should apply certain criteria when evaluating the need for continued regulation. Reviews of occupational licensing programs should include the following criteria:

1. The extent to which the occupational licensing program serves a meaningful, defined public interest, particularly with regard to protecting public health, safety, and welfare;
2. The extent to which the occupational licensing program provides the least restrictive form of regulation consistent with the public interest;
3. The extent to which the conditions that led to the initial regulation have changed; and whether other conditions have arisen which would warrant more, less or the same degree of regulation;
4. The extent to which the regulatory objective of an occupational licensing program may be achieved through market forces, private or industry certification and accreditation programs, and enforcement of other local, state, and federal statutes;
5. The extent to which licensure criteria, if applicable, ensure entry by applicants with occupational skill sets or competencies that correlate with a public interest; and the impact that those criteria may have on individuals, particularly those with moderate or low incomes, seeking to enter an occupation;
6. The economic impact of regulation, including the extent to which the program stimulates or restricts competition, including the effects on consumer choice and the cost of services;
7. Whether the composition of the agency's board or commission adequately represents the public interest and whether the agency encourages public participation in its decisions rather than participation only by the people it regulates;
8. Whether complaint, investigation and disciplinary procedures adequately protect the public and whether final dispositions of complaints are in the public interest or self-serving to the profession.

Issue 2: The State of Texas should implement a process to review proposals to regulate new occupations.

Background:

Judging from historic trends, Texas appears heading towards more, greater occupational licensing programs. As noted in the background of this issue, the number of occupations regulated per legislative session grew from an average of two to three during the 1950's, to an average of 22 to 23 during the last few legislative sessions. During the last session alone, the Legislature regulated 21 additional types of jobs and businesses. This figure does not account for the regulatory programs that were proposed, but not adopted. During the 80th Session the Government Reform Committee considered, but did not approve, legislation that would regulate bodywork therapists, dietetics and nutrition care services, and complementary and alternative health care services. Other bills were introduced to regulate additional professions, including swimming pool installers, lactation consultants, sheet metal workers, landsmen, dyslexia therapists, pharmacy benefit managers, and laser hair removal specialists to name a few. In addition, other bills were introduced to enhance the regulation of occupations already under state oversight. As an example, interior designers attempted to have their title act changed into a

practice act that would essentially outlaw the unlicensed practice of interior design.[225] These measures did not pass.

If the state's past is prologue, then more occupational licensing programs may be anticipated in the future.[226] While not all proposed licensing programs are necessarily suspect, left unchecked, the growth in reliance on occupational licensing threatens to expand government size, spending, and control of the Texas workforce, while limiting consumer choices and job opportunities. In light of these policy concerns, the State of Texas does not have a formal process to review proposed occupational licensing programs. While some programs may be implemented as a result of an interim study or a recommendation by the Sunset Advisory Commission, many appear to be implemented without rigorous review.

Findings:

- New occupational and business regulations expand state government size and spending. Implementing new occupational licensing programs generally requires hiring more state employees to implement them, appropriating more state revenue to pay for those programs, and, in some cases, establishing new state agencies. For example, in 2007, according to the fiscal note for a bill passed to regulate air conditioning and refrigeration technicians, the new regulation would require 12 employees and cost over $680,000 per year.[227] Another bill passed in 2007 to regulate residential appliance installers and contractors would require 3.5 state workers and cost over $172,000 per year.[228] In 2001 the Legislature created a new agency to license geoscientists. That agency currently includes six employees and received $443,490 in appropriations for FY 2008.

  Although implementing new occupational licensing programs requires more state spending and larger bureaucracies, advocates for these programs frequently tout that they are revenue neutral or increase revenues for the state. To be sure, 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.

- Expanding the number of occupations regulated by the state broadens government control over the job market. The effects of occupational licensing on labor markets are described in greater detail in Issue 1 of this interim charge. Nearly one-third of the Texas workforce works in an occupation or business that requires a state-sanctioned license. This means that a large segment of the state's working population must meet certain criteria defined by the state government in order to secure the right from the state to work

225. See HB 1985, Relating to the regulation of interior designers; providing penalties.
226. *As further evidence of this trend, while conducting research for this interim charge, committee staff was approached by representative of several different occupations inquiring with regard to the committee's interest in implementing new occupational licensing programs, or enhancing the regulation of existing programs.*
227. Legislative Budget Board, Fiscal Note for HB 463, 80th Legislative Session.
228. Legislative Budget Board, Fiscal Note for SB 1222, 80th Legislative Session.

within a regulated occupation. This statistic also indicates that any working Texan is prohibited, by law, from engaging in a third of the jobs available without a license. This phenomenon begs the question of how many more jobs would be available for working Texans in the absence of widespread occupational licensing programs administered by the state. The continued growth of occupational licensing programs may impede the growth of the state's labor market, potentially impairing the economic growth of the state as a whole.

- Other states have implemented "sunrise" processes as a way to curb the growth of occupational licensing programs. Currently, the states of 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.

  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[229], interior

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.

229. *"[I]t is not clear that the unregulated practice of landscape architecture harms the public… [d]o not regulate the practice of landscape architecture."* Colorado Department of Regulatory Agencies Office of Policy, Research and Regulatory Reform, *2005 Sunrise Review: Landscape Architects*, 14 October 2005, page 30.

designers,[230] and sign-language interpreters[231], all currently regulated in Texas, because the unregulated practice of each profession failed to demonstrate a significant harm to consumers. 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.[232] 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 is authorized to review legislation filed during a session that creates any new agency to determine if any new regulation proposed in the bill is "the least restrictive form of regulation that will adequately protect the public".[233] The Commission's analysis however, focuses on new regulations associated with the creation of new state agencies. The analysis does not address new occupational regulations that may be implemented within existing state agencies. Moreover, the Commission's analysis of any new agency may only be forwarded to the legislature upon request of a bill's author or committee. This analysis is not procedurally required.

Recommendation:

2.1 The State of Texas should adopt a sunrise process to evaluate the need for new, proposed occupational licensing programs. The sunrise process should also evaluate proposals to enhance existing occupational regulatory programs, such as changing a title act to a practice act, increasing the number of educational hours required for a license, or enhancing the penalties involved for failure to comply with certain requirements. Each sunrise review should occur during the interim leading up to each session. If an industry, vocational, or consumer group wishes to have a proposed regulation evaluated by the sunrise process, it must submit an application to the legislative agency responsible for conducting the review. If the agency accepts an application, and approves the evaluation, then it would be required to produce a report to the next legislature regarding its findings on the need for regulating a given occupation, and what type of regulation, if any, would apply. The agency should evaluate the need for regulation using the criteria depicted in the text box, *Sunrise Criteria Used in Other States*. If the agency recommends that an occupation be regulated, then it should specify the type of regulation necessary. The recommendations made regarding new occupational licensing programs would

230. *"Given the data submitted and obtained during this review, and that the unregulated practice of interior designers has not resulted in significant harm to Colorado consumers, this sunrise review contends that regulation of this occupation is unnecessary."* Colorado Department of Regulatory Agencies Office of Policy, Research and Regulatory Reform, *2000 Sunrise Review: Interior Designers*, 15 October 2000, page 25.
231. *"[T]here is no evidence of harm to the deaf community caused by interpreters for the deaf. The harm that has been identified through research as well as an analysis of the submissions of harm by interested stakeholders cannot be definitively attributed to interpreters, regardless of their competency levels. As a result, regulation is not justified."* Colorado Department of Regulatory Agencies Office of Policy, Research and Regulatory Reform, *2006 Sunrise Review: Interpreters for the Deaf*, 12 October 2006, page 33.
232. West Virginia Legislature, Performance Evaluation and Research Division, http://www.legis.state.wv.us/Joint/PERD/allreports.cfm.
233. Texas Sunset Act, Government Code, § 325.022.

not be binding upon the next Legislature.

Research Methods:

In September 2007 Chairman Callegari's office requested that Legislative Council compile a list of all occupations licensed by the State of Texas. The list was to include the name of each regulated profession, the agency responsible for the regulation, the number of regulated individuals, the fees for each license, the amount of revenue generated by each license for FY 2007, and the year the licensing scheme was initiated. Council was also asked to compile a listing of all of the statutory penalties for violations relating to occupational licenses. The tables prepared by Council, *Table 1: Occupational Licenses in Texas*, and *Table 2: Statutory Penalties for Violations Relating to Occupational Licenses* are available through Council.

Upon receipt of the compendium tables from Legislative Council, staff initiated a series of research interviews with regulatory agencies in order to better understand the application of certain licensing schemes. Those agencies interviewed included Texas Department of Agriculture, Texas Department of Licensing and Regulation, Department of State Health Services, Parks and Wildlife Department, Texas Commission on Environmental Quality, and Board of Architectural Examiners. Staff also interviewed Sunset Advisory Commission staff to learn about the Sunset licensing model, and how Sunset reviews evaluate the need for further regulation of a given occupation.

In addition to the agency interview, staff also interviewed individuals representing several regulated occupations, including egg producers, landscape architects, interior designers, barbers, cosmetology schools, aquaculture farms, talent agencies, and landscape irrigators. Staff also interviewed analysts with the Texas Public Policy Foundation and the Institute for Justice regarding the policy implications of certain occupational license schemes. Additionally, staff interviewed representatives from the states of Washington, Colorado and West Virginia to learn how the "sunrise" processes work in each of those states.

Lastly, facts were also derived from the public testimony heard by the committee on July 16, 2008 at the Capitol, which included numerous experts both the private and public sector.

STATE CONTRACTS WITH PHARMACY BENEFIT MANAGERS

Evaluate and make recommendations, if necessary, regarding state contracts with pharmacy benefit managers. Assess the feasibility of combining prescription drug programs of state health insurance programs. All recommendations should take into consideration any budgetary impacts (Joint Interim Charge with the House Committee on Pensions and Investments).

Background: Pharmacy Benefit Managers (PBMs) explained.

Over the last 30 years, as the costs of prescription drugs have grown, many public and private health benefit plan sponsors have turned to pharmacy benefit managers, or PBMs, to control these costs. PBMs are companies that offer a set of core administrative and clinical services to contain drug expenditures while improving the quality of drug benefits.[234] Some of the administrative services provided by PBMs include establishing a network of participating retail pharmacies and negotiating discounts for drugs purchased in that network; negotiating drug discounts and rebates from pharmaceutical manufacturers; and providing high volume, automated mail order pharmacy services for maintenance medications. Some of the clinical benefits provided by PBMs include the development of drug formularies, a list of approved prescription drugs, for use by a plan's beneficiaries; promoting the use of generic drugs over more expensive brand drugs; and providing disease management services to reduce the overall costs for patients with chronic illnesses such as asthma, diabetes, and hypertension. In addition to these activities, PBMs also provide their clients with claims administration for their prescription drug plans.

PBMs are generally credited for lowering their clients' prescription drug costs. Several studies, including ones by the Government Accountability Office[235], Congressional Budget Office[236], and Federal Trade Commission[237], have concluded that PBMs help lower clients' prescription drug costs. In 2005 in Texas, $9 billion in prescription drug expenditures covering nearly 12.8 million individuals were managed by PBMs.[238] According to a study conducted by the Perryman Group, PBMs helped Texans save nearly $3.04 billion in prescription costs in 2005, and another estimated $4.8 billion in 2006.[239]

Approximately 60 PBMs operate in the United States. The majority of market share is consumed by three publicly-traded companies. These companies are Medco Health Solutions (NYSE: MHS), CVS Caremark (NYSE: CVS), and Express Scripts Incorporated (NASDAQ: ESRX). Each of these companies does business in Texas.

Background: State of Texas contracts with PBMs.

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234. Health Policy Alternatives., Inc., *Pharmacy Benefit Managers (PBMs): Tools for Managing Drug Benefit Costs, Quality, and Safety*, August 2003, page 3.
235. *"The three PBMs we examined achieved savings for FEHBP (Federal Employees' Health Benefit Plan) - participating health plans by using three key approaches: obtaining drug price discounts from retail pharmacies and dispensing drugs at lower costs through their mail-order pharmacies; passing on certain manufacturer rebates to the plans; and using intervention techniques that reduce utilization of certain drugs or substitute other, less costly drugs."* United States General Accounting Office, *Federal Employees' Health Benefits: Effects of Using Pharmacy Benefit Managers on Health Plans, Enrollees, and Pharmacies*, January 2003, page 4.
236. *"The degree to which PBMs could effectively control Medicare drug costs would depend on their being allowed to and encouraged to aggressively use the various tools at their disposal."* Congressional Budget Office, *Issues in Designing a Precription Drug Benefit for Medicare*, October 2002, page xiii.
237. *"To date, empirical evidence suggests that PBMs have saved costs for payers."* U.S. Federal Trade Commission and U.S. Department of Justice, *Improving Health Care: A Dose of Competition*, July 2004, page 20.
238. The Perryman Group, *The Impact of Pharmacy Benefit Managers (PBMs) on the Texas Economy: An Assessment of Current and Projected Benefits and the Consequences of Various Potential Regulations*, October 2006, page 10.
239. The Perryman Group, pages ii, 10.

The Employees Retirement System (ERS), Teacher Retirement System (TRS), University of Texas System, and Texas A&M University System, each sponsor PBM contracts. ERS recently signed a contract with CVS Caremark that began on 1 September 2008. Before then, ERS contracted with Medco Health Solutions. TRS has two PBM contacts, one with Medco for active teachers (TRS - Active Care), the other with CVS Caremark for retired teachers (TRS - Care). The University of Texas and the Texas A&M University systems each have contracts with Medco and CVS Caremark respectively. The chart, *State PBM Contracts*, highlights the contracts maintained by each agency, how many individuals are covered, and the associated costs.

State PBM Contracts, FY 2008

Agency	PBM	Number of Members	Plan Cost
Employees Retirement System	CVS Caremark	450,542	$375,412,136
Teacher Retirement System - Active Care	Medco	252,739	$163,265,434
Teacher Retirement System - Care	CVS Caremark	158,945	$334,409,273
University of Texas System	Medco	147,614	
Texas A&M System	CVS Caremark	34,092	$35,272,843

All agencies procure their pharmacy benefit manager contracts through a competitive bidding process. Each agency issues a request for proposal (RFP) that specifies the types of service and coverage required. PBMs, in turn, submit their bids to the agencies' RFPs. Once received, the agencies evaluate the PBM's bids to select those that best meet the evaluation criteria specified in the RFP, including cost savings relative to other proposals.

Over the past year two agencies, TRS and ERS, have issued requests for proposals for their pharmacy benefit manager contracts. In 2007 TRS received nine bids to its RFP for the Active Care contract. Of the nine bids received, two, Medco and Caremark, were selected as the finalists. The board recommended that the contract be awarded to the incumbent PBM, Medco. Also in 2007, ERS issued an RFP for its PBM contract. The agency received four bids. Two of the bids were selected as finalists. In the end, the ERS board approved a contract with CVS/Caremark starting 1 September 2008. The A&M System is in the process of drafting an RFP for issuance within the next year. The UT System has recently renegotiated its PBM contract effective 1 September 2008.

Background: Policy Issues and Questions Surrounding State PBM Contracts.

Pharmacy benefit managers are not without controversy. Over the past decade several groups have criticized PBMs for engaging in unfair, deceitful, or otherwise deceptive trade practices. Some have alleged that PBMs pocketed rebate revenues without informing clients, or reclassified, and thereby retained, rebates as alternative fees for services provided.[240] PBMs

240. National Community Pharmacy Association, "10 Questions that Benefits Managers Should Ask Their PBM," 14 July 2004, www.ncpanet.org/media/releases/2004/10_questions_that_benefits_managers_should_07-14-2004.php.

have also been accused of engaging in the practice of "differential or spread pricing", where the manager charges a plan a higher amount for a drug, but reimburses a pharmacy a lesser amount for that drug, thereby making a profit on the difference, or spread, between the two prices paid.[241] In addition to these practices, PBMs have also been accused of directing clients towards expensive brand drugs over cheaper generic alternatives. Critics maintain that these types of misleading practices "resulted in higher costs to plan sponsors and significant profits for some PBMs, while payers struggled to manage costs and plan members coped with rising out-of-pocket expenses."[242]

Against the backdrop of allegations regarding pharmacy benefit manager practices, several states attorneys general have filed lawsuits against PBMs. The State of Texas has been involved in four separate actions against PBMs. The text box, *Texas Attorney General PBM Cases*,

Texas Attorney General PBM Cases

State of Texas v. CaremarkRx, LLC, Caremark LLC and Caremark PCS, LLC. Settled in 2008. The Attorney General's office entered into a multi-state settlement with Caremark regarding the company's practice of drug switching, where the company switched patients to different brand-name cholesterol drugs. The settlement requires Caremark to inform patients and doctors about the effects a drug switch will have on the patient's co-payment, and the financial payments, if any, Caremark may realize for initiating the switch. Under the terms of this agreement, Caremark will pay Texas $2.5 million to promote lower drug costs for low-income, elderly or disabled individuals, and provide consumer education.

In re. Express Scripts, Inc. Settled in 2008. Texas, along with 28 other states, entered into an assurance of voluntary compliance agreement with Express Scripts regarding the company's practice of drug switching and its communications with clients. The settlement requires Express Scripts to inform patients and doctors about the effects such switches will have on the patient's co-payments, and the financial incentives the PBM may realize for initiating the switch. Express Scripts agreed to pay Texas $728,000 as part of this agreement.

U.S. & State of Texas, et al. ex rel. Janaki Ramadoss v. Caremark Inc., et. al. Filed in 2005. The Attorney General's Office entered into a lawsuit against Caremark along with several other states and the federal government alleging that the company avoided reimbursing Medicaid for prescription drug payments for individuals who were insured by its prescription drug plan. If an individual were covered by Medicaid and Caremark, and Medicaid paid for that individual's prescription, then federal and state law require Caremark to reimburse Medicaid for that expense. This case is still in litigation.

State of Texas v. Medco Health Solutions, Inc. Settled in 2004. Texas Joined 19 other states in a settlement with Medco for falsely representing to patients, health care plans, and doctors that cost savings would be realized if the doctors switched some patients to different prescription drugs. The switches resulted in greater profits to Medco, and increased costs to patients and plans due to follow-up doctor visits and laboratory tests when the patients used the new drugs. Texas received $2.5 million of the $29 million settlement.

Sources: Attorney General of Texas, Pending Cases Against Pharmacy Benefit Managers as of February 13, 2008; Attorney General of Texas, Company to Pay $9.3 million, offer restitution program for certain consumers, Press Release, 28 May 2008.

241. National Community Pharmacy Association, "10 Questions that Benefits Managers Should Ask Their PBM."
242. John D. Jones, "The Truth About Transparency", *Pharmacy Benefit Insider Newsletter*, September 2004, www.rxsolutions.com/c/pbi/pbi_view.asp?docid=492, accessed 3 April 2007.

describes each case in detail. Although the State of Texas has participated in several multi-state settlements or cases against PBMs, none of the cases involved a specific PBM contract maintained by ERS, TRS, or the university systems. Furthermore, the State of Texas has not taken any legal action against a pharmacy benefit manager under contract with a state agency or university system for any breaches of contract, or other malfeasances.

Critics of state PBM contracts point towards the state's settlements as an indication of a pattern and practice of PBM malfeasance, and justification for the regulation of agencies' contracting practices. During the 80th Legislative Session, three bills were introduced to regulate the State of Texas' PBM contracts.[243] None passed. During the joint hearing between the House Committees on Government Reform and Pensions and Investments, several key questions were raised regarding the state's PBM contracts. Those questions were as follows:

1. Should state agencies be required, by statute, to engage in certain types of contracts with pharmacy benefit managers?
2. Should the State consider consolidating the procurement of pharmacy benefit management services into a single contract?
3. Should the Legislature require that all rebate revenues received by pharmacy benefit managers be remitted to the contracting agency?
4. Do agencies' contracts include sufficient provisions to allow for the appropriate audits to ensure PBMs' compliance, including terms regarding rebates?
5. Do the state's contracts allow the PBMs to steer clients towards more expensive drugs, and towards mail order facilities operated by the PBM?
6. Should the state's contracts include provisions requiring that the PBM serve as a fiduciary?
7. Do the agencies' have the expertise necessary to develop and draft PBM contracts that best reflect the state's interest?

Each of these questions is addressed in the subsequent issues.

Issue 1: Requiring, by statute, the use of certain contracting standards for state PBM contracts may unnecessarily limit agencies' flexibility to leverage competition within the PBM market to the state's advantage.

Background:

PBMs are commonly faulted for lacking transparency. Opaque business practices coupled with a profit incentive, give rise to concerns regarding how -- or even if -- a PBM may satisfy a clients' interest in maximizing savings for their prescription drug plans. The perceived lack of transparency creates two potential problems for the client. First, the client may not know if they are receiving all of the discounts and rebates pledged in their PBM contract. Second, the lack of

243. These bills included HB 3280, relating to treatment of pharmaceutical services provided through specialty and mail order pharmacy services operated under contracts between governmental entities and pharmacy benefit managers; HB 3454, relating to contracts between governmental entities and pharmacy benefit managers; and SB 1834, relating to treatment of pharmaceutical services provided through specialty and mail order pharmacy services operated under contracts between governmental entities and pharmacy benefit managers.

transparency precludes the client from being able to make cost comparisons -- commonly referred to as "apples-to-apples" -- when shopping for PBM plans. Consequently, in the absence of full, consistent disclosure of some PBMs' business practices, some clients may be unable to find the truly lowest cost plan available.

In an effort to bring more transparency to PBM contracts the Pharmaceutical Coalition of the Human Resource Policy Association, a group of 58 private sector employers within the 250-member strong Association, created the Transparency in Pharmaceutical Purchasing Solutions (TIPPS) standards in 2005.[244] These standards require greater disclosures from PBMs regarding drug acquisition costs, disclosure and sharing of rebate revenues from pharmaceutical manufacturers, and the right to engage in a full audit of the PBM. The text box, *2008 TIPPS Standards*, describes the standards in detail.

2008 TIPPS Standards

1. Acquisition Cost for Retail Payments: Charge a Coalition member no more than the amount that it pays the pharmacies in its retail network for brand and generic drugs.

2. Acquisition-Based Pricing for Mail Service Claims: Charge a Coalition member the acquisition cost of drugs at mail order pharmacies, plus a dispensing fee, based on actual inventory cost (AAC) or wholesale acquisition cost (WAC).

3. Pass Through of Pharmaceutical Revenue: Pass through any and all pharmaceutical manufacturer revenue that the Coalition member's utilization enables the PBM to earn.

4. Specialty Pharmacy: Provide all transparency standards as described above for specialty pharmacy products.

5. Plan Management and Consumer Engagement: Provide decision support tools, including online formulary tools, price comparison functionality, and agree to apply all credits including rebates at the point of sale.

6. Right to Audit: Grant a Coalition member full rights to audit their claims, the PBM's pharmacy contracts, utilization management clinical criteria, and any and all pharmaceutical manufacturer contracts and mail service purchasing invoices related to the Coalition member's contract to ensure compliance.

Source: Pharmaceutical Coalition of the HR Policy Association, http://www.pharmacoalition.org/TIPPS_Transparency.aspx

The TIPPS were created by the Pharmaceutical Coalition to provide a uniform set of cost-effective, transparency standards for PBMs to meet when providing services to Coalition members.[245] Since 2005, those PBMs willing to meet these standards may be certified by the Coalition.[246] The certification process allows Coalition members to work with a pre-screened group of PBMs that are willing to adhere to these standards. Participating PBMs are certified on an annual basis by agreeing to comply with the

244. *The Human Resource Policy Association is an association for chief human resources officers for over 250 large corporations. The Association does not deal exclusively with the issue of pharmacy benefit manager contracts. Other issues of concern to the Association include immigration reform, changes in federal employment and discrimination laws, and, among others, reform of the health care system.* (See: www.hrpolicy.org)
245. Transparency in Pharmaceutical Purchasing Solutions (TIPPS) Certification, Pharmaceutical Coalition of the HR Policy Association, www.pharmacoalition.org/TIPPS_Certficiation.aspx, accessed on 3 September 2008.
246. *The Pharmaceutical Coalition of the HR Policy Association is not the only organization that certifies PBMs willing to engage in certain practices. The Utilization Accreditation Review Commission, or URAC, is an independent, non-profit organization that accredits health care plans, networks, and, among other health care-related entities, pharmacy benefit managers. URAC's accreditation process requires that PBMs have policies and procedures in place that ensure the disclosure of rebates and pricing structures, and provide for audit arrangements and formulary decision making by the purchaser. URAC's accreditation also requires that PBMs have policies and procedures in place to ensure the protection of customer's health information, accessibility and reliability of information to consumers, and safeguards to ensure that certain financial incentives do not create conflicts of interest.* (See: http://www.urac.org/accreditation/faq.aspx#pbm, accessed 4 September 2008)

TIPPS standards and to rigorous audit rights to ensure compliance with those standards.[247] In 2008 thirteen PBMs were certified by the Coalition in meeting the TIPPS standards. Both Medco and CVS Caremark, the only PBMs with State of Texas contracts, are TIPPS certified for 2008.

Since their inception in 2005, the TIPPS standards put forth by the Pharmaceutical Coalition of the HR Policy Association have changed. In 2006 additional standards were added. Since then, the TIPPS standards have been streamlined from nine requirements to six.[248] Although the TIPPS standards are recognized as best practices, they are not uniformly employed throughout the private sector. Of the 58 members of the Pharmacy Coalition of the HR Policy Association, only a handful has entered into contracts with PBMs that include all of the TIPPS standards.[249] Although TIPPS were initially designed to assist Coalition members, they are recognized by professionals outside of the HR Policy Association as useful guidelines towards ensuring greater transparency in PBM contracts.

During the 80th Regular Session two bills were introduced that attempted to codify certain TIPPS standards for state PBM contracts. Advocates for these bills claimed that implementing TIPPS standards in statute could save upwards of $100 million per year.[250] Another pointed out that the legislation could save the state between $60 million and $100 million per year for TRS and ERS.[251] Despite these claims, the Legislative Budget Board's fiscal notes for the bills anticipated no fiscal implication to the state.[252]

Findings:

- Increased competition within the PBM industry has improved state sponsors' access to better, more cost-effective prescription drug plans. In an effort to become more competitive, PBMs are willing to offer greater discounts, services, and contract terms that meet the sponsors' interests, including greater transparency. The history of ERS', TRS', and the university systems' use of their competitive bid processes over the past five years indicates that each have leveraged competition within the industry to the state's advantage. Through their respective competitive bidding processes, agencies have secured newer PBM contracts that offer deeper discounts, and preferable contract terms, with some including all or most TIPPS standards.

  The recent history of ERS' PBM contracts illustrates how agencies have leveraged market

247. Background, Pharmaceutical Coalition of the HR Policy Association, www.pharmacoalition.org/background.aspx, accessed on 3 September 2008.
248. http://www.pharmacoalition.org/docs/April%2010%202008%20Mtg%20Presentation.ppt, accessed 3 September 2008.
249. Telephone interview with Marisa Milton, Executive Director of the Pharmaceutical Coalition of the HR Policy Association, 2 September 2008.
250. American Pharmacies, House Must Hear PBM Contract Transparency Bill to Save State As Much as $100 Million Per Year, Press Release, 3 May 2007.
251. Written testimony of Richard Beck, American Pharmacies, to the House Committee on Government Reform, Monday, April 2, 2007.
252. Legislative Budget Board, Fiscal Note for HB 3454, 80th Legislative Session; Legislative Budget Board, Fiscal Note for SB 1834, 80th Legislative Session.

competition to the state's advantage. Before September 2008, ERS' prescription drug program was administered by Medco Health Solutions. When ERS entered into this contract with Medco, ERS leveraged its buying power in a competitive market to garner uniquely advantageous contract provisions favorable to the state,[253] and an estimated savings of nearly $50 million.[254] In 2007 ERS re-bid its PBM contract. The agency awarded its contract to CVS Caremark, whose bid included deeper discounts compared to those offered by the incumbent PBM, Medco. The new contract will save ERS and its members $265 million over the next four years. These savings will accrue through greater discounts for retail and mail order drugs, and larger guaranteed rebates.[255] In addition, the terms of the new contract include all of the preferential provisions from the previous contract, including provisions that "equal or exceed the requirements of the RFP."[256] ERS' new contract also incorporates all of the TIPPS transparency standards.

Like ERS, TRS has leveraged competition within the PBM market to its members' advantage. Before 2006, both of the agency's PBM contracts were administered by Medco Health Solutions. In 2006, the agency solicited competitive bids for its retired teacher PBM program, and awarded the contract to CVS Caremark. Medco, concerned for having lost this contract, subsequently offered TRS better terms, including an estimated $13 million in discounts over the next two years, for its active teacher prescription drug program.[257] In late 2007, TRS re-bid its active teacher PBM contract. The agency awarded the contract to Medco, the incumbent PBM. The discounts and rebates offered under this new contract are projected to save TRS' members approximately $65 million between 2009 and 2010.[258]

The Texas A&M System, too, has leveraged market competition to its own advantage. Compared to its previous contract, the System's current contract includes reduced administrative and dispensing fees, and greater discounts for brand and generic drugs. These new contract terms saved the System approximately $3.5 million in FY 2007.[259]

The experience of Texas' agencies indicates that savings are readily realized by

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253. *These provisions included: a prohibition of therapeutic substitution (a form of drug switching); a "most favored nations" clause requiring that the PBM provide ERS with the same terms provided to any similar clients that are more favorable than those provided to ERS; a requirement that members be allowed to choose between retail and mail order pharmacies for the distribution of their prescription drugs; and a requirement ERS reimburse the PBM for only the amount that the PBM pays the retail pharmacy.* Employees Retirement System, *Briefing on Prescription Drug Program Prepared for the Honorable William "Bill" Callegari, Chairman House Committee on Government Reform*, 14 September 2007.

254 Legislative Budget Board, *Texas State Government Effectiveness and Efficiency, Selected Issues and Recommendations*, January 2007, pages 114 - 115.

255 Employees Retirement System, *Public Agenda Item: Review of and Action on the Selection of a Vendor to Administer the Prescription Drug Program Under HealthSelect of Texas*, 26 February 2008, page 10.

256. Id. at 11.

257. Interview with Ronnie Jung, Executive Director, Teacher Retirement System of Texas; Ray Spivey, Governmental Relations, TRS; Betsey Jones, fiscal analyst, TRS, (Hereafter TRS Interview) 1 October 2007.

258. E-mail from Ray Spivey, Governmental Relations, Teacher Retirement System of Texas, to Jeremy Mazur, Office of Representative Callegari, 16 September 2008.

259. Legislative Budget Board, *Texas State Government Effectiveness and Efficiency, Selected Issues and Recommendations*, pages 114.

leveraging a competitive PBM market. In fact, ERS and TRS approved new contracts that will save nearly $100 million a year for the next two years.[260] This amount equals the annual savings claimed by advocates for the legislation filed during the 80th Session. In addition, in 2008 the UT System took advantage of the competitive market to renegotiate its PBM contract to achieve savings of over $20 million per year for the next three years. All of the savings were accrued in the absence of legislative direction, and without the implementation of any particular contracting standard. This highlights the importance of allowing agencies the flexibility to adjust to market conditions.

- Most agencies have already considered incorporating some, or all, of the TIPPS standards into their contracts. The table, *State Agency Compliance with 2008 TIPPS Standards*, depicts the extent towards which state agencies have incorporated TIPPS standards into their contracts. ERS' new 2008 contract with CVS Caremark incorporates every applicable TIPPS standard.[261] The agency's previous contract with Medco incorporated a majority of the TIPPS standards as well. In its recent RFP for the Active Care contract, TRS required bidders to explain their compliance with the TIPPS standards. The new TRS - Active Care contract includes four of the TIPPS standards. While the University of Texas System's contract incorporates all of the standards, the Texas A&M System's does not. The reason for this is that when Texas A&M bid for a PBM contract in 2006, one year after the TIPPS standards were introduced in the private sector, it selected a traditional contract arrangement rather than a transparent one because of the greater costs associated with the transparent bids.

  Although some agencies have incorporated some, or all of the TIPPS in their contracts, the adoption of these standards alone does not appear to guarantee savings. In fact, as is discussed in detail in Issue 3 of this Charge, requiring full transparency potentially incurs certain risks that may cost the state and the plans' beneficiaries. ERS, TRS, and the university systems have, however, realized and documented actual savings to the state and their beneficiaries through their leveraging of the PBM market.

- Regulating state PBM contracts to require implementation of transparency standards similar to the TIPPS may not ensure savings to the state, and could limit the competitive PBM market already available to state agencies. Experiences of other states suggests that regulating PBM contracts may limit the number of PBMs willing to participate in local markets, thereby limiting the competitive environment. The states of Maine, South Dakota, North Dakota and the District of Columbia have all implemented laws requiring greater transparency in PBM contracts.[262] As a result of the regulations adopted, several PBMs have withdrawn or withheld their business from these markets. Since Maine adopted its regulations in 2003, one major PBM, Medco, has declined to participate in

260. *ERS' contract will save $265 million over the next four years, which is $66.25 million per year. TRS' contract will save $65 million for FY 2009 and 2010, which is $32.5 million per year. Combined, the new plans will save $98.75 ($66.25 + $32.5) million per year.*
261. Letter from Ann Fuelberg, Executive Director, Employees Retirement System, to the Honorable Chuck Hopson, Texas House of Representatives, 8 April 2008, page 2.
262. Richard Cauchi, State Legislation Affecting Pharmaceutical Benefit Managers, National Conference of State Legislatures Background Brief - 2007, 5 February 2007.

state RFPs on grounds of the presence of regulation.[263] After South Dakota passed its law in 2004, Advance PCS, now CVS Caremark, cancelled its contract with that state.[264]

State Agency Compliance with 2008 TIPPS Standards

TIPPS Standard (2008)	ERS	TRS - Care	TRS - Active	UT	A&M(1)
Acquisition Cost for Retail Payments: Charge agency no more than the amount that it pays the pharmacies in its retail network for brand and generic drugs.	✓	X	✓	✓	X
Acquisition-Based Pricing for Mail Service Claims: Charge agency the acquisition cost of drugs at mail order pharmacies, plus a dispensing fee, based on actual inventory cost (AAC) or wholesale acquisition cost (WAC).	✓	X	X	✓	X
Pass Through of Pharmaceutical Revenue: Pass through any and all pharmaceutical manufacturer revenue that the agency's utilization enables the PBM to earn.	✓	X	✓(2)	✓	X
Specialty Pharmacy: Provide all transparency standards as described above for specialty pharmacy products.	✓	X	X	✓	X
Plan Management and Consumer Engagement: Provide decision support tools, including online formulary tools, price comparison functionality, and agree to apply all credits including rebates at the point of sale.	✓(3)	✓(3)	✓(3)	✓(3)	✓(3)
Right to Audit: Grant a agency full rights to audit their claims, the PBM's pharmacy contracts, utilization management clinical criteria, and any and all pharmaceutical manufacturer contracts and mail service purchasing invoices related to the Coalition member's contract to ensure compliance.	✓	✓	✓	✓	X(4)

(1) A&M System requested both transparent and traditional bids in its 2006 RFP, but selected a traditional model because it offered greater savings to the plan and its members.
(2) TRS has a revenue sharing agreement with PBM, along with a minimum guarantee.
(3) Provision applies, except rebates are not credited at point of sale.
(4) The A&M System is entitled to audit PBM records that relate directly and primarily to the PBM's obligations as undertaken pursuant to the contract.

Recommendations:

1.1 State agencies and higher education systems should continue to leverage the competitive PBM market for bids that are cost effective for the state and their members. Agencies' bids for future contracts should continue to consider, but not be statutorily required to incorporate, contemporary private sector best practices. If the State of Texas is to continue to enjoy the benefits offered by a competitive, changing PBM market, then ERS, TRS, and the university

263. E-mail from David Root, Medco Government Affairs, to Jonathan Mathers, Committee Clerk, House Committee on Government Reform, 4 December 2008.
264. E-mail from Allen Horne, Vice President, Government Affairs, CVS Caremark Corporation, to Jeremy Mazur, Office of Representative Bill Callegari, 4 September 2008.

systems should maintain the flexibility to adjust their contracts to prevailing market conditions. Requiring, by statute, that agencies incorporate certain standards into their PBM contracts may impair their ability to leverage a competitive market.

Issue 2: Consolidating procurement of state PBM contracts into a single state contract may erode agencies' leverage in a competitive PBM market.

Background:

Currently, ERS, TRS, and the UT and A&M systems have their own, separate PBM contracts. As depicted in the table, *Lives Covered Through State PBM Contracts*, over one million individuals receive their prescriptions drug benefits through a state-sponsored PBM contract.

Lives Covered Through State PBM Contracts

Agency	Number of Lives Covered
Employees Retirement System	450,542
Teacher Retirement System	383,679
University of Texas System	147,614
Texas A&M System	34,092
Total:	**1,015,049**

The large number of lives covered through each PBM contract provides each agency and systems with a significant amount of buying power. Already, the agencies have leveraged that purchasing power to secure contract terms that are beneficial to the state. Given that over one million individuals are covered under state PBM contracts, consolidating the state's purchasing of PBM services could, in theory, enhance the state's buying power and ability to secure better discounts.

Other states have entered into purchasing pools, or consolidated their PBM contract procurement in an effort to enhance their buying power. In 2002 the states of Delaware, Missouri, New Mexico, and West Virginia formed a coalition to issue an RFP for a single PBM to service each state's employee health benefit plan's prescription drug program.[265] In 2004 Ohio joined this coalition, making it the provider for over 675,000 beneficiaries. Under the contract approved by this coalition, each state received 100 percent of rebate revenues where the PBM guaranteed a minimum rebate to each state that, in turn, paid an administrative fee per prescription.[266] Although the states participating in this coalition claimed savings, the program was discontinued in 2005 after participants' interest in it dissipated.

The State of Georgia has had experience with a single PBM contract for several of its health benefit programs. In 2000, the Georgia Department of Community Health entered into a single contract for the state's Medicaid, PeachCare for Kids (CHIP), higher education systems, and state employee's health benefit programs.[267] This combined contract initially serviced two million Georgians. Officials with the Department of Community Health believed that a consolidated contract would help the state save money by augmenting its purchasing leverage while

265. Brendan Krause, State Purchasing Pools for Prescription Drugs: What's Happening and How Do They Work?, NGA (National Governors Association) Center for Best Practices Issue Brief, August 2004, page 5.
266. Krause, State Purchasing Pools for Prescription Drugs: What's Happening and How Do They Work?, page 6.
267. Sharon Solow-Carroll and Tanya Alteras, "Stretching State Health Care Dollars: Pooled and Evidence-Based Pharmaceutical Purchasing", The Commonwealth Fund, October 2004, page 20.

decreasing duplicative staff functions.[268] Several years later Georgia split up its PBM contracts, primarily to accommodate the unique requirements of its Medicaid and PeachCare programs. At the time that this split occurred, the higher educational system also splintered off to establish its own PBM contract. Now, the State of Georgia maintains several, separate PBM contracts.

Findings:

- Allowing each agency and higher education system to purchase their own PBM services broadens the opportunity to leverage competition within the PBM market -- particularly for larger state contracts -- to the state's advantage. Moreover, the agencies have leveraged the competition among PBMs for their respective contracts towards their own advantage. For example, before 2005, Medco administered TRS' Care and Active Care programs. TRS awarded the contract for its Care program to CVS Caremark in 2005. In an effort to ensure its continued service for the Active Care contract, Medco offered newer; better terms that included approximately $13 million discounts for TRS over the next two years.[269] Similarly, in its 2007 bid for the Active Care program, although TRS awarded the contract to Medco, CVS Caremark, which administers the TRS - Care program, offered the Care program an estimated savings of upwards of $90 million over the next two years. Although TRS' experience is unique, in that the agency administers two, separate PBM contracts, the agency's bidding history illustrates how a competitive market yields savings advantages for each contract. As another example of this phenomenon, in 2008, after ERS finalized its new PBM contract, the UT System decided to approach its incumbent PBM to see if it would be willing to renegotiate its existing contact to include more favorable terms. The UT System was successful in renegotiating its contract to generate significant savings over the next three years.
- Consolidating the state's pharmacy benefit manager contracts may not guarantee long term savings. A single contract would limit the state's participation in the competitive PBM market to once every three to four years, or for the length of the contract. This would depart from the current structure where, by having several agencies issuing bids for PBM contracts on a more frequent basis, the state gains greater exposure to a competitive market that continues to offer better savings and contract terms, such as the "most favored nations" clause in ERS' contract.[270] In addition to limiting the state's exposure to participating in the competitive market, a consolidated contract would limit the number of PBMs capable of bidding on the state's contact. While larger companies such as Medco, CVS Caremark, and Express Scripts may have the capitalization and other infrastructure necessary to meet the state's needs, medium to smaller sized PBMs may not. A single contract approach could limit the state to selecting from a smaller pool of PBMs. Furthermore, the consolidated approach would lock the state into a contract with a single provider for the duration of the contract. This could allow the selected PBM to serve as a monopoly where, even though the rest of the PBM market may be

268. Telephone interview with Lori Garner, Pharmacy Department, Division of Medical Assistance, Georgia Department of Community Health, 23 September 2008.
269. TRS interview, 1 October 2007.
270. *The "most favored nations" clause requires the PBM to provide ERS with pricing terms that are equivalent to those of any other contract that the PBM enters into with a similar client during the term of the ERS contract that are more generous than those included in the ERS contract.*

offering more progressive, or cost effective contract terms, the PBM may not be under any obligation to provide the state with any of those benefits. Lastly, establishing a single contract raises logistical concerns with regard to its funding and administration. While the state's current prescription drug plans are administered through existing resources, establishing a consolidated contract could require the creation of a new state agency that may require the extra appropriation of state resources.

- The prescription drug plans administered by ERS, TRS, and the university systems are part of the larger group benefit plans provided by these entities. Although the health and pharmacy benefits may appear as separate, they are integrated as part of a broader, comprehensive health plan. The established integration of pharmacy and health benefits allows for more effective cost containment programs, customer service, in addition to disease management and wellness efforts.[271] Consolidating the administration of the prescription drug plans from the broader health services offered may detract from providers' salutary plan objectives for their employees.

Recommendations:

2.1 ERS, TRS, and the University of Texas and Texas A&M systems should continue to administer their own pharmacy benefit manager contracts. The State of Texas should not consolidate these existing plans into a single state contract. At some point, however, the agencies and university systems may wish to consider a collective, non-binding bid where each agency may have the option to enter into their own contract. This suggestion does not require any change in statute.

Issue 3: Requiring, by statute, that agencies receive all rebate revenues provided to a PBM by pharmaceutical companies, may limit agencies' flexibility in soliciting competitive bids.

Background:

Each PBM contract includes a list of preferred drugs, otherwise known as a formulary, for use by each plan sponsors' clients. ERS', TRS', and university systems' employees are encouraged to use those drugs listed on their respective plans' formularies through the use of lower co-payments. Non formulary drugs may be prescribed, however a member must pay more to use them. Invariably, a drug's placement on a PBM's formulary increases the likelihood for its use. Pharmaceutical companies will offer PBMs incentives, commonly known as rebates, to have their drugs placed on a formulary list.[272]

Precisely how a PBM uses their rebate revenue is subject to debate. Over the past decade, pharmacy groups and benefits sponsors, such as those members of the HR Policy Association, have faulted PBMs for pocketing rebate revenues as profit. These groups further contend that if a PBM earns rebate revenue through a sponsor's members' use of formulary drugs, then the sponsor should receive those rebates. PBMs counter that the rebates are based in part off of their

271. Employees Retirement System, Combining Prescription Drug Programs of State Health Insurance Programs, ERS Executive Summary, 15 February 2008.
272. Federal Trade Commission, *Pharmacy Benefit Managers: Ownership of Mail-Order Pharmacies*, August 2005, pg. i.

entire book of business, not any certain sponsors' participation within their program. PBMs also point out that while rebate revenues contribute to their profitability, they also fund the services provided. Those PBMs that retain a portion of the rebate revenues received sometimes forgo charging their clients an administrative fee to cover the costs of services provided. If, however, a client requests that all rebate revenues be refunded back to the client, the PBM may assess an administrative fee to cover service costs. Typically, fully transparent contracts where 100 percent of rebate revenues are passed through to the plan sponsor include an administrative fee.

Findings:

- All state agencies have provision in their current PBM contracts addressing the disposition of rebate revenues. The table, *State PBM Contracts and Rebates*, depicts how each agency and higher education system's contract addresses the use of rebate revenues. The table also indicates whether each contract includes an administrative fee. Only ERS and the UT System, with contracts that require the 100 percent pass through of rebate revenues, are assessed administrative fees. The other contracts do not require the 100 percent pass through of rebate revenues, and are not assessed an administrative fee.[273]

State PBM Contracts and Rebates

Agency Contract	Rebate Clause	Administrative Fee
ERS	PBM agrees to pass through to ERS 100 percent of all manufacturer revenue generated by prescription drug utilization of plan members, subject to a guaranteed minimum rebate for each prescription dispensed -- whether generic, brand or specialty, through retail or mail channels -- under the plan.	Yes
TRS - Active Care	TRS has a revenue sharing agreement where the agency receives 90 percent of rebate revenues. The PBM retains a percentage as a management fee. This agreement includes a minimum guarantee.	No
TRS - Care	TRS is guaranteed a uniform flat rebate amount for each rebatable prescription dispensed.	No (except for Medicare D services)
University of Texas	Based on the new contract effective 1 September 2008, PBM agrees to pass through to ERS 100 percent of all manufacturer revenue generated by prescription drug utilization of plan members, subject to a guaranteed minimum rebate for each prescription dispensed -- whether generic, brand or specialty, through retail or mail channels -- under the plan.	Yes
Texas A&M System	System receives a fixed rebate amount for each rebate-eligible claim, with the amount of rebate differing between retail and mail.	No

Sources: Employees Retirement System, Teacher Retirement System, University of Texas System, Texas A&M System.

273. *TRS - Care pays a per member per month administrative fee for Medicare eligible retirees only to administer Medicaid. Both TRS program pay administrative fees for certain services such as prior authorization and processing paper claims.*

- All agencies have used the competitive bidding process to solicit different types of bids, where varying amounts of rebate revenues are returned to the state. The agencies have employed this approach to broaden choices for proposals that may maximize savings. For example, ERS' 2007 bid requested that all vendors submit two types of bids.[274] One bid, would be a "traditional" bid, where the PBM would pay a guaranteed fixed rebate for each prescription dispensed and not charge an administrative fee. The other bid would be a transparent bid, where the PBM pays ERS 100 percent of all pharmaceutical manufacturer revenue received subject to a guaranteed minimum rebate. Under the transparent structure, the PBM would be permitted to charge ERS an administrative fee. ERS ultimately selected a transparent bid.[275]

  In 2007 TRS issued a similar bid for its Active Care contract. In it, TRS asked that respondents submit three different types of bids: a traditional bid, a full transparency bid with 100 percent pass-through of rebate revenue and an administrative fee, and a "revenue sharing" transparent bid with a percentage pass through of rebate revenue and no fee. TRS selected the revenue sharing bid.

  Requests for proposals issued by the University of Texas and Texas A&M University systems also solicited different bids from participants. In 2006 A&M System issued an RFP that requested PBMs submit two bids: a traditional bid where the PBM retained a portion of the rebate revenues and did not charge the System an administrative fee, the other being a transparent bid, where the PBM passed through all rebate revenues to the System and assessed an administrative fee. In its analysis of the bids provided, A&M found that the transparent bids were more expensive. Although the transparent bids required the PBM to give the system the entire rebate revenues received, they came at a cost of higher dispensing and administrative fees and greater drug costs. The contract selected by A&M allows the PBM to retain a portion of the rebate revenue, while also providing the System with a fixed rebate for each rebate-eligible claim.[276]

- Transparent contracts requiring the 100 percent pass through of rebate revenues do not guarantee long term savings. Rebates are based on the pharmaceutical companies' strategies to ensure market share for their brand drugs. To be sure, pharmaceutical rebates are a function of the marketplace: lesser sales of rebate-eligible brand drugs, particularly with the growth in generic drug utilization, may diminish the amount of rebate revenues that a PBM receives. By extension, plan sponsors that require a transparent arrangement where 100 percent of rebate revenues are provided, risk the reduction of those revenues, particularly when a brand drug moves to generic during the

274. Employee Retirement System, *Public Agenda Item: Review of and Action on the Selection of a Vendor to Administer the Prescription Drug Program Under HealthSelect of Texas*, page 6.
275. *ERS' RFP required that the cost of the traditional bids supplied must equal that of the transparent bids where 100 percent of all rebate revenues were provided to the agency. This requirement in the RFP forced the PBMs to structure their traditional bids so that they would have the financial equivalence of the terms of the transparent bids, under which the PBMs were required to pass through to ERS any and all rebates generated by the drug utilization of ERS' participants.*
276. Interview with Paul Bozeman, Office of System Risk Management and Benefits Administration, Texas A&M System; David Rejino, Government Relations, Texas A&M System (Hereafter: A&M System Interview), 26 September 2007.

term of the contract.[277] In this scenario, even though rebate revenues decline, the administrative fees commonly associated with 100 percent pass through arrangements remain fixed. Here, the plan sponsor's costs remain fixed as their rebate revenues decline, potentially obviating any savings benefits intended under the transparent arrangement.

While each agency and university system has contemplated transparent PBM bids, all have approved agreements that, in their analysis, ensure savings while avoiding certain risks. ERS' new contract requires a minimum, guaranteed rebate for each brand and generic drug dispensed. Although ERS' contract includes an administrative fee, the promised rebate savings are protected by the contractual guarantee. TRS, in its new Active Care contract, mitigates the risks associated with rebates through a revenue sharing arrangement where the agency receives 90 percent of rebate revenues and is not assessed an administrative fee. When Texas A&M University System evaluated traditional and transparent bids for its PBM contract, the System found that the transparent bids were more expensive than the traditional ones provided.[278] The UT System, finding the risks involved with a transparent contract too large, selected a traditional contract.[279]

Requiring, by statute, that all state agencies secure the 100 percent pass through of rebate revenues in their PBM, essentially requires that they absorb greater risks associated with rebates. Although rebate revenues may be available in the short term, in the long run, particularly as the patents for brand drugs expire and generic utilization continues to proliferate, the certainty of such revenues is not guaranteed.

Recommendations:

3.1 Agencies should retain the ability to secure PBM rebates in a manner that best serves the interests of their members and the state. Requiring, by statute, that certain amounts of rebate revenues be refunded to the state may unnecessarily lock agencies into contract requirements that may, given certain market assumptions, cost the state and the agencies' beneficiaries in the long term.

Issue 4: Agencies contracting with PBMs must have sufficient audit rights to ensure PBMs' compliance with contract agreements, including rebate pledges.

Background:

277. Letter from Ann Fuelberg, Executive Director, Employees Retirement System, to the Honorable Chuck Hopson, Texas House of Representatives, 8 April 2008, page 3.
278. A&M System Interview, 26 September 2008.
279. Roger Starkey, Assistant Vice Chancellor of Government Relations, The University of Texas System (UT System); Daniel Stewart, Assistant Vice Chancellor of Employee Benefits, UT System; James Sarver, Director of Employee Benefits, UT System; Laura Chambers, Manager of Insurance Benefits, UT System; (Hereafter: UT System Interview) 3 October 2007.

Critics of PBMs frequently claim that the companies operate under a "layer of fog"[280] with largely "secretive"[281] practices and "hidden"[282] costs that effectively preclude any buyer from understanding the true costs of drugs and services provided. Critics further claim that PBMs' use their secretive practices to obscure certain profit margins, retain larger portions of rebate revenues, and restrict a sponsor's members to drugs that are more profitable to the PBM.[283] Although a PBM may pledge certain pricing and rebate revenue-sharing schemes, the plan sponsor may have little recourse with which to verify that the PBM is honoring those terms.

In an effort to ensure that they are being treated fairly by their PBMs, some companies are including comprehensive audit and disclosure rights in their contracts. The Pharmaceutical Coalition of the HR Policy Association TIPPS require that a PBM agree to provide full audit rights to claims and utilization data, retail network contracts, and rebate arrangements.[284] The standard also requires that the auditor be chosen by the sponsor, not the PBM. Allowing for an independent audit would allow for the verification of costs and discounts claimed by the PBM.

In light of the importance of being able to audit a PBM's compliance with a contract, recent attention has been focused on the extent that state PBM contracts include appropriate audit rights. One critique of ERS' 2007 RFP claimed that the agency sought audit rights for "[o]nly claims and certain performance standards, but not actual rebates or mail and specialty acquisition costs."[285] The same critique found that TRS' recent RFP for its Active Care program incorporated "[f]ull audit rights including rebates."

In August 2008 the State Auditor's Office released a report with the finding that, in general, state PBM contracts include provisions that limit the agencies' and university systems' "ability to conduct the audits necessary to verify prescription drug costs and the PBM contractor's compliance with their contracts."286 The Auditor's report also noted that the right to audit should include rebate audits in order to verify the "(1) the amount of rebates a PBM contractor receives from drug manufacturers and (2) the amount of rebates that are passed back to agencies of higher education institution's prescription drug plan."287 Although the Auditor's report generally assessed the state contracts as lacking the appropriate audit standards, three of the four management responses provided indicated compliance with the recommendation. In particular, the management responses furnished by ERS, TRS, and the University of Texas System stated that each entity's contract includes the provisions necessary to conduct audits to ensure

280. Testimony of Sharon Treat, executive Director, National Legislative Association on Prescription Drug Prices, Hearing on State's Role Regulating Pharmacy Benefit Managers, Joint Senate Health and Human Services Committee and Senate State Affairs Committee, Texas Senate, 17 October 2006.
281. Gerry Purcell, "State of Texas: Moving Towards PBM Transparency", 15 February 2008, Power Point Presentation, slide 6.
282. Purcell, slide 20.
283. Purcell, slide 6.
284. http://www.pharmacoalition.org/docs/April%2010%202008%20Mtg%20Presentation.ppt, accessed 3 September 2008.
285. Gerry Purcell, "State of Texas: Moving Towards PBM Transparency", 15 February 2008, Power Point Presentation, slide 31.
286. State Auditor's Office, "Pharmacy Benefit Manager Contracts at Selected State Agencies and Higher Education Institutions", August 2008, page 2.
287. Id.

compliance with the contract.[288] The response furnished by the A&M System agreed on the necessity for comprehensive audit rights, and would take the SAO's recommendation into consideration for a contract starting next year.[289] The actual terms of the audit provisions are summarized in the findings below for each agency and higher education system.

Findings:

- Despite the State Auditor's Office broad conclusions, and other critiques leveled regarding certain contracts, those PBM contracts maintained by ERS, TRS, and the University of Texas System include comprehensive audit right provisions, including the right to audit rebate data. The sub-points below summarize the audit rights provisions within each agency's PBM contract.
    - *Employees Retirement System.* ERS' contract provides the agency with "an absolute right to conduct audits of PBM in connection with the PBM's duties and obligations under the Contract, and that all ERS-related records may be audited by ERS."[290] ERS, or its designee, may "audit and inspect PBM's business practices in connection with the Contract" if the agency determines that the PBM does not satisfy the contract's requirements.[291] ERS also reserves the right to hire a third party auditor to review agreements between the PBM and pharmaceutical manufacturers "to ensure PBM's compliance with the Contract with respect to Rebates."[292]
    - *Teacher Retirement System - Care.* The TRS - Care contract authorizes the agency, or its representative to audit the PBM's "records and books relevant to all services provided" under the contract.[293]
    - *Teacher Retirement System - Active Care.* The TRS - Active Care contract provides TRS with the full audit rights to confirm the PBM's compliance with its contractual obligations. TRS may also audit the guaranteed rebates.
    - *University of Texas System.* The audit provision in the System's contract permits the System to audit claims and formulary information, as well as "other audits of the vendor as it [UT System] deems necessary." The UT System's contract also permits for "representatives of [the] System to audit and examine records and accounts which pertain, directly or indirectly to the Plan at such reasonable times as may be requested by [the] System for purposes of confirming its contractual obligations under this Contract."[294]

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288. Letter from Ronnie Jung, Teacher Retirement System, to John Keel, State Auditor, 7 August 2008, found in SAO, page 35; Letter from Ann S. Fuelberg, Executive Director, Employees Retirement System, to John Keel, State Auditor, 5 August 2008, found in SAO, page 40. Letter from Scott C. Kelley, Executive Vice Chancellor for Business Affairs, University of Texas System, to Willie J. Hicks, Project Manager, State Auditor's Office, 5 August 2008, found in SAO, page 43.
289. Letter from Michael D. McKinney, Chancellor, Texas A&M System, to The State Auditor of Texas, 4 August 2008, found in SAO, page 53.
290. ERS Contract with CVS Caremark, effective 1 September 2008, Section 15.3.
291. Id. at Section 10.1.
292. Id. at Section 15.6.
293. TRS Contract with CVS Caremark, Section 5 Audit Right.
294. E-mail from James Sarver, Director, Office of Employee Benefits, University of Texas System, to Jeremy Mazur, Office of Representative Callegari, 16 September 2008.

- *Texas A&M University System.* A&M's contract entitles the system to audit the PBM's records that relate directly and primarily to the PBM's obligations under its contract with the A&M System.[295] With regard to rebates, A&M's contract authorizes the system to request information from the PBM in order to ascertain that the monies paid to A&M are in accordance with the contract. But for certain claim-specific data, the A&M System has yet to fully exercise its audit rights.

- Executing a comprehensive audit of a PBM contract may cost agencies more than it could save. Although TRS, ERS, and UT have full audit rights, each has expressed concern regarding the cost-effectiveness of exercising those rights on account of the potential audit costs.[296] Furthermore, the costs of a full rebate audit -- upwards of $100,000 -- could likely outstrip any potential savings identified. In its management response to the August 2008 SAO audit, A&M System also noted that a cost-benefit analysis of conducting such an audit could prove that it is more costly than necessary.[297]
- No change in statute is necessary to ensure that state agencies and higher education systems are capable to including appropriate audit rights in their PBM contracts. All entities issuing RFPs have the authority to contract for the desired audit rights that best reflect the state's interest, and to modify future bids to require more stringent audit rights. Furthermore, no agency or higher education system has been challenged on including such contractual provisions on grounds that they are not authorized or otherwise required by statute.

Recommendations:

4.1 Agencies and higher education systems should continue to include appropriate audit provisions in future PBM contracts. Each agency should also maintain the discretion to execute their audit rights. At some point in time, however, an agency should consider exercising its audit right to verify a PBM's compliance with the contract, particularly with regard to promised rebate revenues. Although such an audit may be costly to the state, verifying PBM's compliance may justify this expenditure. This suggestion does not require any change in statute.

Issue 5: Agencies should maintain the flexibility necessary to ensure the provision of cost-effective, efficient pharmaceutical services for their members.

Background:

Critics contend that PBM's profit incentives do not align with their clients' interest in saving money. Common criticisms of PBM contracts point to two alleged practices where PBMs may encourage certain utilization and distribution patterns that are profitable to themselves, while potentially costly to the client. The first alleged practice is that PBMs push expensive brand drugs over cheaper generics, especially in light of the rebate incentives that PBMs may receive for greater brand drug utilization. The second alleged practice is that PBMs steer clients towards using their mail order services, which are more lucrative for the PBM, and actually less cost

295. A&M PBM Contract (see e-mail with David Rejino).
296. TRS Interview, 1 October 2007; Interview with Robert Kukla, Employee Retirement System; Shack Nail, ERS; Phil Dial, Rudd & Wisdom, (Hereafter ERS Interview) 17 December 2007; UT System Interview, 3 October 2007.
297. SAO, page 53.

advantageous for the client.

The issue of steering clients to more expensive, brand drugs is best encapsulated in the debate surrounding the use of Nexium, a brand name drug used for heartburn and acid reflux. Nexium is included on all state contract formularies. In fiscal year 2005 ERS, TRS, and the university systems spent $31 million for Nexium.[298] In fact, in 2005, spending on Nexium was the second largest drug expenditure after that for Lipitor, a cholesterol-lowering medication. Comments from pharmacist representatives point to the significant amount of state spending on Nexium as evidence of PBMs' using formularies to steer state employees towards brand drugs that benefit PBM profit margins because of the rebates associated with the use of this brand drug. They also contend that the emphasis on Nexium to the exclusion of other over the counter and generic alternative results in higher expenses.[299] One pharmacist representative noted that the State of Arkansas saved $2 million by paying pharmacists $25 to call prescribing physicians and suggest that they change prescriptions for Nexium to other heartburn medications.[300]

A similar critique was echoed in the State Auditor's August 2008 report on state PBM contracts. The report stated that agencies' and university systems' contracts do not consistently address the use of therapeutic interchange for brand or generic drugs.[301] The report highlighted the fact that several lawsuits have been filed involving charges that PBMs use therapeutic interchange to promote the use of more expensive, rebate-generating brand drugs over less expensive generic drugs. The report added that the "promotion of expensive drugs may lead to higher overall costs to a plan."[302] Although this was not noted in the SAO's report, the State of Texas never took legal action against a PBM contracting with a state agency or university system over similar drug switching practices. Nor did the SAO's report document that any agency's or university system's plan empirically suffered from the promotion of expensive brand drugs to the exclusion of cheaper alternatives.

In addition to promoting more expensive drugs, PBMs are also criticized for promoting the use of their mail order pharmacy services. Each PBM doing business with the State of Texas owns its own mail order operation where it purchases pharmaceutical products in bulk, and dispenses prescriptions through an automated process. The bulk purchasing coupled with the automated processing lowers the cost of prescriptions filled though this channel. According to one study financed by the PBM industry, mail order pharmacies cut drug costs 27 percent for brand drugs and 53 percent for generic drugs when compared to retail pharmacies' prices.[303] Critics claim,

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298. Legislative Budget Board, *Texas State Government Effectiveness and Efficiency, Selected Issues and Recommendations*, page 112.
299. Observations by nationally known PBM expert Gerry Purcell on Previous Testimony and comments by PBMs on Transparency legislation (on file with committee); E-mail from Richard Beck, Vice President of Pharmacy Affairs, American Pharmacies, to Jonathan Mathers, Committee Clerk, House Committee on Government Reform, 5 October 2007 (on file with committee).
300. E-mail from Richard Beck, Vice President of Pharmacy Affairs, American Pharmacies, to Jonathan Mathers, Committee Clerk, Committee on Government Reform, 5 October 2007 (on file with committee).
301. State Auditor's Office, Pharmacy Benefit Manager Contracts at Selected State Agencies and Higher Education Institutions, page 8.
302. SAO, page 8.
303. Pharmaceutical Care Management Association (PCMA), "How Pharmacy Benefit Managers Help Employers Provide Safer, More Affordable Prescription Drug Benefits", page 2.

however, that a conflict of interest arises when a PBM serves as a plan administrator and also markets drugs through its mail order program.[304] This arrangement allows PBMs to sell generic drugs at a greater profit,[305] and a greater opportunity to push clients towards drugs that pay higher rebates.[306]

Although PBMs claim that the utilization of mail order services helps curb client's prescription drug costs, one study of the ERS and TRS 2004 plans concluded that the use of mail order channels did not translate into significant cost reductions for either agency.[307] Although this conclusion is correct, this study overlooks the policy reasons that led to the development of the reimbursement arrangement for retail maintenance drugs and the savings that arrangement generated for the ERS prescription drug plan. In 2003, as the 79th Legislature explored options to account for a $10 billion budget shortfall, it considered a proposal to require that all maintenance drugs for the ERS prescription drug plan be dispensed through mail order, and not retail pharmacies. This proposal would have resulted in a 12.5 percent reduction in the cost of maintenance drugs.[308] In response to an appeal from the retail pharmacy industry concerned over the potential loss in customers, the Legislature approved a budget rider that required ERS to implement a prescription drug plan "allowing participants to choose retail pharmacies for maintenance medications with the participant paying the extra cost."[309] In response to this directive, ERS adopted a policy that would effectively allow the agency to pay the same amount for maintenance drugs obtained through a retail pharmacy that it would have paid for those drugs through mail order. This arrangement allowed ERS' members to access retail pharmacies for their maintenance scripts, but required that they pay a retail maintenance fee in addition to their regular co-pay when using a retail pharmacy. Under this arrangement, ERS experiences the same cost regardless of whether the member obtains the script at mail or retail.[310] TRS had a similar policy in place requiring that it pay the lesser amount for a drug to either the mail order or the retail pharmacies; neither gets paid more than the other.[311] While the aforementioned study was correct to observe that mail order did not translate into significant cost reductions, it failed to demonstrate any understanding of the policy considerations behind the benefit structure. The same study did, however, find that the use of mail order benefitted the agencies' members. In particular, the study noted that when compared to retail pharmacies, PBM mail order services saved the plans' members an estimated 48 percent.[312] While the plans may effectively pay the same rates for maintenance drugs through mail order and retail pharmacy channels, the cost

304. James Langenfeld and Robert Maness, The Cost of PBM "Self-Dealing" Under a Medicare Prescriptions Drug Benefit, 9 September 2003, page 1.
305. Barbara Martinez, "Selling generic drugs by mail is lucrative business," *The Wall Street Journal*, 9 May 2006.
306. Langenfeld and Maness, The Cost of PBM "Self-Dealing" Under a Medicare Prescriptions Drug Benefit, page 5.
307. Michael Johnsrud, Kenneth Lawson, and Marvin Shepherd, "Comparison of Mail-Order with Community Pharmacy in Plan sponsor Cost and Member Cost in Two Large Pharmacy Benefit Plans", *Journal of Managed Care Pharmacy*, March 2007, page 122.
308. ERS Memorandum, Follow-Up Questions for ERS Interview - Representative Callegari's Office, December 2007 (on file with committee).
309. House Bill 1, 79th Regular Session, I-44.
310. ERS Memorandum, Follow-Up Questions for ERS Interview - Representative Callegari's Office, December 2007 (on file with committee).
311. TRS Interview, 29 January 2008.
312. Johnsrud, Lawson, and Shepherd, "Comparison of Mail-Order with Community Pharmacy in Plan sponsor Cost and Member Cost in Two Large Pharmacy Benefit Plans", *Journal of Managed Care Pharmacy*, page 133.

benefits of mail order are passed through to the plans' members.

Findings:

- All state PBM contracts require the emphasis of cheaper generic drugs over brand drugs. The ERS and TRS plan designs encourage the use of generic drugs through lower co-pays and a "member pay the difference" requirement where, if a member wants a brand drug where chemically-equivalent generic alternative is available, then they must pay the difference between the brand and generic drug. If a member is prescribed a brand drug, and no equivalent generic is available, then the member is only required to pay the co-pay. The University of Texas and Texas A&M systems' contract also encourage the use of generics using plan designs similar to ERS and TRS.

  Over the past four years all state prescription drug plans have experienced significant growth in generic utilization. The table, *Rates of State Generic Utilization, FY 2005-2008*, illustrates this trend. Between fiscal years 2005 and 2008, the generic utilization rate for all entities grew by an average of 13.2 percent. This trend, coupled with the fact that generic drugs account for the majority of drugs utilized by all state prescription drug plans, underscores the fact that generics, and not brand drugs, are promoted as a matter of contract policy.

Rates of State Generic Utilization, FY 2005-2008

Agency	2005	2006	2007	2008
ERS	50%	53%	58%	62%
TRS - Care	46%	49%	54%	59%
TRS - Active Care	50%	55%	59%	63%
UT System	46%	49%	54%	59%
A&M System	45%	48%	53%	58%

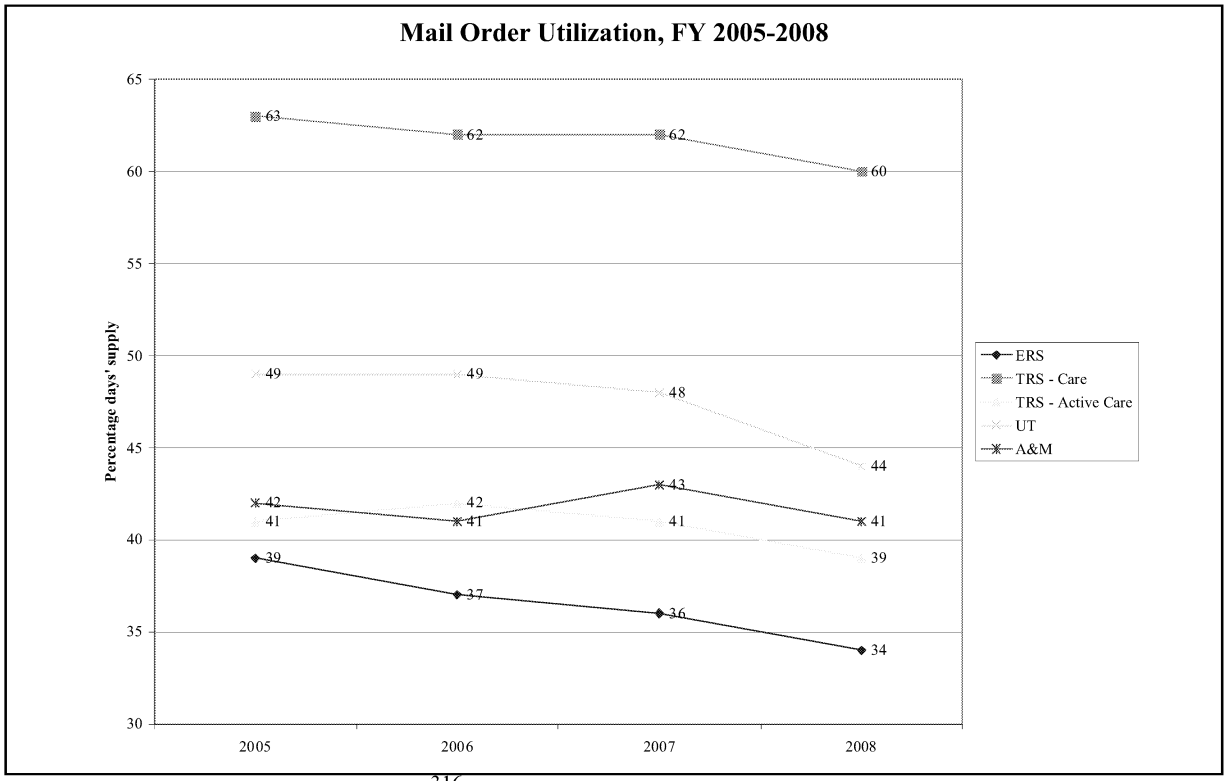
Sources: Employees Retirement System, Teacher Retirement System, University of Texas System, Texas A&M System.

- All state PBM contracts prohibit drug switching practices. ERS prohibits the use of therapeutic interchange, the practice of switching generic for brand, or brand for brand, drugs. Although ERS has contemplated authorizing therapeutic interchange as a cost saving measure, the agency believes that, as a matter of policy, allowing such interchange would interfere with physicians' decisions.[313] Under the current contract a PBM cannot substitute a generic drug for a brand, if that brand is prescribed by a physician. The PBM may, however, substitute a generic drug for a brand drug if that substitution is authorized by that physician. Furthermore, the terms of ERS' 2008 contract prohibit the PBM from using therapeutic substitution to steer members towards using expensive brand drugs. With regard to ERS' members use of any brand drug such as Nexium, although the drug is included on the agency's formulary, since all rebate revenues are returned to ERS, the

313. *"Although ERS has considered using therapeutic substitution as a cost saving measure for the prescription drug program, we have found that it is the subject of much controversy and debate. It raises the question of whether or not ERS is practicing medicine by second guessing the physician, and leads to speculation about whether or not the PBM is acting in the best interest of the patient when the substitute happens to be a drug that the PBM manufactures.* Letter from Robert Kukla, Director of Benefit Contracts, Employees Retirement System, to Representative William Callegari and Representative Vicki Truitt, 18 March 2008, page 2.

PBM has no incentive to promote the use of this high-cost brand drug. In addition, ERS' prohibition of therapeutic interchange precludes the PBM's encouragement of that drug's use.[314] TRS' and the university systems' contract include similar prohibitions regarding therapeutic interchange. As an example, UT System's plan prohibits brand to brand interchanges, as well as low cost to high cost drug interchanges.[315]

- Although each state PBM contract includes the provision of pharmacy mail services, the majority of drugs for most state prescription drug plans are supplied through retail pharmacies. The chart, *Mail Order Utilization, FY 2005-2008*, depicts that, over the past four years for most state-sponsored prescription drug plans mail order pharmacy services account for less than half of all drugs dispensed. Only the TRS - Care plan received a majority of drugs through mail order. The rate of mail order utilization has declined for all plans over the past four years. In fact, between FY 2005 and FY 2008, the amount of days supply provided through mail order to ERS members decreased from 39 percent to 34 percent. Just as the amount of days supply provided through mail order to ERS' beneficiaries decreased, so, too, did the number of scripts filled and the amount paid by



ERS for mail order services.[316] During that same time, the amount of supply furnished through retail pharmacies to ERS' members increased from 61 to 66 percent.[317]

314. ERS Memorandum, Follow-Up Questions for ERS Interview - Representative Callegari's Office, December 2007 (on file with committee).
315. E-mail from James Sarver, Director, Office of Employee Benefits, University of Texas System, to Jeremy Mazur, Office of Representative Callegari, 16 September 2008.
316. Between FY 2005 and 2008, the proportion of ERS members' prescriptions filled through mail order decreased from 15% to 13%. During that same period the amount ERS paid for mail order services declined from 34% to 31%.
317. Employees Retirement System, Retail and Mail Order Usage of ERS Pharmacy Benefit, 14 April 2008.

According to TRS, 84 percent of the prescriptions for the Active Care program are filled at retail pharmacies.[318]

- Although retail pharmacies account for the majority of drugs supplied to state plans' members, the plans' co-pay and supply restrictions favor use of mail order pharmacy over retail pharmacies. The table, *ERS' Co-Pays and Days Supply Requirements*, depicts the co-pays and days supply restrictions for certain drugs purchased through retail pharmacies or mail order. The prescription drug plans administered by TRS and the university systems offer similar co-pay and supply restrictions, although the Texas A&M plan allows for 90 days supplies through certain retail pharmacies, albeit at higher co-payments relative to mail order and greater discounts than 30-days at retail prescriptions.[319] According to the table, ERS members obtaining non-maintenance drugs from a retail pharmacy will pay the same amount for those drugs as they would through mail order. Retail pharmacies are limited to providing only 30 days supply however, less than the 90 days supply available through mail order. ERS members obtaining maintenance drugs retail pharmacies must pay more than they would through mail order. For example, a member receiving Tier 2 maintenance drugs from a retail pharmacy over 90 days must pay $105.[320] That member could receive the same amount of days supply from the mail order pharmacy for $75, which is $30 less than what would be paid to the retail pharmacy. Under the current plan design, members using mail order services may enjoy the convenience of longer supplies and, with regard to maintenance drugs, lower co-pays. In an effort to establish parity between mail order and retail pharmacies, the Texas Pharmacy Association has suggested allowing beneficiaries to choose between mail order or retail pharmacies without co-pay or supply restriction.[321] Although retail pharmacies already account for well over the majority of drugs dispensed under each prescription drug plan, this recommendation would expand plans' members' options when looking for convenient, more cost effective points of sale for their prescription drugs.

ERS' Co-Pays and Days Supply Requirements

	Tier 1 Generic	Tier 2 Formulary Brand	Tier 3 Non-Formulary Brand
Retail pharmacy non-maintenance drugs (1)	$10 co-pay, 30 day supply	$25 co-pay, 30 day supply	$40 co-pay, 30 day supply
Retail pharmacy maintenance drugs (2)	$15 co-pay, 30 day supply	$35 co-pay, 30 day supply	$55 co-pay, 30 day supply
Mail order pharmacy	$30 co-pay, 90 day supply	$75 co-pay, 90 day supply	$120 co-pay, 90 day supply

Source: Employees Retirement System of Texas.

(1) A non-maintenance drug, such as an antibiotic, is used to treat short term illnesses or conditions.

(2) A maintenance drug is medication taken over an extended period of time to treat a chronic disease or condition.

318. Interview with Ronnie Jung, Executive Director, Teacher Retirement System; Betsey Jones, TRS; Ray Spivey, Governmental Relations, TRS; (Hereafter TRS Interview) 29 January 2008.

319. Legislative Budget Board, Texas State Government Effectiveness and Efficiency, page 116.

320. *($35 co-pay for 30 day supply) * 3 = $105 co-pay for 90 days supply.*

321. Letter from Jim Martin, Executive Director/Chief Executive Officer, Texas Pharmacy Association, to John Keel, State Auditor, 6 March 2008, page 2.

Recommendations:

5.1 State agencies and university systems should continue to pursue plan designs that best meet members' pharmacological needs while ensuring cost effectiveness. This recommendation does not require any change in statute.

5.2 State contracts should provide all beneficiaries the option to obtain prescription drugs from a retail community pharmacy in lieu of the mail order pharmacy at no additional co-pay and without supply restrictions, provided the retail community pharmacy agrees to dispense the prescription drug for the same total reimbursement that would be applicable if the prescription drug was dispensed through mail order. This policy should be cost neutral to the state, and should not require an additional appropriation.

Issue 6: Agencies should retain the discretion with regard to the contractual requirement that the PBM serve as the agencies fiduciary.

Background:

All of the pharmacy benefit manager companies that have contracts with state agencies or higher education systems are publicly-held, for-profit companies. Each company employs a business plan to both expand its market share and provide a rate of return -- or profit -- to its shareholders. Critics of state PBM contracts point to the PBM's inherent profit motive as inconsistent with the state's interest in saving taxpayers' dollars. In particular, critics allege that PBMs retain rebate revenues earned through clients' utilization of formulary drugs, manipulate drug pricing to create pricing "spreads" that benefit the PBM, and, among other charges, channel clients towards using drugs that ensure greater revenues for the PBM.[322] If accurate, each of these activities may ultimately cost the state more than what it should be paying for its prescription drug plans.

In an effort to better align a PBM's interests with those of the state; some have advocated implementing a fiduciary duty requirement for all contracts. This provision would require the contracted PBM to serve its client's interest, rather than its own, in securing lower drug prices and rebate revenues. Under this arrangement, the PBMs "will be less able the siphon money away for themselves that could go instead towards lower drug prices for the client."[323] In addition to the potential financial benefits to the state, proponents of the fiduciary duty requirement point out that the fiduciary concept is a readily enforceable, basic principle of common law, and would serve as a "catch-all standard" that could address PBM practices not otherwise addressed through contractual or statutory provisions.[324]

Findings:

322. Testimony of Sharon Treat, executive Director, National Legislative Association on Prescription Drug Prices, Hearing on State's Role Regulating Pharmacy Benefit Managers, Joint Senate Health and Human Services Committee and Senate State Affairs Committee, Texas Senate, 17 October 2006; Gerry Purcell, "State of Texas: Moving Towards PBM Transparency", 15 February 2008, Power Point Presentation, slide 6.
323. Testimony of Sharon Treat, page 3.
324. Id. at 4.

- Only ERS' 2008 contract includes the requirement that the PBM serve as a fiduciary. This contract specifically includes the word "fiduciary" to reinforce the duties and responsibilities of the PBM, and includes other language requiring that the PBM "act with the utmost good faith, loyalty, candor, care, skill, diligence and prudence in discharging its duties."[325] Although the PBM is a fiduciary in connection with the performance of its obligations under the ERS contract, the PBM is not a fiduciary for ERS in connection with the PBM's pharmaceutical manufacturer contracts. Furthermore, ERS retains exclusive authority over all aspects of the plan.
- The University of Texas and Texas A&M university systems' and TRS' contracts do not include the fiduciary duty requirements. The UT System prefers to maintain that duty, pointing out that they are accountable to the legislature, the UT System, and UT employees; as such they would not want to transfer that responsibility.[326] Similarly, the Teacher Retirement System's Board of Trustees prefers that the agency maintain its fiduciary duty.[327] The Texas A&M System's contract does not include a fiduciary duty requirement.
- Private sector best practices guidelines do not require that pharmacy benefit managers serve as a fiduciary. In particular, the TIPPS standards for PBM accreditation promulgated by the Pharmaceutical Coalition of the HR Policy Association do not specifically require that a PBM serve as a client's fiduciary.[328] In addition, the PBM accreditation standards put forth by the Utilization Accreditation Review Commission (URAC), a private organization that certifies health care providers that meet certain standards, does not require PBMs to serve as a fiduciary.[329]

Recommendations:

6.1 Agencies should retain the discretion to establish the fiduciary duty requirement for their PBM contracts.

Issue 7: Agencies should maintain the expertise necessary to continue to identify market trends in the PBM market, and design RFPs that best leverage the state's interest and purchasing power in a competitive market.

Background:

Some agencies have used third party consultants to assist with the drawing of their PBM contracts. The efficacy and value added by these consultants has been called into question. In its August 2008 report on state PBM contracts, the State Auditor's office found that the agencies

325. Letter from Ann Fuelberg, Executive Director, Employees Retirement System, to Representative William Callegari, Chair, House Committee on Government Reform and Representative Vicki Truitt, Chair, House Committee on Pensions and Investment, 25 June 2008.
326. UT System Interview, 3 October 2007.
327. TRS Interview, 1 October 2007.
328. Pharmaceutical Coalition of the HR Policy Association, 2008 Transparency in Pharmaceutical Purchasing Solutions (TIPPS[SM]) Standards, http://www.pharmacoalition.org/TIPPS_Transparency.aspx, accessed 3 September 2008.
329. Utilization Accreditation Review Commission, Pharmacy Benefit Management Standards -For Commercial Use- Version 1.0, 2007.

and higher education institutions "have limited guidance in developing contract provisions for PBM services."[330] Another critique of the state's PBM contracting practices alleged that "outside consultants used by the agencies in the past had insufficient expertise or experience in PBM operations and contracting."[331] Neither the Auditor's report, nor the other criticism of the agencies' use of consultants, identified any specific limitations in the guidance provided to the agencies or other material defects in the expertise provided.

The alleged lack of expertise ties into another, broader argument, that the state's PBM contracts are predicated on terms and conditions defined by the PBM. Here, the argument points out that the types of drugs used by a plan's members, the prices paid for those drugs, and the amount of rebate revenues generated through their utilization are all directed by the contracting pharmacy benefit manager. Consequently, the contract better reflects the interests of the PBM over those of the contracting state agency. In the absence of transparency regarding a PBM's pricing and revenue schemes, the state's RFP writers may not know if they are receiving the best deal for their PBM contracts.[332]

Findings:

- Three out of the four state entities with PBM contracts obtain outside consulting services for their contracts. ERS and the University of Texas System contract with an actuarial consulting firm to assist with their PBM RFP processes. In addition to assisting these agencies in developing their RFPs, the firm also provides UT and ERS technical advice and analysis on proposed contracts and helps identify a customized PBM contract product for UT's and ERS's needs.[333] The consultants used by ERS and UT have 30 years of knowledge and expertise on the state's health plan.[334] TRS also contracts with a private health care consultant to advise and consult in the analysis of proposals.335 The agency's contracts are further reviewed by the Texas Office of Attorney General. A&M System did not use a consultant when evaluating PBM contract bids in 2005. For its upcoming bid in 2009, however, the A&M System plans to use a consultant for evaluating traditional versus transparent bids provided by PBMs.
- Several agencies enter into PBM contracts of their own design; they do not use a contract furnished by the PBM. TRS dictates the terms of its contracts for its Care and Active Care prescription drug plans. ERS requires the PBM to sign a contract developed by the ERS legal staff, not by the PBM. The contract receives input from ERS' Benefit

330. State Auditors Office, Pharmacy Benefit Manager Contracts at Selected State Agencies and Higher Education Institutions, page 13.
331. Letter from Jim Martin, Executive Director/Chief Executive Officer, Texas Pharmacy Association, to John Keel, State Auditor, State Auditor's Office, 6 March 2008, page 2.
332. Interview with Richard Beck, America's Pharmacies; Rusty Word, America's Pharmacies; Gerry Purcell, PBM consultant (via telephone); David Balto, attorney, former Federal Trade Commission attorney (via telephone); Sharon Treat, Maine State Representative (via telephone); Michael Shepherd, Professor, UT School of Pharmaeconomics (via telephone), 4 December 2007.
333. Interview with Phil Dial, actuarial consultant, Rudd and Wisdom, Inc., 18 October 2007.
334. Letter from Ann Fuelberg, Executive Director, Employees Retirement System, to the Honorable Chuck Hopson, Texas House of Representatives, 8 April 2008, page 2.
335. Teacher Retirement System of Texas, Power Point Presentation Before the House Committees on Government Reform and Pensions & Investments, Pharmacy Benefit Managers, 15 February 2008, slide 11.

Contracts Division, and further review of the Office of the Attorney General.[336] This contract includes several unique provisions that differentiate the ERS contract from the typical PBM contract. Some of those unique provisions include: a "most favored nation" clause that requires the PBM to provide ERS with pricing terms that are equivalent to those provided in any other contract entered into by the PBM that are more generous than those included in the ERS contract, a clause that allows ERS to reimburse the PBM for the exact amount that the PBM pays a retail pharmacy, and a clause that the PBM must indemnify and hold ERS harmless for errors and omissions made by the PBM and any of its contracting pharmacies.[337] Like ERS and TRS, the University of Texas System's contract is designed and drafted by the System, not the contracting pharmacy benefit manager. The System's contract includes unique provisions, including ones allowing the System to terminate its contract at any time for any reason, as well as performance guarantees enforced with momentary penalties.[338] The current contract maintained by the Texas A&M System was drafted by the PBM, with modifications made by System Office of Risk Management and Benefits Administration and System Office of General Counsel staff when the contract was approved in 2006. The A&M System plans to incorporate a sample contract in the RFP that it plans to issue later this year.[339]

- Each state PBM contract does use the formulary provided by the contracting pharmacy benefit manager. These formularies are, however, reviewed by experts employed by the contracting agencies. TRS had its PBM formularies reviewed by a licensed pharmacist in order to ensure that the included drugs are appropriate.[340] The University of Texas System receives input from its very own School of Pharmacy.[341] ERS had used a licensed pharmacist on staff.

Recommendations:

7.1 Agencies and university systems should continue to secure the internal and external expertise necessary to draft and design pharmacy benefit manager contracts that best address the interest of the State of Texas and the respective plans' members. Any consultants or auditors used by a state agency or university system should serve as an un-biased, independent contractor, that does not receive any direct or indirect compensation from the pharmacy benefit manager, pharmaceutical manufacturer, or retail pharmacy industries or trade or advocacy organizations associated with those industries. Each agency using a consultant should periodically evaluate the services provided to ensure that they possess the depth of knowledge and experience necessary to design effective PBM contracts.

7.2 All agencies with PBM contracts, including the university systems, should meet periodically to discuss their PBM contracts and current contracting trends. Each agency should

336. Letter from Ann Fuelberg, Executive Director, Employees Retirement System, to the Honorable Chuck Hopson, Texas House of Representatives, 8 April 2008, page 2.
337. Employees Retirement System, follow-up Questions for ERS Interview - Representative Callegari's Office, 17 December 2007 (on file with Committee).
338. UT System Interview, 3 October 2007.
339. E-mail from Paul Bozeman, Benefits Administration, Texas A&M University System, to Jeremy Mazur, Office of Representative Callegari, 11 September 2008.
340. TRS Interview, 29 January 2008.
341. UT System Interview, 3 October 2007.

routinely communicate with other contracting agencies regarding contracting issues, particularly with regard to RFP and contract documents.

Research Methods

Starting in September 2007, a series of in-depth research interviews were conducted with personnel representing the agencies affected by H.B. 3454. These agencies included ERS, TRS, and the Department of State Health Services. Additional interviews were held with representatives from the University of Texas and Texas A&M systems, Texas Department of Insurance, and the Legislative Budget Board to gain further perspectives on state contracts with PBMs, applicable regulatory oversight, and fiscal notes. Pharmacy benefit manager personnel were also interviewed, including representatives from Medco, CVS/Caremark, Wellpoint, and for the Texas Association of Health Plans. In addition to meetings held throughout the 80th Session, a research interview was also conducted with several experts and representatives from the independent pharmacist coalition. Additionally, in an effort to gain some perspective on how the private sector contracts with PBM, an interview was conducted with a human resources director for a large company headquartered in Texas. Lastly, facts were also derived from the public testimony heard by the committee on July 16, 2008 at the Capitol, which included pharmacists, pharmacy benefit managers, and representatives from pharmaceutical manufactures.

AGENCY OVERSIGHT

Monitor the agencies and programs under the committee's jurisdiction.

Background:

The Texas Incentive and Productivity Commission (TIPC)

The Texas Incentive and Productivity Commission (TIPC) was created in 1989 to administer programs that reduced state agencies' operating costs through the improvement of productivity. At the height of its operation TIPC had six fulltime employees, including a director, and operated with an annual budget of $211,233. The agency was funded through a percentage of the savings realized at agencies that implemented TIPC programs.[342]

In general the Commission implemented programs modeled after private sector efforts to encourage the development of productive and innovative state agencies and employees. TIPC also recognized selected employees for their efforts to save money, increase revenues, and improve services.[343]

TIPC adopted two strategies to achieve its goal of encouraging innovations that resulted in a savings to the state. One was an external strategy to promote and educate state employees about various TIPC programs designed to momentarily incentivize sate employees to save money. The other was an internal strategy to review and consider employee suggestions, productivity plans, and productivity bonus applications within specified time frames.[344]

Sunset Advisory Commission

The Sunset Advisory Commission is a legislative body consisting of five House members, five senators, and two public members appointed by the Speaker of the House and the Lieutenant Governor respectively. The Commission oversees the activities of Sunset staff, and the evaluation and recommendations regarding agencies subject to Sunset review.

Approximately 130 state agencies are subject to the Texas Sunset Act. Agencies under Sunset typically undergo review once every 12 years.[345] Each review focuses on the continued need for a state agency and its functions, and potential improvements that may be made to an agency's operation. An agency review is summarized in a report that includes a recommendation to abolish or continue the agency and may also contain other recommendations regarding agency functions. If the Commission recommends continuation of an agency, the Commission must provide draft legislation to the Legislature to continue the agency for up to 12 years and correct other problems identified in the Sunset review.

Issue 1: The Texas Incentive and Productivity Commission (TIPC) no longer exists, obviating the need for the Government Reform Committee's Oversight.

Findings:

342. H.B. 1, 78th Reg. Sess., (Tex. 2003) at 920.
343. Tex. Rev. Civ. Stat. art. 6252-29, § 6 (1998).
344. State Council on Competitive Government, Texas Incentive and Productivity Commission (2004).
345. Sunset Advisory Commission, *Who is Sunset?,* (2008), http://www.sunset.state.tx.us/

- In 2004 the State Council on Competitive Government released a report with the finding that small and mid sized agencies rarely participated in TIPC programs. In the absence of meaningful agency participation in the programs, the Council on Competitive Government recommended that individual agencies be responsible for implementing their own employee suggestion program on a voluntary basis beginning September 1, 2004 under guidelines developed by the Council. The Council also found that the leadership of each individual agency could design a suggestion program that would represent the most efficient use of their respective time, talent and money.346
- The Council on Competitive Government's also reported that in TIPC's last three years, 75 percent of the suggestions come from just ten agencies with these same ten agencies being responsible for 99 percent of the certified savings. However, over 90 percent of the savings result from just four suggestions.347
- Following the Council on Competitive Government's report the TIPC ceased operations during fiscal year 2005. During the 79th Session the Legislature discontinued the general revenue funding for TIPC upon the recommendation of the Legislative Budget Board (LBB).348 The 80th Legislature did not appropriate any funds for the TIPC for the 2008-2009 fiscal biennium.
- During the 80th Session the Committee on Government Reform no oversight action was taken regarding the Texas Incentive and Productivity Commission.

Recommendations:

1.1 Abolish the Texas Incentive and Productivity Commission by repealing Chapter 2108 of the Texas Government Code.

346 State Council on Competitive Government, Texas Incentive and Productivity Commission (2004).
347 Id.
348 S.B. 1, 79th Reg. Sess., (Tex. 2005) at 902.