

SUNSET ADVISORY COMMISSION

STAFF REPORT WITH COMMISSION DECISIONS

Railroad Commission of Texas



2016–2017
85TH LEGISLATURE

SUNSET ADVISORY COMMISSION

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RAILROAD COMMISSION OF TEXAS

SUNSET STAFF REPORT WITH COMMISSION DECISIONS

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HOW TO READ SUNSET REPORTS

Each Sunset report is issued *three times*, at each of the three key phases of the Sunset process, to compile all recommendations and action into one, up-to-date document. Only the most recent version is posted to the website. **(The version in bold is the version you are reading.)**

1. SUNSET STAFF EVALUATION PHASE

Sunset staff performs extensive research and analysis to evaluate the need for, performance of, and improvements to the agency under review.

FIRST VERSION: *The Sunset Staff Report* identifies problem areas and makes specific recommendations for positive change, either to the laws governing an agency or in the form of management directives to agency leadership.

2. SUNSET COMMISSION DELIBERATION PHASE

The Sunset Commission conducts a public hearing to take testimony on the staff report and the agency overall. Later, the commission meets again to vote on which changes to recommend to the full Legislature.

SECOND VERSION: *The Sunset Staff Report with Commission Decisions*, issued after the decision meeting, documents the Sunset Commission's decisions on the original staff recommendations and any new issues raised during the hearing, forming the basis of the **Sunset bills**.

3. LEGISLATIVE ACTION PHASE

The full Legislature considers bills containing the Sunset Commission's recommendations on each agency and makes final determinations.

THIRD VERSION: *The Sunset Staff Report with Final Results*, published after the end of the legislative session, documents the ultimate outcome of the Sunset process for each agency, including the actions taken by the Legislature on each Sunset recommendation and any new provisions added to the Sunset bill.

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— **SUNSET COMMISSION DECISIONS**

SUNSET COMMISSION DECISIONS

Summary

The following material summarizes the Sunset Commission's decisions on the staff recommendations for the Railroad Commission of Texas, as well as modifications and a new issue raised during the public hearing.

In its third review of the Railroad Commission since 2010, the Sunset Commission determined that no major structural changes to the agency or a change to the agency's name were needed. The commission instead focused on improvements to the agency's oil and gas enforcement program, finding that the agency struggles to report reliable data about the program and does not use existing enforcement tools or staff strategically. Recommendations direct the Railroad Commission to develop a strategic plan that tracks and measures the program's success and also to conduct audits to better prevent operators with severed leases from producing oil and gas illegally.

Additional recommendations by the Sunset Commission would provide needed resources for pipeline safety, address damage prevention related to pipelines, and ensure agency contracting improvements stay on track. The Sunset Commission also recommends continuing the agency for 12 years.

ISSUE 1

Continue the Railroad Commission of Texas for 12 Years With a Name That Reflects the Agency's Important Functions.

Recommendation 1.1, Modified — Continue the Railroad Commission of Texas for 12 years; however, the Sunset Commission recommends retaining the agency's name.

ISSUE 2

Contested Hearings and Gas Utility Oversight Are Not Core Commission Functions and Should Be Transferred to Other Agencies to Promote Efficiency, Effectiveness, Transparency, and Fairness.

Recommendation 2.1, Not Adopted — Require use of the State Office of Administrative Hearings for contested gas utility cases.

Recommendation 2.2, Not Adopted — Require the Railroad Commission to use the State Office of Administrative Hearings for all other contested case hearings.

Recommendation 2.3, Not Adopted — Transfer gas utility regulation from the Railroad Commission to the Public Utility Commission.

ISSUE 3

Oil and Gas Monitoring and Enforcement Need Improvements to Effectively Ensure Public Safety and Environmental Protection.

Recommendation 3.1, Adopted — Require the Railroad Commission to develop a strategic plan for the Oil and Gas Division that tracks and measures the effectiveness of monitoring and enforcement.

Recommendation 3.2, Not Adopted — Require the Railroad Commission to develop in rule a process for issuing expedited penalties for minor violations.

Recommendation 3.3, Adopted — Direct the Railroad Commission to accurately track and report the number of oil and gas violations annually. (Management action – nonstatutory)

Recommendation 3.4, Adopted — Direct the Railroad Commission to systematically track major violations. (Management action – nonstatutory)

Recommendation 3.5, Adopted — Direct the Railroad Commission to develop a definition of repeat violations in rule and report the number of repeat violations on its website. (Management action – nonstatutory)

Recommendation 3.6, Adopted — Direct the Railroad Commission to audit a sample of oil and natural gas production reports and transportation reports. (Management action – nonstatutory)

Recommendation 3.7, Modified — Direct the Railroad Commission to develop a policy to require production reports to be filed electronically, and also direct the agency to provide oil and gas production information on its website in a format that is easier for royalty owners to use and understand. (Management action – nonstatutory)

Recommendation 3.8, Adopted — Direct the Railroad Commission to expand its risk matrix for oil and gas inspections. (Management action – nonstatutory)

ISSUE 4

Insufficient and Inequitable Statutory Bonding Requirements Contribute to the Large Backlog of Abandoned Wells.

Recommendation 4.1, Not Adopted — Amend blanket bond requirements in statute to better reflect risk and increase equitability.

ISSUE 5

Improved Oversight of Texas' Pipeline Infrastructure Would Help Further Ensure Public Safety.

Recommendation 5.1, Adopted — Authorize the Railroad Commission to enforce damage prevention requirements for interstate pipelines.

Recommendation 5.2, Adopted — Authorize the Railroad Commission to create a pipeline permit fee.

Recommendation 5.3, Adopted — Modify language in the General Appropriations Act to further ensure that the Railroad Commission collects, and is appropriated back, fee amounts to offset the costs of administering its Pipeline Safety program, including administration costs.

ISSUE 6

The Railroad Commission's Contracting Procedures Are Improving, but Continued Attention Is Needed.

Recommendation 6.1, Adopted — Direct the Railroad Commission to centralize all contract administration functions by September 1, 2016. (Management action – nonstatutory)

Recommendation 6.2, Adopted — Direct the Railroad Commission to implement and keep updated contracting best practices as outlined by recent legislation and the comptroller. (Management action – nonstatutory)

Recommendation 6.3, Adopted — Direct the Railroad Commission's executive director to report quarterly to the commissioners at their open meetings regarding the status of contracting improvements. (Management action – nonstatutory)

ISSUE 7

The Railroad Commission's Statute Does Not Reflect Standard Elements of Sunset Reviews.

Recommendation 7.1, Adopted — Apply the Sunset across-the-board recommendation regarding alternative dispute resolution to the Railroad Commission.

Recommendation 7.2, Adopted — Allow the Oil and Gas Regulation and Cleanup Fund Advisory Committee to expire.

Recommendation 7.3, Adopted — Continue requiring the Railroad Commission to submit its report on the Oil and Gas Regulation and Cleanup Fund to the Legislature.

ADOPTED NEW ISSUE

Seismicity Data in Railroad Commission Rules

Direct the Railroad Commission to incorporate findings from the TexNet Seismic Monitoring Program at UT's Bureau of Economic Geology as they become available into its oil and gas disposal well rules or guidance, as applicable. The rules should seek to prevent any induced seismicity caused by disposal wells. (Management action – nonstatutory)

Fiscal Implication Summary

The recommendation to begin requiring production reports to be submitted to the Railroad Commission electronically by September 1, 2018, would save the Oil and Gas Regulation and Cleanup Fund \$46,835 annually because a contractor would no longer be needed to scan reports submitted on paper. Authorizing

the Railroad Commission to establish a pipeline permit fee is expected to result in a \$1.8 million annual savings to general revenue beginning in fiscal year 2019.

Railroad Commission of Texas

Fiscal Year	Savings to the Oil and Gas Regulation and Cleanup Fund	Savings to the General Revenue Fund
2018	\$0	\$0
2019	\$46,835	\$1,842,394
2020	\$46,835	\$1,842,394
2021	\$46,835	\$1,842,394
2022	\$46,835	\$1,842,394

**SUMMARY OF SUNSET
STAFF RECOMMENDATIONS**

SUMMARY

Few agencies are as steeped in the Texas mystique as the Railroad Commission. Created 125 years ago at a time when regulating rates and operations of railroads made it arguably one of the most important and powerful government agencies in the country, the commission's profile grew still higher when it assumed responsibility for regulating oil and gas production and associated pipelines. In its heyday, the actions of the Railroad Commission largely determined the global price of oil. This heightened profile was not limited to the commission, but also extended to individual commissioners. State office buildings have been named for railroad commissioners.

But the world has changed. While the commission still regulates oil and gas drilling and production, it has not overseen railroads in many years. Capitol insiders know this, but the average citizen, busy with the demands of everyday life, most assuredly does not. Additionally, while the commission continues to establish production allowables and seeks to prevent waste of natural resources, its actions no longer control oil markets or oil prices as they once did. Today, the commission is also concerned with other aspects of the energy industry, including preventing pollution, well plugging and site remediation, and other activities like pipeline safety and damage prevention, surface mining of coal and uranium, rate regulation of gas utilities, and regulation of alternative fuels.

During the Sunset review, the Railroad Commission commemorated its 125 years with a celebration attended by past commissioners, and retrospectives of its history. The agency and its place in history should be a source of pride for the commission and its hardworking staff and for the regulated oil and gas industry. But instead of looking back to its storied past, the agency now needs to look forward to the challenges of regulating energy resources in an environment of continued urbanization, water concerns, and possible seismic activity.

For the Railroad Commission to even be under Sunset review is a direct challenge to the commission's status quo. Intense and pointed debate in the waning days of the 2015 legislative session rejected a proposal to delay the agency's review until 2021 and instead culminated in this third Sunset review of the agency since 2010. Such frequent review is hard on agency staff who have their own important jobs to do in addition to attending to the needs of the Sunset review. It also heightens interest in having a positive review and a "clean" Sunset bill that will finally pass the Legislature. However, the Legislature did not suggest such limitations and directed a full review of the agency with detailed requirements to examine alternative organizational structures and assess whether other state agencies would be able to perform the commission's functions.

*Transparency demands
that the agency's name
reflect its actual mission.*

Sunset staff followed the Legislature's direction in conducting its review. The recommendations in this report aim to better prepare and position the agency to achieve its important mission. Enactment of a bill in the next legislative session to reauthorize the commission for 12 years would be a start. However, probably the most important change to provide transparency is to let the people of Texas in on what this agency does by having its name accurately reflect its mission. Recommendations in Issue 1 would continue the agency and change its name to the Texas Energy Resources Commission, while fully addressing the constitutional, federal delegation and cost concerns that have ensnared past efforts to achieve this simple transparency improvement.

The other recommendations would help the agency better focus on its core regulatory activities without having to replicate hearings and utility rate functions that are so capably administered by the State Office of Administrative Hearings and the Public Utility Commission of Texas. These recommendations would also provide needed tools for an improved, more strategic enforcement program that makes the best use of limited staff resources; provide a fairer, updated approach to making operators responsible for plugging abandoned wells; provide needed resources for pipeline safety; address damage prevention related to pipelines; and ensure agency contracting improvements stay on track.

Some of these changes have been suggested in previous Sunset reviews of the Railroad Commission. This approach reflects the continuing need for better and more efficient ways for Texas to regulate the oil and gas industry, and is not a reflection of Sunset staff simply maintaining a semblance of consistency with past recommendations. The following material highlights Sunset staff's key recommendations on the Railroad Commission of Texas.

Issues and Recommendations

Issue 1

Continue the Railroad Commission of Texas for 12 Years With a Name That Reflects the Agency's Important Functions.

Sunset staff determined that the functions of the Railroad Commission of Texas continue to be needed, and that a standalone agency is warranted to carry out these functions. However, two of these functions would be more efficiently placed at other agencies. Issue 2 reflects these transfers. Further, if the commission is continued, its name remains problematic. The agency's outdated name misleads the public and continues to impede the agency's efforts to be more transparent. Changing the commission's name to the Texas Energy Resources Commission would help resolve these issues.

Key Recommendation

- Change the name of the Railroad Commission of Texas to the Texas Energy Resources Commission and continue the agency for 12 years.

Issue 2

Contested Hearings and Gas Utility Oversight Are Not Core Commission Functions and Should Be Transferred to Other Agencies to Promote Efficiency, Effectiveness, Transparency, and Fairness.

Statute charges the Sunset Commission with reviewing overlapping programs and their potential for consolidation, and statute further requires Sunset's current review of the Railroad Commission to assess state agencies that would be able to perform the commission's functions. Both the State Office of Administrative Hearings (SOAH) and the Public Utility Commission of Texas (PUC) not only have clear expertise to perform the same or similar functions the Railroad Commission currently conducts, they specialize in these functions. SOAH provides a neutral and independent forum to conduct contested hearings for nearly 60 agencies. Although the Railroad Commission has taken steps to restructure its in-house hearings function, the fairness of its contested proceedings is clouded by ongoing ex parte concerns and the commission's in-house judges' lack of independence, and the commission fails to adequately track its hearings performance.

In addition, PUC provides state-level regulation of all utilities other than gas utilities, which are currently regulated by the Railroad Commission. PUC focuses on utility ratemaking and has developed an organizational structure and systems to ensure fair and transparent ratemaking. PUC's expertise has grown even more in recent years since the Legislature transferred regulation of water and wastewater utilities to PUC beginning in 2014. Transferring gas utility regulation from the Railroad Commission to PUC offers significant benefits from aligning all state utility regulation within a single agency.

Key Recommendations

- Require use of the State Office of Administrative Hearings for contested gas utility cases.
- Require the Railroad Commission to use the State Office of Administrative Hearings for all other contested case hearings.
- Transfer gas utility regulation from the Railroad Commission to the Public Utility Commission.

Issue 3

Oil and Gas Monitoring and Enforcement Need Improvements to Effectively Ensure Public Safety and Environmental Protection.

Despite the attention given to the Railroad Commission's oil and gas enforcement program in recent years, the agency continues to struggle to provide reliable data to show the effectiveness of its efforts. Basic questions such as how many severe violations occurred, what percentage of violations were repeat violations, and how many operators with severe violations did not face legal enforcement last year remain unanswered. The commission's emphasis on getting operators to take corrective action to come into compliance with its requirements certainly has merit, but falls short of providing incentive for operators to comply without first having to be told by the commission's limited field staff. What information is available suggests that the commission's actions have little deterrent effect and that its main enforcement tool — severing a lease to stop production — may well be weakened because of inadequate cross checks to ensure compliance with the severance. Requiring the Railroad Commission to demonstrate the effectiveness of oil and gas enforcement through performance measures and to use existing resources strategically addresses concerns raised through this review and through the 2011 and 2013 Sunset reviews.

Key Recommendations

- Require the Railroad Commission to develop a strategic plan for the Oil and Gas Division that tracks and measures the effectiveness of monitoring and enforcement.
- Require the Railroad Commission to develop in rule a process for issuing expedited penalties for minor violations.
- Direct the Railroad Commission to accurately track and report the number of oil and gas violations annually.
- Direct the Railroad Commission to develop a definition of repeat violations in rule and report the number of repeat violations on its website.
- Direct the Railroad Commission to audit a sample of oil and natural gas production reports and transportation reports.
- Direct the Railroad Commission to develop a policy to require production reports to be filed electronically.

Issue 4

Insufficient and Inequitable Statutory Bonding Requirements Contribute to the Large Backlog of Abandoned Wells.

Since 2004, the Legislature has required all oil and gas well operators to provide financial assurance, referred to as bonding, to cover a portion of the cost to plug the well and remediate the site, should the operator go out of business. The revenue from these required bonds covered just 15.9 percent of the cost to plug wells in fiscal year 2015. These insufficient statutory bond requirements have left the Railroad Commission with less funding to plug wells and increased liability, as the cost to plug wells has more than doubled since the bond amounts were set in 1991, diverting commission funding that could have been used for other needed program improvements. In addition, the backlog of abandoned wells has increased since 2011 to 9,715 wells. While the question of funding levels for well plugging is an appropriative decision, the review identified a problem with the bonding structure. The current statutory blanket bond structure does not account for risk of well abandonment and places a disproportionate share of bond coverage per well on oil and gas producers who operate fewer than 19 wells. Increasing the number of blanket bond tiers and decreasing the bond requirements for operators with fewer wells would increase equitability and better reflect risk.

Key Recommendation

- Amend blanket bond requirements in statute to better reflect risk and increase equitability.

Issue 5

Improved Oversight of Texas' Pipeline Infrastructure Would Help Further Ensure Public Safety.

Sunset staff found that the Railroad Commission requires additional statutory authority to more effectively protect public safety. Neither the federal government nor the Railroad Commission enforces damage prevention rules for interstate pipelines. This regulatory gap limits Texas' ability to fully enforce damage

prevention rules. Additionally, while the Railroad Commission has required pipeline operators to receive a permit from the agency to operate a pipeline for almost 100 years, it has never had the authority to have operators pay a permit fee to support this function.

Key Recommendations

- Authorize the Railroad Commission to enforce damage prevention requirements for interstate pipelines.
- Authorize the Railroad Commission to create a pipeline permit fee.

Issue 6

The Railroad Commission's Contracting Procedures Are Improving, but Continued Attention Is Needed.

The Railroad Commission depends on contracting to carry out essential functions, including state-funded well plugging, site remediation, and information technology improvements. While most individual contract amounts are relatively small, almost 40 percent of the agency's fiscal year 2015 expenditures were on contracted activities. Sunset staff found that the Railroad Commission is actively implementing policies to improve contracting procedures, but ongoing effort to institutionalize these improvements will ensure this momentum continues.

Key Recommendations

- Direct the Railroad Commission to centralize all contract administration functions by September 1, 2016.
- Direct the Railroad Commission to implement and keep updated contracting best practices as outlined by recent legislation and the comptroller.
- Direct the Railroad Commission's executive director to report quarterly to the commissioners at their open meetings regarding the status of contracting improvements.

Issue 7

The Railroad Commission's Statute Does Not Reflect Standard Elements of Sunset Reviews.

Among the standard elements considered in a Sunset review are provisions that the Sunset Commission applies across the board to all state agencies under review designed to ensure open, responsive, and effective government. The Railroad Commission's governing statute does not include a standard provision relating to alternative dispute resolution that would help improve rulemaking and resolution of other disputes. In addition, the Texas Sunset Act states that advisory committees are abolished on the date set for abolition of an agency unless the committee is expressly continued by law. Sunset staff found that the Oil and Gas Regulation and Cleanup Fund Advisory Committee has not met in more than four years and should be allowed to expire. The Sunset Act also directs the Sunset Commission to recommend the continuation or abolishment of each reporting requirement imposed on an agency under review. Sunset staff found that the Oil and Gas Regulation and Cleanup Fund report continues to be needed.

Key Recommendations

- Apply the Sunset across-the-board recommendation regarding alternative dispute resolution to the Railroad Commission.
- Allow the Oil and Gas Regulation and Cleanup Fund Advisory Committee to expire.
- Continue requiring the Railroad Commission to submit its report on the Oil and Gas Regulation and Cleanup Fund to the Legislature.

Fiscal Implication Summary

Overall, recommendations in two issues would result in an increase of almost \$4.1 million in revenue to the state over the next five years. Two additional recommendations could potentially result in an overall five-year positive impact on the General Revenue Fund of more than \$18 million. The fiscal implication of each recommendation is summarized below.

Issue 3 — The recommendation to begin requiring production reports to be submitted to the Railroad Commission electronically by September 1, 2018, would save the Oil and Gas Regulation and Cleanup Fund \$46,835 annually because a contractor would no longer be needed to scan reports submitted on paper. The recommendation to develop a process for issuing expedited penalties could add about \$2.7 million annually to the General Revenue Fund beginning in fiscal year 2019. This figure is based on the number of sign violations issued in fiscal year 2015 and a penalty of \$250 to \$500 per violation, including the agency’s standard 50 percent discount, but the actual revenue gain would depend on the violations the agency chooses to include in the new expedited penalty process.

Issue 4 — Changing the tier structure of required blanket bonds would increase the amount of money the Railroad Commission collects from those bonds and deposits in the Oil and Gas Regulation and Cleanup Fund by almost \$900,000 in 2019 and then \$1.3 million annually thereafter. The recommendation would not take full effect until January 1, 2019, resulting in the smaller amount in 2019.

Issue 5 — Authorizing the Railroad Commission to establish a pipeline permit fee could result in a \$1.8 million annual savings to general revenue beginning in fiscal year 2019, but the actual amount of savings would depend on the fee amount set by the agency.

Railroad Commission of Texas

Fiscal Year	Revenue Gain to the Oil and Gas Regulation and Cleanup Fund	Savings to the Oil and Gas Regulation and Cleanup Fund
2018	\$0	\$0
2019	\$886,373	\$46,835
2020	\$1,329,559	\$46,835
2021	\$1,329,559	\$46,835
2022	\$1,329,559	\$46,835

AGENCY AT A GLANCE

APRIL 2016

AGENCY AT A GLANCE

The Railroad Commission of Texas serves as the state’s primary regulator of the oil and natural gas industry. The commission aims to protect public health and the environment through an effective regulatory program and to support the development of the state’s energy resources. To fulfill this mission, the commission:

- regulates all aspects of oil and natural gas exploration and production through permitting, monitoring, and inspecting oil and natural gas operations;
- permits, monitors, and inspects surface coal and uranium exploration, mining, and reclamation;
- permits and inspects intrastate pipelines and enforces damage prevention rules relating to digging near pipelines;
- oversees natural gas utility rates and ensures compliance with rates and tax regulations;
- regulates businesses and employees involved in the alternative fuels industry, chiefly propane; and
- conducts contested case hearings related to oil and gas production, gas utilities, and mining.

Key Facts

- **Commissioners.** The commission consists of three statewide elected officials who serve staggered, six-year terms. The accompanying chart, *Railroad Commission of Texas*, details the current commissioners and when their respective terms expire. Commissioners elect their chair, and the governor appoints a new member if a vacancy on the commission occurs. The commission met 17 times in fiscal year 2015.

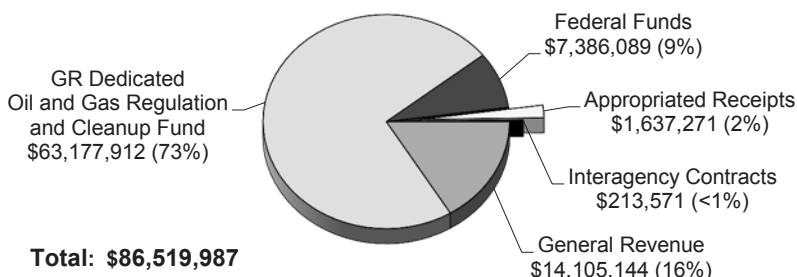
Railroad Commission of Texas

Commissioner	Term Expires
David Porter	2016
Christi Craddick	2018
Ryan Sitton	2020

- **Staff.** The commission employs about 740 staff, 40 percent of whom operate out of the commission’s 11 field offices. Field office staff primarily perform inspections of oil, natural gas, and pipeline facilities and surface coal mining sites.

- **Funding.** The commission’s primary sources of funding are fees and surcharges paid by the oil and gas industry to support the commission’s oil and gas regulatory operations, which include permitting, inspecting, and cleanup. The commission spent \$86.5 million in fiscal year 2015, including about \$63.2 million in dedicated revenue from fees and surcharges and \$14.1 million in general revenue. The pie chart *Railroad Commission Sources of Revenue* details the commission’s sources of funding in fiscal year 2015.

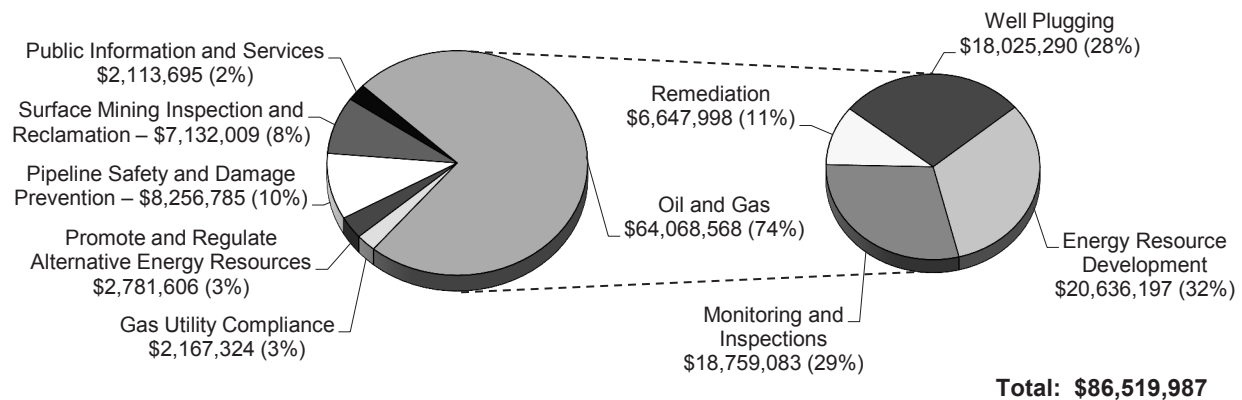
**Railroad Commission
Sources of Revenue – FY 2015**



In fiscal year 2015, the Railroad Commission collected \$46.3 million in fees, administrative penalties, and the gas utility pipeline tax that it deposited in the General Revenue Fund. The gas utility tax accounted for almost \$24 million of that amount. For fiscal year 2016, the Legislature shifted about \$5.6 million in agency fees from general revenue to the Oil and Gas Regulation and Cleanup Fund, slightly reducing the agency's reliance on general revenue.

The pie chart, *Railroad Commission Expenditures by Program*, provides a breakdown of the commission's \$86.5 million in expenditures in fiscal year 2015, with a more detailed breakout of the 74 percent of expenditures devoted to permitting, inspecting, and remediating oil and natural gas operations.

Railroad Commission Expenditures by Program – FY 2015



- **Oil and natural gas production oversight.** The commission regulates the exploration and production of oil and natural gas from drilling and production to well plugging and remediation.

Permitting. Statute requires all operators involved in the exploration or production of oil and natural gas to provide the commission with basic organizational information and financial surety, ensure water quality and prevent production-related pollution, and prevent waste and protect the correlative rights of mineral owners. In fiscal year 2015, the commission issued more than 17,900 drilling permits, down 39 percent from fiscal year 2014.

Monitoring and inspections. The commission was monitoring more than 433,000 oil and natural gas wells at the end of fiscal year 2015, over 78 percent of which were actively producing. Field inspectors inspect oil and gas leases and respond to complaints and pollution violations. In cases of ongoing pollution or where an operator refuses to come into compliance with state regulations, the commission has the authority to enter a lease and shut off production. In fiscal year 2015, the commission performed more than 134,480 oil and natural gas facility inspections, identified about 61,000 violations, issued about 9,500 severance orders, pursued more than 262 formal enforcement actions, and assessed \$3.6 million in penalties.

Well plugging and site remediation. In fiscal year 2015, the commission plugged 692 abandoned wells and completed cleanup activities at 252 abandoned and polluted sites. An estimated 9,715 abandoned wells remain unplugged. Additionally, the commission oversees pollution cleanups performed by the oil and gas industry — ensuring cleanups do not become state-managed projects — and provides incentives to landowners to remediate production-related pollution by granting landowners a release of liability in exchange for successful remediation. At the conclusion of fiscal year 2015, the commission was monitoring 615 active cleanup efforts.

- **Pipeline safety.** To ensure the integrity of Texas' 217,000 miles of regulated intrastate pipeline, field staff conduct pipeline safety inspections, audit pipeline operators and their records, and investigate pipeline accidents. In fiscal year 2015, field staff conducted over 3,800 pipeline safety inspections, identified about 2,250 violations, initiated 21 enforcement actions, and collected \$487,000 in penalties. The commission also develops educational programs on damage prevention for pipeline operators and excavators and enforces damage prevention rules, completing nearly 6,800 enforcement actions, and collecting more than \$9.9 million in penalties for damage prevention violations in fiscal year 2015.
- **Gas utility oversight and rate setting.** The commission ensures customers have equal access to natural gas by overseeing gas utility rates for 200 gas utility companies operating in Texas. The commission has exclusive jurisdiction over the rates set by 167 gathering and transmission utilities, but divides its jurisdiction with cities for 33 investor-owned local distribution companies. The commission has appellate jurisdiction for rates these companies may charge within cities they serve, and it has exclusive jurisdiction for rates in unincorporated areas. The commission has limited jurisdiction over the 85 municipally owned gas utilities operating in the state.

In addition, the commission collects the gas utility pipeline tax and audits gas utility companies to ensure compliance with rate and tax regulations; prevents discrimination among gas utilities by ensuring equal access to pipelines; and offers dispute resolution for parties in the natural gas industry. In fiscal year 2015, the commission heard 16 gas utility rate cases and conducted 139 field audits.

- **Coal and uranium mining, exploration, and reclamation.** The commission regulates coal mining and uranium exploration to help prevent harmful effects to land and water resources, and to ensure the reclamation of mined land. To oversee these mining activities, the commission evaluates permits, inspects and monitors mining sites, and investigates complaints against mining operators.

Coal mining. The commission oversees 29 coal mining operations in Texas, completing 490 inspections and pursuing four enforcement actions in fiscal year 2015. The commission, using federal funds, has reclaimed almost 2,700 acres of abandoned surface mines and 455 abandoned underground mine openings since 1980.

Uranium exploration. The commission permits in situ uranium exploration, issuing two new permits and renewing 13 existing permits in fiscal year 2015. Beyond exploration, the Texas Commission on Environmental Quality oversees in situ uranium mining production. In situ mining uses drilling similar to that used for underground injection control wells and dissolves underground uranium to bring it to the surface. For surface mining of uranium, the Railroad Commission has authority to issue permits, although no such permits currently exist in Texas. Similar to coal mines, the Railroad Commission uses federal funds to reclaim abandoned uranium mines.

- **Alternative fuels oversight.** All businesses and employees involved in supplying, transporting, or distributing propane, liquefied natural gas, or compressed natural gas in Texas must obtain a license or certification from the commission after meeting specified training and testing requirements. The commission also inspects alternative fuels facilities and enforces alternative fuels-related laws and rules. In fiscal year 2015, the commission issued or renewed about 5,700 business licenses and 12,000 employee certifications, provided 2,700 hours of training, and administered 5,462 exams. The agency also performed 16,642 inspections, identified 15,536 violations, resolved 74 enforcement cases, and assessed \$101,700 in administrative penalties.
- **Contested case hearings.** The commission uses in-house hearings staff, including eight administrative law judges, to conduct contested case hearings. In fiscal year 2015, the commission held nearly 1,100 contested case hearings, including 1,057 oil and gas, 20 surface coal mining, and 16 gas utility hearings.

ISSUES

ISSUE 1

Continue the Railroad Commission of Texas for 12 Years With a Name That Reflects the Agency's Important Functions.

Background

Authorized by constitutional amendment in 1890 and established by the Legislature a year later, the Railroad Commission of Texas has primary oversight of the state's oil and natural gas industry. Originally created to regulate the rates and operations of railroads and other common carriers, the commission received responsibility for overseeing oil and gas pipelines, also deemed common carriers, in 1917.

As Texas' oil and gas industry boomed, the need for regulating production of those resources followed. Using the pipeline link to oil and gas production, the Legislature continued to add to the commission's oil and gas regulatory responsibilities and slowly removed other, non-energy resource functions. The Legislature completed this refocusing when it transferred all railroad regulatory functions to the Texas Department of Transportation in 2005.

Today, the commission aims to protect public health and the environment through an effective regulatory program and support the development of the state's energy resources. To accomplish this goal, the commission regulates all aspects of oil and natural gas exploration and production; permits, monitors, and inspects surface coal and uranium mining, exploration, and reclamation; permits and inspects intrastate pipelines; oversees natural gas utility rates and ensures compliance with rates and tax regulations; regulates businesses and employees involved in the alternative fuels industry; and conducts contested case hearings.

The commission employs about 740 staff, 40 percent of whom operate out of the agency's 11 field offices. The commission spent \$86.5 million in fiscal year 2015, including about \$63.2 million in dedicated revenue from fees and surcharges paid by the oil and gas industry, and \$14.1 million in general revenue. Three full-time, elected commissioners oversee the agency, along with an executive director. The commissioners serve staggered, six-year terms.

The Railroad Commission underwent a regular Sunset review in 2011, and when the agency's Sunset legislation did not pass that year, the agency underwent another review in 2013. When that bill did not pass, the Legislature scheduled the agency for another review in 2017. The agency's current Sunset clause includes several provisions unique to the Railroad Commission, including requiring an examination of alternative organizational structures and ways to increase the public's role in commission decisions relating to the effect of the growth of resource extraction.

Findings

Texas has a continuing need to regulate the exploration and production of the state's energy resources.

- **Oil and natural gas regulation.** Unregulated production of oil and natural gas can harm the environment and hinder future product recovery efforts. Improper drilling and well maintenance can allow oil, saltwater, and other drilling byproducts to contaminate soil and freshwater supplies. To help

The commission monitors about 433,000 oil and natural gas wells.

prevent this possibility, the commission monitors about 433,000 oil and natural gas wells, more than 337,700 of which are actively producing. Commission staff inspect well drilling operations and producing wells, and witness critical steps in the drilling process such as the pouring of cement casings that separate the ground and any underground water supply from drilling fluids and produced oil or gas. Although the commission's rules set out requirements that aim to prevent pollution, spills still occur. More willful actions, such as failing to plug inactive wells, can also lead to pollution. In fiscal year 2015, the commission completed cleanup efforts at 252 abandoned, contaminated sites and plugged 692 abandoned oil and gas wells.

Other activities associated with oil and natural gas production, such as hydraulic fracturing and drilling waste disposal, can also have significant environmental impacts. For these functions, the commission's authority to permit underground injection wells is federally delegated and reviewed by the U.S. Environmental Protection Agency. Given the controversy surrounding such activities, the state has a continued interest in retaining control and playing a strong role in regulating these activities.

In addition to protecting the environment, the commission protects the correlative rights of mineral owners and works to prevent the waste of natural resources. To that end, the commission reviews spacing requirements when granting drilling permits to ensure that drilling activities in one area do not infringe on another mineral owner's ability to recover oil or natural gas from their land. The commission also allocates how much oil or natural gas an operator can produce from an active well within a certain period of time. This function prevents oil or gas from being extracted too quickly which can ultimately make it much harder, and more expensive, to recover all of the oil and gas from a given area.

Texas has far more miles of pipeline than any other state.

- **Pipeline safety.** Texas has far more miles of pipeline than any other state. These pipelines transport gas, hazardous liquids, and carbon dioxide to different points throughout the state and across state borders. Through its federally delegated pipeline safety program, the commission oversees more than 217,000 miles of intrastate pipelines, including gathering lines, large transmission lines, and distribution lines that bring natural gas directly to consumers. Commission staff inspect pipeline infrastructure on a regular basis and audit pipeline companies to ensure they follow proper safety standards.
- **Coal mining and uranium exploration regulation.** Similar to the regulation of oil and natural gas production, the commission's role in overseeing surface coal mining provides needed environmental protection. The commission oversees coal mining operations from the pre-mining, planning stage through the final reclamation process, aiming to ensure that mining companies restore mined land to its pre-mining, productive condition. Federal law requires coal mining oversight, and if the state did not operate this program, the federal government would regulate Texas' 29

surface mining operations. Although mining companies are responsible for reclaiming their mine lands, the commission also administers a program that has reclaimed almost 2,700 acres of abandoned mine lands.

The commission permits uranium exploration for in situ mining, which involves drilling similar to oil and gas production drilling. The agency oversees 15 permits, working to ensure that proper casing and other preventive techniques preserve water quality throughout the exploration process. The actual production of uranium through in situ mining is regulated by the Texas Commission on Environmental Quality because it is more similar to the underground injection control wells overseen by that agency.

- **Gas utility regulation.** In Texas, 200 investor-owned utilities gather, transport, and distribute natural gas to domestic, commercial, and industrial end users in both cities and rural areas. Since these companies operate as monopolies in most cases, the state has an interest in ensuring such utilities charge fair rates. While this function remains necessary, whether the Railroad Commission is the best agency to oversee it is further discussed in Issue 2.
- **Alternative fuels regulation.** Texas has a continuing interest in ensuring that businesses and employees involved in supplying, transporting, or distributing propane, liquefied natural gas, and compressed natural gas do so safely. The commission issued or renewed about 5,700 alternative fuels business licenses and 12,000 certifications for employees who worked at those businesses, and performed more than 16,600 inspections in fiscal year 2015.
- **Hearings.** The state continues to need to adjudicate disputes through contested case hearings involving permits and enforcement actions for the oil and gas industry, surface coal mining, and gas utilities. Issue 2 discusses the many benefits of moving these hearings to the State Office of Administrative Hearings.

The magnitude of Texas' oil and gas industry continues to warrant a separate agency.

Texas is far and away the largest oil and gas producing state in the U.S. Among the 14 states comprising the largest oil and gas producers, Texas is one of six with an independent agency structure, with the other eight using a larger, umbrella environmental protection or natural resources agency to regulate oil and gas. Although maintaining the current, independent structure is not essential, wholesale consolidation with other agencies and most program transfers — aside from gas utility regulation and contested case hearings — would not significantly benefit the state.

- **Texas Commission on Environmental Quality (TCEQ).** Many of the Railroad Commission's programs have an environmental protection

The commission oversees 29 surface coal mining operations and 15 permits for uranium mining exploration.

Of the 14 largest oil and gas producing states in the U.S., Texas is one of six with an independent agency.

component that appears to be at odds with the commission's goal of increasing opportunities for developing energy resources. Further, these environmental aspects raise the question whether some programs should be transferred to TCEQ or whether the agencies should be completely consolidated. However, neither option presents clear benefits that outweigh the drawbacks.

Consolidating the commission with the Texas Commission on Environmental Quality does not provide clear benefits that outweigh the drawbacks.

Completely consolidating the agencies has pitfalls in that oversight of the oil and gas industry involves activities that reach well beyond TCEQ's environmental work, including allocating allowable oil and gas production and establishing well spacing requirements. While improvements are needed at the Railroad Commission, no glaring problems exist that would warrant such a wholesale consolidation.

Regulating production and environmental threats in one shop has worked for the Railroad Commission through its authority to curtail a well's production to prevent further damage and swiftly punish violators — though the agency's processes for severing a lease need strengthening, as noted in Issue 3. Transferring authority for environmental regulation to TCEQ would remove this tool. In addition, because of the way oil and gas regulation is funded, the Railroad Commission would need to maintain responsibility for oil and gas remediation and well plugging.

Finally, some of the agencies' programs have split jurisdictions that a program transfer to TCEQ could potentially resolve. For example, the Railroad Commission has responsibility for preserving water quality in oil and gas production, but because of federal delegation requirements, TCEQ retains the authority to regulate air emissions from oil and gas production. However, the Railroad Commission's energy resource development and environmental protection functions depend on industry-specific expertise that is not duplicated at TCEQ, reducing any efficiencies of transferring these programs.

- **Public Utility Commission of Texas (PUC).** Public utility regulation is currently split between the Railroad Commission and PUC. While the Railroad Commission began as a rate oversight agency, the commission's core mission has evolved with time, with its current primary role regulating oil and gas exploration and production. Meanwhile, PUC has a well-developed ratemaking function, complete with an organizational structure and in-house expertise that supports efficiency. PUC can effectively oversee gas utilities, allowing the Railroad Commission to focus on its primary functions. Issue 2 lays out the benefits of this transfer.
- **State Office of Administrative Hearings (SOAH).** While the Railroad Commission conducts oil and gas, surface coal mining, and gas utility contested case hearings, this function is a small part of the agency's responsibilities. SOAH focuses solely on conducting impartial administrative hearings for nearly 60 agencies. Issue 2 addresses the benefits of transferring contested case hearings to SOAH, with the railroad commissioners still making the final decisions.

Issues regarding the Railroad Commission’s three-member structure are well known to the Sunset Commission and Legislature regardless of additional staff analysis.

The current organizational structure of the agency, with three full-time, elected commissioners, is unlike that of any other agency in Texas. While state law requires the agency to separate the policymaking responsibility of the commissioners from the day-to-day management responsibilities of the agency’s staff, in practice, all three commissioners’ offices must approve many day-to-day decisions.¹ For example, because of the agency’s tight budget, all three commissioners currently approve each employee hire and pay raise. This structure clearly leads to administrative inefficiency. The structure is costly, too. In 2011, Sunset staff estimated that the commissioners and their staff — each commissioner has three to five employees — cost the state about \$1.3 million annually. The current structure also creates the appearance of favoritism because commissioners accept substantial campaign contributions from many of the industries they regulate.

Each commissioner has three to five staff, costing the state at least \$1.3 million annually.

In its 2011 review of the agency, Sunset staff recommended replacing the three elected commissioners with a board of five part-time, governor-appointed members to address the problems noted above. The Sunset Commission instead recommended changing the structure to a single elected commissioner to improve accountability. This recommendation resulted in significant debate throughout the 2011 legislative session and was seen as one of the key reasons for the failure of the agency’s Sunset bill. In its 2013 review, the Sunset Commission left the agency’s structure unchanged and instead recommended limits on campaign contributions to commissioners and a requirement that commissioners resign from office upon becoming a candidate for another elected office. These recommendations also resulted in significant debate during the session and were seen as a major cause of the Sunset bill’s failure for a second time.

Changes in the commission’s structure and campaign limits were seen as a cause of the agency’s Sunset bills’ failure.

The Railroad Commission’s Sunset clause requires an “examination of alternative organizational structures,” which Sunset staff carried out.² The Sunset Commission and the Legislature as a whole remain aware of these alternatives discussed above and can choose to address them during the upcoming legislative session. For this review, Sunset staff focused its attention on recommendations that strengthen the state’s ability to effectively and transparently regulate energy resources.

The Railroad Commission’s name continues to be misleading and thwarts the agency’s efforts to increase transparency.

As noted in the two recent Sunset reviews, the Railroad Commission’s name does not reflect its current duties since the Legislature transferred the agency’s last rail oversight functions to the Texas Department of Transportation more than a decade ago. While oil and gas activity has slowed significantly due to the low price of oil, Texans still need an easily identified regulator of oil and gas. Texans living in suburban and urban areas are increasingly likely to be

The name of an agency for which the public is electing statewide commissioners should not be so clearly misleading.

affected by industry activities due to advances in hydraulic fracturing technology, but they may not know whom to call with questions or complaints. In the case of an emergency, the unclear link between the commission's name and its regulatory duties creates potential risks to public safety. Members of the public also continue to mistakenly call the Railroad Commission with complaints regarding rail noise and safety, which staff have no ability to address but must take time to appropriately forward. Finally, confusion about the agency's name challenges the notion that voters effectively endorse or ratify the policy positions of elected railroad commissioners. Many who support maintaining the current name note that an internet search quickly reveals the functions of the agency, but voters are unlikely to google the agency's name. The name of an agency for which the public is electing statewide commissioners should not be so clearly misleading.

The agency's Sunset clause requires an examination of ways "to increase the public's role in commission decisions that relate to the effect of the growth of resource extraction."³ The agency is clearly making efforts to improve transparency and outreach to the public. The commission has a fully staffed Communications Department for the first time, published its first *Year in Review* report that lists the agency's accomplishments in 2015, and established a social media presence last September. While these are all welcome and much needed efforts, the agency's name itself makes transparency more difficult.

The three most common misconceptions regarding changing the agency's name are addressed below.

The Railroad Commission is not constitutionally created.

- **Changing the agency's name does not require a constitutional amendment.** The constitutional provision mentioning a Railroad Commission is permissive.⁴ The Legislature has the authority to create such an entity or not. Two Texas Supreme Court decisions have established that just because the Constitution mentions an agency does not mean the Constitution creates or requires the agency, and that the Railroad Commission was not constitutionally created.⁵ Further, the fact that the agency is not constitutionally created explains how it can be subject to abolishment under the Sunset Act. If the Legislature changed the agency's name, it would no longer be the Railroad Commission. Candidates would not have to run for the position of railroad commissioner if the Legislature changed the agency's name because state law would clearly match the commissioners' title to the agency's new name.
- **Changing the agency's name should not jeopardize federal delegation of the Railroad Commission's underground injection control program.** The word and actions of the U.S. Environmental Protection Agency (EPA) and separate legal analyses indicate little to no risk to the Railroad Commission's delegated authority over certain injection wells under the Safe Drinking Water Act. Regarding the specific name change of the Railroad Commission, EPA has not provided an official opinion without first assessing potential changes to the program, but it has indicated informally that a simple name change would likely represent a minor

modification to the agreement between the two agencies that would not affect delegation. The separate underground injection control program at TCEQ has required EPA approval for several regulation changes over the years, but the three agency name changes were always treated separately.⁶ In a 2004 rule approving state program changes, EPA specifically addressed the name change from Texas Natural Resource Conservation Commission to TCEQ, noting: “The Agency duties did not change, only the name.”⁷ Finally, separate legal analyses of proposed legislation last session that would have changed the name of the Railroad Commission also concluded that such a change would not constitute a program revision under the Safe Drinking Water Act that would even trigger notification to EPA.⁸

- **Changing the agency’s name will not have a cost.** Phasing in the name change over time will eliminate significant costs as discussed in the Fiscal Implication section. The fiscal note for the 2001 legislation that changed the Texas Natural Resource Conservation Commission to the Texas Commission on Environmental Quality did not have a cost, and more recent legislation attempting to change the Railroad Commission’s name also had no assigned costs.⁹ In addition, the agency is already updating its letterhead and website every two years with the election of a new commissioner.

The name change, by itself, will not affect the current structure of the commission as a three-member, elected body. With a name change, the agency would continue to exist as a statutory entity, subject to the authority of the Legislature, like any other agency. Though some reluctance to change the agency’s historic and time-honored name is understandable, the agency must focus on serving Texans of today.

A name change, by itself, will not affect the current structure of the commission as a three-member elected body.

Recommendation

Change in Statute

1.1 Change the name of the Railroad Commission of Texas to the Texas Energy Resources Commission and continue the agency for 12 years.

This recommendation would continue the agency with a new name to ensure increased transparency for its primary role of regulating energy resource exploration and production in Texas. The term energy resources encompasses the agency’s duties beyond regulating oil and gas to include regulation of coal mining and uranium exploration. Including the word resources in the name should help eliminate any confusion that the agency also regulates electricity. State law would establish that three statewide elected commissioners would oversee the Texas Energy Resources Commission — the same structure as today — so that when Texans go to the polls to elect a new commissioner, the ballot will list candidates for the Texas Energy Resources Commission. The name change would not affect the terms of current commissioners. The agency should phase in the name change by September 1, 2019.

Fiscal Implication

These recommendations would not have a significant fiscal impact to the state. Changing the agency's name would not have a significant cost when phased in over time. The agency can change the name on vehicles as they are replaced, on forms and publications as they run out, and on signs as funding allows. Continuing the agency for 12 years would require the continuing legislative appropriation of \$86.5 million annually — about 73 percent of which comes from fees and surcharges paid by the oil and gas industry — to cover the costs of the agency's operations.

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¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Section 81.01016, Texas Natural Resources Code.

² Section 81.01001(a-1), Texas Natural Resources Code.

³ Ibid.

⁴ Section 30(b), Article XVI, Texas Constitution.

⁵ *Cowell v Ayers*, 220 S.W. 764 (Tex. 1920) and *City of Denison v Municipal Gas Co.* 3 S.W. 2nd 794 (Tex. 1928).

⁶ The Environmental Protection Agency's initial approval of underground injection control in 1982 was implemented by the Texas Water Commission, consolidated into the Texas Natural Resource Conservation Commission in 1993, which was subsequently renamed the Texas Commission on Environmental Quality in 2002.

⁷ Revision to the Texas Underground Injection Control Program Approved Under Section 1422 of the Safe Drinking Water Act and Administered by the Texas Commission on Environmental Quality, 69 Fed. Reg. 8565, 8566 (Feb. 25, 2004) (to be codified at 40 CFR Part 147).

⁸ Memorandum from Michael J. Nasi, Jackson Walker L.L.P. to Railroad Commissioner Ryan Sitton (April 15, 2015) and memorandum from John R. Hays, Jr. and Alicia R. Ringuet, Hays & Owens L.L.P. to Chairman Darby and Members of the House Energy Resources Committee (April 17, 2015), <https://www.texastribune.org/2015/04/20/texas-mulls-railroad-commission-name-change-again/>.

⁹ Fiscal Note for H.B. 2912, 77th Texas Legislature, Regular Session, 2001 and Fiscal Note for H.B. 1106, 84th Texas Legislature, Regular Session, 2015.

ISSUE 2

Contested Hearings and Gas Utility Oversight Are Not Core Commission Functions and Should Be Transferred to Other Agencies to Promote Efficiency, Effectiveness, Transparency, and Fairness.

Background

One of the Sunset Commission's statutory charges is to review the extent of overlapping programs and their potential for consolidation.¹ In addition, statute provides that Sunset's current review of the Railroad Commission of Texas must examine alternative methods for performing the commission's responsibilities that would enable the efficient and effective accomplishment of its functions.² The examination must include an assessment of existing state agencies that would be able to perform the commission's functions.³

This assessment occurs after a spectacular boom and bust cycle in the oil and gas industry that has clearly and appropriately revealed the industry to be the commission's operational priority. In times of intense activity and during the current downturn, the oil and gas industry rightly has first call on the commission's attention and resources because of the industry's preeminent status in the state's economy and its potential threat to the environment. Other functions of the commission related to contested case hearings and gas utility rate regulation stand apart, not just from the agency's primary responsibility for oil and gas, but also from the state's recognized approach of having other agencies perform comparable functions. The following material describes both of these areas in more detail, including their recent experience with the Sunset Commission.

Contested Case Hearings

- **Railroad Commission.** The commission's Hearings Division conducts all of the commission's contested case hearings and has 25 employees, including eight administrative law judges (ALJs) and seven technical examiners. In 2015, the division spent nearly \$1.8 million, and held 1,057 oil and gas, 20 surface coal mining, and 16 gas utility contested case hearings.
- **State Office of Administrative Hearings (SOAH).** The Legislature created SOAH in 1991 to conduct administrative hearings for state agencies, which now total nearly 60, and it may also hear matters from certain local political subdivisions. In fiscal year 2015, SOAH's 58 ALJs conducted 22,248 contested case hearings for 38 agencies and government entities, including major regulatory agencies like the Public Utility Commission (PUC) and the Texas Commission on Environmental Quality (TCEQ), as well as groundwater conservation districts.
- **Previous Sunset reviews.** Based on a Sunset Commission recommendation in 2001, statute required the Railroad Commission to use SOAH for gas utility hearings from 2002 to 2003. The Railroad Commission referred 20 cases to SOAH during that time, of which 14 were consolidated. As a result, SOAH conducted eight proceedings and charged the commission about \$43,000 for its services. Since 2003, statute has authorized SOAH to conduct gas utility hearings, but the Railroad Commission has not contracted with SOAH to do so.⁴ A decade later, Sunset's 2013 review of SOAH found the agency continues to provide a needed and independent venue for contested matters largely involving state agencies and members of the public.

In 2011 and 2013, Sunset staff recommended requiring use of SOAH for contested cases for Railroad Commission enforcement and gas utility matters. The Sunset Commission adopted staff's recommendation in 2011. In 2013, the Sunset Commission adopted an alternate approach to allow the Railroad Commission an opportunity to address concerns about fairness of contested cases and the independence of its in-house judges by developing a policy to prohibit and ensure against any inadvertent ex parte communications. No Sunset bill enacting recommendations relating to the Railroad Commission passed in either 2011 or 2013.

Gas Utility Rate Regulation

- **Railroad Commission.** The commission has a long history in gas utility regulation dating to the 1920s. Today, nearly 19 commission employees directly carry out rate-related regulation of 33 investor-owned natural gas distribution utilities to help ensure fair and equitable gas rates in the monopolistic gas utility industry. An investor-owned utility often serves customers within a city, as well as in the “environs” surrounding a city. The commission has original jurisdiction over investor-owned gas utility rates outside a municipality as well as rates a company can charge for transporting gas to the city limit.⁵ Cities have rate jurisdiction over investor-owned gas utilities within their boundaries, but utilities may appeal city decisions to the commission.⁶ For fiscal years 2011 through 2015, the commission conducted an average of 11 full ratemaking reviews each year. About half of the cases came to the commission under its original jurisdiction, and half came on appeal. The commission regulates 167 transmission and gathering utilities that generally use negotiated rates for those services. The commission also has limited rate jurisdiction over 85 municipally owned natural gas utilities in Texas.⁷

Commission staff collect and analyze various required filings, reports, and records from gas utilities, review and process annual reports submitted by utilities, audit proper computation and application of authorized rates, and verify that rates charged to gas customers are accurate. In addition, staff review certifications from gas pipelines to determine whether the pipeline is private or functions as a gas utility.⁸ Staff handle informal complaints involving negotiated rates between businesses and provide a resource for customers and potential customers to determine if discrimination is occurring with regard to pipeline access or rates being charged. The commission also handles utility-related consumer complaints and inquiries for residential and small commercial consumers. In addition, four commission employees collect and audit the gas utility pipeline tax.

- **Public Utility Commission of Texas.** The Public Utility Commission of Texas (PUC) regulates the state's electric, telecommunications, water, and sewer utilities, and helps resolve consumer complaints. In fiscal year 2015, PUC operated with an average of 189 authorized staff and a budget of \$18.5 million. PUC's rate responsibility covers 4,040 water and sewer utilities, four vertically integrated investor-owned electric utilities, four transmission utilities, six combined transmission and distribution utilities, and 58 local telephone companies.

PUC regulates water and sewer rates and services, certificates of convenience and necessity, and the sale, transfer, or merger of water and sewer utilities. PUC regulates the rates and services of electric and telecommunications companies in Texas as a substitute for competition where it does not exist or lacks robustness. Within the large part of the state that is open to electric competition, PUC oversees rates of transmission and distribution utilities that operate as monopolies in the deregulated market. Outside competitive areas, PUC is fully responsible for the rates of investor-owned electric utilities that generate, transport, and sell electricity to the public. PUC also has varying degrees of regulatory responsibility over local telephone service.

- **Previous Sunset reviews.** In 2011, Sunset staff recommended transferring to PUC the regulation of water and sewer utilities from TCEQ and the regulation of gas utilities from the Railroad Commission. In 2011, the Sunset Commission adopted the recommendation to transfer water and wastewater utility oversight, but not the recommendation to transfer gas utility oversight. The bill containing the water utility transfer did not pass in 2011 but was enacted in 2013, and PUC began regulating water and wastewater utilities in September 2014.

Findings

While the commission has taken positive steps to restructure its in-house hearings function, systemic issues prevent the commission from performing this function at the level of the state’s hearing agency created solely for this purpose.

- **Commission improvements.** For most of its history, the Railroad Commission held hearings within separate departments. In 1987, the commission consolidated hearings as part of the functions of the Office of General Counsel. At that time, the Office of General Counsel included adjudicatory, enforcement, and general counsel functions. That structure created the opportunity for ex parte communication between in-house hearings examiners and agency staff acting as a party to a case. The perception that agency personnel are communicating about a case when other parties are not present can erode the claim that the hearings process and the in-house judge’s decision are independent and fair. After the Sunset Commission raised concerns about this arrangement in 2011, the following year, the commission created a separate Hearings Division to conduct its adjudicatory functions.
- **Ongoing ex parte concerns.** In 2013, the Sunset Commission recommended that the Railroad Commission develop a policy in rule to prohibit and ensure against any inadvertent ex parte communications between railroad commissioners and hearings examiners, and between hearings examiners and technical staff that are parties to a hearing.⁹ While the legislation did not pass, the Sunset Commission’s directive was clear and within the power of the Railroad Commission to accomplish through its existing rulemaking authority. However, the Railroad Commission has not done so. In fact, the commission has not updated its general ex parte communications rule since 1991 and its coal mining related ex parte provisions since 1997.¹⁰

In September 2014, the Hearings Division created its first ever memorandum on ex parte communications. However, it does not explicitly address ex parte communications between railroad commissioners and Hearings Division staff — a significant area of concern identified by the Sunset Commission. Further, the Railroad Commission does not distribute the memorandum to all staff, and could not provide requested documentation to confirm past trainings on ex parte communication.

- **Lack of independence for commission’s in-house judges.** Before the Legislature created SOAH in 1991, many agencies conducted their

Agency personnel communicating about a case without other parties present can erode the claim of independent, fair hearings.

The commission is one of few agencies to use in-house administrative judges, yet cannot demonstrate their effectiveness or efficiency.

administrative law hearings in-house. Today, the Railroad Commission is one of very few agencies to continue this practice. This arrangement fosters the impression that in-house judges may be biased due to their employee status at the agency. The perception exists because of the organizational connection and proximity that easily allow these agency employees to socialize and develop relationships with other agency employees who may be parties to contested cases. The perception also exists because of the essential nature of employment, from the decision to hire, to employee evaluations, to promotions and pay raises. At the commission, the connection between the employee status of hearings officers and railroad commissioners is quite direct — railroad commissioners are currently approving each hiring decision and staff pay raise because of the agency's tight budget. The commission's practice differs from that of many other state commissions and boards who delegate such day-to-day operational decisions to their executive director.

As elected officials, railroad commissioners receive campaign contributions from the industry that they regulate, raising inevitable concerns about the potential influence on decision making. In January 2007, the Comptroller of Public Accounts, who also receives campaign contributions from affected industries, transferred tax hearings to SOAH in response to questions about the independence and impartiality of judges who worked for the state's chief tax collection officer. The Legislature formalized that transfer to ensure individual taxpayers who disagree with the comptroller's office on tax collection matters have access to a fair and impartial hearing.¹¹ All other agencies overseen by statewide elected officials that have contested hearings use SOAH to conduct essentially all of their contested case hearings.¹²

The commission's Hearings Division does not have a case management system to provide a picture of its performance.

Unlike having ALJs at an agency, where they are both paid and housed by that agency, SOAH judges are members of a distinct, neutral hearings organization. Statute requires SOAH's chief administrative law judge to protect and ensure the decisional independence of each ALJ.¹³ SOAH's chief ALJ hires all judges based on relevant experience and other requirements.¹⁴ In addition, state law establishes that an ALJ employed by SOAH is not responsible to or subject to the influence of any employee of another state agency who performs investigative, prosecutorial, or advisory functions for the other agency.¹⁵

- **Lack of performance measures.** A state agency that conducts its own administrative hearings has a special responsibility to stakeholders and the public to prove that its alternate model is at least as effective and efficient as SOAH's. Despite conducting nearly 1,100 contested case hearings in fiscal year 2015, the commission could not provide documentation to show that it conducts hearings effectively or efficiently. The Hearings Division does not have a case management system, and until 2015, the division did not even track the types of cases it received. Currently, staff records a running tally of cases and docket types in Excel. Staff also has no routine access to historical case information to analyze trends in the Hearings Division's performance. The commission simply does not track processes, milestones, and staff time spent on hearings necessary to provide

a meaningful picture of its performance, as detailed in the textbox, *Baseline Hearings Performance Not Tracked by the Commission*. For example, the Administrative Procedure Act sets a key best practice for measuring timely decisions by ALJs, specified as within 60 days of concluding a contested case hearing.¹⁶ However, the commission does not track timelines of its judges' decisions for oil and gas enforcement cases and thus cannot be sure it is meeting standards for timely action and avoiding delays. In addition, the commission does not track whether judges are issuing a final decision in oil and gas permitting contested cases within 60 days, as required by the General Appropriations Act.¹⁷

On the other hand, SOAH has a long history of tracking and meeting its performance measures, including number of cases received and disposed each year, hearings held, cases dismissed, number of proposals for decision and final orders issued, whether those decisions are issued timely, number of days to conduct a contested matter, and total hours spent on cases.

- **Inadequate systems to support hearings.** Information technology improvements for the Hearings Division have trouble competing for needed improvements with the commission's core functions more directly associated with oil and gas. The commission appropriately focuses its limited funding on information technology projects in high-volume areas like permitting where the stronger business case supports an investment that will benefit a large numbers of users. Given the comparatively low volume of contested case hearings, the needs of the Hearings Division have not been organizational priorities in the commission's legislative appropriations request process — nor should they be in light of the commission's significant competing demands and the fact that such support systems already exist at SOAH.

SOAH's case management system is robust enough to handle cases for roughly 60 agencies and can accommodate commission hearings without additional programming, which would benefit taxpayers by avoiding the cost of funding a duplicative case management system at the Railroad Commission. SOAH's system provides a wealth of information about all stages of a case, including proposals for decision and filings associated with each case, and the public can easily access this information through SOAH's website. As a benefit to policymakers, SOAH is also able to provide a complete archive about cases from more than a decade ago, while the commission's Hearings Division struggles to explain what its caseload was last fiscal year.

Baseline Hearings Performance Not Tracked by the Commission

- Time for Hearings Division to complete a contested case
- Time ALJs and technical examiners spent on specific cases
- Total cases received, disposed, and dismissed
- Time from hearing to issuance of a proposal for decision or final order
- Number of proposals for decision or final orders issued
- Number of oil and gas proposals for decision issued within 60 days of a hearing
- Number of final oil and gas permitting orders issued within 60 days of a hearing
- Number of cases commissioners remanded to the Hearings Division

While SOAH can provide detailed information on cases past and present, the commission struggles to explain last year's caseload.

- **Commission final orders lack transparency.** As the final administrative decision maker, an agency's commission or board can accept, modify, or vacate a proposal for decision issued by an administrative law judge. For cases heard by SOAH, an agency's changes to a proposal for decision must be placed in writing in the agency's final order.¹⁸ Any such change must indicate whether the ALJ failed to properly apply or interpret applicable law, rules, policies, or prior administrative decisions; that a prior administrative decision on which the ALJ relied is incorrect or should be changed; or that a technical error in a finding of fact should be changed.¹⁹

The commission gives no written explanation for its changes to a judge's proposed decision, reducing the clarity of the agency's record on appeal.

In comparison, the Railroad Commission provides no written explanation why its final order differs from the proposal for decision issued by the commission's in-house ALJ. Railroad Commission final orders simply insert substitute findings of fact or conclusions of law or note when the commission declines to adopt a recommendation. Requiring a written explanation places an appropriate and higher burden on an agency's board or commission to explain its reasoning since its members did not hear all the testimony, evidence, and cross-examination directly that the administrative law judge did. The practice of providing a written explanation also provides clarity to parties in a case and for purposes of judicial review, since the court's review is generally confined to the agency record, except for evidence of procedural irregularities.²⁰ This practice discourages an agency's commission or board from arbitrarily or capriciously changing a finding of fact or conclusion of law.

- **Commission use of technical examiners to co-preside over cases is unusual.** By standard administrative practice, an ALJ presides over the hearing and witness testimony, including testimony of agency technical experts, who are subject to cross-examination by all parties. For gas utility and oil and gas cases, the commission takes a different approach, employing technical examiners who are not lawyers to co-preside at contested hearings with the ALJ. After a hearing, the examiner prepares a technical analysis, helps to write the proposal for decision and interpret the record, and can discuss the facts of the case with the ALJ. While the commission cites the highly technical nature of its cases as a reason for this approach, this practice undermines the transparency of the administrative proceeding, which typically incorporates technical expertise and evidence through witness testimony provided on the record for the case. The development of the record is a crucial aspect of a case on appeal, because it largely provides the basis for the court's review under the substantial evidence standard. Also, ALJs at SOAH and district judges presiding over appeals routinely hear complex matters without using technical examiners in this way. The Railroad Commission uses the standard approach for hearing its small number of contested surface coal mining cases.
- **SOAH judges have experience to conduct the commission's contested cases.** SOAH's judges have considerable experience in administrative law including the areas of utilities and natural resources. As of February 2016, SOAH's 58 ALJs had nearly 12 years average experience conducting

Typically, technical expertise is provided by witnesses at a hearing, not separate examiners co-presiding over cases.

administrative hearings at the agency. At that time, the Railroad Commission had seven ALJs with almost seven years average experience hearing cases for the commission, as well as one vacant ALJ position, since filled. Three commission ALJs have worked at the agency for less than two years. The table, *Number and Average Tenure of Administrative Law Judges*, compares the experience of judges working at the two agencies.

Number and Average Tenure of Administrative Law Judges

	SOAH	Railroad Commission
Total ALJs	58 (11.7 years)	8 (6.7 years)
All utility ALJs	18 (8.6 years)	2 (3 years)
All SOAH natural resources ALJs	22 (9.5 years)	—
Commission oil and gas and mining ALJs	—	6 (8.1 years)

SOAH assigns its ALJs to teams, including the utilities and natural resources teams, which allows judges to have a specialized focus. The utilities team specializes in hearing utility cases referred by PUC, and the natural resources team specializes in hearing cases referred by TCEQ and groundwater conservation districts. In addition, both PUC and TCEQ refer enforcement cases to SOAH, so its ALJs are familiar with similar technical issues arising in enforcement hearings.

Although Railroad Commission ratemaking functions are working, transferring these duties to the Public Utility Commission offers potential benefits from aligning all state utility regulation within one agency.

- **No clear benefit from maintaining separate utility regulation.** Texas is unique among the states in separating state-level oversight of gas and electric utilities between two agencies. Nearly all states have only one agency that regulates electric, telecommunications, natural gas, and water utilities. Gas utility regulation has worked over its long history at the Railroad Commission, but interconnections between rate regulation and other programs within the commission may not bring significant benefits.

One such benefit claimed is that keeping gas utility rate regulation with the regulation of pipeline safety at the Railroad Commission better protects the public because pipeline safety staff can help inform utility staff about a utility's degrading and dangerous pipelines and the utility's revenue needs to fix the problem. While such communication may well occur to help utility staff understand the needs of pipeline safety, a careful balance must be struck. Similar to the situation of ALJs needing to maintain objectivity by making decisions from the record developed in a contested case, so too, must utility staff not be predisposed to the interests of the regulated

Nearly all states use a single agency to oversee utilities.

industry. Any needs, such as upgraded infrastructure to promote pipeline safety, would have to be developed on the record in a rate case and be carefully considered to avoid “gold-plating” beyond the legitimate needs of public safety. To this end, pipeline safety personnel have participated in a gas utility ratemaking proceeding only once in the last six years.

In addition, gas utilities have clear statutory authority to seek interim rate adjustments to improve pipeline safety whether the Railroad Commission or PUC is providing utility oversight.²¹ These interim rate adjustments are largely pro forma functions that a utility can use for a five-year period to make pipeline safety improvements before being reviewed as part of that utility’s full statement of intent ratemaking proceeding.

Finally, the Railroad Commission has limited visibility about the overall safety of many pipelines due to an ongoing shortage of pipeline inspectors. Specifically, the commission is not meeting its federal requirement to review all pipeline operator integrity management plans — plans to mitigate current and future pipeline safety risks — and has developed a significant backlog. Even if interrelated functions are separated between the Railroad Commission and PUC, the two agencies can still communicate and share information on these issues as needed. The agencies could look to other models on coordinating issues between pipeline safety and ratemaking. The federal government separates these two functions, with the Federal Energy Regulatory Commission regulating interstate gas rates and the U.S. Department of Transportation regulating pipeline safety. In addition, PUC has worked out arrangements with TCEQ to ensure water quality and public safety protection in water utility regulation.

PUC works with TCEQ to ensure public safety protection in water utility regulation.

- **Opportunities for improved utility regulation.** The following material lays out potential benefits of consolidating gas utility rate regulation at PUC that have only gotten stronger with the 2014 consolidation of water utility regulation.

Focus on utility ratemaking. The Legislature established PUC in 1975 to regulate utilities, and PUC still carries out ratemaking functions as one of its primary focuses. Even after the Legislature restructured the telecommunications and electric markets in most of Texas to encourage competition, PUC continues to have major rate-related regulatory functions, particularly in the electric industry, but also with local telephone service. In 2013, the Legislature further consolidated utility ratemaking expertise at PUC by transferring responsibility for water and wastewater utility regulation from TCEQ, leaving gas utility regulation as an outlier in an otherwise integrated approach to utility ratemaking.

Organizational structure for fair ratemaking. PUC’s organizational structure has evolved in large part to promote fairness in decision making and ensure that all parties have an equal, and therefore fair, opportunity to hear and persuade decision makers. PUC’s separation of staff with party status and staff involved in decision making into physically distinct offices significantly reduces the possibility of inadvertent, improper communication between

them. SOAH's involvement as a separate agency that conducts contested hearings apart from PUC further insulates the decision-making process from improper influence. Finally, PUC actively trains its entire staff on their proper role and the lines of communication they should not cross.

Development of expert staff. PUC's larger ratemaking staff and more defined approach to ratemaking allows it to separate staff involved in different phases of the rate case in a way that is not possible at the Railroad Commission. PUC has about 34 staff directly involved in ratemaking, whereas the Railroad Commission has about 10 staff performing these and other functions.

PUC ratemaking staff has expertise in economic regulation and is large enough to specialize in specific areas of responsibility. Staff consists of Certified Public Accountants, financial analysts, and economists who evaluate a utility's cost of service and other revenue requirements, and translate that amount into a reasonable rate of return and a schedule of rates to be charged to different customer classes. PUC infrastructure and reliability staff, often engineers, help evaluate facilities-related questions, such as depreciation, for use in determining a utility's revenue needs. In addition, personnel advising utility commissioners have no connection with other PUC offices on ratemaking matters, developing their own separate expertise.

The Railroad Commission's technical staff must multi-task in performing several ratemaking functions such as financial analysis, calculation of fair rates of return, calculation of plant depreciation, and complaints. At PUC, these functions tend to be exercised by staff specialized in each area. Consolidating duties, especially of this specialized nature, would provide a greater opportunity to develop and maintain focused expertise that is essential in ratemaking.

Attention to consumer complaints. Consolidation of utility ratemaking functions at PUC would provide the public with a single agency focused on addressing its concerns and complaints about utilities. PUC has a separate Customer Protection Division of about 21 employees to manage complaints, including those involving rates, for the entire agency, helping to ensure agencywide consistency and focus on customer protection issues. Receiving complaints at its call center and from other sources, these employees respond to all complaints, including rate-related matters; investigate jurisdictional complaints; and provide information to address inquiries.

At the Railroad Commission, tariff and statistical analysts must also dedicate their time to resolving residential and small commercial complaints, and the commission's utility rates and services staff must multi-task to resolve informal complaints between businesses.

- **Extensive and accessible online records.** PUC makes all filings in docketed cases, as well as other information, available to the public online through its Interchange system. This resource is significant, given the immense

PUC's larger ratemaking staff offers additional and focused ratemaking expertise.

The public could turn to one agency to address all concerns and complaints about utilities.

volume of records developed through PUC's various proceedings. The online document management system allows for electronic submission of annual reports and tariffs and contributes to the transparency of PUC operations.

Recommendations

Change in Statute

2.1 Require use of the State Office of Administrative Hearings for contested gas utility cases.

This recommendation would change the option in law to have contested gas utility cases heard at SOAH to a requirement for all cases filed on or after September 1, 2017. This recommendation would apply regardless whether gas utility regulation is ultimately transferred to PUC, and would apply to cases held under original and appellate jurisdiction. As with other agencies using SOAH, the responsible agency would maintain final authority to accept, reverse, or modify a proposal for decision made by a SOAH judge. This recommendation would remove the requirement in law that SOAH charge a fixed annual rate for conducting hearings since the hearings would be funded through general revenue as described in the Fiscal Implication section. As a management action, SOAH should give consideration to hiring existing Railroad Commission Hearings Division staff to the extent that additional employees are needed to handle this contested case workload. The agencies should work together to ensure a smooth transition and disposition of cases still in process at the commission after September 1, 2017.

2.2 Require the Railroad Commission to use the State Office of Administrative Hearings for all other contested case hearings.

Under this recommendation, the commission would be required to use SOAH for all cases filed on or after September 1, 2017, that result in a contested matter. In conducting hearings, SOAH would consider the commission's applicable substantive rules and policies. Like other agencies that have hearings conducted at SOAH, the commission would maintain final authority to accept, reverse, or modify a proposal for decision made by a SOAH judge. The commission may reverse or modify a decision only if the judge did not properly apply or interpret applicable law, commission rules, written policies, or prior administrative decisions; the judge relied on a prior administrative decision that is incorrect or should be changed; or the commission finds a technical error in a finding of fact that should be changed. The commission would be required to state in writing the specific reason and legal basis for a change. As with other cases heard at SOAH, if a party to a contested case has defaulted under SOAH's rules, the administrative law judge may dismiss the case from SOAH's docket and remand it to the commission for informal disposition. After the case is dismissed and remanded, the commission may informally dispose of the case by applying its own rules or SOAH's procedural rules relating to default proceedings. As a management action, SOAH should give consideration to hiring existing Railroad Commission Hearings Division staff to the extent that additional employees are needed to handle this contested case workload. The agencies should work together to ensure a smooth transition and disposition of cases still in process at the commission after September 1, 2017.

2.3 Transfer gas utility regulation from the Railroad Commission to the Public Utility Commission.

This recommendation would transfer the responsibility that resides at the Railroad Commission for gas utilities to PUC. Under the recommendation, PUC would administer these regulations under the same original and appellate jurisdiction over rates as currently exists at the Railroad Commission. The transfer would include the Railroad Commission's existing efforts regarding utility rates and services, consumer complaints, reports, non-utility status determinations, and audits relating to tariffs and annual reports, but would not include the gas utility pipeline tax collection function that would remain at the commission. Generally, the same regulatory approaches that exist now in gas utilities statutes would continue to apply at PUC, including provisions for interim rate adjustments, cost-of-service adjustments, and relocation cost-recovery surcharges.

The recommendation would provide for the transfer to be completed by September 1, 2018, and for planning and coordination to occur between the Railroad Commission and PUC to implement the transfer. The transfer would include all necessary powers, duties, functions, programs, activities, and rights of action relating to gas utility regulation; and any related obligations, funds, negotiations, memoranda of understanding, leases, rights, and contracts. The transfer would include all personnel, furniture, computers, equipment, other property, records, related materials, and office space in the William B. Travis State Office Building. The agencies would establish a transition team with high-level employees of both agencies to develop plans regarding the required transfer to PUC as described above for gas utility functions and for the sharing of records and information. The team would develop ways to coordinate on areas of interrelated responsibilities, such as the impact of the Railroad Commission's pipeline safety requirements on the rates of gas utilities. The recommendation would also require the agencies to develop memoranda of understanding to implement specific elements of the transfer and the plans developed by the transition team. Statute would require the memoranda to be completed by August 1, 2018.

This recommendation would require PUC to make a comparative analysis of its own authority and any new ratemaking or other authority transferred to PUC. PUC would report to the Legislature any recommendations about opportunities to standardize these ratemaking requirements in time for consideration in the 2019 legislative session. PUC should submit the report to the Legislative Budget Board and the governor's budget office at the same time PUC submits its Legislative Appropriations Request for the 2020–2021 biennium. The report should detail any staffing changes, including reductions that the agency recommends related to savings from consolidated functions. This portion of the recommendation gives PUC the opportunity to gain first-hand knowledge about the programs transferred and the staffing required to meet program needs.

Fiscal Implication

The recommendations to require use of SOAH for contested cases would require the transfer of about \$1.3 million in general revenue and 12 FTE positions from the Railroad Commission to SOAH. The recommendation to realign gas utility regulation would require the transfer of about \$2 million and about 30 FTE positions from the Railroad Commission to PUC.

State Office of Administrative Hearings

The recommendations to require the use of SOAH to conduct all contested case hearings for the Railroad Commission would increase SOAH's budget and staff by about \$1.3 million in general revenue

and 12 FTEs each year, including eight administrative law judges and four administrative staff, with corresponding reductions from the Railroad Commission's Hearings Division.

The commission's Hearings Division budget is \$1,818,177 and 25 FTEs annually. Five oil and gas technical examiners and \$370,677 in associated funding would remain at the commission and not be transferred to SOAH. The commission could use these staff to participate in contested case hearings held at SOAH. Two full-time equivalent technical examiner employees that work on gas utility cases in the Hearings Division and \$145,741 in associated funding would transfer to PUC, as discussed below. The Hearing Division's remaining annual budget of \$1,301,759 would transfer to SOAH. Since SOAH only needs 12 FTEs, the commission's FTE cap would be reduced by six additional FTEs. The savings from these positions would be directed to SOAH, because salaries for administrative law judges at SOAH are higher than salaries of judges at the commission, and additional office space would be needed.

An annual amount of about \$1.3 million would largely cover SOAH's costs for all contested hearings currently held at the commission, including gas utility hearings, and the two agencies would not need to enter into an interagency contract. This amount is an estimate given the Railroad Commission's difficulty providing accurate information about its Hearings Division's staff activities. This separation of funding would be simpler for SOAH's finance staff to administer, and would remove any perception that SOAH is not neutral and independent because of the manner in which the hearings are funded.

Contingent on transfer of gas utility oversight to PUC, a portion SOAH's \$1.3 million in costs would be allocated to pay for gas utility hearings referred by PUC. Those agencies would also not be required to enter into a contract, as this funding would be appropriated directly to SOAH.

Public Utility Commission

Currently, the Railroad Commission reports 34.4 FTEs, including 22.6 direct and 11.8 indirect staff, and \$2,285,691 in total annual funding allocated to ensure fair rates and compliance with gas utility regulation. The recommendation to move gas utility regulation from the Railroad Commission to PUC would require the transfer of total funding of \$2,029,196 and 30.4 FTEs annually, which excludes four FTEs and \$256,495 used for collection of the gas utility pipeline tax. All direct funding comes from general revenue, except \$57,000 in appropriated receipts. As discussed above, two technical examiner employees and associated funding would also transfer to PUC. The funding and FTEs for the two examiner positions are already included as indirect costs in the total FTEs and funding described above.

The recommendation requiring PUC to conduct a comparative analysis of ratemaking provisions and to analyze staffing requirements of any transferred functions could be performed with current resources. PUC may be able to achieve a cost savings by consolidating the Railroad Commission's complaints function within its existing Customer Protection Division, but a savings could not be estimated at this time.

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- ¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Section 325.011(6), Texas Government Code.
 - ² Section 81.01001, Texas Natural Resources Code.
 - ³ Ibid.
 - ⁴ Section 102.006, Texas Utilities Code. The Legislature first made the Railroad Commission's use of the State Office of Administrative Hearings (SOAH) mandatory in 2001, but changed the provision to be permissive in 2003.
 - ⁵ Sections 102.001 and 104.003, Texas Utilities Code.
 - ⁶ Section 102.001, Texas Utilities Code.
 - ⁷ Sections 102.002 and 103.053, Texas Utilities Code.
 - ⁸ Section 121.005, Texas Utilities Code.
 - ⁹ Sunset Advisory Commission, *Railroad Commission of Texas, Final Report with Legislative Action*, accessed March 23, 2016, https://www.sunset.texas.gov/public/uploads/files/reports/Railroad%20Commission%20Staff%20Report%202013%2083rd%20Leg_0.pdf.
 - ¹⁰ 16 T.A.C. Section 1.6 and 16 T.A.C. Section 12.222.
 - ¹¹ S.B. 242, 80th Texas Legislature, Regular Session, 2007.
 - ¹² SOAH conducts all contested hearings for the Office of Attorney General, the Comptroller of Public Accounts, and the Texas General Land Office. For the Texas Department of Agriculture, SOAH conducts some but not all enforcement hearings relating to the Child and Adult Care Food Program. SOAH conducts all other enforcement proceedings relating to agriculture-related businesses, weights and measures, general disease and pest control; and disputes concerning organic certification and grain warehouses.
 - ¹³ Section 2003.022(d), Texas Government Code.
 - ¹⁴ Section 2003.041, Texas Government Code.
 - ¹⁵ Section 2003.041(c), Texas Government Code.
 - ¹⁶ Section 2001.143, Texas Government Code.
 - ¹⁷ Rider 10, page VI-52, Article VI (H.B. 1), Acts of the 84th Legislature, Regular Session, 2015 (the General Appropriations Act).
 - ¹⁸ Section 2001.058, Texas Government Code.
 - ¹⁹ Section 2001.058, Texas Government Code.
 - ²⁰ Section 2001.175, Texas Government Code.
 - ²¹ Section 104.301, Texas Utilities Code.

ISSUE 3

Oil and Gas Monitoring and Enforcement Need Improvements to Effectively Ensure Public Safety and Environmental Protection.

Background

The Railroad Commission of Texas permits and monitors oil and natural gas exploration and production. In fiscal year 2015, the Railroad Commission employed 151 oil and gas field inspectors who oversee drilling, hydraulic fracturing, production, and well plugging activities, as well as activities associated with the disposal and cleanup of waste generated by oil and gas exploration and production.

In fiscal year 2015, inspectors cited 61,189 violations during 134,484 inspections. When inspectors uncover violations of state law or commission rule, they document the violation and notify the operator. Violations can range from inspectors being denied access to a site to conduct their inspection to oil spills and groundwater contamination. The flowchart on the following page, *Typical Oil and Gas Inspection and Enforcement Process*, illustrates the typical process from initial inspection to the Railroad Commission's final order. As the flowchart indicates, the process emphasizes corrective action, giving operators with violations several opportunities to come into compliance and avoid further action. These opportunities to correct the violation without legal enforcement action end when the Enforcement Section in Austin mails a notice of enforcement to the operator with a proposed penalty amount. To take enforcement action against violators of law or rule, statute provides a variety of sanction options, including assessing administrative penalties and suspending oil and natural gas production. In fiscal year 2015, the Railroad Commission assessed 1,878 administrative penalties against oil and natural gas operators and ordered suspension of oil and natural gas production on 7,936 leases.

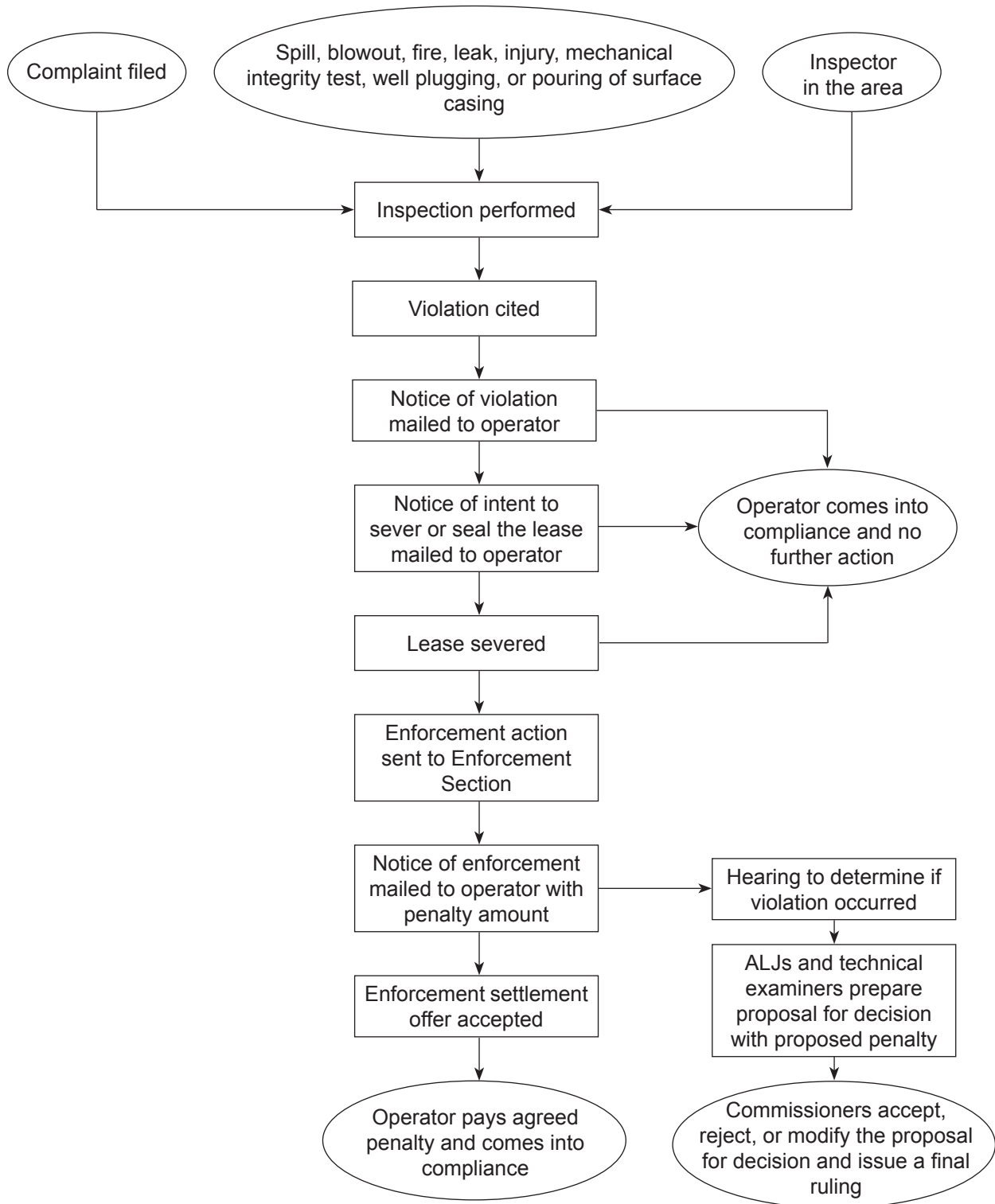
Findings

Increased emphasis on the Railroad Commission's oil and natural gas regulation places even more importance on the need for demonstrable results.

With oil and natural gas production's prevalence in the fabric of Texas' economy, the state's role of ensuring public safety and environmental protection remains essential. Enforcing regulations dictated by statute and rule designed to achieve these goals not only ensures that oil and natural gas activities can continue safely and efficiently in the state, but also bolsters the public's confidence as advancing technology facilitates expansion into new areas across the state and introduces new concerns about oil spills, blowouts, freshwater contamination, and safety. The passage of House Bill 40 in 2015 further highlights the Railroad Commission's critical role in regulating Texas' expansive oil and natural gas activity. As asserted in the bill, existing Texas laws "provide effective and environmentally sound regulation of oil and gas operations," and directs that this regulation is the role of the state and not municipalities.¹ Such forceful backing by the Legislature magnifies the importance on the Railroad Commission to demonstrate its readiness to effectively regulate and to clearly show through its data how well it is doing to meet the expectations placed on it.

Recent legislation magnifies the commission's critical role in regulating Texas' expansive oil and natural gas activity.

Typical Oil and Gas Inspection and Enforcement Process



While the enforcement tools set in statute are designed to ensure sound regulation, the Railroad Commission's effective use of those tools has been called into question repeatedly in the past. In its 2011 and 2013 reviews of the agency, the Sunset Advisory Commission adopted recommendations in response to the Railroad Commission's limited enforcement action against violators and failure to track information related to the severity of violations, enforcement actions taken against violators, and repeat violations. Although the Railroad Commission has taken steps to improve its monitoring and enforcement program, the overall themes related to a lack of strategic approach to enforcement and inability to provide basic performance information persist.

Strategic use of existing monitoring and enforcement tools is critical to the Railroad Commission's effectiveness going forward. While the Railroad Commission struggles to keep pace with fluctuations in the industry and suffers from a loss of fee revenue due to the recent decline in new drilling activity, the number of wells in need of regulation remains high and the risk these wells pose has not declined.

The Railroad Commission cannot demonstrate the effectiveness of its oil and natural gas enforcement program.

- **The Railroad Commission struggles to report reliable data.** Since at least 2010, the Railroad Commission has reported to the public on its website, the Legislative Budget Board, and multiple Sunset staff review teams a number of oil and gas enforcement violations. Railroad Commission staff now indicates this number is incorrect. The unreliability of this data point — how many oil and gas violations occurred in Texas last year — only came to light during the last week of a seven-month review despite considerable effort to obtain this number. The difficulty accurately providing basic data after so much time and attention has been focused on the agency's enforcement perpetuates concerns about the commission's overall data capability and accuracy.

In the fall of 2015, the Railroad Commission launched a new inspection database designed to track more detailed information about inspections and violations. However, the extent to which the new system will capture necessary data and address concerns identified in this report is not yet clear.

No accurate count of total oil and gas violations in Texas. The reported number of oil and gas violations last fiscal year, 61,189, includes not only the first time the specific violation was cited but also counts each time the field inspector returned to the site to check on the compliance status of the specific violation. The Railroad Commission now reports these 61,189 reported oil and gas violations originate from 15,056 unique violations. In other words, field inspectors cited 15,056 oil and gas violations and then checked up on those violations 46,133 times.

Both the reported number, 61,189 violations, and the number of unique violations 15,056, exclude approximately 25,000 additional oil and

The commission's lack of a strategic approach to enforcement and inability to provide basic performance information persists.

The commission has been over-reporting the number of oil and gas violations by a factor of four.

gas violations cited by Oil and Gas Division technical permitting and administrative compliance staff located in Austin. The Railroad Commission does not, and seemingly cannot, report the complete number of oil and gas violations cited by Railroad Commission staff last year.

No accurate count of major violations. The Railroad Commission does not track how many major violations occur. While the Railroad Commission tracks the number of violations by rule, violations of a single rule may vary from a small oil spill next to a tank battery to failure to report a large spill that contaminates freshwater. The Railroad Commission tracks the number of major violations referred to the Enforcement Section, but does not track the total number of major violations cited by field inspectors. In fiscal year 2015, inspectors referred 842 major violations to the Enforcement Section, but more than 37,000 citations could have potentially qualified as major violations under the Railroad Commission's definition. Without a sound process for distinguishing between minor and major violations and tracking the number of major violations cited, the Railroad Commission cannot guarantee that major violations are being appropriately addressed.

No accurate measure of violations referred for legal enforcement action. Without an accurate count of total oil and gas violations or an accurate count of major violations, the Railroad Commission cannot determine what percentage of oil and gas violations were referred to the agency's Enforcement Section for potential sanctions.

This lack of data is concerning because certain violations pose such a threat to public safety or the environment that requiring operators to come into compliance alone is not enough. While the Railroad Commission places a strong emphasis on bringing operators into compliance with regulations, this emphasis does not always incentivize operators to comply with regulations in the first place because operators have a reasonable expectation they will likely not be penalized. Obviously, taking corrective action to come into compliance is a good thing. However, when this approach is seen to define an agency's enforcement process, it can have the unintended effect that operators will simply wait to be told to comply with regulations. The limited reach of the commission's field staff only makes this situation worse.

In the 2011 Sunset review, staff found that the commission referred just 4 percent of total violations for legal enforcement.² As discussed previously, this conclusion was based on inaccurate data provided by the Railroad Commission that included re-inspections of violations. However, when Sunset staff requested the same data for fiscal year 2015 to see how the percent of violations referred to enforcement had changed since the last review, a direct comparison indicates that violations referred for legal enforcement action decreased from 4 percent in 2010 to 2 percent in 2015. Since the total number of violations included re-inspections in both years, the year-to-year comparison remains valid.

Operators have a reasonable expectation they will not be penalized.

- **Violations not referred for enforcement action may not have been resolved.** The Railroad Commission does not track violations systematically and therefore cannot guarantee that the vast majority of violations that were not referred to legal enforcement actually came into compliance. To provide information regarding the resolution of these nearly 60,000 violations, the Railroad Commission indicated it would have to hand count each inspection report. Successful resolution of violations would be a key performance indicator, if tracked.
- **Failure to accurately track repeat violations.** As highlighted in previous Sunset reviews of the Railroad Commission, if operators are able to repeatedly commit the same offense and avoid a penalty by coming into compliance, the threat of a penalty loses its deterrent effect. Field staff record all violations, but the Railroad Commission does not specifically track repeat violations unless the violation is one of the small percentage brought forward to legal enforcement. As a result, the Railroad Commission cannot be certain that operators are not committing repeated violations, only to come into compliance before the Railroad Commission assesses an administrative penalty.
- **Current enforcement policies do not effectively deter pollution violations.** A closer examination of violations of pollution prevention rules indicates that the Railroad Commission's enforcement actions failed to deter operators from repeatedly violating regulations that could result in groundwater contamination.³ Because the Railroad Commission does not track major violations, Sunset staff reviewed violations of pollution prevention rules across operators, accounting for the variable sizes of operators. Over the past five fiscal years, 114 operators were repeatedly among the top 100 pollution rule violators in the state.⁴ These 114 operators accounted for 3 percent of the wells in Texas but 22 percent of the pollution rule violations from 2011 to 2015.

Successful resolution of violations would be a key performance indicator, if tracked.

The Railroad Commission does not use its existing enforcement tools strategically.

- **The Railroad Commission's main enforcement tool, lease severances, may be an empty threat for operators.** The Railroad Commission's most used tool for bringing operators into compliance is to sever a lease, in theory no longer allowing oil or gas from a lease to be transported or sold. This tool would be an excellent way to incentivize compliance, as operators lose revenue each day the lease is severed, but many operators violate the lease severance order. In fiscal year 2015 the Railroad Commission severed 7,936 leases and caught at least 1,552 leases that continued to produce oil or gas under the severance. The Railroad Commission's system automatically catches operators producing on a severed lease when the operators turn in production reports indicating how much oil or gas the operator produced on the lease if the amount is more than zero. Accurate production reports are necessary to ensure operators do not waste resources

In fiscal year 2015, the commission severed 7,936 leases and caught at least 1,552 leases that continued to produce oil and gas.

through overproduction, to protect the correlative rights of all operators, and to determine proper well classification for tax breaks administered by the Comptroller of Public Accounts.

Cross checking production and transportation reports could highlight lease severance violations.

Virtually no cross checks to ensure compliance with lease severance. The Railroad Commission does not have the resources to inspect every lease under severance to ensure the operator ceases production as required, although Railroad Commission guidance encourages field inspectors to do so. Instead, other reporting requirements are widely thought to provide the opportunity to see activity on a lease in violation of a severance order. The Railroad Commission's system only catches operators producing on a severed lease if the operators effectively turn themselves in, as described above. The Railroad Commission receives more than 248,000 production reports every month from operators reporting the amount of oil and gas produced from each lease. At the same time, operators who transport oil from leases report the oil they collected, and from where, to the Railroad Commission. Cross checking these reports with information about operators with severed leases could highlight lease severance violations, but this activity does not routinely occur.

Two-thirds of leases have gone more than two years without an inspection.

Too much staff time spent reviewing paper copies of documents. Railroad Commission staff spend a significant amount of time verifying paper filings of production and transportation reports that could be better spent cross checking for violations of severances. While the agency estimates that 96 percent of production reports are filed electronically, operators submit the remaining 4 percent by mail, requiring the agency to contract to have these reports scanned each month. The Production Audit team, with seven staff, spends a significant amount of its time reviewing these 4 percent of production reports each month for basic accuracy. For online filings of these large files, the system will automatically run most of these basic accuracy checks. The Railroad Commission could prioritize staff time to conduct cross checks for severance violations by phasing in a requirement that all operators file electronically.

- **The Railroad Commission does not make strategic use of oil and gas field inspectors' valuable time.**

Inspection priority system does not consider basic risk factors. Currently, the 151 oil and gas inspectors prioritize their time by first overseeing activities designated high risk and then inspecting operators nearby. While maximizing time in the field over time on the road is important, the Railroad Commission does not include other factors when prioritizing inspections, including basic considerations such as operators' compliance history, how long a well or lease has gone without an inspection, if a lease is severed, or if an operation is near homes. Not considering these factors may result in repeatedly overlooked violations, as two-thirds of leases have gone more than two years without an inspection, and leases can include thousands of wells.

Citations have minimal impact. Based on the latest data provided by the Railroad Commission showing 15,056 unique violations in the field and the 46,133 continuing violations documented during re-inspections, the inevitable conclusion is that field inspectors expend considerable time and effort for little benefit. After issuing the initial citation, inspectors follow up on each violation an average of three more times to bring the violation into compliance. Such a cumbersome follow-up process comes at the expense of additional inspections and broader field work.

Time spent citing minor violations with little deterrent effect. With a limited number of inspectors, operators face very little chance of a penalty for minor violations that remain essential for public safety and environmental protection. For example, each year inspectors cite more than 14,000 instances where operators did not have signs properly posted — signs indicating to the public, first responders, local government agencies, and the Railroad Commission the name of the operator and therefore whom to contact in case of an emergency or complaint. If the Railroad Commission incentivized compliance with this and other minor violations in the first place, inspectors could spend more of their limited time on additional well sites or overseeing high-risk activities.

The Texas Commission on Environmental Quality addressed a similar issue by developing a Field Citation program, which is intended to promote a quick resolution for specific, clear-cut violations documented during an investigation. In place since 2006, the program offers violators a reduced penalty and 45 days to come into compliance, as explained through brochures and sample citations on their website.⁵

Inspectors have to follow up on each violation an average of three more times to ensure compliance.

Recommendations

Change in Statute

3.1 Require the Railroad Commission to develop a strategic plan for the Oil and Gas Division that tracks and measures the effectiveness of monitoring and enforcement.

This recommendation would require the Railroad Commission to develop an annual strategic plan for the Oil and Gas Division to assess the most effective use of limited resources to best ensure public safety and minimize damage to the environment. At minimum, the Oil and Gas Division strategic plan should include the measures accurately capturing the effectiveness of the monitoring and enforcement program over time, including an accurate measure of the number of oil and gas violations by type, repeat violations at the lease level, major violations resulting in penalties, type and severity of violations referred to the Enforcement Section, and field inspector time spent overseeing the highest risk activities and locations. As a management action, the Railroad Commission should report to the Sunset Advisory Commission the performance measures and accompanying methodology for capturing the data that the Railroad Commission plans to use in the strategic plan by December 1, 2016. The plan itself, including and beyond the data collected for performance measures, should be developed with input from stakeholders including groundwater conservation districts and local government entities and should be posted with the performance measure data on the Railroad Commission's website annually. The first strategic plan and set of data used to demonstrate effective enforcement efforts should be posted by September 1, 2018.

3.2 Require the Railroad Commission to develop in rule a process for issuing expedited penalties for minor violations.

This recommendation would require the Railroad Commission to develop a policy in rule for issuing expedited penalties for minor oil and gas violations by March 1, 2018. Similar to the Texas Commission on Environmental Quality's Field Citation program, the Railroad Commission would identify high volume, easily documented and clear-cut minor violations that risk public safety and environmental protection, such as sign violations, and assign a penalty amount based on a penalty matrix set in the rule. The rules should also include the opportunity and mechanisms for appeal. The Railroad Commission would develop the necessary policies and procedures to assess administrative penalties when the violation is cited in the field and would track penalties assessed to ensure consistency and equitability across the state. The Railroad Commission would use existing communications staff to educate operators on the new rules and procedures, ensuring operators are aware of their due process right to appeal these penalties. The Railroad Commission Oil and Gas Division would ensure adequate training for field inspectors and technical staff on the new expedited minor violation process and penalties and the documentation necessary to issue such penalties. Developing a consistent enforcement policy for minor violations that includes an expedited administrative penalty would increase compliance with rules that, while minor, ensure public safety and environmental protection. Incentivizing compliance will reduce field inspectors' time on certain low-priority sites and allow inspectors to increase inspections for more significant violations.

Management Action

3.3 Direct the Railroad Commission to accurately track and report the number of oil and gas violations annually.

This recommendation would direct the Railroad Commission to track the complete number of oil and gas violations Railroad Commission staff cite annually, including violations not identified by field inspectors, and report this number on their website and in the annual Oil and Gas Division strategic plan in Recommendation 3.1. The number of oil and gas violations tracked and reported under this recommendation should not include the number of repeat visits each field inspector conducts on the same violation, although the Railroad Commission should continue to track this information as well. Reporting an accurate number of oil and gas violations would provide a more precise picture of the effectiveness of the monitoring program and how field inspectors spend their valuable time.

3.4 Direct the Railroad Commission to systematically track major violations.

Through better tracking of major violations statewide, this recommendation would direct the Railroad Commission to ensure major violations come into compliance and face legal enforcement, as appropriate. Current Railroad Commission guidance suggests field inspectors refer some major violations to the Enforcement Section, but without tracking all of these violations, a large portion of major violations may not face sanctions, even if warranted.

3.5 Direct the Railroad Commission to develop a definition of repeat violations in rule and report the number of repeat violations on its website.

This recommendation would direct the Railroad Commission to develop new measures of repeat violations that better capture the number of leases and operators that have a new violation of the same rule or similar type of rule cited by Railroad Commission staff within a 12-month period. Consideration for repeat violation should include both violations cited in the field and violations cited by state office staff, such as not filing or late filing needed documentation. The Railroad Commission should measure repeat

violations both at the operator level and the lease level, as the lease-level measurement will help minimize concerns that large operators with several disparate leases will appear to have higher-than-average repeat violations. The Railroad Commission would report the number of repeat violations and the number of operators with repeat violations in aggregate going forward, reporting the data in a trend line over time to demonstrate the effectiveness of the enforcement program. Accurately capturing the number of operators or leases that repeatedly violate the same rules will allow the Railroad Commission to assess the effectiveness of its enforcement program at deterring these repeat violations. This recommendation does not direct the Railroad Commission to increase or enhance penalties based on tracking and reporting these repeat violations. Capturing and monitoring these data would better ensure the Railroad Commission identifies weaknesses and strengths in its enforcement program and responds as needed.

3.6 Direct the Railroad Commission to audit a sample of oil and natural gas production reports and transportation reports.

This recommendation would direct the Railroad Commission to audit a sample of production reports and transportation reports each month to ensure operators with severed leases are not producing oil and gas illegally. The Railroad Commission would assess current resources and develop a minimum number of monthly transportation and storage reports to be compared to production reports and lease severance orders to ensure accuracy and compliance with enforcement actions taken. The review should ensure a random sample of reports selected each month.

3.7 Direct the Railroad Commission to develop a policy to require production reports to be filed electronically.

This recommendation would direct the Railroad Commission to develop a policy to begin requiring production reports to be filed electronically. The Railroad Commission currently allows electronic filing, through which more than 96 percent of production reports were filed last fiscal year. The Railroad Commission would phase in this requirement, with full implementation by September 1, 2018. Requiring electronic filing for these high volume reports would ensure greater accuracy and allow staff to use their time more strategically.

3.8 Direct the Railroad Commission to expand its risk matrix for oil and gas inspections.

This recommendation would direct the Railroad Commission to expand its formal, risk-based system for prioritizing inspectors' activities. The current system of prioritizing high-risk activities such as spills, mechanical integrity tests, and surface casing, regardless of the operator, would be augmented with additional factors such as the operator's enforcement history, the length of time a well or site has been without an inspection, whether or not the lease has a severance order, and if the site is near sensitive areas, such as residences or surface water. This risk matrix should be developed and in rule by March 1, 2018.

Fiscal Implication

Overall, these recommendations would have a positive fiscal impact to the state. The recommendations could generate approximately \$2,760,375 of increased revenue to the General Revenue Fund and would save the Oil and Gas Regulation and Cleanup Fund \$46,835 annually, for a total positive impact of \$11 million over five fiscal years starting in fiscal year 2018.

Recommendation 3.1 would have no cost to the state, as the Railroad Commission could strategically ensure the effective use of resources for oil and gas monitoring and enforcement and demonstrate such results to the public within existing resources.

Recommendation 3.2 would increase revenue to the state through increased penalties. While the threat of monetary penalty would potentially decrease the number of violations, an estimate on just one frequently cited minor violation indicates that the state would gain approximately \$2.8 million each year starting in fiscal year 2019.

One example of a minor violation the Railroad Commission should include when developing its policy for issuing expedited administrative penalties is sign violations. During fiscal year 2015, Railroad Commission inspectors issued 14,722 sign violations. If the Railroad Commission issues just half the number of penalties for sign violations in the first year, and the penalty guidelines assign a penalty for violating sign requirements of \$250 to \$500 per sign, including the agency’s standard 50 percent discount, revenue to the state would increase by \$2,760,375.⁶ This is just one example of a violation that would result in new penalty revenue; the Railroad Commission would include other minor violations when developing the policy in rule, likely resulting in increased revenue to the state beyond this estimate.

Recommendations 3.3, 3.4, and 3.5 would have no cost to the state, as the Railroad Commission can track an accurate number of unique oil and gas violations already and could develop measures for repeat violations within existing resources, given that the Railroad Commission successfully defined and began tracking major and minor violations referred to the Enforcement Section, and reporting the number of each on the Railroad Commission’s website, after the last Sunset review.

Recommendation 3.6 would be cost neutral to the Railroad Commission because implementation of Recommendation 3.7 would allow the seven existing staff members who review production reports and transportation reports to spend their time each month auditing a cross section of forms rather than reviewing and notifying operators of basic mistakes found in forms submitted by mail. Additionally, the Railroad Commission would no longer spend \$46,835 annually contracting out to have hard copies of new production reports scanned.

Recommendation 3.8 would have no fiscal impact to the state because the Railroad Commission could expand the risk matrix and accompanying policies with existing staff. The Railroad Commission has developed similar risk matrices in the past with existing staff, such as the penalty guidelines now in rule.

Railroad Commission of Texas

Fiscal Year	Savings to the Oil and Gas Regulation and Cleanup Fund
2018	\$0
2019	\$46,835
2020	\$46,835
2021	\$46,835
2022	\$46,835

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¹ H.B. 40, 84th Texas Legislature, Regular Session, 2015.

² Sunset Advisory Commission, *Final Report on Railroad Commission of Texas* (Austin: Sunset Advisory Commission, 2011).

³ The Railroad Commission defined pollution violations as “violations of Statewide Rules 8, 9, 13, 14, 17, 20, 21, 46, 81, 91, 95, 96, 97, and 98 (water protection, disposal wells, well completion and plugging, wellhead pressure, fire prevention and swabbing, fluid injection, brine mining, oil spills, hydrocarbon storage, and hazardous waste management) and violations of 16 T.A.C. Chapter 4, Subchapter F (Oil and Gas NORM).”

⁴ Top pollution violators defined as the 100 operators with the most violations of pollution prevention rules in a fiscal year and an above-average number of violations of pollution prevention rules per well for that fiscal year.

⁵ “Field Citation Program,” Texas Commission on Environmental Quality, last modified November 3, 2015, https://www.tceq.texas.gov/field/field_citation.html.

⁶ 16 T.A.C. Section 3.107(e)(1).

ISSUE 4

Insufficient and Inequitable Statutory Bonding Requirements Contribute to the Large Backlog of Abandoned Wells.

Background

The Railroad Commission of Texas regulates oil and natural gas drilling and producing activity. In fiscal year 2015, the Railroad Commission recorded more than 433,000 oil and gas wells and 7,100 well operators across the state.

Statute requires all oil and gas well operators to file a bond, letter of credit, or cash deposit, which the Railroad Commission will collect if operators abandon a well, based on a finding that they can no longer legally produce or sell oil and gas, often due to bankruptcy or outstanding enforcement actions.¹ As set out in statute, funds raised through collection of bonds, letters of credit, or cash deposits must be used to plug wells or remediate sites.² At the beginning of fiscal year 2016, the Railroad Commission documented 9,715 abandoned wells — generally wells that had not produced oil or gas in over a year and did not belong to an operator who could legally produce or sell oil and gas.

Wells covered by financial assurance, whether through bonds, letters of credit, or cash deposits, are considered “bonded” for purposes of this discussion and are all subject to the same dollar thresholds for bond requirements used to demonstrate financial assurance based on the number of wells the operator has. The majority of operators use blanket bonds. Although blanket bonds make up just one source of the funds used to plug wells, their statutory requirements have not been fully assessed to see how well they serve the state’s well-plugging needs.³ This analysis aims to do so. Bonding also attaches more personal responsibility to addressing problems caused by abandoned wells, rather than relying on other collective funding sources the agency needs to perform its duties. The textbox, *Blanket Bond Requirements*, describes the three tiers established in statute that determine the bond amount operators must file with the Railroad Commission depending on the number of wells. Operators each file one bond for all the wells they are permitted to operate and update the bond if they move from one tier to another tier due to increasing or decreasing the number of wells they operate.

Blanket Bond Requirements

- Operators with one to 10 wells file financial assurance for \$25,000.
- Operators with 11 to 99 wells file financial assurance for \$50,000.
- Operators with 100 or more wells file financial assurance for \$250,000.

Blanket bond requirements have been set in statute since 1991, though the Legislature did not require every operator in Texas to be bonded until 2004. Statutory bond requirements cover land wells. The Legislature allows the Railroad Commission to set bay and offshore financial assurance requirements in rule, but the Railroad Commission has not adjusted these requirements since it first set the amounts in 2004. The Railroad Commission requires operators who have active bay or offshore wells to offer financial assurance of an additional \$60,000 or \$100,000, respectively, on top of their blanket bond.^{4,5} Because the Railroad Commission already has the authority to address bay and offshore wells, this issue focuses on blanket bond requirements applied to land wells.

Findings

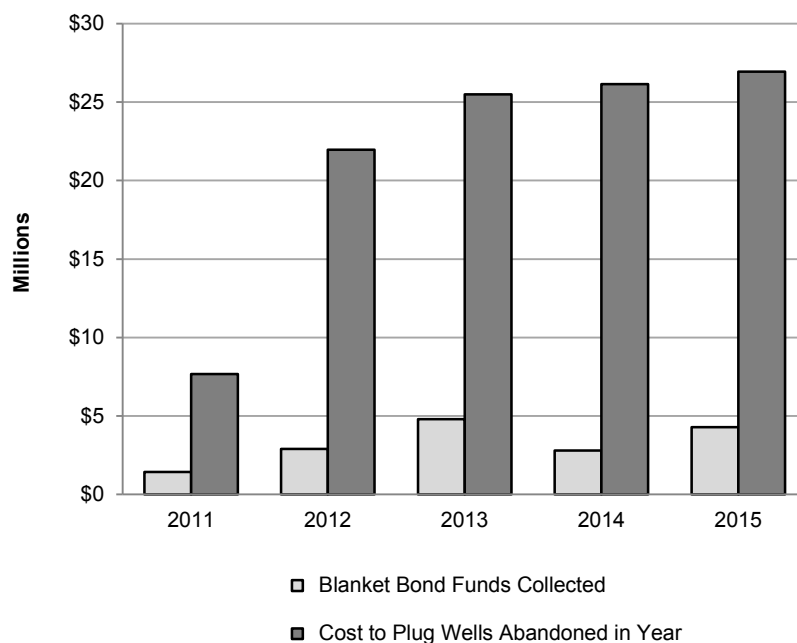
Current statutory bonding requirements for oil and gas operations cover too small a portion of the cost to plug abandoned wells.

- **Bond funds collected to plug abandoned wells only cover 15.9 percent of the total annual plugging cost.** In the last fiscal year, the Railroad Commission collected \$4,288,068 in blanket bonds from 94 operators who abandoned 1,584 wells — collecting \$2,707 per well as of April 2016. In the same year, the Railroad Commission spent \$11,772,895 plugging 692 wells — spending \$17,012 per well.
- **Insufficient bond requirements divert other commission funding sources to pay for well plugging.** The deficit between the revenue from blanket bonds and the actual cost to plug abandoned wells forced the Railroad Commission to spend more than \$7 million in additional funds to plug only a portion of the backlog of abandoned wells.

The commission collected \$2,707 in bond revenue per abandoned well but spent \$17,012 for plugging per well.

The actual cost to plug all abandoned wells from just fiscal year 2015 would cost \$27 million — more than double what the Railroad Commission spent. The graph, *Cost to Plug All Abandoned Blanket Bond Wells Per Year Versus Blanket Bond Revenue Collected*, illustrates the amount of bond revenues collected each year for blanket bonds compared to the estimated cost to plug each blanket bonded well in a year.⁶ With a backlog of 9,715 abandoned wells, the Railroad Commission could be on the hook to pay more than \$165 million to plug all of those wells.

Cost to Plug All Abandoned Blanket Bond Wells Per Year Versus Blanket Bond Revenue Collected FYs 2011–2015

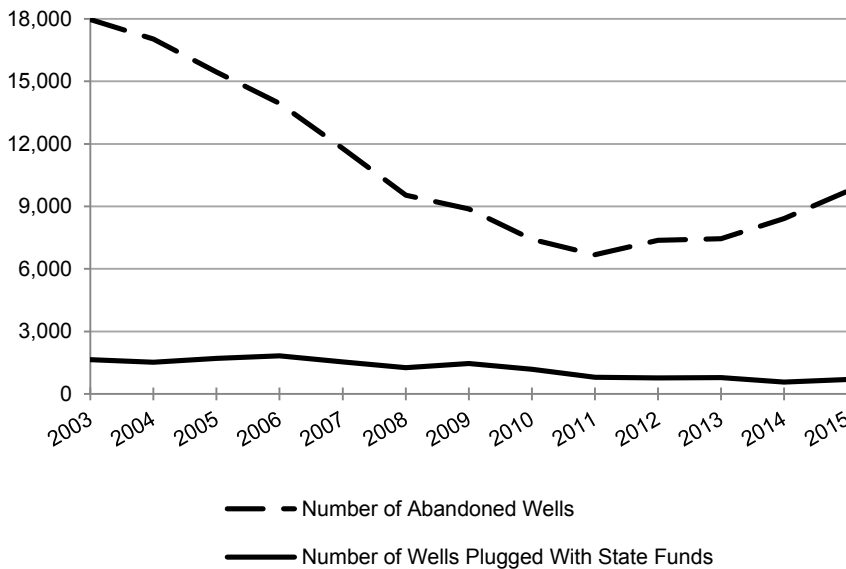


Although not every abandoned well needs to be plugged immediately, and some will be returned to operation, eventually the majority of those wells will need to be plugged to protect both the environment and public safety. Because blanket bond amounts cover a small portion of the cost, the Railroad Commission makes up a portion of the gap in bond coverage with money that could be spent on inspection, enforcement, and permitting staff, information technology upgrades, or other regulatory functions.

The backlog of abandoned wells has increased since 2011.

- **The backlog of abandoned wells is on the rise.** As illustrated in the graph, *Abandoned Wells Compared to Plugged Wells*, the number of wells plugged with state funds has decreased by 58 percent since 2003, and the backlog has increased since 2011 as a result. The recent downturn in the oil market and increased requirements on operators may also lead to an increased number of abandoned wells.

**Abandoned Wells Compared to Plugged Wells
FYs 2003–2015**



- **Current bond requirements were set in 1991.** The Legislature set blanket bond amounts for land wells in statute in 1991 when well plugging cost the Railroad Commission the equivalent of \$8,250 per well.⁷ From fiscal year 1991 to 2015, plugging costs increased 106 percent, but statutory blanket bond requirements remained the same.

Plugging costs have increased 106 percent since statutory bond requirements were set in 1991.

The current bond tier structure is inequitable and does not correspond to risk.

- **Smaller oil and gas producers pay a disproportionate share of bond coverage per well.** As previously mentioned, bonds collected cover 15.9 percent of the cost to plug each well, on average. However, within each blanket bond tier, the bond coverage ranges from \$25,000 to \$14.19 per well, covering from 147 percent of the cost to plug to less than 0.1 percent.

As a result of the current blanket bond tier structure, most operators with fewer than 19 wells have bonds that cover more than 15.9 percent per well, while most other operators in Texas with land well blanket bonds cover less than 15.9 percent of the costs to plug their wells. Therefore, operators with fewer than 19 wells essentially subsidize the plugging costs of the remaining, larger operators, as illustrated by the 2015 de-identified examples in the chart *Examples: Percent of Plugging Cost Covered by Blanket Bonds Collected*.

**Examples: Percent of Plugging Cost
Covered by Blanket Bonds Collected – FY 2015**

Operators with fewer than 19 wells essentially subsidize the plugging costs of larger operators.

Operator	Number of Abandoned Wells	Bond Collected Per Well	Percent of Cost Covered by Bond
Operator A	83	\$602	3.5%
Operator B	19	\$2,632	15.5%
Operator C	18	\$2,778	16.3%
Operator D	11	\$4,545	26.7%
Operator E	2	\$12,500	73.5%

- **The current blanket bond tier structure does not account for risk of well abandonment.** As outlined in the chart, *Who Abandons Blanket-Bonded Wells*, on average 1.4 percent of operators with blanket bonds abandon wells each year. Operators with fewer than 100 wells are most likely to abandon wells — 13 to 18 times more likely to abandon wells than operators with 100 wells or more. The current statutory blanket bond tier structure does not account for this variation in risk and allows operators with 21 to 99 wells to pay the same or less per well than operators with 100 to 450 wells. Operators with 21 to 99 wells effectively receive steep discounts in per-well bond requirements but still pose a relatively high risk of abandonment.

Who Abandons Blanket-Bonded Wells, FYs 2011–2015

Type of Bond	Average Number of Blanket-Bonded Operators	Average Number of Operators With Blanket Bonds That Abandoned Their Wells Each Year	Average Percent of Operators With Blanket Bonds That Abandoned Wells Each Year
Blanket Bond – \$25,000 (1–10 wells)	2,824	50.2	1.8%
Blanket Bond – \$50,000 (11–99 wells)	2,368	30.8	1.3%
Blanket Bond – \$250,000 (100 or more wells)	477	0.4	0.1%
Total	5,669	81.4	1.4%

Recommendation

Change in Statute

4.1 Amend blanket bond requirements in statute to better reflect risk and increase equitability.

This recommendation would amend statute to increase the number of tiers in the current blanket bond structure and restructure the financial assurance requirements within the new tiers. These tiers are not primarily intended to significantly increase revenue from bond collections, as that decision is for the Legislature. Instead, these changes better distribute costs and increase fairness of the bond structure. The recommended tier structures appear below:

- 10 or fewer wells require a \$22,500 blanket bond
- 11 to 20 wells require a \$40,500 blanket bond
- 21 to 35 wells require a \$74,000 blanket bond
- 36 to 60 wells require a \$128,000 blanket bond
- 61 to 99 wells require a \$213,000 blanket bond

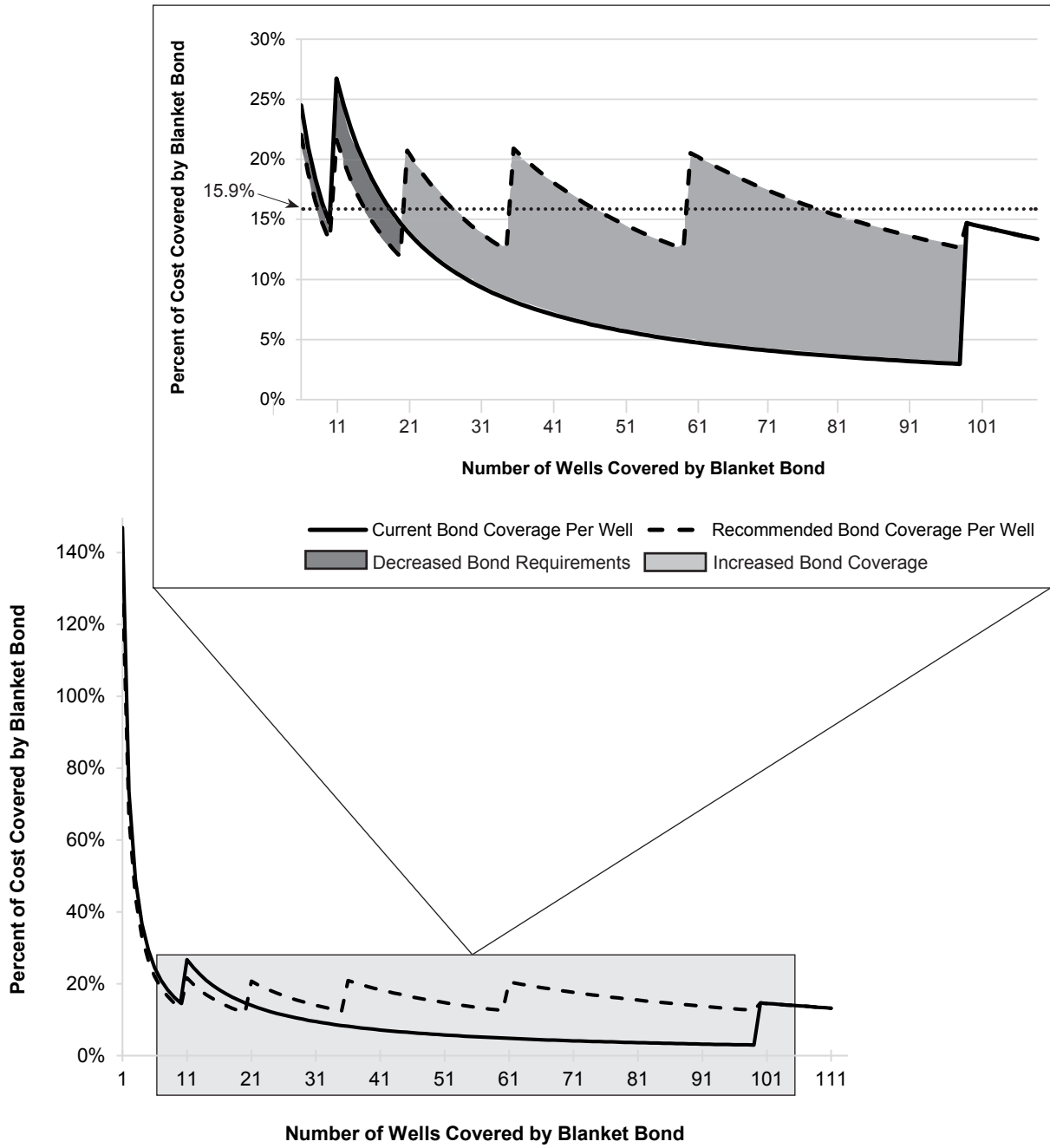
Blanket bond requirements would decrease for those operating fewer than 21 wells, because under existing requirements these operators' blanket bonds require a significantly higher per-well blanket bond and do not pose a significantly higher risk of abandoning wells. This category includes the median Texas well operator, who operates six wells. Blanket bond requirements would remain the same for those operating 100 or more wells because the risk for this category of operators abandoning their wells is significantly lower.

This recommendation would require new operators beginning September 1, 2017, to meet the new financial assurance requirements. The recommendation would be phased in for existing operators by January 1, 2019.

This recommendation would ensure that operators within the tiers at greatest risk of abandoning wells, those with fewer than 100 wells, pay closer to 15.9 percent of the cost to plug wells on average, thereby distributing the cost of well plugging among those at most risk of leaving wells for the state to plug. Increasing the number of tiers ensures that operators at the margins of each tier do not receive a significant discount in per-well financial assurance requirements, while keeping the tiers large enough to minimize the administrative burden of filing new bonds when operators move from one tier to another.

More equitably distributing the financial assurance requirements, as in the tiers recommended, would also increase the total revenue brought in from blanket bond collections by 35 percent, covering 21.5 percent of costs rather than 15.9 percent. The graph on the following page, *Comparison of Current and Recommended Blanket Bond Coverage Per Well*, illustrates the inequity of the current tier structure and the increase in revenue from the recommended, equitable tiers. Establishing a more equitable financial assurance system would generate more well-plugging funds and allow the Railroad Commission to decrease the backlog of unplugged wells. While these recommendations would increase cost recovery to 21.5 percent, the Legislature could choose to further augment costs covered by increasing the bond amounts within the recommended tiers.

Comparison of Current and Recommended Blanket Bond Coverage Per Well



Fiscal Implication

Recommendation 4.1 would increase revenue to the state from blanket bond collections by approximately 37 percent per year, starting in January of fiscal year 2019. Sunset staff reached this estimate by applying the recommended tier structure to the operators with blanket bonds who abandoned their wells in fiscal years 2011 to 2015 and comparing the blanket bond revenue that would be collected from those bonds under the recommended tier structure to the amount actually collected in fiscal years 2011 to 2015. The average collection rose from \$3.6 million under the existing tier structure to \$4.9 million under the recommended tier structure each year. Therefore, the state could better cover well-plugging costs by \$1.3 million on average each year for a total of \$4.9 million from fiscal year 2018 to 2022.

Railroad Commission of Texas

Fiscal Year	Revenue Gain to the Oil and Gas Regulation and Cleanup Fund
2018	\$0
2019	\$886,373
2020	\$1,329,559
2021	\$1,329,559
2022	\$1,329,559

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¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Sections 91.103, 91.104, 91.1041, 91.1042, and 91.105, Texas Natural Resources Code.

² Section 91.108, Texas Natural Resources Code.

³ Other sources of revenue that contribute to funds the Railroad Commission uses to plug wells include revenue from fees assessed by the commission for other activities such as drilling permits and revenue from other types of bonds such as bonds based on well-depth or bonds for activities not including oil and gas wells.

⁴ Section 91.1042(b), Texas Natural Resources Code.

⁵ The Railroad Commission defines bay wells in rule as any well under its jurisdiction for which the surface location is either in or on a lake, river, stream, canal, estuary, bayou, or other inland navigable waters of the state and which requires plugging by means other than conventional land-based methods or located on state lands that are in water of a depth at mean high tide of not more than 100 feet from the open seas of the Gulf of Mexico. The Railroad Commission defines offshore wells as any well subject to its jurisdiction for which the surface location is on state lands in or on the Gulf of Mexico that is not a bay well. 16 T.A.C. Section 3.78(a).

⁶ Total cost to plug abandoned wells is calculated using fiscal year 2015 plugging costs per well. Costs to plug wells vary annually and depend on area, often due to fluctuations in demand. Fiscal year 2015 costs present an accurate and conservative picture of potential future plugging costs given that 2015 was the cheapest plugging year in the last four complete fiscal years and is nearly in line with the five-year average of costs.

⁷ The cost to the Railroad Commission to plug a well in 1991 was \$4,741, which is equivalent to \$8,250 in 2015 according to the Bureau of Labor Statistics' CPI Inflation Calculator.

ISSUE 5

Improved Oversight of Texas' Pipeline Infrastructure Would Help Further Ensure Public Safety.

Background

In 1917, the Legislature authorized the Railroad Commission of Texas to regulate intrastate pipelines — pipelines that operate within the state's borders — and required all pipelines and gathering systems transporting oil or gas in the state to receive a permit from the agency. The agency permits pipeline operators, performs field inspections, conducts accident investigations, responds to emergencies, enforces Texas' pipeline damage prevention rules, and provides educational programs to excavators and pipeline operators.¹ In 2015, Texas had more than 1,300 pipeline operators with over 217,000 miles of regulated intrastate pipeline transporting gas, oil, hazardous liquids, and carbon dioxide.

The federal Pipeline and Hazardous Materials Safety Administration (PHMSA) oversees Texas' interstate pipelines — pipelines that transport natural gas and other products across state lines. Texas has more than 46,000 miles of interstate pipeline. Both the commission and PHMSA focus on protecting the public against risks to life and property posed by pipeline transportation. In addition to monitoring Texas' interstate pipeline system, PHMSA provides funding for the Railroad Commission's Pipeline Safety and Pipeline Damage Prevention programs and conducts yearly audits to ensure the agency's programs meet federal requirements.

To prevent damage to the nation's pipelines, the federal government created the 811 Call Before You Dig program, a national program that facilitates locating and marking services for most underground utilities, including electric, telephone, cable, gas, and sometimes water or sewer lines. The Railroad Commission works in conjunction with the 811 program to prevent excavation damage and potential pipeline incidents caused by digging or excavation-related activities. The Railroad Commission assesses penalties for failing to call 811 or for violations of its damage prevention rules, which set out best practices for excavators and pipeline operators.

From 2011 to 2015, Texas had 10 fatalities and 32 injuries related to pipeline incidents. Over the same time period, operators spilled more than 150,000 barrels of hazardous liquids due to pipeline incidents. The total reported cost of all gas and hazardous liquids incidents during this time period was over \$200 million, including clean-up costs.² In fiscal year 2015, Railroad Commission staff completed 3,846 inspections, investigated 52 pipeline incidents, and reviewed about 8,400 pipeline excavation damage reports.

Findings

The Railroad Commission lacks statutory authority to enforce damage prevention rules for interstate pipelines, potentially endangering public safety and the integrity of Texas' pipeline infrastructure.

Neither the federal government nor the Railroad Commission enforces damage prevention rules for interstate pipelines. If a pipeline incident involves an

interstate pipeline, the damage poses the same risks as damage to an intrastate line, yet the Railroad Commission has no authority to enforce preventive measures. While PHMSA has safety oversight over interstate pipelines, the federal government views damage prevention as a state issue best handled by a state's regulatory compliance agency and encourages states to enforce damage prevention regulations for violations that affect interstate pipelines. In addition to creating a risk to public safety, this regulatory gap limits Texas' ability to fully use the 811 program to educate interstate pipeline operators and excavators regarding damage prevention best practices.

The federal government encourages states to enforce damage prevention regulations for interstate pipelines.

In fiscal year 2015, the Railroad Commission completed more than 3,800 enforcement actions against excavators for damaging intrastate pipelines, collecting more than \$6.3 million in penalties. The agency also completed 2,912 enforcement actions against pipeline operators for violating damage prevention requirements, collecting about \$3.6 million in penalties. The Railroad Commission cannot provide an accurate picture of how large a problem damage to interstate pipelines is because the agency currently has no authority over damage to these pipelines and does not collect information about such events.

In 2011 and again in 2013, the Sunset Commission recommended that the Legislature amend Texas statute to give the Railroad Commission authority to enforce damage prevention regulations for interstate pipelines. Because the agency's Sunset bills did not pass, the Railroad Commission continues to lack the authority to enforce damage prevention rules for interstate pipelines.

The Railroad Commission does not have statutory authority to assess a fee for pipeline permits, limiting the agency's ability to ensure public safety and the integrity of Texas' pipeline infrastructure.

While the Railroad Commission has required pipeline operators to receive a permit from the agency to operate a pipeline for almost 100 years, it has never had the authority to have operators pay a permit fee to support this function. Most regulatory agencies require the regulated entity to pay a permit fee on the front-end to support regulatory functions. Instead, to support its Pipeline Safety program, the Railroad Commission assesses a pipeline safety fee on all natural gas distribution and municipal operators on a per service line basis.³ Natural gas utilities pass this pipeline safety fee on to gas utility customers each year in their utility bill. Statute caps the pipeline safety fee at \$1 per service line and the agency has currently set the fee, by rule, at \$1 per line.⁴ In fiscal year 2015, the agency collected about \$4.9 million in pipeline safety fees, which was deposited to the General Revenue Fund. The agency spent \$2.4 million in federal funds and almost \$4.7 million in general revenue for the program. Beginning in fiscal year 2016, revenue from the pipeline safety fee is deposited to the Oil and Gas Regulation and Cleanup account in general revenue, but is expected to fall short of state appropriations for the Pipeline Safety program by approximately \$1.8 million.

Most regulatory agencies require the regulated entity to pay a permit fee on the front-end to support regulatory functions.

Not charging an upfront permit fee to operators limits the agency's ability to generate sufficient revenue to keep pace with growth in the oil and gas industry. Texas has the country's largest pipeline system, the safety of which is of great importance to the Texas economy. Assessing a permit fee would help the agency employ and retain sufficient staff and field inspectors, ensure pipelines are safely transporting hazardous liquids and gas across the state, and allow the agency to appropriately oversee an important industry as it continues to grow. Retaining sufficient numbers of inspectors has long been challenging for the agency, leading to a backlog of routine on-site inspections and specialized audits.

In 2013, the Sunset Commission recommended that the Legislature amend Texas statute to allow the Railroad Commission to assess a fee for pipeline permit applications and renewals. Because the agency's Sunset bill did not pass, the Railroad Commission continues to lack the authority to assess a pipeline permit fee.

Assessing a permit fee would help the agency employ and retain sufficient staff and field inspectors.

Recommendations

Change in Statute

5.1 Authorize the Railroad Commission to enforce damage prevention requirements for interstate pipelines.

This recommendation would authorize the Railroad Commission to amend its pipeline damage prevention rules to apply to interstate, as well as intrastate, pipelines; and to enforce these rules for violations that affect both types of pipelines. Under this recommendation, the agency could assess administrative penalties against operators and excavators that violate damage prevention rules on interstate lines. The Railroad Commission would deposit these penalties in the General Revenue Fund, as it does with penalties collected from its intrastate Pipeline Damage Prevention program.

5.2 Authorize the Railroad Commission to create a pipeline permit fee.

This recommendation would enable the commission to collect additional revenue to offset the administrative costs of issuing a pipeline permit. The agency would adjust the newly created permit fee to meet the growing needs of the program, within limits established by the Legislature. The Railroad Commission would collect the permit fee at the time of application.

Under this recommendation, the agency would establish a methodology for developing a fee that reflects the time needed to perform the work associated with permitting pipelines; the impact of the permit fee on operators of all sizes; and other factors it considers important to the fair and equitable levying of a permit fee. The agency would have the flexibility to establish a permit fee to cover all program costs, including administration costs, and could base the fee on the mileage of pipeline, the number of new and renewed permits, the number of amended permits, the number of pipeline systems, or any other factor that enables the agency to equitably and efficiently recover costs of its Pipeline Safety program. The Railroad Commission would establish the methodology in rule, ensuring the opportunity for affected pipeline operators and the public to comment. The Railroad Commission should establish this methodology and begin assessing a fee by September 1, 2018.

Creating a new permit fee would provide a mechanism for the agency, based on legislative appropriations, to generate additional revenue to hire more pipeline safety field inspectors and other pipeline safety support staff to meet the needs of Texas' growing oil and gas industry.

Change in Appropriations

5.3 Modify language in the General Appropriations Act to further ensure that the Railroad Commission collects, and is appropriated back, fee amounts to offset the costs of administering its Pipeline Safety program, including administration costs.

This recommendation would modify rider language in the Railroad Commission's appropriations pattern to require that the pipeline operator permit fee, pipeline safety fee, and any other miscellaneous revenue associated with the Pipeline Safety program covers, at a minimum, all program costs, including direct and indirect administrative costs.

Fiscal Implication

Overall, these recommendations would have a positive fiscal impact to the state.

Recommendation 5.1, expanding damage prevention authority, would not result in a significant fiscal impact to the state. Railroad Commission staff could oversee damage prevention for interstate pipelines as part of the agency's already established intrastate Pipeline Damage Prevention program.

As part of this expanded authority, the Railroad Commission would assess and collect administrative penalties, which would result in a gain to the General Revenue Fund. However, a fiscal impact cannot be estimated as amounts generated depend on the number and seriousness of future violations.

Recommendation 5.2, creating a pipeline permit fee, could have annual estimated positive impact of \$1.8 million to the General Revenue Fund, based on the 4,283 pipeline permits issued in fiscal year 2015 multiplied by a theoretical \$425 pipeline permit fee. The Railroad Commission would be appropriated revenue from the newly created pipeline permit fee to offset any general revenue the Legislature appropriates to the agency for its Pipeline Safety program. In fiscal year 2016, the agency estimates it will collect \$4,153,000 in pipeline safety fees and will be appropriated \$5,995,394 from general revenue and the Oil and Gas Regulation and Cleanup account, a shortfall of \$1,842,394 that could be offset by the new fee.

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¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Chapters 117 and 118, Texas Natural Resources Code; Chapter 121, Texas Utilities Code; and Section 756.126, Texas Health and Safety Code.

² "Pipeline Incident 20 Year Trends," U.S. Department of Transportation, Pipeline and Hazardous Materials Safety Administration, last accessed March 23, 2015, <http://www.phmsa.dot.gov/pipeline/library/data-stats/pipelineincidenttrends>.

³ Section 121.211, Texas Utilities Code.

⁴ 16 T.A.C. Section 8.201.

ISSUE 6

The Railroad Commission's Contracting Procedures Are Improving, but Continued Attention Is Needed.

Background

The Railroad Commission of Texas depends on contracting to carry out essential functions, including state-funded well plugging, site remediation, and information technology improvements. The chart *Railroad Commission Contract Expenditures* shows agency estimates for contract expenditures in fiscal year 2015. While most individual contract amounts are relatively small, almost 40 percent of the agency's fiscal year 2015 expenditures were on contracted activities.

Railroad Commission Contract Expenditures

Function	FY 2015 Expenditures
Oil and Gas Well Plugging	\$11,772,895
Oil and Gas Site Remediation	\$3,649,554
Abandoned Mine Lands Remediation	\$2,559,867
Information Technology	\$16,247,562

In 2015, the Legislature dedicated significant attention to state contracting practices, ultimately passing Senate Bill 20, which makes comprehensive changes to state contracting, purchasing, and accounting procedures. Additionally, the Legislature has long recognized contracting standards and practices for state agencies to follow, such as those contained in the *State of Texas Contract Management Guide*, prepared by the Comptroller of Public Accounts.¹ When evaluating an agency's contracting practices, Sunset staff uses the general framework established in statute and in the Guide, as well as its own experience evaluating agency contracting and other documented contracting standards and best practices developed by other oversight entities. Sunset staff has compiled a list of high-level model standards to help evaluate an agency's contracting practices, recognizing the individual circumstances, risks, and needs of each agency and contract. These model standards continue to evolve with new legislative mandates, the state's experience in contracting, and Sunset staff's experience applying these standards and evaluating agency contracting.

Sunset staff found that the Railroad Commission is actively implementing policies to improve contracting procedures, but ongoing effort to institutionalize these improvements will ensure this momentum continues. The following material describes the areas where continued focus is needed.

Findings

The Railroad Commission has only recently begun to address areas of contracting deficiency.

- **Combined contract administration and monitoring responsibilities.** Divisions within the Railroad Commission, specifically the Oil and Gas Division, have historically combined contract administration and monitoring responsibilities, potentially undermining the objective oversight needed to ensure the contract stays on track. Contract administration involves procuring bids, determining best value, and enforcing contract provisions. Contract monitoring involves the day-to-day work with contractors,

generally carried out by field staff with the expertise to ensure the work is appropriately done. When staff administering and enforcing the terms of the contract are the same as those working with the contractor on a day-to-day basis, relationships that naturally develop can make it difficult to take adverse action when necessary.

The commission has not had a contracting manual but plans to have one in place shortly.

- **Lack of contracting manual.** Before beginning to draft one in September 2015, the Railroad Commission did not have a contract management manual. Lack of a contracting manual increases the risk that contract managers are uninformed as to standard procedures and best contract management practices. Clear guidelines would protect the integrity of the contracting process and ensure employees are aware of their responsibilities throughout the contracting process. The agency plans to have a new contract management manual in place shortly after the release of this report in late April 2016.
- **Lack of contracting database.** The agency had difficulty producing a list of large contracts because of an inefficient, largely paper-based record-keeping system. Without a comprehensive central contract management database, the agency misses the complete picture of its contracted activities and has difficulty keeping track of problematic contracts and producing timely and accurate reports for management and oversight entities. An agency's ability to track contract expenditures informs its overall budget process and also helps ensure the agency spends its contracting dollars appropriately.
- **Lack of centralized training policies.** Until very recently, the agency did not have a centralized approach to contract-related training. Since 2001, Texas law has required training and certification through a program developed by the comptroller for state employees involved with contract management.² In addition, training of other agency personnel involved in the contracting process — from solicitation development to contract close-out — can help ensure general knowledge of contracting procedures, roles and responsibilities, and ethical behavior.

The commission had difficulty producing a list of its large contracts.

Despite recent efforts, the history of contract oversight at the Railroad Commission indicates the need for greater attention to contracting procedures.

The Railroad Commission is already taking action to revamp its contracting efforts. The agency is in the process of moving Oil and Gas Division contract administration to the Procurement and Contract Management Department, separating contract administration from monitoring functions to provide more objective contract oversight and enforcement. The agency is also completing a contracting manual, transitioning to the Centralized Accounting and Payroll/Personnel System, which will better capture contracting data, and improving contracting training procedures.

These improved contracting practices require continuing leadership from the agency's executive management and the commitment of high-level managers throughout the agency. The agency has taken positive steps; however, the Railroad Commission currently lacks formal processes and mechanisms that can serve to institutionalize its commitment. Agencywide emphasis on improving this important function will help avoid costly mistakes and ultimately help improve oversight of the state's vital natural resources.

Recommendations

Management Action

6.1 Direct the Railroad Commission to centralize all contract administration functions by September 1, 2016.

The Railroad Commission should move all contract administration activities to the Procurement and Contract Management Department by September 1, 2016. The agency is already well on the way to centralizing these activities; this recommended completion date will help ensure the agency fully and quickly implements the centralization.

6.2 Direct the Railroad Commission to implement and keep updated contracting best practices as outlined by recent legislation and the comptroller.

In accordance with the state's focus on transparency and accountability, the Railroad Commission should continue efforts to improve contracting procedures as follows:

- By September 1, 2017, the agency should have in place a contract management manual that includes an ethics policy, and have processes in place to ensure the manual remains up to date. The Procurement and Contract Management Department should ensure compliance with the principles in the manual.
- The agency should transition to using a contracting database as soon as technology allows. The database should include all agency contracts and enable quick and timely retrieval of contract information considered basic to managing the agency's contracts.
- The agency, through its central Procurement and Contract Management Department, should oversee and coordinate contract-related training required by the state for contract management personnel and develop training requirements for other agency personnel involved in contract development and monitoring. Having a bigger pool of trained personnel for contract development and management would help improve delivery of contracted activities.

These efforts will bring the Railroad Commission in line with standard contracting requirements, such as those outlined by Senate Bill 20, passed last session, and the comptroller's *Contract Management Guide*. It would also provide the agency essential tools to better manage procurements and contracts.

6.3 Direct the Railroad Commission's executive director to report quarterly to the commissioners at their open meetings regarding the status of contracting improvements.

To demonstrate continued progress towards, and executive interest in, improved contracting practices, the executive director should report to the railroad commissioners regarding the status of improvements

on an ongoing basis. These quarterly reports should continue until the agency comes into substantial compliance with statewide contracting best practices.

Fiscal Implication

These organizational and operational changes, while improving the effectiveness of the Railroad Commission's significant contract activities, do not have a fiscal impact that can be estimated. However, better contracting usually results in fiscal savings in the long run.

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¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Chapters 2261 and 2262, Texas Government Code.

² Section 2262.053, Texas Government Code.

ISSUE 7

The Railroad Commission's Statute Does Not Reflect Standard Elements of Sunset Reviews.

Background

Over the years, Sunset reviews have included a number of standard review elements from direction provided by the Sunset Commission, statutory requirements added by the Legislature to the Criteria for Review in the Texas Sunset Act, or general law provisions imposed on state agencies. This review identified changes needed to conform the statutes of the Railroad Commission of Texas to standard Sunset language generally applied to all state agencies and to address the need for the agency's advisory committee and required reports.

- **Sunset across-the-board provisions.** The Sunset Commission has developed standard language that it applies across the board to all state agencies reviewed unless a strong reason exists not to do so. These provisions reflect an effort by the Legislature to place policy directives on agencies to prevent problems from occurring, instead of reacting to problems after the fact. The provisions also reflect review criteria contained in the Sunset Act designed to ensure open, responsive, and effective government.
- **Advisory committees.** The Sunset Act states that advisory committees are abolished on the date set for abolition of an agency unless the committee is expressly continued by law. The Act also directs the Sunset Commission and staff to make recommendations on the future of agency advisory committees using the same criteria to evaluate both committees and their host agencies.¹
- **Reporting requirements.** The Sunset Act establishes a process for state agencies to provide information to the Sunset Commission about reporting requirements imposed on them by law and requires the commission, in conducting reviews of state agencies, to consider if each reporting requirement needs to be continued or abolished.²
- **Equal employment opportunities and historically underutilized businesses.** The Sunset Act requires the Sunset Commission and its staff to consider agencies' compliance with applicable federal and state requirements regarding equal employment opportunities (EEOs) and historically underutilized businesses (HUBs).³ Staff routinely evaluates agency performance regarding these requirements in the course of a Sunset review, but only reports deficiencies significant enough to merit attention.

Findings

The Railroad Commission's statute does not reflect standard language typically applied across the board during Sunset reviews.

The commission's governing statute does not include a standard provision relating to alternative rulemaking and dispute resolution that the Sunset Commission routinely applies to agencies under review. This provision helps improve rulemaking and resolution of other disputes, such as interagency

conflicts, through more open, inclusive, and conciliatory processes designed to solve problems by building consensus rather than through contested proceedings.

The Oil and Gas Regulation and Cleanup Fund Advisory Committee is no longer needed.

State law requires the Oil and Gas Regulation and Cleanup Fund Advisory Committee — called the Oil Field Cleanup Fund Advisory Committee until 2013 — to meet quarterly with the Railroad Commission, monitor and report the effectiveness of the Oil and Gas Regulation and Cleanup Fund, review recommendations for legislation proposed by the commission, and review

Oil and Gas Regulation and Cleanup Fund Advisory Committee Membership

- One member of the Senate appointed by the lieutenant governor
- Presiding officer of the House committee with primary jurisdiction over energy resources
- One public member appointed by the governor
- One member appointed by the lieutenant governor from the academic field of geology or economics
- One member appointed by the speaker of the House from the academic field of geology or economics
- A representative from each of the following organizations: Texas Oil and Gas Association, Texas Independent Producers and Royalty Owners Association, Panhandle Producers and Royalty Owners Association, Permian Basin Petroleum Association, and the Texas Alliance of Energy Producers

rules relating to the fund. Statute also requires the committee to submit a biennial report to state leadership regarding any problems with administration of the fund and recommendations to address those problems. The composition of the 10-member committee can be found in the accompanying textbox.⁴ However, the committee has not met since February 2012 and has not issued a report since 2009, missing both its quarterly meeting and biennial reporting requirements. In addition, commission staff — not the advisory committee — routinely tracks and reports to the railroad commissioners and the Legislature on these matters relating to the Oil and Gas Regulation and Cleanup Fund.

The Railroad Commission’s reporting requirement on the Oil and Gas Regulation and Cleanup Fund continues to serve a useful purpose.

State law requires the Railroad Commission to produce four reports that are specific to the agency. Three of these reporting requirements include information relating to the amount of money deposited and spent from the Oil and Gas Regulation and Cleanup Fund; the balance of the fund; and the commission’s use of money in the fund related to oil and gas activities. Because these three reports require similar information, the commission produces one report that includes all statutorily required information. This reported information continues to be valuable. The commission’s other report, required by the Oil and Gas Regulation and Cleanup Fund Advisory Committee, is no longer needed as it largely duplicates the commission’s other reports and has not been produced in seven years. Appendix A lists all four of the commission’s reporting requirements and Sunset staff’s analysis of their need.

The commission has not met EEO statewide civilian workforce percentages in certain categories for the last three years.

As in years past, the commission did not meet civilian workforce percentages in its major job categories — administration, professional, and technical — and falls especially low for female employees in these categories. The agency indicates it was unable to meet these percentages because the pool of applicants for open positions was predominately men, as is reflective of the greater workforce pool in the oil and gas industry. Appendix B shows the commission's EEO performance in each job category for fiscal years 2013 to 2015.

The agency falls especially low compared to other state agencies for female employees in its major job categories.

The commission has not met the state's HUB purchasing goals in certain categories.

While the commission has met HUB program requirements such as appointing a HUB coordinator and establishing a HUB policy, the commission has had difficulty meeting some statewide purchasing goals. The agency did not meet purchasing goals for professional services from fiscal year 2013 to 2015, and did not meet goals for other services — its largest category of purchasing — in 2014 or 2015. The agency also did not meet purchasing goals for special trade in the last three years but spent little money in this category. The commission states that many of its purchases in the other services category are limited to certain entities for activities such as well plugging, site remediation, and surface mining reclamation, making it difficult to meet goals. The agency did meet or exceed the state's goal for spending for commodities in each of the last three fiscal years. Appendix C details the commission's HUB spending for fiscal years 2013 to 2015.

Recommendations

Change in Statute

7.1 Apply the Sunset across-the-board recommendation regarding alternative dispute resolution to the Railroad Commission.

This recommendation would require the commission to develop and implement a policy to encourage alternative procedures for rulemaking and dispute resolution that conforms, to the extent possible, to model guidelines by the State Office of Administrative Hearings. This provision ensures that the commission develops a written, comprehensive plan that applies these procedures, when appropriate, to its rulemaking, internal employee grievances, interagency conflicts, contract disputes, and other appropriate potential conflict areas. The agency would also coordinate implementation of the policy, provide training as needed, and collect data concerning the effectiveness of these procedures.

7.2 Allow the Oil and Gas Regulation and Cleanup Fund Advisory Committee to expire.

In accordance with the Sunset Act, this recommendation would allow an unneeded and essentially defunct committee to expire. Allowing the committee to expire would also eliminate its required report, though the commission would continue providing the information in its other required report regarding the Oil and Gas Regulation and Cleanup Fund.

7.3 Continue requiring the Railroad Commission to submit its report on the Oil and Gas Regulation and Cleanup Fund to the Legislature.

This recommendation would continue the commission's report on the Oil and Gas Regulation and Cleanup Fund.

Fiscal Implication

These recommendations would not have a fiscal impact to the state. The recommendation regarding alternative dispute resolution can be accomplished with existing resources and does not require the hiring of additional staff. Allowing the Oil and Gas Regulation and Cleanup Fund Advisory Committee to expire would not have a savings because the committee has not met in more than four years and members do not receive travel reimbursements.

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¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Sections 325.011, 325.012, and 325.013, Texas Government Code.

² Sections 325.0075, 325.011(13), and 325.012(a)(4), Texas Government Code.

³ Section 325.011(9), Texas Government Code.

⁴ Section 91.1135(b), Texas Natural Resources Code.

APPENDICES

APPENDIX A

Railroad Commission of Texas Reporting Requirements

Report	Legal Authority	Description	Recipient	Sunset Evaluation
1. Performance Goals for the Oil and Gas Regulation and Cleanup Fund	Section 81.069(b), Texas Natural Resources Code	Requires the Railroad Commission to report the quarterly and cumulative status of the Oil and Gas Regulation and Cleanup Fund, including the amount of money deposited in and spent from the fund, the fund balance, and the commission's progress towards meeting quarterly performance goals.*	Legislative Budget Board	Continue
2. Oil and Gas Regulation and Cleanup Fund Activities	Section 81.069(c), Texas Natural Resources Code	Requires the Railroad Commission to annually submit a publicly available report to the Legislature detailing the commission's progress in meeting performance goals during the past fiscal year. The report must also include data on well plugging, well abandonment, compliance and enforcement, and site remediation.*	Legislature	Continue
3. Oil and Gas Regulation and Cleanup Fund	Section 91.1135(e), Texas Natural Resources Code	Requires the Railroad Commission to report the quarterly and cumulative status of the Oil and Gas Regulation and Clean Up Fund, including the amount of money deposited in and spent from the fund, the fund balance, the number of wells plugged and sites remediated with money from the fund, and the number of wells abandoned.*	Legislative Budget Board and the Oil and Gas Regulation and Cleanup Fund Advisory Committee	Continue
4. Oil and Gas Regulation and Cleanup Fund Advisory Committee	Section 91.1135(g), Texas Natural Resources Code	Requires the Oil and Gas Regulation and Cleanup Fund Advisory Committee to provide a biennial analysis of any problems with the administration of the Oil and Gas Regulation and Cleanup Fund as well as recommendations for any legislative action needed to address identified problems.	Governor, Lieutenant Governor, and Speaker of the House of Representatives	Eliminate – See Recommendation 7.2

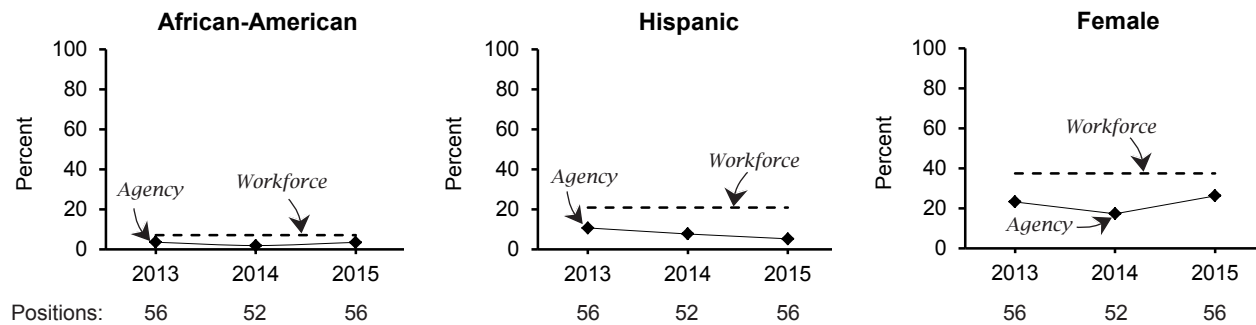
* The commission combines the required information from reports one through three into a single report.

APPENDIX B

Equal Employment Opportunity Statistics 2013 to 2015

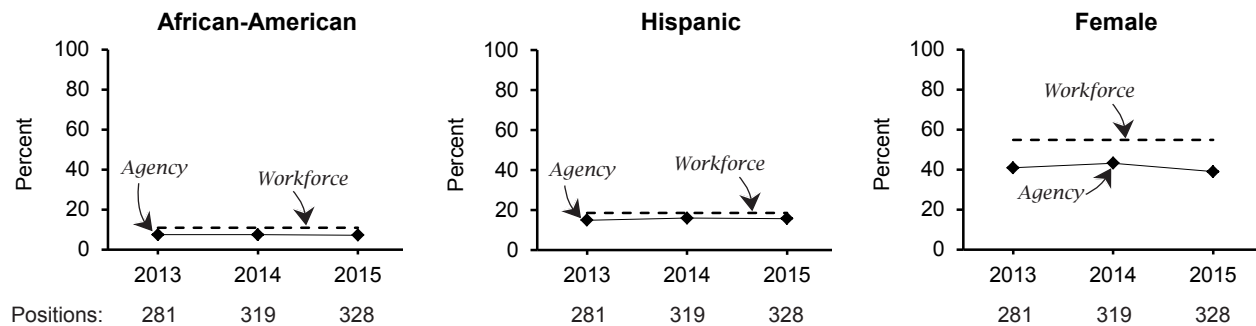
In accordance with the requirements of the Sunset Act, the following material shows trend information for the employment of minorities and females in all applicable categories by the Railroad Commission of Texas.¹ The agency maintains and reports this information under guidelines established by the Texas Workforce Commission.² In the charts, the dashed lines represent the percentages of the statewide civilian workforce for African-Americans, Hispanics, and females in each job category.³ These percentages provide a yardstick for measuring agencies' performance in employing persons in each of these groups. The diamond lines represent the agency's actual employment percentages in each job category from 2013 to 2015. The Railroad Commission consistently fell below the civilian workforce percentages for African-American employees, Hispanic employees, and female employees in the administration, professional, and technical job categories from fiscal year 2013 to 2015. The agency generally exceeded statewide percentages in the administrative support category and had mixed success in the skilled craft category.

Administration



The Railroad Commission fell below the civilian workforce percentages in all three categories in the last three fiscal years.

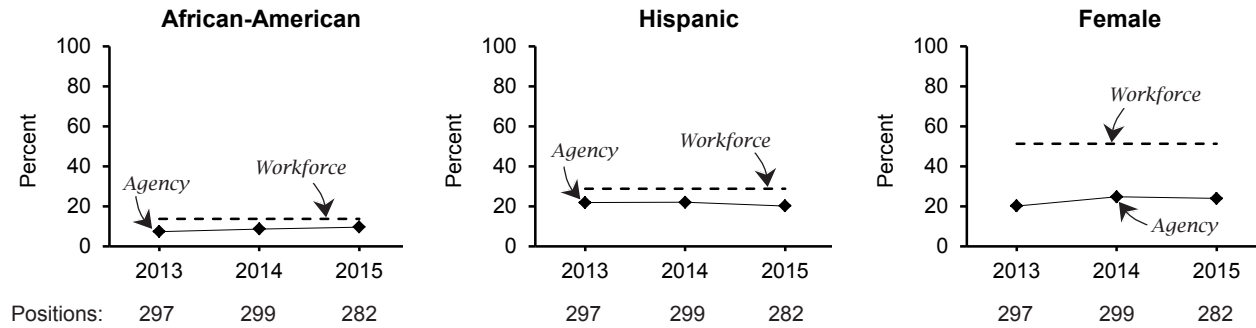
Professional



In the area of the agency with the most employees, the Railroad Commission fell below civilian workforce percentages in all three categories in the last three fiscal years, particularly for females.

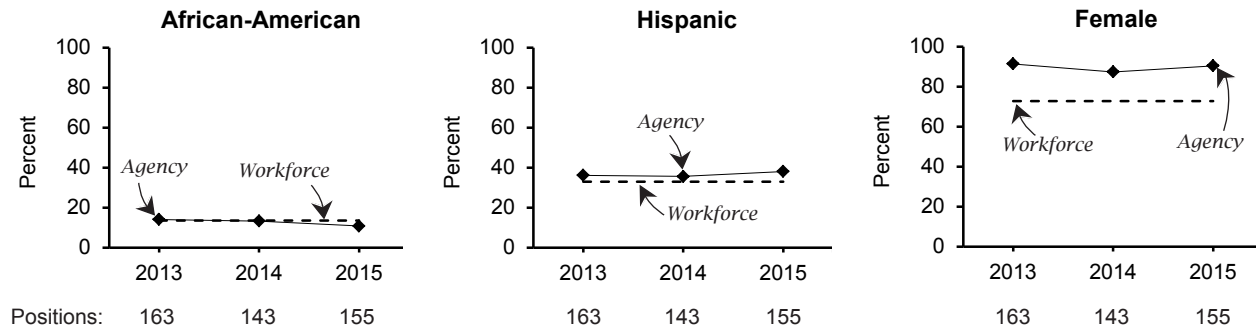
Appendix B

Technical



In an area of the agency with a significant number of staff, the Railroad Commission fell below the civilian workforce percentages in all three categories over the last three fiscal years, particularly for females.

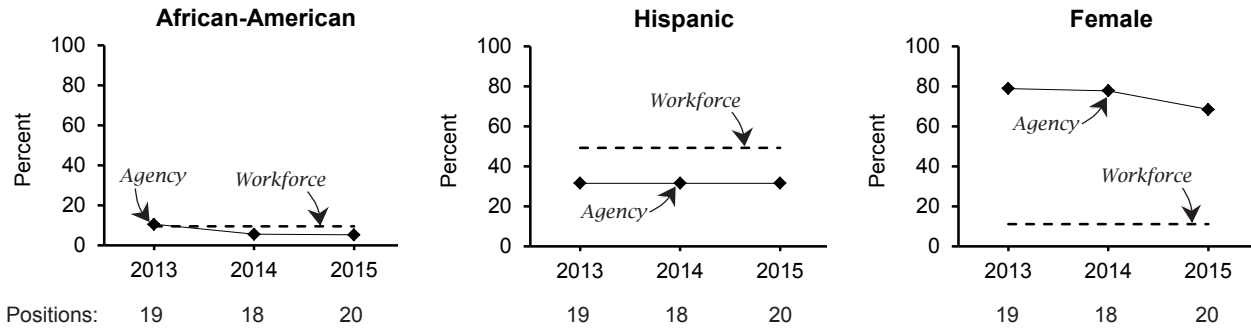
Administrative Support



In the administrative support category, the Railroad Commission exceeded the statewide average by employing 90 percent women in the past three fiscal years. Additionally, the Railroad Commission met or exceeded the civilian workforce percentages for Hispanic employees in administrative support and met or fell below for African-American employees.

Appendix B

Skilled Craft



The Railroad Commission fell below the civilian workforce percentages for Hispanic employees in the last three fiscal years, met or fell below averages for African-Americans, and exceeded averages for female employees.

¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Section 325.011(9)(A), Texas Government Code.

² Section 21.501, Texas Labor Code.

³ Based on the most recent statewide civilian workforce percentages published by the Texas Workforce Commission.

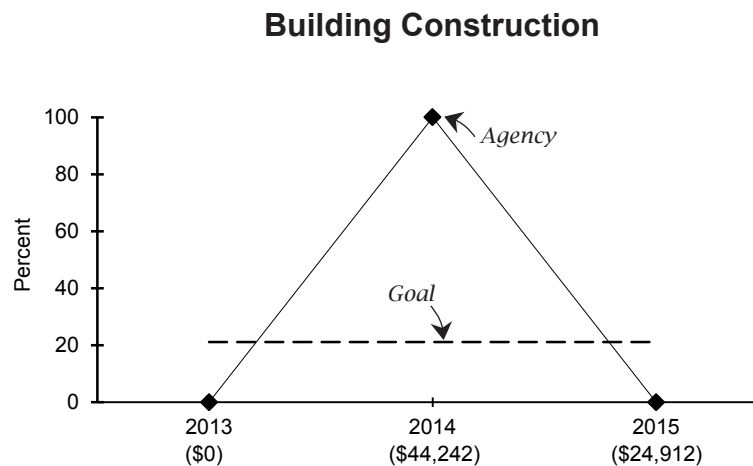
APPENDIX C

Historically Underutilized Businesses Statistics 2013 to 2015

The Legislature has encouraged state agencies to increase their use of historically underutilized businesses (HUBs) to promote full and equal opportunities for all businesses in state procurement. The Legislature also requires the Sunset Commission to consider agencies' compliance with laws and rules regarding HUB use in its reviews.¹

The following material shows trend information for the Railroad Commission of Texas' use of HUBs in purchasing goods and services. The agency maintains and reports this information under guidelines in statute.² In the charts, the dashed lines represent the goal for HUB purchasing in each category, as established by the comptroller's office. The diamond lines represent the percentage of agency spending with HUBs in each purchasing category from 2013 to 2015. Finally, the number in parentheses under each year shows the total amount the agency spent in each purchasing category.

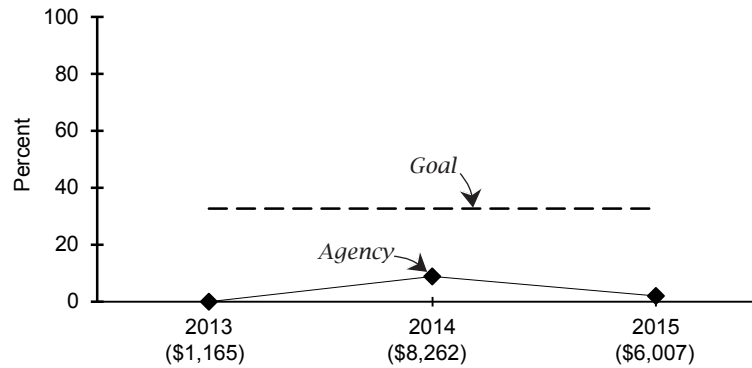
The Railroad Commission failed to meet the state's goal for HUB spending in the special trade and professional service categories each year from fiscal year 2013 to 2015. The agency met goals for commodities in all three years and had mixed success with building construction and other services.



In fiscal year 2014 the Railroad Commission exceeded the state's goal for spending for building construction, but fell short of the goal in fiscal year 2015.

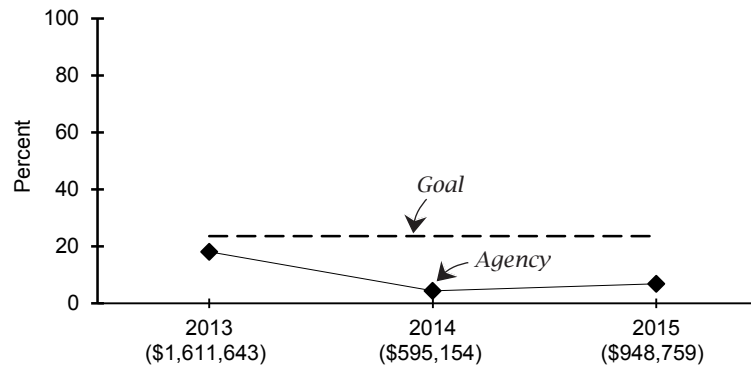
Appendix C

Special Trade



Purchases for special trade fell significantly below the state’s purchasing goal each of the last three fiscal years, though the agency spent little money in this category.

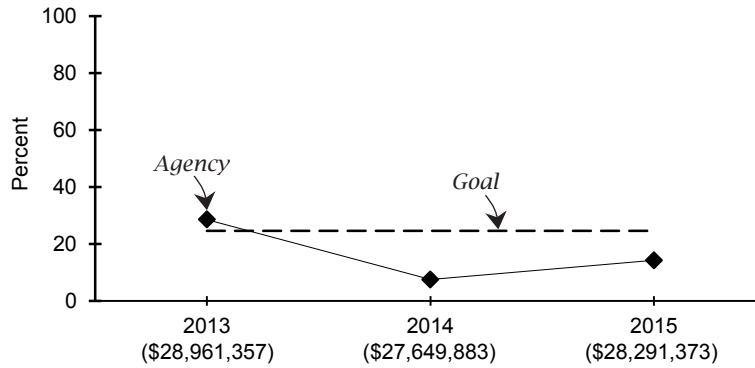
Professional Services



The Railroad Commission fell short of the state’s goal for spending for professional services each of the last three fiscal years.

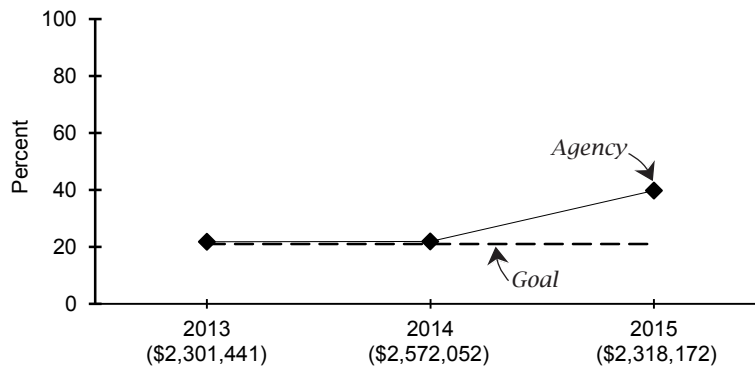
Appendix C

Other Services



While the Railroad Commission exceeded the state’s goal for spending in this category in fiscal year 2013, purchases fell below the goal in fiscal years 2014 and 2015.

Commodities



The Railroad Commission met or exceeded the state’s goal for spending for commodities each of the last three fiscal years.

¹ All citations to Texas statutes are as they appear on <http://www.statutes.legis.state.tx.us/>. Section 325.011(9)(B), Texas Government Code.

² Chapter 2161, Texas Government Code.

APPENDIX D

Staff Review Activities

During the review of the Railroad Commission of Texas, Sunset staff engaged in the following activities that are standard to all Sunset reviews. Sunset staff worked extensively with agency personnel; attended commission meetings; conducted interviews and solicited written comments from interest groups and the public; reviewed agency documents and reports, state statutes, legislative reports, previous legislation, and literature; researched the organization and functions of similar state agencies in other states; and performed background and comparative research.

In addition, Sunset staff also performed the following activities unique to this agency:

- Toured oil and natural gas drilling, hydraulic fracturing and production sites, and a natural gas plant
- Toured a surface coal mining operation and reclaimed land project at various stages of completion
- Accompanied staff on a monitoring visit to an active oil and gas reclamation site
- Observed an inspection with pipeline safety field inspectors
- Observed a state-funded well plugging
- Visited three Railroad Commission field offices
- Observed Railroad Commission contested case hearings
- Met with each railroad commissioner
- Interviewed staff from the Office of the Comptroller of Public Accounts, Texas Commission on Environmental Quality, State Office of Administrative Hearings, Public Utility Commission of Texas, U.S. Department of Transportation, and U.S. Environmental Protection Agency

Sunset Staff Review of the *Railroad Commission of Texas*

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