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BILL ANALYSIS

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Senate Bill 592 (as reported without amendment)
Sponsor: Senator Wayne Kuipers
Committee: Education

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RATIONALE

The volatility of energy prices can make it difficult for school districts to project diesel and natural gas costs when creating their annual budgets. Two of the most significant energy supplies that school districts need are diesel fuel for buses and natural gas for heating school facilities, and the prices of both of those commodities have fluctuated significantly in recent years. When diesel prices rose higher than $4.70 in some places in 2008, many districts had to make cuts elsewhere in their budgets to cover the unexpected costs. Conversely, when energy prices declined sharply as the country entered a recession, many districts were left with excess money in their fuel budgets. To mitigate that volatility and give districts more certainty about their upcoming energy costs, it has been suggested that districts should be permitted to enter into fuel purchasing contracts that could be paid for with bond proceeds.

CONTENT

The bill would amend the Revised School Code to permit the board of a school district or intermediate school district (ISD) to acquire fuel, electrical energy, or natural gas directly or through a purchasing cooperative agreement, for up to five years. Those commodities could be paid for from the operating funds of the district or ISD or from the proceeds of bonds or notes issued for the purpose of acquiring the commodities.

A purchasing cooperative agreement could incorporate one or more guarantees of performance by the commodity supplier, letters of credit, swaps, hedges, commodity price exchange agreements, termination payments, or other features that would achieve cost limits or discounts, or both, for the period of the agreement.

The Code permits the board of a school district or intermediate school district to contract with a qualified provider for energy conservation improvements to school facilities, and to provide for the removal or treatment of asbestos or other injurious material for school facilities. In each case, the improvements may be paid for from operating funds of the school district, among other means. The bill would refer to operating funds of the school district or ISD in those provisions.

MCL 380.1274a

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

The bill would provide greater price stability for school districts purchasing energy, by allowing them to enter into purchase contracts that could be paid for with bond proceeds and could include various types of arrangements that would result in cost discounts or limits. One arrangement that would be permitted under the bill is a so-called fuel collar, which fixes energy costs within a predetermined range. As described in testimony before the Senate Education Committee, a district could issue a taxable bond and place the proceeds into an escrow account. The district then could negotiate a purchase agreement that included a fuel collar that would fix prices within a certain range for three to five years. If prices rose above a maximum amount (the collar ceiling), the collar provider would pay the difference. For example, if the collar ceiling were $3.00 a gallon and the price rose to $3.50, the district would continue to pay $3.00 a gallon for its fuel while the provider would pay the additional $0.50 per gallon. If the price of fuel fell below the collar floor, then the district would continue to pay the floor price, and the collar provider would collect the difference.

The fuel costs would be paid directly out of the escrow account, while the district's monthly expenses would be limited to servicing the debt on the bonds. In this way, the purchase agreement would replace unpredictable fuel expenses with steady, predictable bond payments. The fuel collar would be provided at no additional cost to the district.

In addition to limiting volatility, the arrangement could lower fuel prices by locking in low fuel costs for the next three to five years. Average diesel fuel prices in the Midwest are currently at less than half their 2008 peak and natural gas prices are near six-year lows, making this an ideal time to secure a long-term purchase contract.

The use of a dedicated bond escrow account would have several benefits. First, it would allow the district to fix its energy costs for three to five years. According to Committee testimony, without an escrow account, a district would be able to obtain only a one-year contract. The escrow account also would act as collateral, helping to reassure vendors that there was low risk of nonpayment. In addition, since payment would come directly from the escrow account, vendors could be assured that they would be paid promptly, rather than having to wait for payment to be processed through the district's purchasing system. These advantages would make school districts more attractive customers, enabling them to negotiate fuel and energy discounts. Reportedly, some fuel suppliers have offered discounts on diesel fuel and natural gas to school districts that have set up an escrow account. The bill would permit districts across the State to take advantage of similar cost savings and budgeting certainty, using fuel collars, direct purchases of fuel, or other purchase agreements.

Opposing Argument

While a school district could benefit from a fuel collar when prices were rising, it could end up paying more than the market rate if fuel prices fell below the collar floor. A school district should carefully consider that risk when entering into any such contract, and district officials may not always have the necessary financial background to make informed decisions regarding the potential risks and benefits.

Response: Financial services firms with expertise in fuel hedges and similar contracts could advise school districts on the proper course of action for their needs. School districts already engage in one-year contracts and limited hedges, but the bill would allow more extended use of those tools.

Opposing Argument

Although a fuel collar would not cost a district directly, if the collar providers expected to make money on the contract, ultimately that profit would have to come at the expense of the school district. The district also would have the additional costs of servicing the bonds to fund the escrow account.

Response: Collar ceilings and floors are based on projected fuel prices, and are designed so that on average the collar provider will make a profit. Still, with the discounts available under a long-term contract, a district should come out ahead even with the additional cost of servicing the bond.

Legislative Analyst: Curtis Walker

FISCAL IMPACT

The bill would have no fiscal impact on the State.

Section 1274a of the Revised School Code (MCL 380.1274a) authorizes school boards to contract for energy conservation improvements and to pay for their cost from the proceeds of bonds or notes. While this section does not explicitly state that bonds may be *issued* for energy conservation improvements to school facilities, bond counsel testified at the Education Committee meeting that Section 1274a implicitly allows bonding for the purposes laid out under the section, by allowing the *proceeds* from such bonds to be used for those purposes. The bill would expand the allowable uses for such bond proceeds to include the purchase of fuel, electrical energy, or natural gas for a period not to exceed five years. If the cost of the bond used to purchase and lock in the price of the stated commodities were less than what would be spent to pay for these commodities out of operating funds without a locked-in price, then this legislation could provide an avenue for cost savings to districts and intermediate districts.

Fiscal Analyst: Kathryn Summers-Coty