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BILL ANALYSIS



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Senate Bill 372 (as passed by the Senate)  
Sponsor: Senator Michael J. Bouchard  
Committee: Technology and Energy

Date Completed: 3-29-95

### RATIONALE

Many of the State's public school buildings reportedly are outmoded in design and, thus, are inefficient in their energy use. Updating the energy equipment in these facilities can be expensive. The cost of modernization, however, reportedly can be offset in a relatively short time by the resulting improvement in energy efficiency. It has been shown that renovating older school buildings by installing new heating, cooling, and ventilation equipment; improved energy control systems; improved doors and windows; and, insulation can reduce future operational costs for school districts. Districts considering making such improvements currently may engage contractors by issuing performance based contracts. Under these contracts, a contractor generally must guarantee that the cost of making the improvements will be offset by future savings resulting from improved operational performance. Performance based contracts, thus, are considered especially appropriate in situations in which school districts wish to upgrade their energy systems without increasing energy expenses. These types of contracts, however, still are subject to the bidding process. Under the School Code, school boards cannot purchase an item or items costing \$12,500 or more without obtaining competitive bids. Furthermore, the Code requires a school board to seek competitive bids on construction, renovation, or repair projects that cost more than \$12,500. Some people contend that the bidding process is not appropriate when letting performance based contracts because these contracts do not include pre-engineered specifications, unlike most contracts that are bid. Under performance based contracts, a variety of approaches may be proposed to achieve the same energy savings. For example, one company may promote the use of weatherization techniques and insulation to achieve energy savings, while another company may suggest new heating and cooling systems to achieve the same savings.

Furthermore, school district officials may select one proposal over another because they prefer the approach for energy savings outlined in the proposal, even though another proposal could have lower immediate costs. A school district also might want to negotiate with companies when designing an energy savings program. Consequently, some people believe that performance based contracts for energy conservation projects should not be subject to the competitive bidding process.

### CONTENT

The bill would amend the School Code to:

- Permit a school board, intermediate school district (ISD) board, local act school district, or consortium of districts to enter into a "performance based contract" for "energy conservation measures".
- Establish requirements for a board or consortium to meet when entering into a performance based contract that was obtained without competitive proposals.
- Exempt performance based contracts from the Code's requirements that competitive bids be obtained before districts purchase items costing more than \$12,500; commence construction, repair, or renovation of a school building; or, implement energy conservation measures.
- Require that information provided to a board as part of a performance based contract obtained without competitive proposals be open for public inspection.
- Provide that a board or consortium could seek competitive proposals for a performance based contract and

**establish factors to be used in evaluating the proposals.**

- Permit a board to negotiate with proposers after competitive proposals were opened.**
- Require the Michigan Public Service Commission (PSC) to develop a list of potential providers to be made available to districts that entered into a performance based contract without seeking competitive bids.**
- Permit a performance based contract to be paid from a district's operating funds, or from proceeds of bonds or notes issued for energy conservation measures.**

"Performance based contract" would mean an agreement under which a provider, in return for payments by the district or consortium, provided "energy conservation measures" to a district or a consortium of districts and in so doing guaranteed specific levels of comfort and guaranteed that the total costs for project design, equipment, servicing, and financing would not exceed the savings realized over the agreement's term. "Energy conservation measures" would mean goods and/or services to reduce energy consumption or operating costs of school facilities, including, but not limited to, installation or servicing of one or more of the following:

- Insulation of a building structure and systems within a building.
- Storm windows or doors, caulking or weatherstripping, multiglazed windows or doors, heat absorbing or reflective glazed and coated window or door systems, or other window or door modifications that reduced energy consumption.
- Automatic energy control systems, including, but not limited to, licenses for computer software and technical data for the systems.
- Heating, ventilating, or air-conditioning systems, modifications, or replacements.
- Lighting fixtures that increased energy efficiency.
- Energy recovery systems.
- Cogeneration systems that produced steam or another form of energy for private use by the district or consortium in a building or complex of buildings owned by the district or a district within the consortium.

### Exemption

Currently, a school board or an ISD board cannot purchase an item or group of items in a single transaction costing \$12,500 or more unless competitive bids are obtained for those items and their purchase is approved by the board or the ISD board.

The Code also requires the board of a school district, or board of directors of a public school academy, other than a first class school district, before commencing construction of a new school building, or an addition to or repair or renovation of an existing school building, except repair in emergency situations, to obtain competitive bids on all the material and labor required for the complete construction, addition, repair, or renovation, unless the work costs less than \$12,500.

The bill would provide an exception to these provisions for a performance based contract or package of performance based contracts authorized under the bill.

Currently, energy conservation improvements or substance removal or treatment (for asbestos or other material injurious to health) is subject to the Code's competitive bidding requirements. The bill would exempt from these requirements energy conservation improvements that were energy conservation measures under a performance based contract or package of contracts.

### Performance Based Contracts

In addition to the purchasing powers specified in the Code, the board of a school district, ISD, or local act school district, or a consortium of these districts could enter into a performance based contract or package of contracts for energy conservation measures. An ISD board could enter into a contract or package of contracts either on its own behalf or on behalf of one or more of its constituent school districts at their request.

A board or consortium could enter into a performance based contract or package of contracts without obtaining competitive proposals, if all of the following were met:

- The board or consortium obtained from the PSC at least one year before entering into a performance based contract or package of contracts the list of potential energy services "providers" developed by the PSC.

("Provider" would mean a person with whom a board or a consortium entered into a performance based contract or package of contracts.)

- The performance based contract covered a period of not more than 10 years after installation was completed.
- The provider filed with the board or consortium a performance bond, insurance policy, or other guaranty instrument accepted by the district and issued by a third party insurer that guaranteed the faithful execution of the performance based contract or contracts in an amount that was at least equal to 110% of the combined total of the savings guarantee amounts described below and that the board or consortium determined to be reasonable and necessary to protect the interests of the district or districts in the consortium. The performance bond, insurance policy, or other guaranty instrument would have to be in effect for at least the term of the savings guarantees. The board or consortium also could require a separate performance bond, insurance policy, or other guaranty instrument for the installation of energy conservation measures.
- The performance based contract or contracts contained a written guarantee of a minimum amount of money that the district or districts in the consortium would save in operating costs and energy costs as a result of the contract or contracts, including, but not limited to, electrical, gas, and other utility costs, and a written guarantee by the provider to perform the necessary service to ensure that at least that amount of savings was realized.
- The provider agreed to monitor the results of the energy conservation measures.
- The board or consortium found that the amount that the district or districts in the consortium would spend on energy conservation measures under the contract or package of contracts would not exceed 95% of the combined total over the contract period of the savings guarantee.
- The board or consortium found that the district's or consortium's contractual obligation in any year of the contract or contracts would not exceed the annual savings guarantee amounts specified in the contract or contracts.

In making these findings, a board or consortium would have to consider all costs of the energy conservation measures, including, but not limited to, costs of design, engineering, installation,

maintenance, repairs, operations, and debt service for the energy conservation measures.

A board or consortium could enter into a performance based contract or a package of contracts after obtaining competitive proposals if the above requirements, except for the requirement that the board or consortium obtain from the PSC a list of potential energy services providers, were met.

#### Lease

A performance based contract or contracts could include a lease with an option to purchase, if the lease term did not exceed 10 years and the lease contract met Federal tax requirements for tax-exempt municipal leasing or long-term financing.

#### Public Inspection

If a board or consortium entered into a performance based contract or contracts without obtaining competitive proposals, all information provided to the board or consortium by the provider pertaining to the contract or contracts would have to be open for public inspection after the contract or contracts were awarded.

The board or consortium could enter into a software license agreement or nondisclosure agreement to protect a provider's software or "trade secrets". Software and/or a trade secret that was the subject of a software license or nondisclosure agreement under the bill would not be open for public inspection and would be exempt from the Freedom of Information Act. ("Trade secret" would mean a confidential formula, pattern, device, or compilation of information that was used in the provider's or proposer's business and that gave the provider or proposer an opportunity to obtain advantage over competitors who did not know or use it.) These provisions would apply to contracts that were obtained without competitive bidding.

#### Competitive Proposals

If a board or consortium chose to obtain competitive proposals for a performance based contract or contracts, it would have to advertise for the proposals and specify in the notice the relative importance of guaranteed savings, price, financial performance and stability, quality, technical ability, experience, and other factors to be used to evaluate proposals and proposers. The notice would have to state whether the proposals were subject to negotiation between the proposer and the board or consortium after the proposals were

opened. If a board or consortium awarded a contract or package of contracts after obtaining competitive proposals, the contract or contracts would have to be awarded to the proposer whose proposal, following negotiations, was selected by the board or consortium considering the savings guarantees and other evaluation factors specified in the proposal notice.

If a proposal notice stated that proposals were subject to negotiation after the proposals were opened, a board or consortium could negotiate with the proposers after proposals were opened and could allow proposal revisions before the contract or contracts were awarded.

If provided in a notice for competitive contract proposals, proposals would have to be opened so as to avoid disclosure of trade secrets to competing proposers during negotiations. All proposals would have to be open for public inspection after the contract or contracts were awarded. The board or consortium, however, could enter into a software license agreement or nondisclosure agreement to protect a provider's software or trade secrets. Software and/or a trade secret that was subject to the software license or nondisclosure agreement would not be open for public inspection and would be exempt from the Freedom of Information Act.

#### Contract Payment

A board or consortium could pay for a contract or package of contracts from operating funds of the district or districts in the consortium, or from the proceeds of bonds or notes issued for energy conservation measures. Issuance of bonds for these purposes would be considered as issued for capital expenditures for all purposes including Article 9, Section 16 of the State Constitution, which permits the State to borrow amounts required to make loans to school districts as provided in the Constitution.

#### Public Service Commission

If energy conservation measures were contracted for by a board or consortium, it would have to report to the PSC the same information required under the Code of a local school board or ISD board completing energy conservation improvements. The PSC would have to furnish the forms for the required reports.

The PSC would be required to develop and maintain a list of potential energy services providers to be made available to districts and consortia that entered into a performance based contract or package of contracts without seeking

competitive proposals. The PSC would not be liable for inaccuracies in the list. The bill specifies that the list would be intended and could be used only for informational purposes and would have to contain a disclaimer stating that it did not indicate a potential provider's competence to perform energy conservation measures. Upon request, the PSC immediately would have to make available to anyone the names and addresses of districts, consortia, and other persons requesting a copy of the list in the 12 months immediately preceding the request. In developing and maintaining the list of potential providers, the PSC would have to do all of the following:

- Determine specific energy conservation measures that were part of performance based contracts and for each energy conservation measure indicate which potential providers on the list were willing to provide it.
- Establish and implement procedures for: including in the list all potential providers who wished to be included, adding a potential provider to the list upon request, and amending the list as requested by a potential energy services provider regarding the energy services the potential provider was willing to provide.
- Remove automatically from the list any potential provider who did not request at least once every 24 months to be kept on the list.
- Establish and implement procedures for making the list immediately available to anyone upon request.

MCL 380.623a et al.

#### **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**

Performance based contracting differs from contracting that is done for building construction, for example, in that performance is a key component of the contract. In effect, this type of contracting contains an assurance that the cost of making improvements will be covered by the amount of future savings. The technologies recommended in performance based contracts may vary widely among contractors, as compared with more standardized approaches to typical construction projects. Thus, a traditional, direct comparison between contract proposals is not always possible or appropriate for energy

conservation projects. While school districts now may seek performance based contracts, they still must obtain competitive bids for these contracts. This requirement has proven to be a stumbling block. Many contractors who, otherwise, would participate in performance based contracts hesitate to do so when they must bid competitively because, they contend, the preparation of these contracts is expensive. Consequently, contractors aren't willing to spend their funds preparing a bid on a project from which they may not be awarded a contract. Many school districts, especially those with small projects, also find the process to be lengthy, complex, and expensive. The bill would exempt performance based contracts from the bidding process, and would permit districts that still chose to bid these contracts, to negotiate with a contractor before the contract was awarded. Reportedly, performance based contracting is being used in a number of states where school systems have funded energy-saving projects and reduced their costs. Permitting districts to use this type of contracting without obtaining competitive bids, and to negotiate with contractors when competitive bids were obtained, would grant districts the flexibility needed when they attempt to solve energy problems that may have multiple solutions.

#### **Supporting Argument**

School districts should be encouraged to save energy by remodeling or renovating buildings and replacing out-of-date equipment. Performance based contracting is seen as one way that school districts can upgrade their energy systems without increasing current energy expenses, since future savings will pay for modifications. Under the bill, a provider of these services would have to furnish a performance bond, insurance policy, or other guaranty instrument issued by a third party insurer that guaranteed faithful execution of the contract in an amount that was at least equal to 110% of the savings guarantees. Thus, the local school would be protected in the event a new energy system did not perform as projected or a contractor failed to fulfill the contract. The use of performance based contracting to address energy savings, moreover, would provide school districts with the ongoing expertise of energy consultants who would monitor energy projects to assure that savings occurred.

**Response:** Concern has been raised that requiring a bond to be issued by a third party insurer and requiring the bond or other guaranty instrument to equal 110% of the savings guarantees could reduce the amount of funds available to a school district for these improvements.

#### **Opposing Argument**

Several concerns have been raised about the bill. Some people believe that it is bad public policy to move away from competitive bidding on school projects. In addition, some people fear that large utility companies, through their subsidization of a subsidiary company, could bid on these projects and undercut smaller competitors. Furthermore, some heating and air conditioning contractors in the State reportedly are concerned that the bill would give an unfair advantage to national manufacturers of heating and cooling systems who could negotiate directly with school districts and bypass local contractors when proposing a performance based contract to a school district. In addition, Governor John Engler vetoed a similar bill that the Legislature passed in 1991-92. The Governor gave several reasons for vetoing the bill including: a reluctance to exempt any public contract, over the statutorily prescribed monetary value, from competitive bidding; the exemption by reference from the Freedom of Information Act of certain information that could be included in a performance based contract; and, the expansion of responsibilities of the PSC.

**Response:** The bill would not prohibit the competitive bidding of performance based contracts. Additionally, a board that entered into a contract without obtaining competitive bids would have to open for public inspection information pertaining to the contract that the board received from the contract provider. In addition, the bill would not prohibit a school district from selecting a proposal designed by local heating and cooling contractors. For example, the Detroit Public School District reportedly has entered into performance based contracts with local contractors. Furthermore, a national manufacturer that was awarded a performance based contract could subcontract with local contractors. The bill's proponents also contend that cross subsidization concerns should be addressed in separate legislation, since that issue relates to existing law.

Legislative Analyst: L. Arasim

#### **FISCAL IMPACT**

The bill would have a fiscal impact on State government and local and intermediate school districts.

The board of a local or intermediate school district choosing to use performance based contracts for energy conservation measures would be required to make a finding that the expenses of the contract would be less than 95% of the total savings to the

district in reduced operating costs. In addition, the finding would have to specify that payments in any year of the contract would not exceed the savings in that year. Based on these requirements, a district using the performance based contracting method of obtaining energy conservation services would reduce its operating costs.

The option provided by the bill for districts to enter into a performance based contract for energy conservation improvements without competitive bidding would have an unknown fiscal impact on school districts. Although a district would be required to make the finding discussed above regarding reduced operating costs, a competitive bidding process could result in a lower cost contract. Alternatively, a competitive bidding process could be regarded as increasing the administrative costs of obtaining a contract expected to reduce operating costs.

There could be a marginal increase in the administrative workload of the Public Service Commission, but it would not be necessary to provide added resources or to make other adjustments to address the requirements in the bill.

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.