

Fuel-Cost Clauses Important Says MTAS

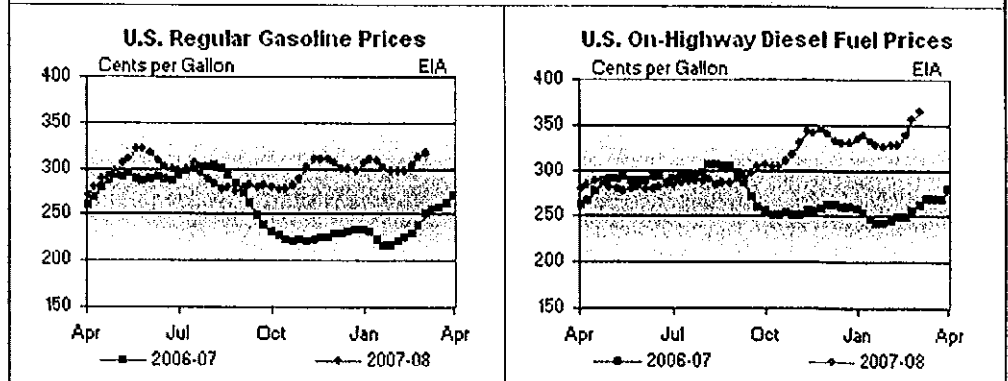
Approximately 18 months ago, The Municipal Technical Advisory Service (MTAS) received a call from a city with a solid waste collection problem. This city had contracted with a well known company for solid waste collection and disposal. Approximately two years of the original five-year contract term remained. Since the date that the contract had been executed, the price of fuel had increased far beyond what anyone had foreseen. The contractor asked the city to pay a fuel surcharge to help with the financial losses they claimed to be experiencing as a result of the unforeseen fuel cost increases. The city pointed out that their contract had no provision for a fuel surcharge, and accordingly, they had no obligation, or for that matter, authority, to pay a surcharge. The contractor responded by stating that, based on their losses, if the city would not help them, the contractor would be forced to default on the remainder of the contract. After consultation, the city pointed out that if the contractor were to default, the contractor would have to buy out the remainder of the contract. The contractor responded that this option would lose them less money than operating under existing conditions for the remainder of the contract period. It was a very ugly situation all the way around.

During 2005, the average retail price of diesel fuel skyrocketed from \$1.93 per gallon in January to \$3.15 per gallon in late October. This 63 percent increase sent a shock wave throughout the solid waste industry. The National Solid Wastes Management Association (NSWMA) estimates that more than \$2 billion was spent on diesel fuel during 2005 to collect trash and recyclables in the United States. Because of long-term contracts and other restrictions, the 2005 diesel cost increases were not always easy to pass on to customers. While the price of diesel has declined from its post-Hurricane Katrina peak, it remains much higher than it was in the 2000-2004 time period. Experts project prices will remain high for the foreseeable future.

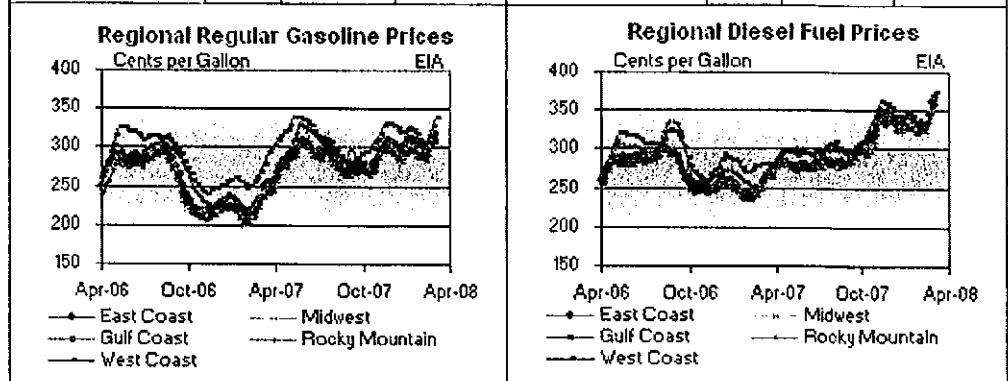
In addition to the major pinch felt at fuel pumps, waste management companies have experienced other commodity related price increases such as higher vehicle and container costs due to steel and resin price increases, higher vendor fees for delivering supplies and services, more expensive tires and other vehicle parts, and increased utility costs.¹

In addition, the U.S. Environmental Protection Agency's (EPA) regulations requiring cleaner diesel fuel for trucks and buses in-

U.S. Gasoline and Diesel Fuel Prices, 03/03/08



Gasoline (Cents per Gallon)				Diesel Fuel (Cents per Gallon)			
	03/03/08 Price	Change from			03/03/08 Price	Change from	
		Week Ago	Year Ago			Week Ago	Year Ago
U.S.	316.2	↑ 3.2	↑ 65.7	U.S.	365.8	↑ 10.6	↑ 103.2
East Coast	316.8	↑ 2.0	↑ 67.7	East Coast	370.0	↑ 9.2	↑ 109.6
New England	314.6	↑ 1.2	↑ 63.1	New England	381.3	↑ 10.3	↑ 112.0
Central Atlantic	316.4	↑ 1.6	↑ 63.8	Central Atlantic	382.5	↑ 13.2	↑ 115.7
Lower Atlantic	317.7	↑ 2.4	↑ 71.9	Lower Atlantic	363.6	↑ 7.4	↑ 106.8
Midwest	308.0	0.0	↑ 61.5	Midwest	363.9	↑ 11.4	↑ 103.3
Gulf Coast	308.8	↑ 3.2	↑ 72.1	Gulf Coast	360.9	↑ 9.9	↑ 102.2
Rocky Mtns.	308.8	↑ 3.7	↑ 73.5	Rocky Mtns.	357.3	↑ 10.0	↑ 91.5
West Coast	338.6	↑ 12.1	↑ 62.1	West Coast	373.6	↑ 12.7	↑ 94.1
California	345.9	↑ 13.1	↑ 56.2	California	380.3	↑ 13.1	↑ 90.6

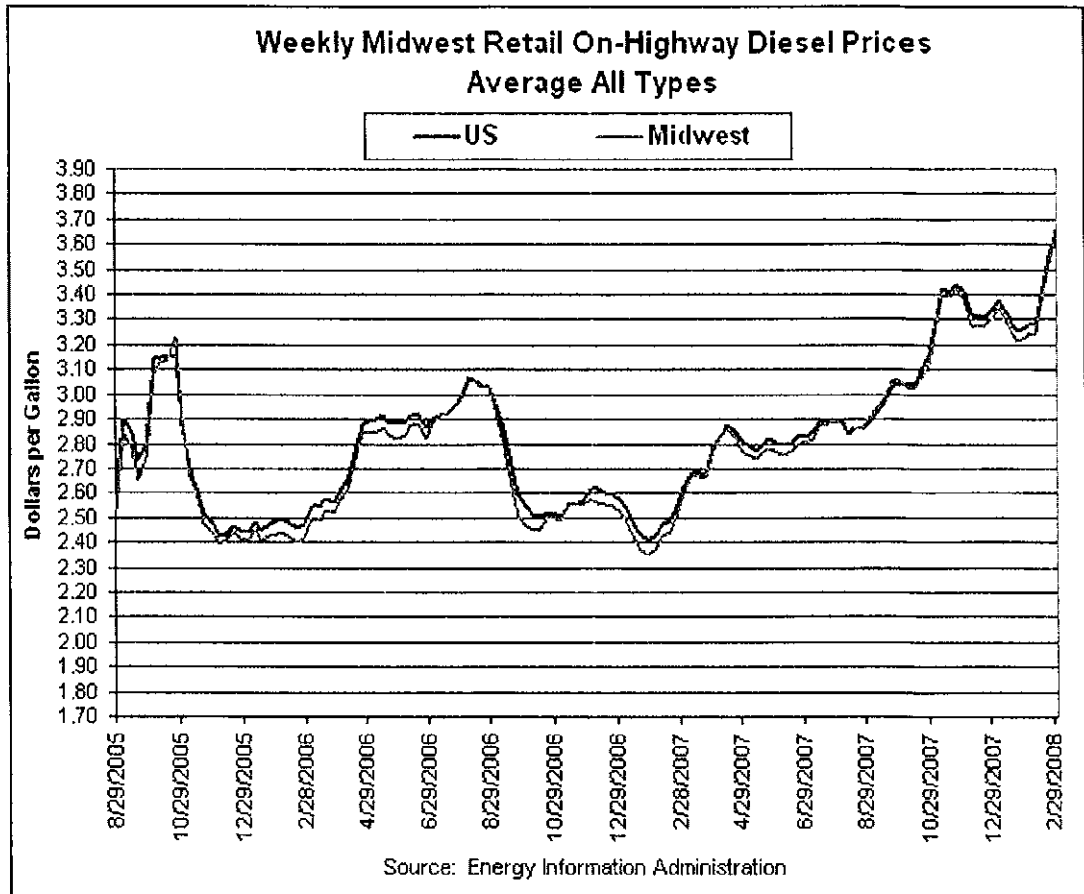


creased the price of diesel in various regions starting in mid-2006. These regulations require a reduction in the sulfur content of diesel from 500 parts per million (ppm) to 15 ppm. Refineries have until October 15, 2006 to make "ultra low sulfur diesel" (ULSD) available for sale at the pump, but some retailers may phase in ULSD prior to that.

The transition to ULSD and increased costs associated with creating a new distribution system for ULSD will increase diesel costs and create some local supply problems and volatile pricing. The EPA estimates that the ULSD rule will result in price increases of up to 13.5 cents per gallon between 2007 and 2010.

Limited U.S. refinery capacity is another factor con-

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tributing to higher diesel prices. Because of more stringent regulations and globalization, oil companies have not increased refinery capacity in the U.S. to satisfy increasing domestic fuel demand. Although a few companies have announced their intent to expand capacity at some refineries, these expansions will take several years to come into effect.²

To obtain fuel surcharges, benchmark tracking of diesel prices is desirable, along with a provision that a surcharge is triggered if diesel prices reach a certain amount above the benchmark on either an absolute or percentage basis. One company official noted, "If surcharge language is absent and the customer won't budge from the existing contract, we will figure a much higher cost of fuel to offset such costs in future contracts."³

Similar issues have come up several times since with other MTAS clients. In seeking to help municipalities avoid these problems, and to help them obtain the best bids for solid waste collection and disposal, MTAS is publishing some suggestions for including fuel cost adjustment clauses in the solid waste collection contract documents.

As the statement above indicates, with the volatility of the cost of fuel, the only way a contractor can protect themselves without a fuel cost adjustment clause in a multiple year contract is to inflate their bid enough to allow for the kind of price increases that we have seen in the past few years. To get the best bid possible on the front end, MTAS recommends including a fuel cost adjustment provision in municipal solid waste collection bid and contract documents.

Currently, many municipalities include an escalation clause,

under which an annual adjustment of rates will be made to reflect the general increase in the cost of operations. The unit rates for collection and disposal are increased by the same percent increase (if any) as accrued for the previous 12 months in the all-items Consumer Price Index (CPI). The fuel cost adjustment is for increases in fuel costs beyond the annual all-items CPI. The National Solid Wastes Management Association has a good model clause:

Fuel Cost Adjustment – Annual compensation shall be made to the Contractor to cover fuel cost increases beyond the control of the Contractor which exceed the CPI automatic annual cost escalation. At the end of each year the year's weighted average fuel price will be calculated as the year's total expense for fuel divided by the total number of gallons. If the weighted average fuel price for the second and each succeeding year of this contract exceeds the product of that for the previous year and the current (most recent) CPI, the difference will be the Fuel Adjustment Factor. This Fuel Adjustment Factor multiplied by the total number of gallons purchased in the latest year will equal the additional compensation due the Contractor. If the weighted average fuel price for the most recent year does not exceed the product of that for the previous year and the most recent annual CPI, no adjustments will be made in compensation due the Contractor. All interpretations of the fuel cost adjustment calculation method shall be made by the City. Documentation to the satisfaction of the City must be provided before any fuel cost compensation will be made.⁴

Acceptable documentation on fuel prices would include the

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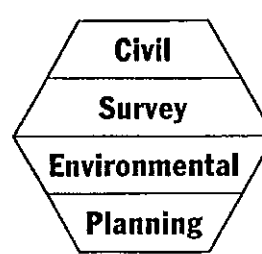
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Department of Energy's Energy Information Administration website: <http://tonto.eia.doe.gov/oog/info/gdu/gasdiesel.asp>

A source such as this could provide the fuel cost documentation, then the city and the contractor would have to negotiate the method for documenting the contractor's fuel consumption connected with the collection and disposal of the city's solid waste.

Once the documentation for both cost and consumption is agreed upon, calculating any fuel cost adjustment payment is pretty straight forward as shown in the following process:

Step 1: Determine if a fuel cost adjustment is warranted.

Take the weighted average % of fuel cost increase and subtract the % of the CPI, if the remainder is positive, then a fuel cost adjustment is warranted. (If % fuel cost increase > % CPI)

Step 2: Calculate the % of fuel cost adjustment.

Weighted average % fuel cost increase - % CPI = % fuel cost adjustment

Step 3: Calculate the fuel cost adjustment payment.

(% fuel cost adjustment/gallon) x (Previous year agreed fuel cost baseline/gallon) x (number of gallons consumption for contract/previous 12 months) = fuel cost adjustment payment

EXAMPLE:

It is January, 2006. From January 2005 through the end of 2005, the fuel cost increase was 63%. The initial baseline cost was \$1.93/gallon. The weighted average % fuel cost increase was 31.5%. The 2005 CPI increase was 3.4%. The city's contractor used 130,000 gallons of diesel fuel for solid waste collection and disposal.

Step 1:

$31.5\% > 3.4\%$ therefore a fuel cost adjustment is warranted.


Step 2:

$31.5\% - 3.4\% = 28.1\%$ cost adjustment. This equates to a 0.281 multiplier.

Step 3:

$0.281 \times \$1.93/\text{gallon} \times 130,000 \text{ gallons} = \$70,502.90$ fuel cost adjustment payment.

NOTE: A truer adjustment, possibly costing less, might be obtained if the adjustment is made over shorter periods, such as quarterly or monthly. Data is available for either.

This example from actual historical data shows why a fuel adjustment clause is so important to protect the interests of both the city and the contractor. To ensure that your city gets the best possible bids from the most contractors on the front end and avoids putting the contractor in a possible default situation, MTAS recommends considering using a fuel cost adjustment clause when seeking bids for solid waste collection and disposal. 

¹*Rising Diesel And Commodity Prices Mean Higher Garbage And Recycling Costs* National Solid Wastes Management Association, 4301 Connecticut Avenue, NW - Suite 300, Washington, DC 20008 800-424-2869 www.nswma.org

²*Ibid.*

³*Ibid.*

⁴Technical Bulletin #85-7, Release Date: November 1, 1985, NSWMA Model Municipal Contract, Model Contract Documents for Residential Solid Waste Collection and Disposal, National Solid Wastes Management Association.

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