11-4-04
#16

MEMORANDUM

TO: Mayor and City Council
Toby H. Futrell, City Manager

FROM: Diana L. Granger, Purchasing Officer

DATE: November 1, 2004

SUBJECT: Item No. 16 - RCA on Surcharges for Steel Products

The referenced RCA is a request to authorize the payment of temporary "surcharges" to vendors who supply steel products to Austin Energy. The "surcharge" is a dollar amount (based on a percentage increase that covers the unanticipated increased cost to the vendor) that is temporarily paid in addition to the unit price stated in the contract. During 2004 the worldwide steel market fluctuated sharply, which resulted in unprecedented price increases and instability in the steel industry. This instability is ongoing and has impacted the City's contracts with steel product vendors. See attached charts for industry trends which reflect the significant price per ton escalation in 2004 compared to the price per ton changes in previous years for the steel used by Austin Energy for poles, rebar, transformers, switchgear, etc.

Austin Energy holds contracts for steel products with the vendors named in the RCA. Each contract requires the vendors to provide steel products at firm prices for twelve months. At the end of the twelve months, if Austin Energy requests a contract extension, the vendor may request a price increase of up to five percent (5%) under the Economic Price Adjustment clause if the vendor can document increased costs. This type of contract has been used successfully for many years with steel vendors as well as vendors of other goods and services in general.

In today's market some vendors are no longer able to hold the bid prices for the original twelve-month period. They are experiencing unanticipated price increases and surcharges from their metal suppliers. Metal suppliers are refusing to provide firm pricing and are imposing price changes without notice. In turn, Austin Energy's vendors cannot provide firm pricing because they are not able to secure it for themselves.

The steel vendors are seeking relief from their contract pricing and have requested that Austin Energy agree to pay surcharges. After reviewing the market conditions, the experiences of other governmental entities, and internal staff discussion, Austin Energy and Purchasing Office staff (Staff) recommend the surcharge approach as the most advantageous and flexible method to address the instability of the steel market because:

1. Surcharges are temporary and will not change the base price of the goods covered by the contracts.

2. Surcharges allow both the vendor and Austin Energy to deal with each other fairly. As prices increase due to unpredictable market conditions, Austin Energy will pay the vendor the unanticipated increased cost if it is justified in accordance with the surcharge procedures established by Staff. When prices fall or return to normal circumstances, Austin Energy will either pay a reduced surcharge or eliminate the surcharge entirely.

To be eligible for a surcharge, a vendor must submit an application and provide a copy of the vendor's actual invoice and letter from the metal supplier with an explanation and justification for the price change. The vendor must also provide exact steel content for each item ordered so Austin Energy can validate the actual increased cost experienced by the vendor. When this information is received, it will be compared to the Bureau of Labor Statistics Producer Price Index (Index) that is published monthly. Austin Energy will not pay a surcharge in excess of the Index guidelines. Once a surcharge is approved, the vendor must submit an update each month, to demonstrate how its costs have risen or fallen. Staff will review or request additional justification. The surcharge will be adjusted based on this monthly update.

Two other options were reviewed by Staff before the surcharge approach was considered. For the reasons discussed below, the surcharge was determined to be the only viable alternative.

Option 1:
The City/Austin Energy could insist that vendors comply with the current terms of their contracts. Discussion with some of the vendors made it clear if they do not receive additional compensation (surcharge), they will seriously consider defaulting on their contracts because of the significant losses they are experiencing. Many of the vendors are not small businesses but rather, are national and international corporations with whom Austin Energy has had long-standing relationships. The companies are experiencing similar losses throughout their business relationships and cannot absorb such losses.

Option 2:
Austin Energy could agree to terminate the contracts and issue new solicitations. A survey of several vendors revealed that their current pricing on new solicitations is well above what the vendors are willing to accept as additional payment via surcharges.

The surcharge approach and process was reviewed and approved by Austin Energy Law. Austin Energy is authorized to pay surcharges under the Critical Business Need definition subject to City Council approval.