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Question: In early 2003, Class I rail carriers began imposing fuel surcharges on tariff rates and contract rates where allowable because of rapidly escalating fuel costs. Do these fuel surcharges over-recover the increase in carriers' fuel costs on individual movements?

Phil Burris' Answer: In most instances the fuel surcharge over-recovers the carrier's increased fuel costs. Fuel surcharges are equal to a percentage of individual shipment tariff rates, or contract rates (when allowed by the terms of the contract), and are typically tied to either the US Department of Energy's On-Highway Diesel Fuel price per gallon or the West Texas Intermediate Crude Oil price per barrel.

The fuel surcharges imposed by the Class I carriers in February 2005 ranged from KCS' fuel surcharge of 8.0% to CN's fuel surcharge of 12.0%. The fuel surcharges are applied in addition to any other rate adjustment published by a carrier on its tariff rates or the rate adjustments allowed in contracts.

Increased Fuel Cost – The Surface Transportation Board (STB) publishes an all-inclusive index of railroad input prices quarterly titled the *Rail Cost Adjustment Factor* (RCAF), both unadjusted for productivity (RCAF-U) and adjusted for productivity (RCAF-A). The RCAF-U is used to adjust tariff rates and some form of the RCAF-U is used to adjust most contract rates.

The index reflects the railroad industry's market basket of costs, and is comprised of labor, fuel, materials and supplies, equipment rents, depreciation, interest, and other items. The fuel component of the RCAF, which equals 10.6% of the railroad industry's market basket of costs, has increased by 52.2% from 2003 to first quarter of 2005 (1Q05). Measuring the 52.2% increase as a percent of the carriers' total costs yields a fuel-related increase in total cost of 5.5% between 2003 and 1Q05.

Increased Revenues – The RCAF-U, in whole or in part, is used by the railroad industry to adjust both tariff and contract rates. For the period 2003 to 1Q05, the RCAF-U has increased by 9.3%, driven largely by the 52.2% increase in the carriers' fuel cost. Applying the 9.3% increase in the RCAF-U to an individual rate, plus applying the current industry average fuel surcharge of 9.0%, produces a compounded increase in rates of 19.1%. Of the 19.1% increase,15% is related to fuel (1.09 x 1.055).

Over-Recovery of Cost – Clearly a 19.1% *rate* increase will more than offset the carrier's 5.5% *cost* increase that is related to fuel. For example, assume an individual shipment moves for $18 per ton in 2003, that the carrier's cost is $10, of which its fuel cost (10.6%) is $1.06 per ton. As shown previously, the fuel portion of the *rate* increase is 15% or $2.70 ($18 x 0.15). By comparison, the carrier's *fuel cost* increased by only $0.55 ($1.06 x 0.522) for which the carrier receives $2.70 in fuel recovery.

Possible Solutions – In order to be successful in reducing the fuel surcharge imposed by a rail carrier, it's essential for a shipper to have a thorough knowledge of the carrier's fuel cost, its total cost of providing service, and what portion of the carrier's rate increases are attributable to changes in fuel costs. Based on this information, a strategy may be structured to negotiate a fuel surcharge that will compensate the carrier only for fuel cost increases not covered by the rate adjustment mechanism, thus avoiding a fuel surcharge that creates a second profit center for the carrier.

If you're a consultant, Supply Chain Comment would like to feature you in an upcoming issue. Please send your contact information to mholodnicki@cscmp.org.

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