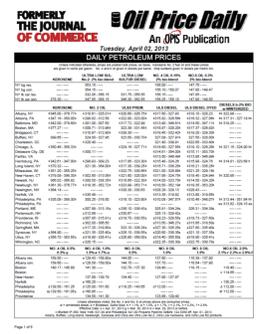


## Understanding Performance Bonds for Petroleum Purchasing

Understanding and planning for risk during a bid process is critical to any government's efforts to procure goods or services. Many governmental entities require contractors to obtain performance bonds that insure the completion of the project being bid out since the government is at risk for 100% of the funds being expended. While this is a good strategy for high risk projects like construction, many governments require it for petroleum purchasing as well, even though the risks for these projects are significantly different. This results in higher costs for vendors, which are then passed on to the government in the company's markup for services.

The potential exposure for petroleum purchases is very different than traditional projects like construction. The price that the government pays for petroleum is based on a floating posting, like the Oil Price Information Service's (OPIS) Oil Price Daily (OPD) posting (formerly the Journal of Commerce). All companies that submit bids for the delivery of petroleum to a particular governmental entity use a posting like this as the basis for their pricing. They will then add a markup based on their costs involved with delivering the product (freight, labor, requirements, etc.). These costs will also include the company's costs for obtaining performance bonds required by the bid.



Below is an analysis of the potential risk exposure for a contract for the delivery of 200,000 gallons of gasoline:

| Price Type     | Price  | Potential Risk                     | Explanation  |
|----------------|--------|------------------------------------|--|
| OPD Posting    | \$3.16 | \$0                                | No risk because government will pay this regardless of bid                   |
| Company Markup | \$0.06 | \$12,000<br>(200,000 gal x \$0.06) | Actual risk because if contractor does not perform, markup may change        |
| Total Cost     | \$3.22 | \$12,000                           | Total risk equals \$12,000 because dollars at risk only correspond to markup |

Many government bids require a performance bond for the Total Cost of the contract, which in the case of the example above would total \$644,000 (\$3.22 x 200,000 gallons). A performance bond of this size would typically cost a contractor \$6,440 per year (\$644,000 x .01 bond cost). If the government were to require a performance bond equal to the Company Markup and proportionate to the risk of the contract, the performance bond would cost \$120 per year (\$12,000 x .01 bond cost). If the government requires a performance bond for the total cost of the contract (\$644,000) instead of the actual dollars at risk (\$12,000), contractors are required to spend an additional **\$6,320 per year. This cost is typically passed along to the government through the company markup.**

Performance bonds are essential tools for governments to manage the risks of their contracts, but the size of the required bond should align to the actual risk of the project. This will ensure that the government is sufficiently managing their risk while being good stewards of taxpayer dollars.