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How To: Plan for the rising cost of construction materials

Costs for copper, gypsum and other materials have skyrocketed; make sure you're prepared for escalating construction costs before starting your project.

By MAYA PAYNE SMART

Once upon a time, contractors gave construction project estimates that were good for weeks, and owners could take their time negotiating contracts.

But today, demand from China and India, the Hurricane Katrina rebuilding effort, high new home construction rates and speculation in the commodity markets are driving prices for copper, gypsum and other building materials to unprecedented heights and adding an unwelcome complexity to construction projects from conception to completion.

The price pressures have left local construction companies scrambling to manage costs without sacrificing quality, said John D. Pumper, chief financial officer for Garfield Heights-based D-A-S Construction Co.

“There are a lot of things outside of our borders affecting things inside our borders that we have no control over,” Mr. Pumper said. “It certainly has me concerned … how we are going to be able to continue working for our clients to build their projects for them at a price that they can afford.”

The reality is that current price trends are going to require owners to spend more money — 10% to 15% more — to get the same project done, Mr. Pumper said.

Prices for gypsum, which is used to make drywall and plaster, leapt 26% from May 2005 to May 2006 as residential home construction pushed plants to full capacity, said Jim Haughey, chief economist at Reed Construction Data, a research firm based in Norcross, Ga. The price that electricians and plumbers pay for copper has doubled due to a high level of construction and speculation in the financial markets, he said.

In addition, prices for cement and petroleum-based products like asphalt roofing installation are on the rise.

Facing the facts

Barry Miller, a partner with the law firm Benesch, Friedlander, Coplan & Aronoff LLP in Cleveland, said property owners must acknowledge this new market reality of “dramatic and unpredictable price escalation” and its far-reaching implications.

The price volatility characterizing today’s construction materials market has adversely affected the accuracy of pre-construction estimates, shortened the timeframe for contract negotiation and even hindered some contractors’ ability to complete projects, he said.

Those who don’t educate themselves and take action to manage construction costs risk spending beyond their budgets or, worse, enduring financial collapse, Mr. Miller said.

He advises owners to plan for the worst-case scenario by increasing the size of contingency costs in their budget to account for rising material costs and putting performance bonds in place to protect themselves if a contractor is unable to complete the project.

Performance bonds are three-party instruments between a surety, contractor and owner in which a bonding company assumes the risk and agrees to fulfill the contractor’s obligations by providing funds or hiring replacements if needed. The risk management mechanisms increase project costs, but are well worth it when doubt exists about a contractor’s ability to get the job done, Mr. Miller said.

“You (the owner) may be doing everything right, but in certain situations you have a contractor who doesn’t have the financial resources to weather the storm,” he said.

Banks providing project financing also look favorably upon bonding and contractor insurance policies like Subguard, a bonding alternative that gives contractors more control in the face of default than traditional performance bonds, said David Drummond, national construction engineering manager at KeyBank.

Additionally, the current price environment has prompted banks to add more contingency funds — 5% to 8% compared with 3% to 5% in the past — to construction loans and to be more selective about their borrowers, he said.

“We’re looking at best-in-class developers that can bring things to market in budget and on schedule,” Mr. Drummond said.

And in the event that things still go south, banks work to renegotiate loan terms, find equity partners to infuse cash into the deal, finance a mezzanine loan or increase the loan amount where appropriate, he said.

“It doesn’t make sense for us to stop funding unless it is a huge problem,” Mr. Drummond said. “We like to work with developers to come to a successful conclusion.”

Sharing the burden

Contractors say that the recent wave of market volatility has made closer relationships with architects, owners and other industry participants indispensable.

It is important that all parties stay attuned to the market and in communication with each other so that expectations are realistic, said Don Dreier, executive vice president for Donley’s Inc., a Cleveland-based construction firm.

“The biggest thing we continue to do is stay in touch with suppliers, vendors and economists, who look at these (material price) trends, so that as we prepare estimates we’re using the most current information available,” he said. Publications such as *Engineering News-Record*, a trade journal, also are valuable resources, he said.

“We are constantly trying to educate the owners of what’s going on in the marketplace so that the pricing that we’re giving them is not overly escalated, but they are sharing in the risk if pricing does increase sharply, ” he said.

Current market conditions have made fair price escalator clauses — contract provisions that distribute price increase burden between contractors and owners — more popular, Mr. Miller said.

Typically, the burden of swelling prices rests on contractors’ shoulders so they pad price quotations to shield themselves from fluctuations.

“They add a factor to their pricing to account for the fact that they are going to have to pay more when the time comes to place the order,” Mr. Miller said. “If dramatic increase doesn’t occur, the windfall goes to the contractor.”

By contrast, fair price escalator clauses eliminate hidden contractor contingencies and state that the owner will cover price increases based on an agreed upon material price index.

Managing costs

Owners also may buy construction materials for themselves at a project's outset to avoid the price increases that can occur during the long timeframe between contractor bidding and material ordering.

Pre-purchasing materials "is an alternative that people can utilize to minimize price uncertainty," Mr. Miller said.

But it's not for everyone and is most appropriate for experienced owners with the means to accurately identify the amount of materials needed and key supplier relationships, he said.

Getting the contractor involved on the front lines with the architect also can help manage construction costs.

This type of designer-builder collaboration is a dramatic departure from the typical procedure where multiple contractors bid on projects designed without their input, but leads to smarter and more cost-effective solutions for the owner, said Mr. Pumper of D-A-S Construction.

He has found that when contractors are engaged earlier in the process, they can work with the architect to find savings at each project level from more cost-effective design to alternative materials that accomplish the same thing.

"There's not one silver bullet as a part of this project," Mr. Pumper said. "It is accomplishing a lot of little things that add up to big savings for our clients."