



What's it cost?

Anyone who has experienced a river's flooding knows the feeling of watching the waters rise, hoping that the flood will be averted but fearing the inevitable. There's a point when the river reaches the bank full stage where water seems to be testing the river bank and holding the level just before it breaks through and begins covering what had been dry land. Over the past year the progress of price inflation for construction has been progressing like a rising river and some recent events may be pointing to the bank full stage for pricing.

First, a look at the data. The Bureau of Labor Statistics (BLS) released its report on producer price inflation on April 15, which showed that the trend upward since the end of the recession is pushing inflation well ahead of the historical norms. The producer price index (PPI) for finished goods jumped 1.3 percent, not seasonally adjusted (0.7 percent, seasonally adjusted), in March and 5.8 percent over the past 12 months. The PPI for inputs to construction, which includes diesel fuel, leaped 2.0 percent, not seasonally adjusted, for the month and 6.9 percent over 12 months.

PERCENTAGE CHANGES IN COSTS		March 2011 compared to		
Consumer, Producer & Construction Prices	1 mo.	3 mo.	1 yr.	
Consumer price index (CPI-U)	1.0	2.0	2.7	
Producer price index (PPI) for finished goods	1.3	3.5	5.8	
PPI for construction	2.0	4.0	6.9	
Costs by Construction Types/Subcontractors				
Residential buildings	1.6	3.3	5.7	
New industrial building construction	-0.3	-0.2	0.5	
New warehouse construction	0.0	0.2	1.0	
New school construction	-0.1	0.6	1.3	
New office construction	0.0	1.3	0.7	
Concrete contractors, nonresidential	0.0	-0.3	0.1	
Roofing contractors, nonresidential	0.4	1.3	-0.4	
Electrical contractors, nonresidential	-0.2	0.7	1.8	
Plumbing contractors, nonresidential	0.2	0.3	0.5	
Costs for Specific Construction Inputs				
#2 diesel fuel	11.1	22.8	42.5	
Asphalt paving mixtures and blocks	0.0	1.0	1.8	
Concrete products	0.0	-0.2	-0.6	
Brick and structural clay tile	-1.0	-3.7	-3.3	
Plastic construction products	1.4	1.2	2.5	
Gypsum products	7.0	2.7	5.4	
Lumber and plywood	0.6	2.3	0.7	
Architectural coatings	1.3	2.9	6.4	
Steel mill products	5.3	12.4	15.3	
Copper and brass mill shapes	-6.0	1.5	17.2	
Aluminum mill shapes	1.9	3.5	11.7	
Fabricated structural metal	-0.2	3.0	3.3	
Prefabricated metal buildings	3.6	10.7	16.9	
Crude petroleum (domestic production)	19.9	17.1	27.0	
Asphalt (at refinery)	0.3	7.9	-5.6	
Cement	0.8	-0.2	-3.7	
Iron and steel scrap	-1.2	12.2	18.8	
Copper base scrap	-0.1	5.0	16.9	
Source Bureau of Labor Statistics, Updated April 18, 2011 Compiled by Ken Simonson, AGC Chief Economist				

The largest increases in materials prices were for diesel fuel, which was up 11 percent in March and 42.5 percent since March 2010; copper and brass mill shapes, which declined 6.0 percent in March but were up 17 percent over 12 months; aluminum mill shapes, up 1.9 percent in March and 12 percent for the year; and, steel mill products up 5.3 percent and 15 percent respectively. Steel pricing has spiked locally during the past two months, climbing from \$2,700 or \$2,800 per ton to \$3,600 per ton in late April. Short supply due to constrained refining capacity is the primary reason being given for the price of diesel rising faster than that of oil.

March's data shows a steep jump compared to previous months and the major factor in the increases – rapidly rising energy costs – will likely push April's and May's index higher as well. Of greater concern to the long-term trend is the fact that the compounded impact of the more accelerated inflation over the past six months has pushed annual inflation to levels that are more than 50 percent higher than the four percent or so that has been the norm over the past two decades.

PNC senior economist Robert Dye addressed the spike in diesel prices at an April 25 construction cost seminar. Dye broke the price of oil into four components in what he calls the 'Oil Price Pyramid.'

"The underlying supply and demand fundamentals support an oil price of \$80 or \$90 per barrel," he explained. "But on top of supply and demand you have a risk premium – triggered by things like the unrest in Libya – as well as pricing that accounts for the day-to-day speculation in the price of oil and for the fluctuations in foreign currency exchange. Those three factors can add from \$10 to as much as \$25 per barrel."

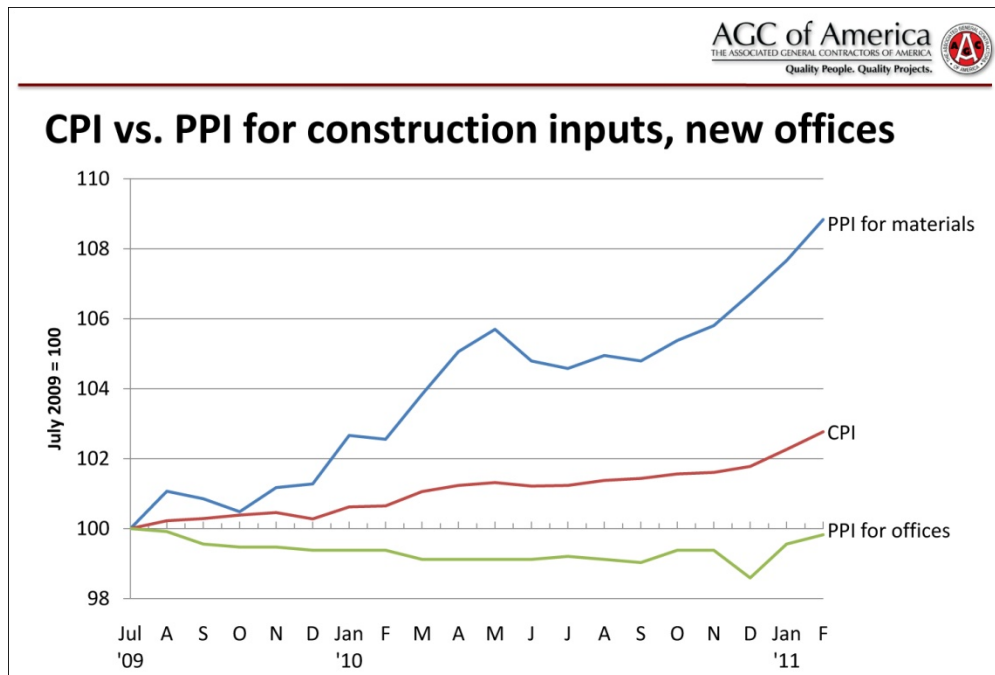
Dye's opinion is that the current prices of roughly \$110 per barrel are beginning to impact consumption of fuel and will trigger what he calls the 'long-term negative feedback' that pushes prices back down to the \$90 level.

AGC's chief economist Ken Simonson agrees with Dye's opinion that oil should reach a plateau soon and added that the inflation for construction costs is divided into two categories.

"The inputs that have seen the bigger increases and most volatility all have significant global demand," he says. "The more stable materials – lumber, plywood, drywall, asphalt – are readily available in the U. S. and have little export demand."

Simonson forecasts that additional inflation is probable but that the upward action has less momentum now. His expectation is that increase could reach as much as eight percent but that energy costs should pull back in the second half, keeping producer prices at inflation levels between four and eight percent.

When put into the context of market conditions, the rising material prices may be compounded to have a larger impact on construction projects. As prices have continued to accelerate since early 2010, costs for completed structures have remained virtually flat. The BLS March report showed the index for finished industrial rising one-half percent during the past year, offices 0.7 percent and schools 1.3 percent. That means that the inflation has not been passed on from contractors to project owners, creating a squeeze on contractors' profit margins that reflects their anxiety about getting work.



Producer prices for construction materials have outstripped increases in consumer prices since the last quarter of the recession. Producer prices for offices, which include market forces, continue to lag the July 2009 level. Source, Bureau of Labor Statistics.

More than one developer or building owner has bought into the notion that the most recent two or three years have been a good time to build because of aggressive, competitive contractor bids. Many owners in our region have in fact shifted their modus operandi away from negotiating or bidding to a narrow group of contractors to more open competitive bidding to take advantage of the market. Bidding six points or more below the cost of the materials is not a sustainable model for the market.

When prices climbed dramatically in the first half of 2008 the market conditions were quite different. Nearing the end of an extended growth cycle at that time, local contractors reflected the higher prices in their bids early in the inflationary period. Over the past twelve months the prices climbed more gradually and contractors were still fighting to rebuild backlogs and create positive cash flow. While market conditions have not improved to the same level as in 2008, the squeeze from higher prices – especially from rising diesel prices that impact almost all products – may have reached the point where inflation can no longer be absorbed by contractors.