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Andrew Richards - Solutions owners and contractors can utilize to manage construction cost escalation

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Recently, too many owners have discovered that the construction budgets they developed in 2009 and 2010 are inadequate today, as the cost of construction materials continue to rise due to rising costs of oil and the effects of recent natural disasters. Fortunately (and unfortunately), this is not the first time that the construction industry has faced such a crisis caused by rapid cost escalations. The fact is, despite forces beyond individual control, owners can contain the risks to their projects due to cost escalation by controlling several key factors. These factors might slightly increase the cost of the project, but they could ultimately save the project from collapse in the event of significant cost escalations.

Develop a budget at inception

To be a truly effective tool, project budgets need to be reviewed at the beginning of the project, even if the project is being self-funded. By doing the conceptual estimate on day one, owners can determine if their project is feasible. If the cost review is deferred to a later date, the initial work might be wasted if the project is deemed over budget and not feasible. The cost estimate must include a bill of quantities providing a description of materials, a clear definition of the quantities and costs of the materials, and the cost of the labor. In addition to saving time during the preconstruction phase, these estimates provide coordination of the construction documentation so that all aspects of the project-from demolition, site work and structure to finishes and services-are included in the estimates. The process also saves time in evaluating bids and detecting errors or ambiguities in the documentation, which can result in costly delay claims or change orders. Owners should also seriously consider retaining an expert cost consultant to review the initial project budget. Again, the extra cost involved in retaining such an expert will pale in comparison to the losses an owner can incur if its project runs out of money during construction.

Distribute escalation risk

between owner and contractor

A simple way for an owner to limit its costs is to insist on the use of guaranteed maximum price (GMP) and lump sum contracts instead of cost-plus-fee agreements. The use of such agreements will cap an owner's costs at a certain price. Knowledgeable contractors will be aware of the seemingly-ever increasing costs of materials, and their bids reflect their consideration of such risk. Thus, the risk of cost escalation is distributed among the parties, and thereby reduces the likelihood that either party will be financially unable to complete the project.

Avoid bargains that

seem too good to be true

Everyone loves a bargain, especially owners who are paying millions of dollars in construction costs. Even during good economic times, however, an owner should think twice before accepting a bid that is significantly lower than all of the other bids received because such bids are likely the result of a contractor incorrectly estimating the cost of the project. The likelihood of a contractor "underbidding" a project increases dramatically when costs of materials escalate suddenly and significantly. When a contractor "underbids" a project, the chances of the contractor defaulting increase dramatically. In such cases, an owner must retain another contractor to complete the work and, almost certainly, will pay significantly more for the work. Unless the owner has protected itself against such a contingency (i.e. reserve funds and/or a performance bond), the additional costs incurred could lead to the owner running out of the money needed to complete the project. Therefore, owners should be wary of accepting bids that are significantly lower than all other bids they have received.

Insist on Performance
and Payment Bonds

Although required on almost all public improvement projects, performance and payment bonds much are used less frequently on private construction projects because owners and contractors both deem them to be unnecessary and costly expenditures. However, in times of economic uncertainty and rising material costs, contractor defaults increase dramatically, especially on projects where the contractor cannot pass through cost increases to the owner. In order to ensure that their projects are completed in the event of a contractor default, owners of medium and large scale projects should require their contractors to procure performance and payment bonds. The premiums associated with the bonds can be passed along to the owner, who should not think twice about assuming the costs thereof in order to ensure their projects get completed.

Set an aggressive
schedule and stick to it

The quicker a construction project progresses, the less likely the project is to be impacted by escalations in the cost of materials. Owners should include strict time of performance language in their contracts and makes sure that such terms are enforced.

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