Don't Count on Cost Relief

By Ken Simonson

Do slower economic growth and a lingering housing slump mean lower costs for nonresidential construction? Don't bet on it.

In fact, the lull in cost escalation, such as it was, may already be over. The producer price index (PPI) for inputs to construction industries leaped 9.1% in 2004 and 8.2% in 2005 before slowing to a 4.6% gain in 2006. In the 12 months ending in August 2007, the rate of increase had slowed to 1.6%, less than the growth in the consumer price index (CPI). But by November, the construction PPI had accelerated again to a 5.4% growth rate. What happened, and what is likely for 2008?

Learning from the Past

The 2004 jump was a shock to contractors, fabricators and owners alike. It followed several years in which inflation wasn't significant for either consumers or the construction industry. But a combination of recovery from the 2001 recession, strong growth abroad and the lingering effects of steel tariffs that were in place from 2001 to 2003 caused the PPI for steel mill products to shoot up 49% in 2004. The PPI for diesel fuel soared 38%, and ever-increasing demand for copper and brass mill shapes and gypsum products pushed those indexes up 30% and 20%, respectively.

In late 2005, Hurricanes Katrina and Rita knocked out hundreds of oil and gas platforms in the Gulf of Mexico and shut down or damaged numerous refineries and gas processing plants. That sent the PPI for plastic construction products up 22%. Diesel, copper, gypsum and concrete products all recorded double-digit gains.

By mid-2006, all of these increases subsided or turned into declines as oil and gas facilities came back on line and demand from home-builders plunged. Why hasn't the moderation continued into 2008, especially with home-building sinking further?

Energy and Exchange Rates

Two interrelated factors explain the new upturn: oil and dollars. Construction is an exceptionally oil-intensive business, topped only by transportation and petrochemicals. Contractors use diesel fuel directly for earth-moving and other offroad equipment and for construction vehicles such as dump trucks, concrete mixers and pumpers, and mobile cranes. In addition, the thousands of deliveries of equipment and materials, and the backhauls of dirt, debris and equipment, generally include diesel fuel surcharges on the freight bill. Asphalt and some construction plastics depend on oil as a feedstock.

Furthermore, most construction inputs embody a lot of petroleum, or other forms of energy that are sensitive to the price of oil, in their mining, manufacturing, milling, delivery and installation. Thus, the 65% increase in the PPI for crude oil from November 2006 to November 2007 shows up directly in construction inputs through the cost of diesel fuel (PPI increase of 50%), and indirectly in many other costs.

The decline in the value of the dollar against several key currencies has made imported items and ocean shipping costs more expensive, and has enabled domestic manufacturers that compete with imports to raise their prices accordingly. These effects have just begun to show up in some PPIs: the index for hot-rolled bars, plates and structural shapes increased 5.8% in the 12 months through November 2007, but the index for steel pipe and tube was down 3.2%.

Divergent Drivers

For 2008, three forces will shape construction costs. The ongoing decline in housing starts will continue to depress prices for wood, brick, insulation and gypsum products. Near-record oil prices (more than 60-100% higher in January 2008 than a year earlier) will show up in high diesel and asphalt costs and in delivery and hauling costs, especially for heavy, bulky materials like concrete, steel and dirt. And the weaker dollar will make imports and import-competitive materials, such as steel and copper products, more expensive.

These three factors will affect different types of construction according to their respective weights. Single-family homebuilding, the only type that uses a lot of wood products, will benefit from abundant supplies of wood and sluggish demand. At the other extreme, fuel-thirsty highway construction, with its heavy reliance on diesel fuel, asphalt, concrete and steel, could return to double-digit cost increases. Such disparity would match the record from December 2003 to November 2007, when the PPI for inputs to single-unit homebuilding climbed 22% and for highway and street construction, 49%. In comparison, the CPI rose 14% over those four years.

The bottom line: The PPI for construction inputs, including diesel fuel and other items consumed during construction as well as materials that go into the finished project, is likely to rise 6-8% in 2008, compared to a probable CPI increase of 2-3%. Moreover, construction cost increases will likely continue outpacing the CPI in future years, for two reasons. First, many construction inputs, such as copper, are in hot demand from countries throughout Asia and elsewhere that are simultaneously building infrastructure, industrial capacity, housing and consumer goods. These materials come from relatively few mines and output does not rise in tandem with growing demand, leading to price surges. Second, construction – far more than consumers – depends on physical delivery of dense, energy-intensive items, making the industry vulnerable to transportation bottlenecks and oil-price spikes.▪

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