

Cost Escalation in Construction



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The evolution of cost escalation in construction

Background

Mid-2022, Downer published a paper on escalation in construction. It was pleasing to see how much interest the paper generated and hopefully helped increase awareness on cost challenges and how best to mitigate the risk.

A year on, we are still challenged with the issue of high inflation and cost escalation on our construction contracts. But what has changed? In this paper, we highlight changes in cost movements over the past year.

Labour costs

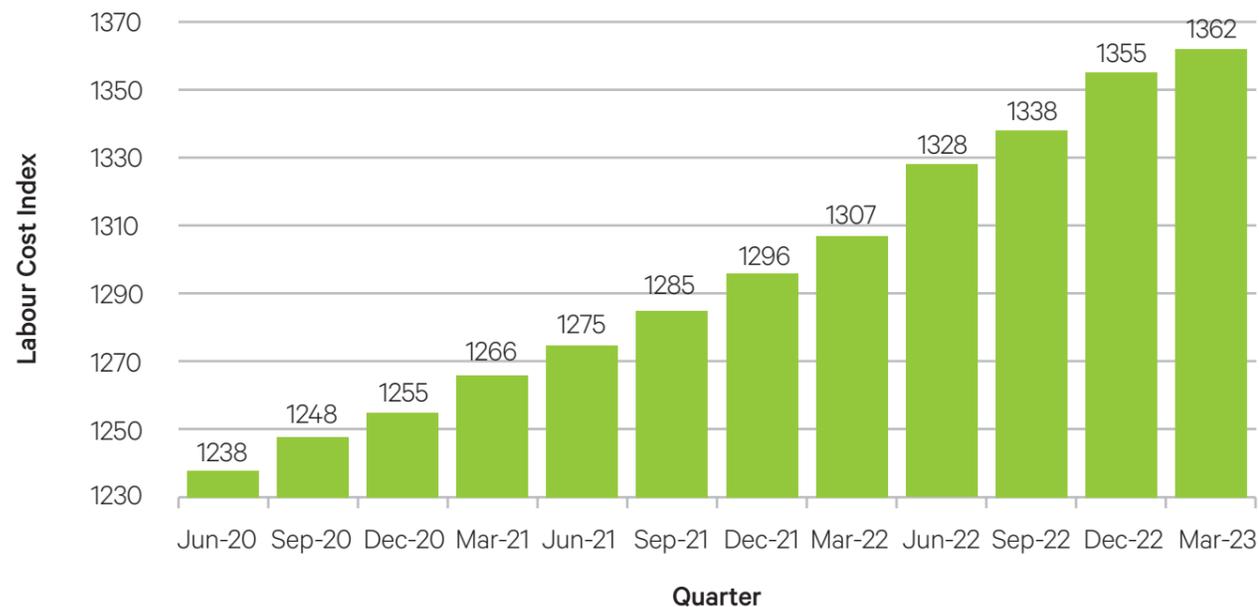
Our labour costs continue to rise - driven by several key factors. These include the ongoing general demand for skilled workers, relatively low unemployment rate and workers' demands to meet higher living costs.

This situation is compounded by legislative changes associated with increases in the minimum wage (up \$1.50 per hour from 1 Apr 23) with similar increases expected in 2024 in line with inflation.

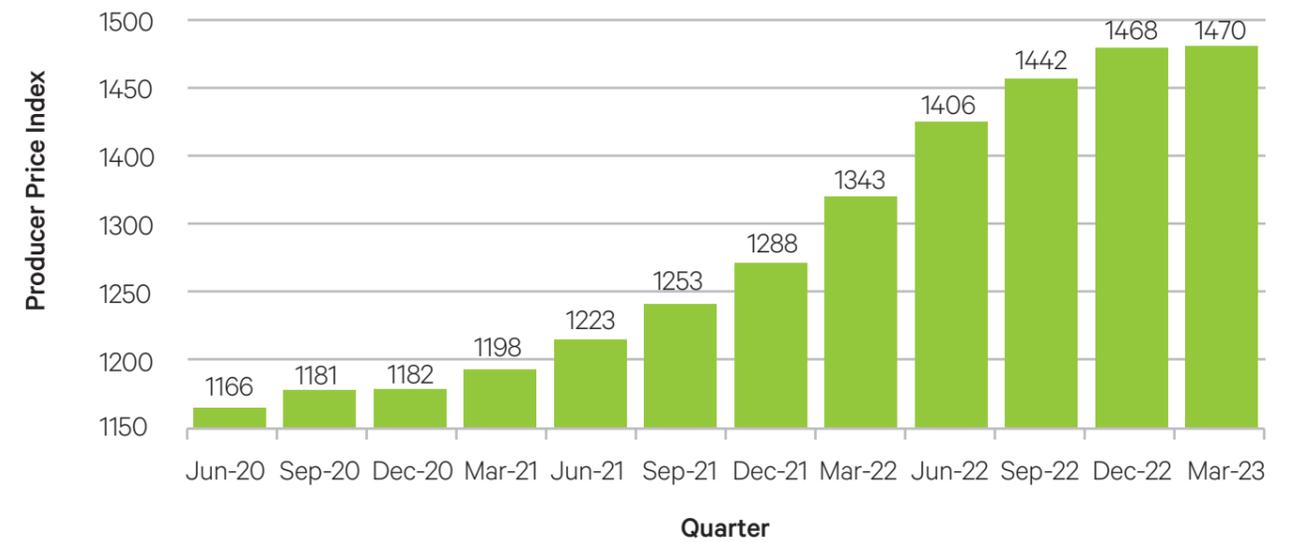
Despite a net migration turnaround of over 70,000 people into New Zealand (April 2023) since the re-opening of our borders post-Covid, the demand for skilled labour (particularly in hospitality, tourism, transport and construction) remains very high. Australia increasingly remains a significant drawcard to our skilled workforce.

Competition for skilled labour in our sector has led to increased demands for enhanced employment packages incorporating better employee benefits (health insurance, paternity leave supplements, well-being/leave provisions, incentive schemes such as bonuses, shares, etc.) plus more flexibility in working arrangements. These have contributed to increased labour costs for businesses; typically, in the order of 2-5% to the labour on-costs.

Construction Labour Cost Index



Heavy and Civil Engineering Construction material Cost Escalation



Statistically, the construction labour indices have also shown these increases in costs. As stated previously, construction labour costs have increased at an average rate of just under **4% per annum** since 2019 and this has continued through to 2023 as illustrated below (*Labour Cost Indices for Construction - Private and Public combined*). This rate is expected to continue to 2024. By comparison, our own internal labour costs have continually increased 5-6% per annum since 2021.

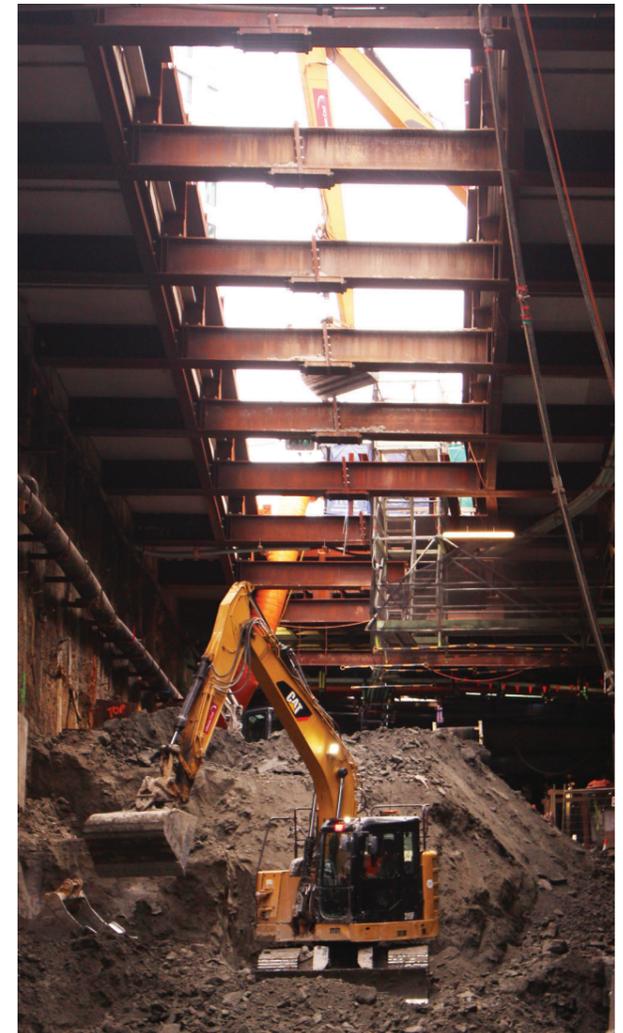
Material costs

In contrast, construction material costs appear to have stabilised entering 2023, with very few notifications from major suppliers advising us of pending future price increases since late 2022.

Primary reasons for this change are suppliers have been able to rebuild their stock levels since the pandemic and transport costs have also stabilised, although domestic freight costs are still challenging, particularly given the recent weather events in New Zealand.

Survey data from the building sector highlighted that building material costs increased by just under 20% over the 12-month period to February 23, but this percentage was only 6% over the preceding six months to February 23. This decline was anticipated to continue at a rate of around 3% over 2023.

The graph above illustrates the Producers Price Indices for Heavy and Civil Engineering. These include input data for raw material, fuel, and services and excludes labour. The graph clearly illustrates material costs stabilising from 3rd quarter 2022.



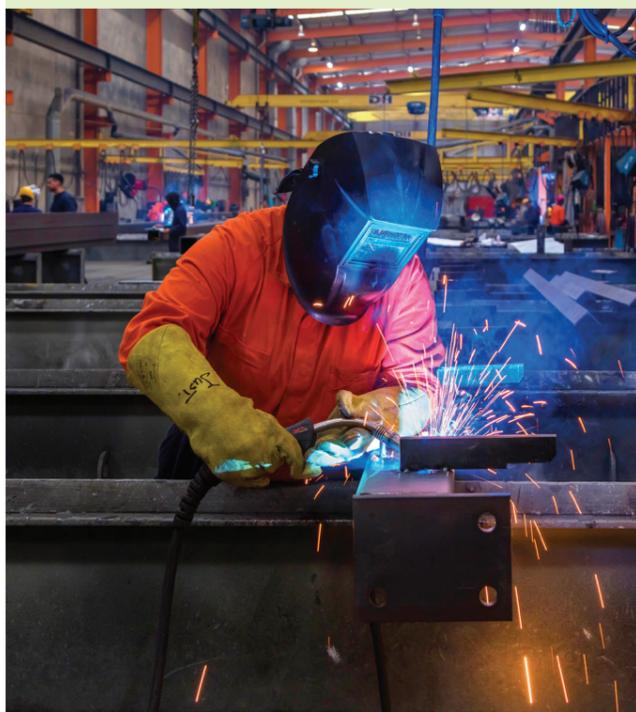
Steel

Steel prices have also fallen, driven largely by a fall in the cost for raw steel. However, demand remains high as overseas governments continue to maintain their substantial capital investment in infrastructure.

The reduction in steel costs has seen a fall in steel reinforcing bar costs.

The slowdown in the building sector has also seen a decline in the number of enquiries for steel products. An update from Steel Construction NZ highlighted growing spare capacity reported by their fabricators which is anticipated to be nearly 30% for year ending March 2024.

This downward pressure (removal of constrained capacity) may stimulate more competition in the sector resulting in lower costs. However, the reduction in raw steel costs has also been offset to an extent by increasing labour costs associated with fabricated steel products.



Shipping costs

Global shipping costs have generally declined, and this has been reflected with lower shipping costs to New Zealand. However, costs are not quite to pre-pandemic levels.

In general, shipping rates from Asia and Europe during the current “low season” is now around 60-85% lower than 2022; while shipping costs from the United States and Australia have only declined around 15-30% over this same period in 2022. Import air freight rates have also declined significantly (again not to pre-pandemic levels), driven by more competition and lower cargo volumes. Conversely, land transport and port costs have increased, driven by high labour, fuel and compliance costs. Challenges at the major ports have remained, with average delays of around 10-20 days being reported at Ports of Auckland and around 10 days at Port of Tauranga.

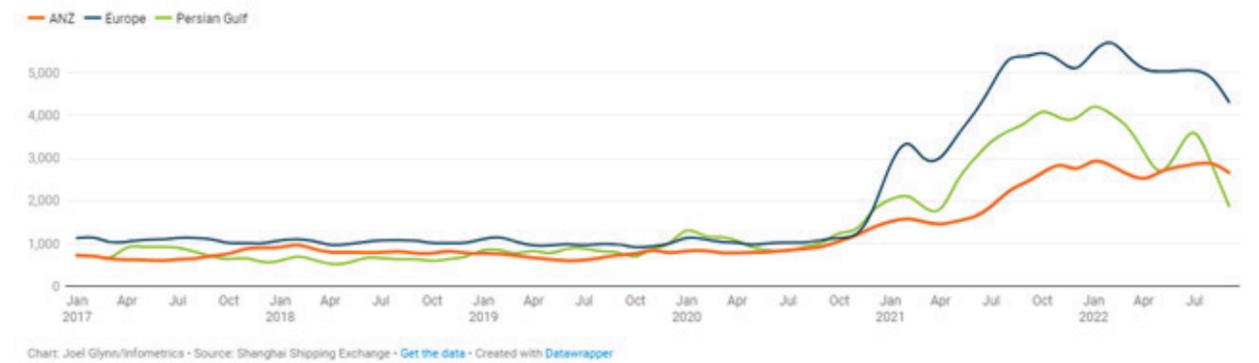
It is likely that shipping rates will continue to decrease and possibly stabilise for a pre-Christmas peak season (September – December). However, based on current contractions in economic activity, the expected peak season may not actually occur or be relatively short. Shipping lines are expecting a more robust peak season in 2024, which may drive rates back up.

Other pressures

At the start of this year, Cyclone Gabrielle caused severe flooding and damage to homes, infrastructure, and livelihoods in parts of Auckland and north of Auckland, the Coromandel, and eastern regions of the North Island.



China Containerized Freight Index service components, monthly averages



This cyclone and subsequent severe weather events are likely to comprise one of New Zealand’s costliest natural disasters, with repairs and economic loss expected to exceed the recent Kaikōura earthquake.

Predictions that escalation is likely to ease to 4-5% for non-residential construction may need reassessing. Previous natural disasters such as the Christchurch earthquake resulted in inflation in Canterbury over a three-year period, nearly three times higher than the rest of the country at around 10%.

It is anticipated that the regions affected by Cyclone Gabriel, particularly the eastern regions of the North Island, will experience similar cost pressure in the residential and infrastructure areas.

It is expected that increased construction activity associated with post cyclone recovery will result in a more sustained period of elevated escalation across the country.

Conclusion

Despite construction material costs having stabilised, due to declining steel and shipping costs, labour costs continue to rise, and construction activity associated with post cyclone recovery will likely result in sustained escalation. These factors will continue to create challenges in forecasting risk contingency. In looking for a solution to these ongoing challenges, Downer will continue to engage with industry peers and push for a collaborative approach to risk sharing. It has been pleasing to see our major clients recognising the need for a more collaborative approach to escalation risk on their contracts, rather than taking the stance that it is to be a contractor risk.

The principle that neither party should profit from escalation must continue to be adopted in any contract negotiations involving escalation costs.

Based on the current climate crisis and continued cost escalation in construction, we are entering a new era in disaster recovery. Collaboration is essential to address these challenges. As part of the East Coast Recovery Alliance, we look forward to playing our part in influencing the economic prosperity of our communities, as well as NZ Inc.



About the Cost Escalations Author



John Oey, Chief Estimator – Transport

John has nearly 40 years’ experience in the civil construction industry, including over 20 years in senior estimating roles. He has been involved in large high-profile projects across New Zealand and the Pacific, many of which were delivered in a collaborative working environment. With long experience in leading the TCE and cost estimation process, John uses his engineering knowledge to provide insightful input on costs, commercial topics, and constructability when working with design and construction teams.

The strong long-term relationships John holds with his industry peers, clients, and suppliers, has allowed him to stay on top of issues such as cost escalation and carbon estimation.



Downer 
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Relationships creating success