



## Understanding and Anticipating Volatile Construction Costs

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Volatile costs have been a plague for Canada's construction industry over the past several years. **The explanation for the roller coaster ride lies in a complicated mix of domestic and global circumstances.** Let's look at the traditional determinants first and then move on to factors that have been overlaid on top.

**The level of construction activity in each of the three major sectors – residential, non-residential building and engineering – is a primary driver.** This becomes important because some degree of material substitution can be made, helping to maintain the demand-supply balance. When residential markets are weak, this can free up some materials and workers for non-residential building activity. Engineering work, with its specialized trades and concentrated use of steel and concrete, will receive the least help from cyclical declines in the other two categories.

**Looking forward through the end of 2009, the mix of activity levels in Canada is likely to be:** (1) residential weakening; (2) non-residential building muddling through, but restrained by access-to-credit problems and lack of confidence; and (3) engineering construction forging ahead due to a push for infrastructure and a burst of electric power projects. Lower oil prices and new royalties will take some of the pressure off Tar Sands work.

**Add to this mix commodity prices.** Most construction materials are commodity-based. This ranges from wood products (lumber), through copper (wiring and plumbing), to oil and natural gas (plastics, paint, asphalt, insulation, etc.) Energy prices are also important for materials that need heat (brick, steel and cement) in the production process.

Commodity prices are set internationally. Rising demand, to go along with a growing middle class, from a host of emerging and industrializing nations such as China, India, South Korea and Taiwan has provided the main impetus behind skyrocketing commodity prices – agricultural, metals and minerals, and energy – since 2004.

**Add another layer based on currency movements.** Some materials can only be purchased from foreign suppliers. A key factor to know is that commodity prices have been moving in the opposite direction to the U.S. dollar. That is because almost all commodities are priced in greenbacks. Therefore, if the U.S. dollar declines in value, which has been the case long term, producers can only achieve the same "real" return by upping the price.

**From now through the end of 2009, there is likely to be a respite from ever-increasing commodity prices.**

This will not be sustained long term, however. The emerging nation effect, which includes expansions of their own domestic economies as well as export sales, will mean increasing demand for oil, foodstuff and building materials. Where supply is relatively inelastic, prices can only move upward. Also consider the impact of carbon taxes. These will provide another upward push to production costs and pricing.

**Contractors can take certain actions to ease their dilemma.** They can secure future supplies well ahead of when they are needed. For example, Air Canada announced earlier this year that it had lined up contracts for its jet fuel needs out to the end of 2008. Futures contracts can be signed with respect to currency, if purchases will need to be made from foreign sources. In these cases, one may guess wrong about the direction of change, but at least one can sleep at night knowing what the consequences will be on the cost side if one's bid on a project is successful.

Finally, the next year-and-a-half may be a good time to assure owners, who have cash on hand or the financing lined up, that acting sooner rather than later on a contemplated project will ensure a reasonable price.