Simonson on Water

THE OUTLOOK FOR CONSTRUCTION SEGMENTS & MATERIALS

By Ken Simonson

Growth in non-residential construction and weakness in homebuilding presents a dual challenge for the wastewater construction industry

A lopsided economy and construction market herald uncertainty ahead for the water and wastewater markets. Compounding that uncertainty, the volatility of cost of materials has made project budgeting even more challenging than usual.

Economic growth slowed to a crawl in the first quarter. Real, or inflation-adjusted, gross domestic product—the broadest measure of output—expanded at an annual rate of only 0.65% in the first three months of 2007, down from 5.6% one year before. But most forecasters expect the economy to rebound vigorously in the rest of 2007 and into 2008.

Housing blues

The dramatic reversal of homebuilding from hot to horrid was a major factor in this slowdown. Homebuilders will likely keep their tools locked up until the heavy overhang of unsold new and existing homes shrinks. That probably won't happen until the spring of 2008.

As homebuilding and home sales have shriveled, house prices have weakened. Each quarter, the Office of Federal Housing Enterprise Oversight (OFHEO) calculates the median change in value of single-family homes sold or refinanced with loan participation from Freddie Mac or Fannie Mae.

Nationally, the median value inched up 0.5% in the first quarter of 2007, after rising 1.3% in the fourth quarter of 2006.

Nevertheless, any positive number is higher than many people had expected and may overstate the appreciation for the universe of houses because OFHEO captures only houses that had "prime" loans and were successfully sold or refinanced.

The national median masks how uneven local results are. Seven states had slight declines in value in the first quarter, as did 46 out of 285 metro areas. Over the past four quarters, the national median appreciation was 4.3%. Median appreciation by state ranged from 17% in Utah and 12% in Idaho, Montana, Wyoming and Washington, to decreases of 0.6% in Massachusetts and 0.7% in Michigan.

The implication of these housing numbers is twofold for the water and wastewater markets.

First, the cutback in new construction means less need to extend service lines or expand plant capacity. Second, and more ominously, flat or falling property values mean less property-tax revenue to fund projects.

Red hot non-residential

In contrast to the deep freeze in homebuilding, most non-residential construction markets remain red hot.

In the first four months of 2007, public and private non-residential construction jumped 14% compared to the same months a year ago, nearly offsetting the 15% drop-off in residential spending. The biggest growth occurred in construction of hotels and resorts, which soared 56% in the first four months of 2007 combined. Other big year-to-date private sector gains included offices, up 32%; communication, up 19%; and hospitals and multiretail, both up 18%.

Many of these categories will remain robust through 2007, although the retail and office sectors are vulnerable to a slowdown.

Water supply and sewage and waste disposal construction each rose 7% in the year to date. These figures represent modest slowdowns from the 10 and 17% growth rates recorded in 2005 and 2006, and further deceleration is likely as projects that began in those years are wrapping up.

Within those categories, there is a big variance in where the dollars went. The Census Bureau, which reports construction spending data, breaks out three monthly subtotals for water supply: two for sewage and dry waste and one for wastewater.

In the first four months of 2007, spending on state and local plant construction leaped 26%; line construction sagged 5%; and the small amount of pump station spending was up 8%. State and local spending on sewage/dry waste climbed 5%, divided between line/pump stations, which slipped 3%, and plant construction, which vaulted 21% from a small base. State and local spending on waste plants increased 20% and on line/drain, 38%. Small additional amounts of federal and private spending are included in the totals but not shown by subcategory.

Hot and cold running prices

These percentage gains overstate the amount of pipe or plant being built, because they do not account for increases in materials cost.

From the steel price explosion of early 2004 to more recent spikes for diesel fuel, copper, asphalt and plastics, contractors have faced unprecedented pricing challenges.

From December 2003 to April 2007, the producer price index for construction inputs rose 26%, more than double the 12% rise in the consumer price index.

Many of these price spurts faded or reversed course in late 2006 and early 2007. The overall index for construction input prices rose 3.5% in the 12 months through April 2007, far more moderate than the 10% rate of increase recorded in 2005.

Still, even 3.5% is well above the 2.6% rate for the consumer price index. That poses a continuing educational and planning challenge for project managers and their contractors.

Too often, budget officials use a single inflation factor for all of any agency's purchases. A 3% escalation rate worked well enough for construction projects before 2004, and it may still be adequate for projecting office supply or wage costs.

But two factors make construction materials costs susceptible to steeper increases than the overall rate of inflation.

First, construction generally requires fixed quantities of materials, unlike industries that can substitute cheaper materials or design products to be smaller or lighter than their predecessors. Many materials used in construction are also in demand from other sectors, both in the U.S. and in fast-growing economies, like China and India. Yet supplies of some materials expand only slowly. An example is the copper industry, where all of the major mines have been subject to labor unrest or political turmoil and as a result, prices jump.

Second, materials must be physically delivered, using a transportation network that is often stretched to its limits. Cost of transport is high and bottlenecks frequent. Fuel price spikes add to transport costs and the direct costs of operating equipment. Consequently, construction materials are likely to resume their recent 6 to 8% cost increases, with higher spikes possible.

In short, the economy seems to be growing, especially in non-residential construction and notable weakness in homebuilding. That presents a dual challenge for the water and wastewater construction industries, as revenue growth slows but demand for materials remains high, making further price escalation likely. WWD

Ken Simonson is chief economist for the Associated General Contractors of America. He can be reached at 703/837-5313 or by e-mail at simonsonk@agc.org.

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