

construction cost management

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# Construction cost increases: Owners should know the difference between the myths and realities

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How many times must we read in the media that a construction project has exceeded its budget? It may seem to be non-news but it should always be disturbing news.

Take the following examples:

- The owner, architect and builder of the \$419 million Miami Performing Arts Center recently reached a \$44 million settlement after years of delays and cost overruns. The complex is 600 days overdue and more than \$67 million over budget.

- Press reports frequently describe disastrous experiences of school districts as they construct and renovate schools. A 1999 analysis by PricewaterhouseCoopers for the NYC School Construction Authority found consistent patterns of delays and cost overruns in school construction.

- The U.S. Capitol Visitor Center, a vast, underground complex with theaters and an auditorium, was projected in 1995 to cost \$100 million and be completed in 2002. The cost has reached \$265 million, with completion at least a year away.

claims that "may swell the cost of construction far beyond the original contract price."

Though nominally "fixed price," traditional contracts are actually mutable cost contracts subject to constant adjustment throughout the construction process. Contractors can easily raise prices during construction. Industry expert David Gerstel calls this "change order artistry." Competitive bidding ... often leads to the owner getting nailed during construction for numerous extra charges by a builder intent on making up for the too low price he had to submit to win the job in the first place.

One advisor to the construction industry tells prospects that "it would be very easy to 'low-ball' a figure, get [the owner's] name on the dotted line, and then start with the added costs... It puts [the owner] on notice to watch out for this maneuver from the competition." Another states: "Some contractors may bid low with the intent of garnering profits from change orders." Low bidding is common because the bidding process encourages it.

Change orders are sometimes necessary if the owner orders changes midstream or if architects miss important details. But change orders can also be gouging mechanisms. "Often," said one study, "contract change proposals are the result of contractor errors or omissions unrelated to the contract specifications."

Markets operate on information, and do not run at all without it. They run best when buyers and sellers have equal access to it.

In the construction industry, equal access to information does not exist. The fact that contractors have sole control information over project costs is the major source of inefficiency in construction. Owners cannot easily compare building price or quality at the start, during construction, or even after completion.

Most owners cannot read blueprints or fathom the complexities of turning these prints into usable structures. Construction teams typically establish budgets by reviewing architectural and engineering design plans. Owners rarely challenge these budgets. If the price is too high, owners must eliminate various desired features to meet the contractor's pricing scheme — and maintain the latter's profitability.

Moreover, sundry difficulties — real or imagined — necessitate change orders, charges that are usually presented after any real threat of competition has passed. Construction economist Patricia Hillebrandt said, "The monopoly power of the negotiating contractor will be greater, the greater the time and money already invested by the client in these negotiations." In some jurisdictions, builders can default on payments to subcontractors, file bankruptcy, and stick the owner with subcontractor

Incredibly, one industry text recommends building "slush funds" into every project, for use if disgruntled owners refuse to pay for a change and "you felt you had to give." The text boldly continues: "Cheer up; maybe the owner will ask for a legitimate change order and you can get your money back." This text essentially advises contractors to steal money from owners, call it a "slush fund," return it only under duress, and steal it back at the first opportunity!

Owners often find it hard to "push back" on change orders:

- They lack independent methods of determining whether costs or increases are legitimate.
- Delays cost even more than the contractor's extra charges.
- They fear that if they successfully deny the extra charges, builders will retaliate or skimp on quality.
- Overruns are now so commonplace that owners typically carry "contingency allocations" or "engineering reserves" to cover extra charges.

Owners can avoid the vagaries of the construction pricing mechanism by always securing a truly "fixed price" agreement from the contractor/construction manager.

*This article is excerpted from the book "Broken Building" by Barry LePatner, Esq. to be published by the University of Chicago Press in 2007.*

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