THE BOND BUYER

Construction prices likely to remain high, posing risks for cities, states

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Cities and states facing elevated construction costs face an unappetizing menu of choices ranging from more borrowing to delaying projects, each of which carry their own set of credit risks.

Elevated construction costs also mean fewer bids for public projects, as contractors are likely to opt first for the private sector, particularly when the market is strong, as it has been for the last two years.

High material prices, a tight labor market, fewer bids: it all threatens to eat into the purchasing power of $100 billion of new annual federal infrastructure funding that will roll out over the next five years under the Infrastructure Investment and Jobs Act.

Construction costs, which typically outpace the consumer price index, have moderated this summer but are expected to remain well above pre-pandemic levels, posing risks to cities and states. **Bloomberg News**

Federal transportation officials overseeing the IIJA have said inflation poses the biggest risk to its successful implementation.

Construction prices have moderated this summer from the "extreme escalation" of the past two years, said Ken Simonson, chief economist for the Associated General Contractors of America.

But bid prices continue to go up.

"We may have seen the peak for now in runup in material costs, but I don't think they're going to get back to where they were pre-pandemic and we've been hearing reports about projects where the bids have come in well over what the agency has calculated," Simonson said.

For contractors under pressure, public issuers are often "the client of last resort," he said.

Public agencies are less flexible than private owners when costs rise or when it comes to dealing with contracts and regulation.

"States and municipalities and special authorities just don't have the flexibility that some private owners do," Simonson said.

"Generally the only way states can cover the higher cost is to appropriate more money or have a higher bond issue," he said. "So, when the private market is hot then contractors may be more likely to go after private work than public work."

Issuers that downsize, delay or borrow more for projects may be inviting credit trouble, Moody's Investors Service warned in an Aug. 17 credit outlook.

"Deferring projects or paying materially higher costs is a particular risk for issuers with pressing needs to replace or repair critical infrastructure," Moody's said, adding that "some issuers with both acute needs and funding difficulties face the prospect of falling further behind communities with stronger financial positions and more flexibility to either delay projects or raise additional revenue to complete them on schedule."

Moody's predicted that U.S. construction spending will rise 6.5% this year and 5.5% in 2023, or about $100 billion each year.

"The longer inflation remains high, the more difficult it will be for issuers to navigate an environment with declining purchasing power as their needs intensify," analysts wrote.

In an April report, S&P noted that high-profile and complex megaprojects already face difficulties in locking in cost and schedules, naming California's high-speed rail project, which currently carries a price tag of $105 billion, the Gateway tunnel project under the Hudson River, and the $17 billion Second Avenue subway line.

"To preserve and maximize federal dollars, public project sponsors might direct their near-term spending to smaller projects that are further along in the development process," S&P said in the report.