

# Risk Management in the Current Low Bid Climate



## Construction Bids were High in the Recent Past

For nearly six years following the 2002 recession, commercial construction bids consistently rose each quarter, and many times exceeded architect-engineer (A-E) opinions of probable cost by 10% to 25%. National construction costing firms, such as R.S. Means, struggled to keep their cost databases in step with rapidly rising commodity and labor prices.

During these years, A-E firms relied on cost databases that underestimated costs almost as soon as they were released. Even professional cost estimating firms were seeing bid prices come in significantly above their estimates—then came the summer of 2008!

## The Bid Climate Pendulum Swings

We all recall seeing gasoline prices exceeding \$4 per gallon and the massive steel bird's nest at the Beijing Olympics. Beginning last summer, major cracks in our economy began to emerge. The housing bubble had burst, a credit crisis had developed, the stock market began a steep decline, and the construction bid climate made a sharp change. No longer were bid prices rising, but falling along with the rest of our economy.

After the economic crisis hit the construction industry, the few projects that were bidding received remarkably low bid prices, fueled by falling commodity prices and extreme competition. Many construction firms began taking work at or below their cost, just to keep equipment and personnel busy.

Owners and A-Es now find themselves in unexplored territory. Over the past six months,

bid prices have been as low as 70% of opinions of probable cost. While many owners celebrate these low bid prices, the significant risks associated with them demand review of current risk management protocols.

## Current Low Bid Examples and Risks

First, we must understand the major forces behind the current low bid prices. Lower worldwide commodity prices have certainly played a role in reducing contractor costs, but other competition factors are causing most of the low bids. Two recent examples illustrate this point:

- **Example One**

On a civil engineering project, the low bidder was more than \$1 million below the next closest bid. When the owner gave the contractor an option of withdrawing their bid without penalty, the contractor decided they wanted the work at that price since they didn't have other upcoming projects.

- **Example Two**

After the bid opening on a building project, a bidder told us they bid below their cost, but the lowest bidder was substantially less. The lowest bid was approximately \$4 million. By comparison, our opinion of probable construction cost was \$6 million.

An owner incurs certain additional project risks if a contractor's bid on a project is extremely low. A "low-ball" contractor may increase the use of the **change order process** to recoup bid day losses.

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**Project construction schedules** may be greatly delayed because, in an attempt to save money, the contractor may not apply sufficient resources to a project.

**Construction quality** may be a problem as inexperienced, cheaper labor is used instead of skilled craftsmen; again, to save money.

The worst case scenario is the **financial ruin** of a general contractor or major subcontractor in the middle of a project. Even when exercising a performance bond, the owner is often left with the bonding company continuing to use the same general contractor.

It certainly costs more *to administer* a construction contract in a competitive, cut-throat, trying-to-survive market than in a market where contractors are making a profit. **Always remember, the odds of a successful project are greater when a contractor is receiving a fair profit for work.**

## Bid Prices will Increase

Another risk of the low bid climate is relying on it to continue for any particular amount of time. The current cost of building construction is excellent if you are an owner considering renovation or new construction. How long the current market will continue this low is anyone's guess. But it is guaranteed that construction costs will increase in the future. The question is when.

## What should an Owner do?

As A-Es, when we give an opinion of probable cost at today's construction cost rates we run the risk of being too low if a project is not built immediately. However, it would not be appropriate for us to arbitrarily inflate the cost

of construction above our opinion of the current level. Instead, we advise our owners to take advantage of the present bid climate and get projects designed and bid as soon as possible. We also advise owners to keep 10% of the opinion of probable cost as a contingency to cover possible increases until the project has completed construction.

In addition to maintaining a **healthy contingency** and **adequate construction contract administration funds** for a project in this climate, the following risk management tools can also be employed.

- At the pre-bid conference spend extra time reviewing the general conditions, especially the sections referring to termination, claims, changes, delays and other related area.
- Now more than ever, being clear about contract terms is critical. Ask the low bidder to review their bid for mistakes; a bidding error benefits no one.
- Follow the contract verbatim from day one; this sets a precedent that the contract will be enforced as written—this is always good advice.
- Owners may wish to expand the basic services of their A-Es and special inspectors to include more frequent field observations than requested during other bid climates. This helps mitigate the risk of non-compliant construction.

While the risks remain high during the current low bid climate, they can be mitigated through careful planning and execution. Wiley|Wilson is well qualified and experienced in minimizing an owner's exposure to risk during the design and construction processes.