

**MEMORANDUM**

FC 14 (08-21-19)

TO: Luz Penilla
Assistant Officer
Office of Integrated Water Management

FROM: Jessica Collins
Unit Manager
Business Planning and Analysis Unit

SUBJECT: Capital Improvement Program (CIP)
FY25-FY39 Recommendation for
Construction Cost Escalation Rate

DATE: November 15, 2023

This memorandum presents the annual review of the Construction Cost Escalation Rate (CCER) applicable to the Capital Improvement Program and makes recommendations for adjustment.

Staff has commissioned O'Connor Construction Management, Inc. (OCMI) to conduct a San Jose Market Study (Attachment 1) and to compile a CCER for FY25-FY39 and the findings are summarized as follows:

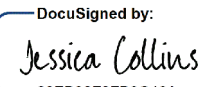
1. The global COVID-19 pandemic continues to have an impact on supply chain, labor and inflation, which all impact the cost of construction. Therefore, the average escalation conditions for the next five years are forecast above average, with 2025 expected to see 7% before trending down to 5.5% for the next three years thereafter. (See Attachment, page 2)
2. By a number of metrics, the historical average annual construction cost escalation rate is approximately 3.2% per year. Counter to this trend, the years 2021 and 2022 registered construction cost escalation rates of 5.2% and 19.9%, respectively. (See Attachment, page 4)
3. Overall, the Santa Clara County construction market is and will remain very tight in terms of the balance between volume and laborers' ability to support. Reductions in the near term in the vertical construction market will help to ease some aspects of the construction labor shortage, but the large amount of public infrastructure investment slated for the next five years will continue to put steady pressure on local labor suppliers to keep up with demand, particularly in trades that infrastructure utilizes heavily like concrete workers, pipe fitter and equipment operators. While material pricing continues to recover across most categories, certain materials, such as concrete and piping, remain at elevated levels of consumption. (See Attachment, page 19)
4. The worst of the unprecedented price spikes due to supply chain system shocks are likely over, but monetary inflation has left the predicted price floor to which prices will settle less clear. At present, the temporary stasis appears to rough out to an anecdotal formula of: PreCOVIDPrices + 30%. (See Attachment, page 4)

These findings will be used to provide the CIP Evaluation Team with a recommended annual CCER for future CIP construction costs. It is recommended that an annual CCER of 7.0% be applied for projects with planned construction in FY25 before trending down to 5.5% for the three years thereafter and then to 4.8% for FY30-39.

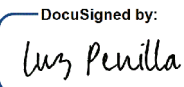
	FY25	FY26	FY27	FY28	FY29	FY30-39
CCER	7.0%	5.5%	5.5%	5.5%	5.0%	4.8%

If you have questions, please contact Jessica Collins JCollins@valleywater.org.

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Jessica Collins
Unit Manager
Business Planning and Analysis Unit

Accepted by:

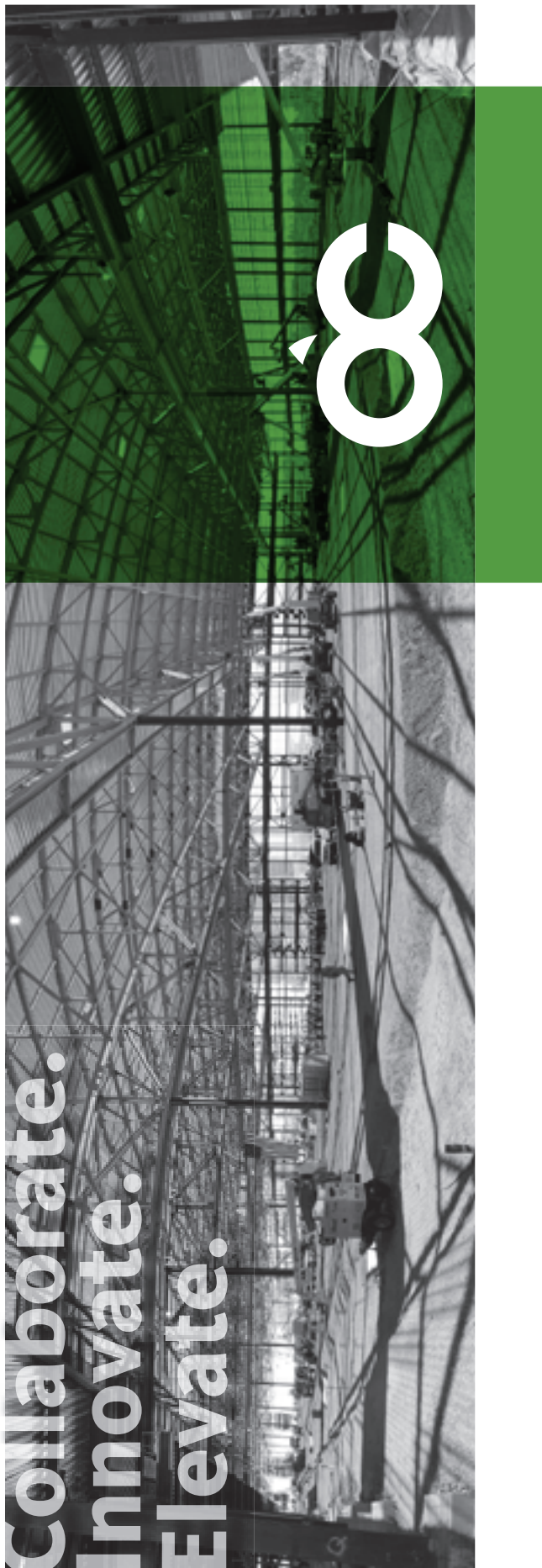
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Luz Penilla
Assistant Officer
Office of Integrated Water Management

Attachment: Santa Clara Valley Water District Market Study

cc: CIP Evaluation Team, Finance, CIP Team, and CPMPC
sb:jc

Santa Clara Valley Water District
Market Study
Job No. 210355.007
14 August 2023

Collaborate.
Innovate.
Elevate.



Santa Clara Valley Water District Market Study

San Jose, CA



EXECUTIVE SUMMARY

Purpose

The Santa Clara Valley Water District covers approximately 1,300 square miles (138,000 acres) and serves approximately 2 million residents spread across 15 different cities. It manages approximately 10 reservoirs, 300 miles of creeks and watersheds, and provides approximately 220 million gallons of drinking water per day. The construction priorities for the District are both significant and complex in nature, and as such have considerable capacity to be impacted by fluctuations in local market conditions. Accordingly, the District has requested that OCMI, Inc. prepare a market report that evaluates the short and medium term prospects for large scale construction in the area and provides forecasted escalation rates to be utilized in the preparation of cost analysis documents.

Summary

Overall, the Santa Clara construction market is and will remain very tight in terms of the balance between volume and laborers' ability to support. Reductions in the near term in the vertical construction market will help to ease some aspects of the construction labor shortage, but the large amount of public infrastructure investment slated for the next five (5) years will continue to put steady pressure on local labor suppliers to keep up with demand, particularly in trades that infrastructure utilizes heavily like concrete workers, pipe fitter and equipment operators. While material pricing continues to recover across most categories, as documented in our previous sections, certain materials

like concrete and piping remain at elevated levels of consumption. In the overall we forecast above average escalation conditions for the next five (5) years, with 2025 expected to see 7% before trending down to 5.5% for the next three years thereafter.

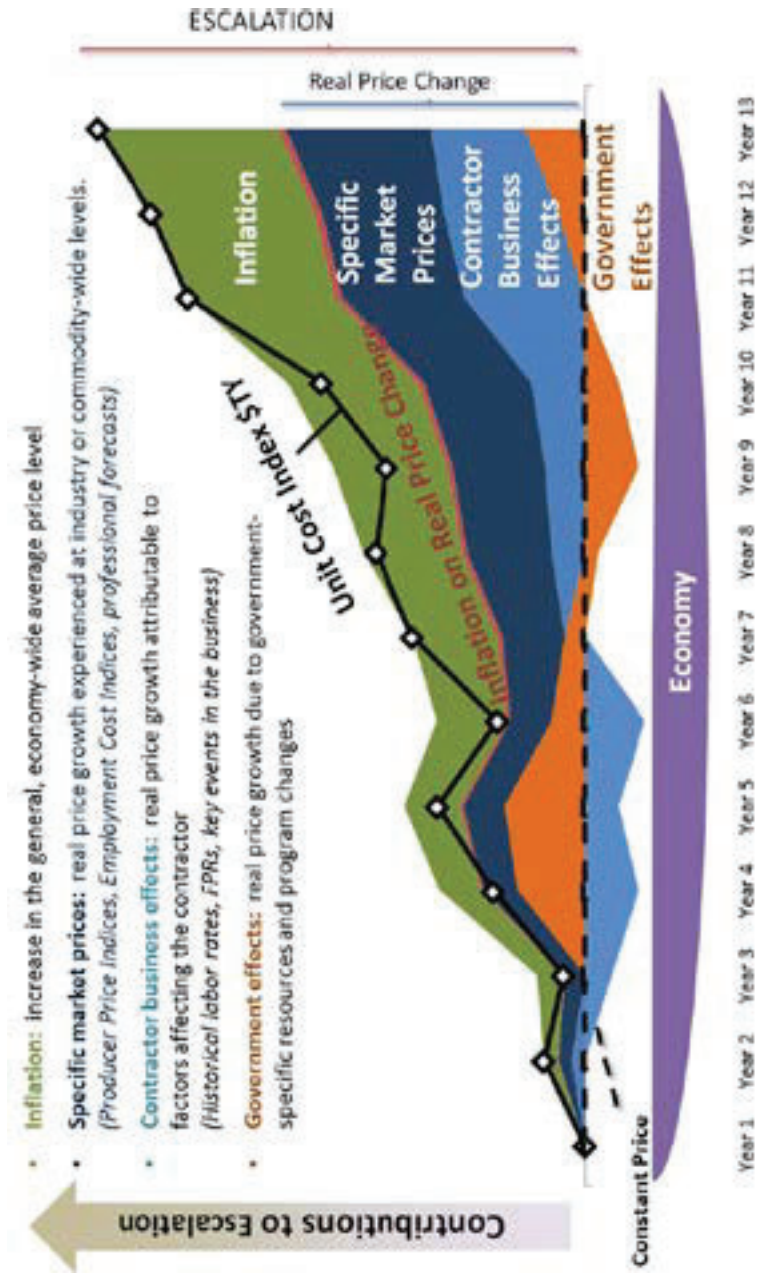
ESCALATION OUTLOOK						
Year	FY25	FY26	FY27	FY28	FY29	FY30-39
Construction Cost Escalation Rate	7.0%	5.5%	5.5%	5.5%	5.0%	4.8%

MACRO MARKET ANALYSIS

Factors of Escalation

Before the discussion on escalation, it is important to emphasize and illustrate the factors and components that make *cost escalation* - a primary subject of this report - and how those differ from one the component parts, *inflation*. While cost escalation includes inflation, other economic variables make calculating the escalation factor for any one specific industry and/or region a more complicated exercise. Escalation is as a combination of variables; any number of which can vary from expectations in response to ordinary or extraordinary market activities, as seen during the recent global COVID outbreak.

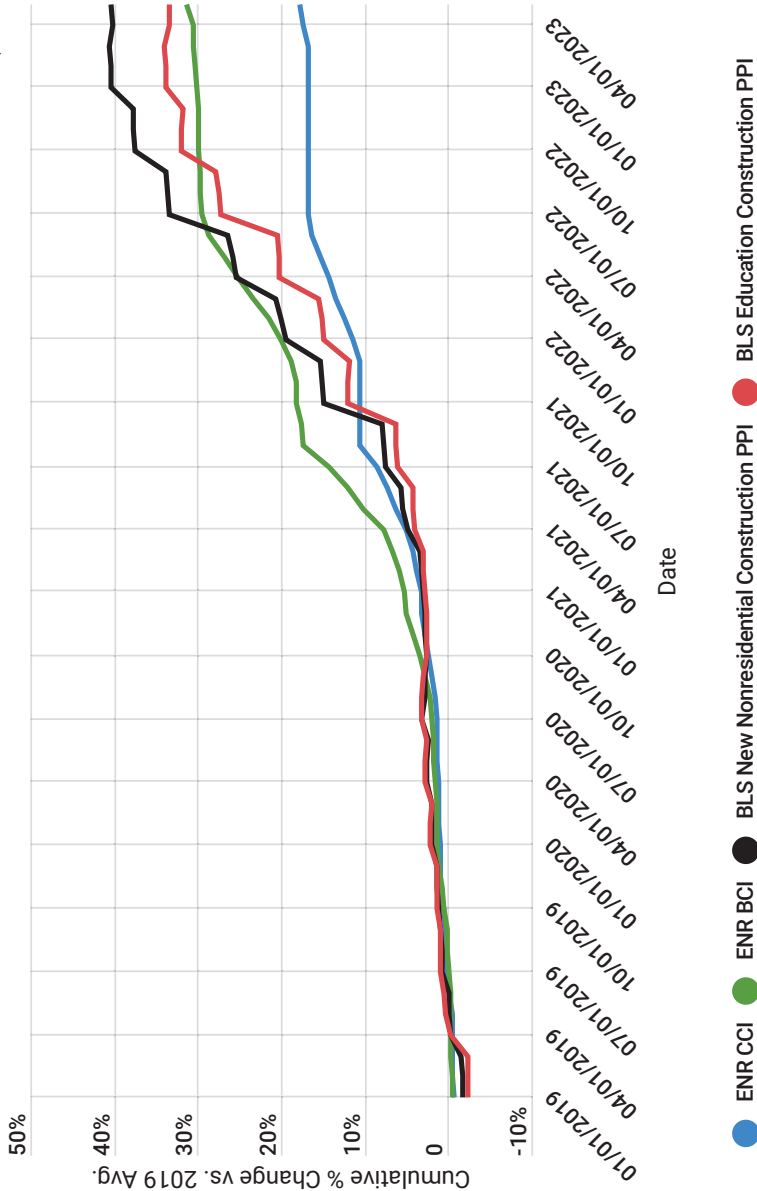
At the same time, it is valuable to try to parse what is permanent and what is conditional. While the specifics and contextual variables are too numerous to fully quantify, the underlying principle of temporary spikes is important to apply to this analysis. For example, temporary spikes in price due to prolonged supply access shortages (real or contrived) should not necessarily dictate the calculus of the authoritative 'new normal' in terms of pricing and growth rate. This is critical to realistic projections of future escalation which rely on a current period denominator.



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Recent National Construction Cost Escalation

By a number of metrics (including ENR CCI, ENR BCI, BLS Non-residential Construction Cost PPI), the historical average annual construction cost escalation rate is approximately 3.2% per year. Counter to this trend, the years 2021 and 2022 registered construction cost escalation rates of 5.2% and 19.9%, respectively (BLS, New Nonresidential Construction PPI, WPU8011). While 2021 brought about surges in speculative endeavor valuations (equities, new housing development) which betrayed the supply chain challenges, 2022 manifested the downsides of aggressive relief monetary policy. Supply chain challenges continued into 2022 with the spikes in material commodity prices reaching their peaks in the first two quarters. The worst of the unprecedented price spikes due to supply chain system shocks are likely behind us, but monetary inflation has left the predicted price floor to which prices will settle less clear. At present, the temporary stasis appears to rough out to an anecdotal formula of: PreCOVIDPrices + 30%.



Recent Escalation

Sources: ENR CCI, ENR BCI, BLS New Nonres PPI, BLS Education PPI

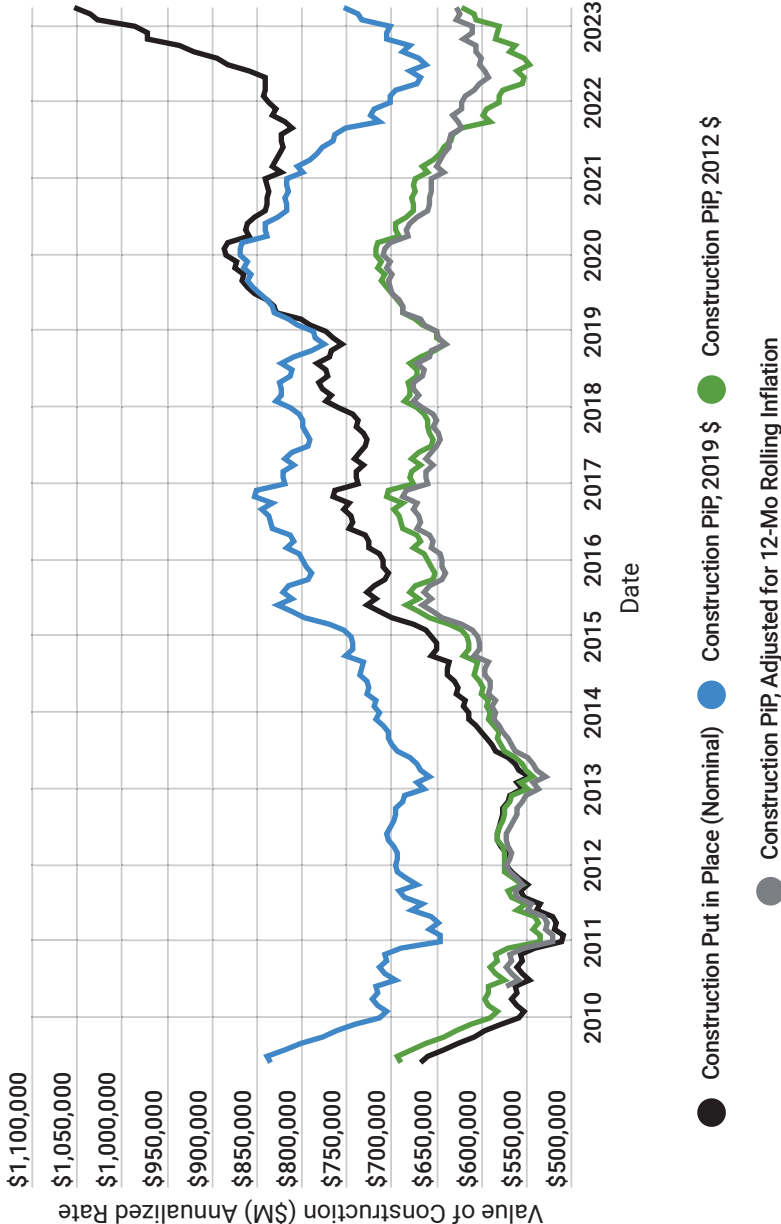
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National Construction Spending

At a nominal level (black line), Total Nonresidential Construction Spending (TNCRS) in the US has rebounded from post pandemic-onset dip since September of 2021, with annualized rates of construction put in place reaching a new high in September 2022 at \$900,777,000.

Importantly, though, the reported spending values are not controlled for inflation; monetary or otherwise. While it is difficult to apply a perfect adjustment methodology, the graph to the right demonstrates the results of adjusting the data to reflect 2012 dollar values and, alternatively, to 2019 dollars and via a 12-month preceding rolling average inflation adjustment. In all three (3) scenarios, it is clear that the aggressively upward trend in nominal spending is not likely reflective of actual volume of work being accomplished. This is an important filter for the data so that one may understand the other factors (discussed later in this report) that are driving construction costs in addition to volume of demand.

The subsequent analysis indicates that late 2021 and 2022 were strong periods for construction starts as financing was secured at low rates. These projects are seeing spending curves peak. An appreciable drop-off in the second half of 2024 is possible. The severity of this would indicate the follow-on impact on labor and subcontractor availability, generally.



Nonresidential Construction Spending

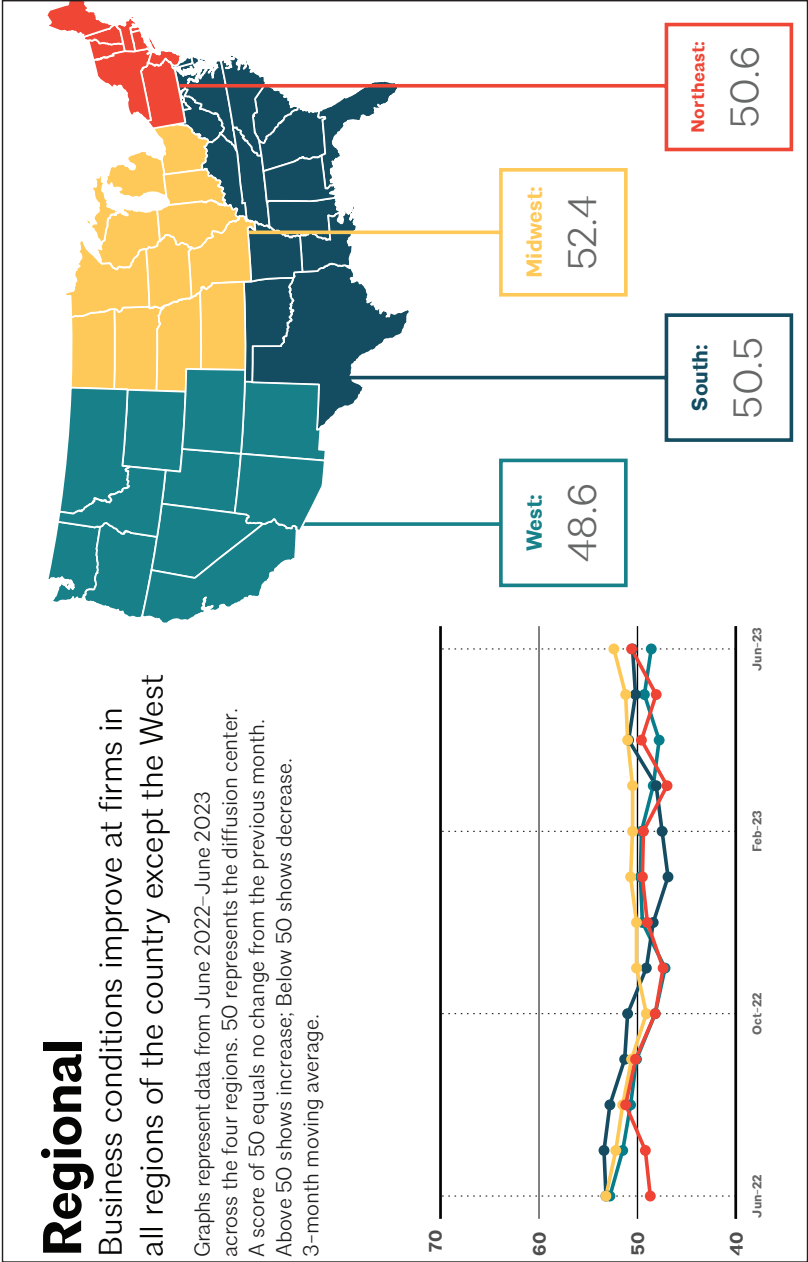
Source: U.S. Census Bureau

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Projected Construction Activity

The Architecture Billings Index (ABI) is a regarded leading indicator of future construction activity by roughly 9-12 months. As the American vaccine roll out progressed, so too did capital project owner outlook. Accordingly, the ABI has followed along that optimistic* trend line over the last two years (Jan 2021 - Sept 2022), returning to positive projections after roughly a year of negative reports.

Since September of 2022, however, indicates a sub-50 aggregate Index reading for the West region. Per the AIA's accompanying report commentary, a downturn in executed design contracts and a 'wait and see' approach from capital owners is driving much of the survey responses. Recent moves by the Federal Reserve Board to increase effective interest rates have most certainly curtailed investor appetites, to some degree, as private capital investment becomes more costly from an equity perspective.



Source: AIA ABI, June 2023

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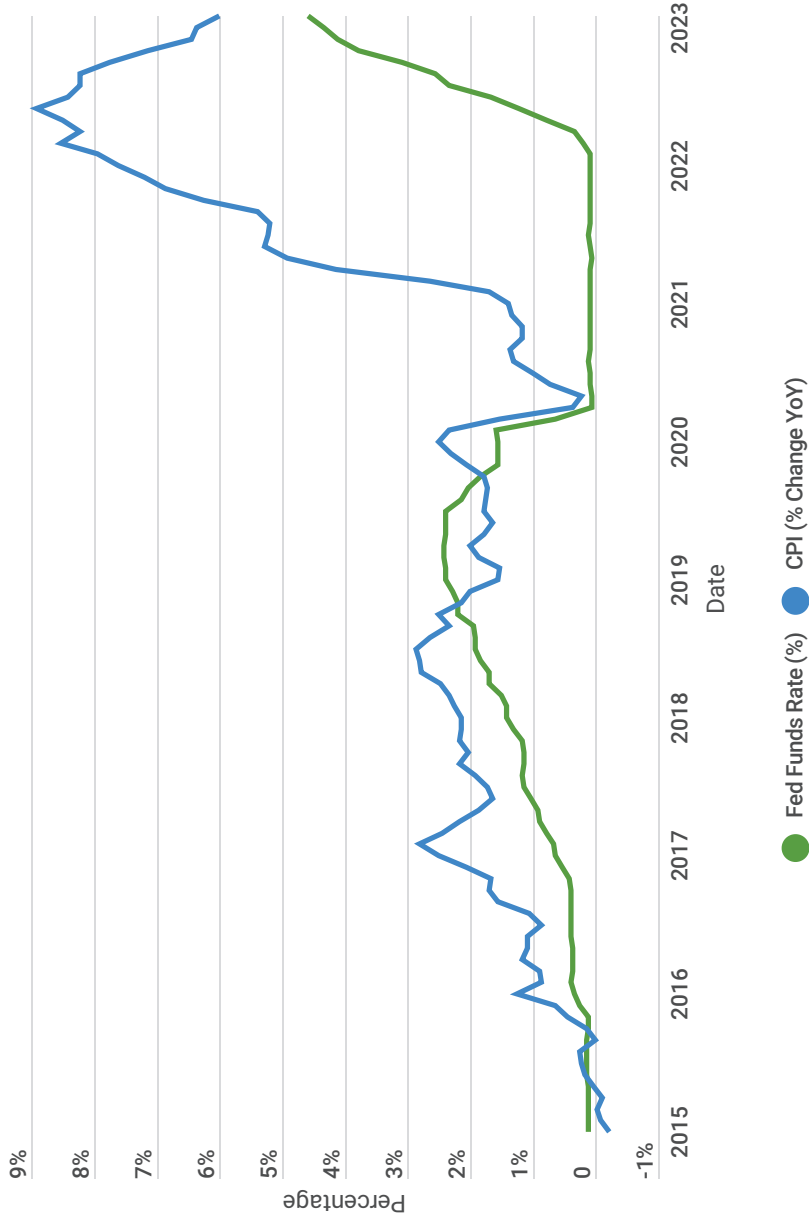
Inflation @ Medium-Term Wage Growth

Relief actions by the federal government, including the CARES Act and Consolidated Appropriations Act of 2021, infused trillions of new dollars into the U.S. (and international) economy as the government worked to shield citizens and companies through the worst of the economic turmoil. In turn, this resulted in monetary supply growing at an unprecedented rate, as seen for example, in the graph to the right. These actions combined with extremely low interest rates, supply chain disruptions, and energy price turmoil to create record high inflation over the last year.

As a correction, the U.S. Federal Reserve has worked to increase Effective Federal Interest Rates (Fed Rate) as the quickest pace in the nation's history. The rapidity of this action has caused uncertainty across markets, particularly highly leveraged and lending-dependent markets such as property development and, to a degree, manufacturing. Recently, the impact of these moves on the U.S. Bond market has translated into the failure of Silicon Valley Bank and general warnings that other medium-sized financial institutions may have similar liquidity stresses not yet realized.

The net effect by design, however, is likely to be a staunch slowdown in borrowing and spending across the U.S. economy. When this will manifest and how deeply this will impact private-side non-residential construction is not fully understood. Further, how severe the private-side slow down is will be the biggest

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Source: Bureau of Labor Statistics

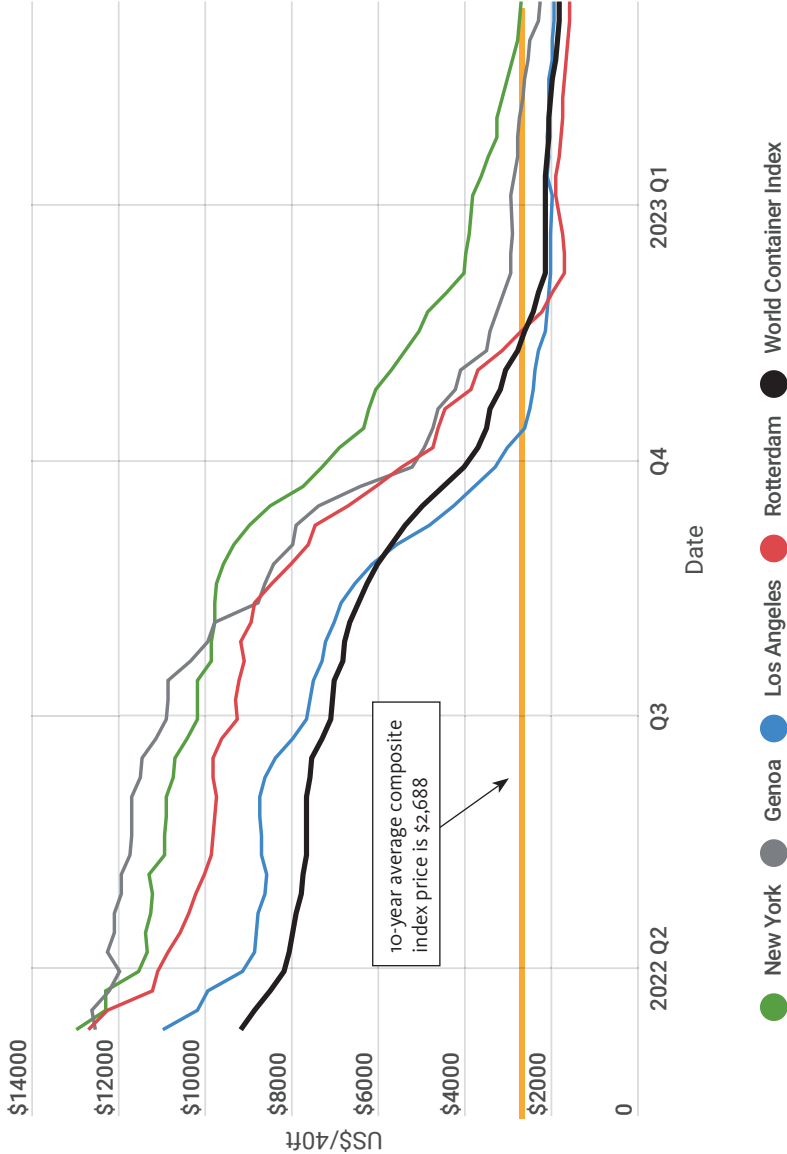
Inflation & Wage Metrics

determinant how decreased demand will impact pricing and bidder interest in public (federal) projects.

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Material Pricing

A primary contributor to many of the material price spikes of the COVID era, transoceanic shipping disruptions and cost increases reached previously unimaginable levels in 2021 and early 2022. Drewry Supply Chain Advisors, which tracks and publishes container shipping costs, is currently tracking the composite cost of shipping containers at roughly \$1,709/ea, or approximately on par with pre-pandemic pricing levels. While perhaps more acutely felt at the personal consumer level, this regression to previous levels represents a positive sign for equipment and foreign material pricing. It should be noted, though, that while this is positive for pricing, this has not negated manufacturing lead times that persist for large, engineered equipment like air-handler units and switch gears.



Source: Drewry World Container Index

Transoceanic Shipping Rates, Last 12 Months

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Material Pricing (continued)

As of June 2023 data reporting, material cost growth has been led by increases in steel products, which are still up 24.0% over the last 24 months, diesel fuel at +36.0% over the last two years, and cement construction products which are up 17.0% YoY. While spikes in the last two years have been severe due to a number of previously discussed stimuli, it is important to note that the market is beginning to see substantive easing of many material cost surges. While many major price categories are still well into the 'plus' category YoY, recent trend lines have shown a slowing to the volatility and a retreat in several product lines.

Material PPI	1 Mo. Change	3 Mo. Change	12 Mo. Change	24 Mo. Change
Iron & Steel Scrap	-7.8%	-0.7%	-20.4%	-8.6%
Sheet Metal	5.1%	20.4%	-36.1%	-17.7%
Steel Mill Products	5.2%	9.9%	-18.9%	7.7%
Lumber	0.1%	-1.9%	-33.8%	-43.4%
Precast Concrete Products	0.4%	1.7%	9.2%	24.6%
Cement	0.1%	0.4%	13.6%	21.8%
Plastic Construction Products	-0.7%	-0.8%	-1.6%	27.6%
Paint & Coating	0.0%	0.0%	3.8%	36.9%
Glass	-1.1%	-1.1%	8.0%	18.6%
Diesel Fuel	-4.5%	-11.3%	-29.7%	21.7%
Copper & Copper Products	-2.7%	-4.8%	-6.8%	-8.4%
Aluminum	-2.0%	-5.5%	-25.3%	-7.3%

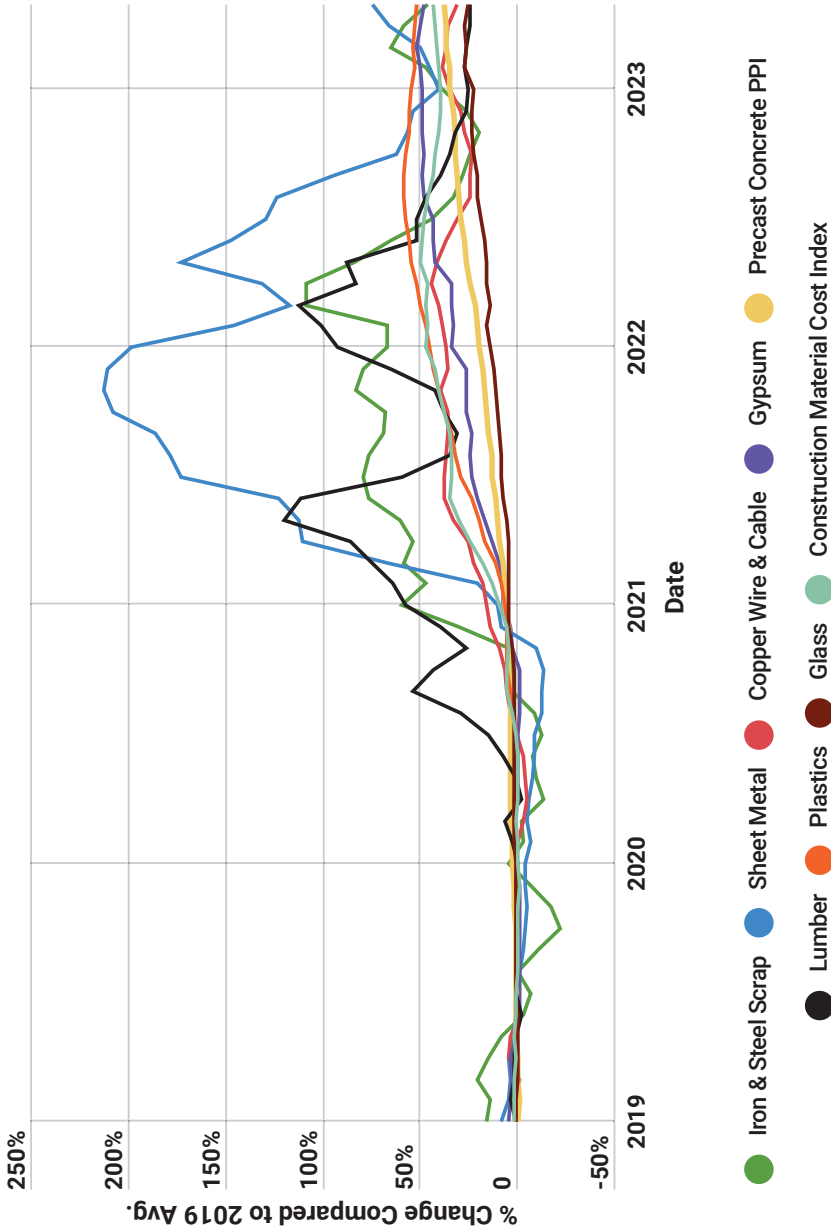
Change in Producer Price Indexes

Source: Bureau of Labor Statistics

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Material Pricing

The graph to the right provides a visual representation of cumulative change in Producer Price Index value for a variety of materials. This serves to highlight the to-date net change in pricing levels through, and after, the COVID pandemic and associated market volatilities.



Producer Price Indexes - Select Materials

Source: Federal Reserve Economic Data (FRED)

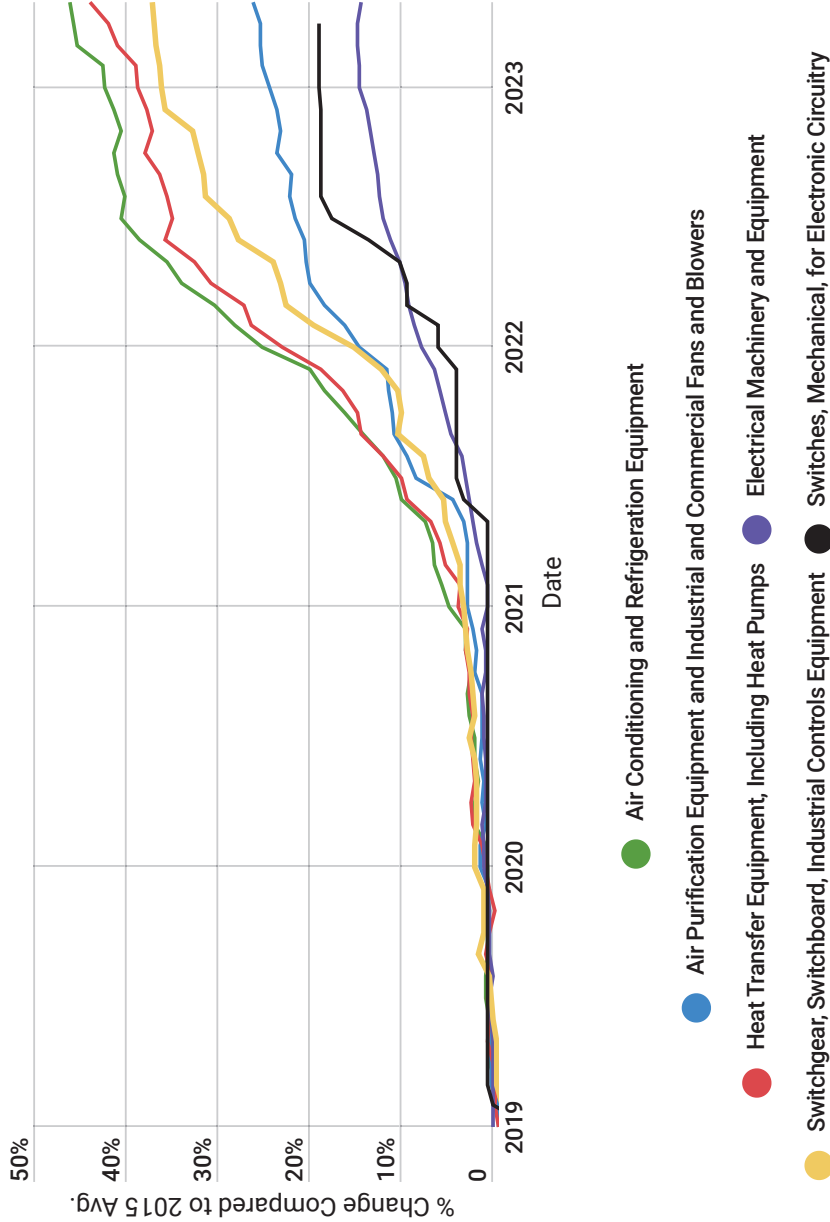
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The exceptions to this forecast for easing are particular equipment and materials related to HVAC and engineered electrical equipment. Ongoing supply chain issues stemming from backlog in manufacturing overseas has yet to ease, causing persistent demand-induced price premiums and extended lead times. This continued volatility has also resulted, anecdotally, in greater contingencies carried by contractors and subcontractors during bid and preconstruction activities. As several contractors interviewed for this report noted; switchgears, transformers, and even some non-typical electrical panel boxes are substantial causes of delay if not properly planned for via early release packages or other alternative procurement strategy.

There is currently no firmly forecasted future point of relief for this extreme long-lead reality. With ever more electrification and preparation for Electric Vehicle (EV) charging infrastructure being planned, continued vigilance and proactive planning will be necessary to mitigate future issues. Standardization of equipment specifications to facilitate maximum early procurement, as well as early identification of future capacity needs and related equipment will help avoid compounding complications as the LRCP is executed.

Reshoring of domestic production of components of these materials will assist in reducing wait times further down the line (Foxcon builds, etc.) but the ongoing conflict in the Eurasian plane and

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Producer Price Indexes - Select Equipment

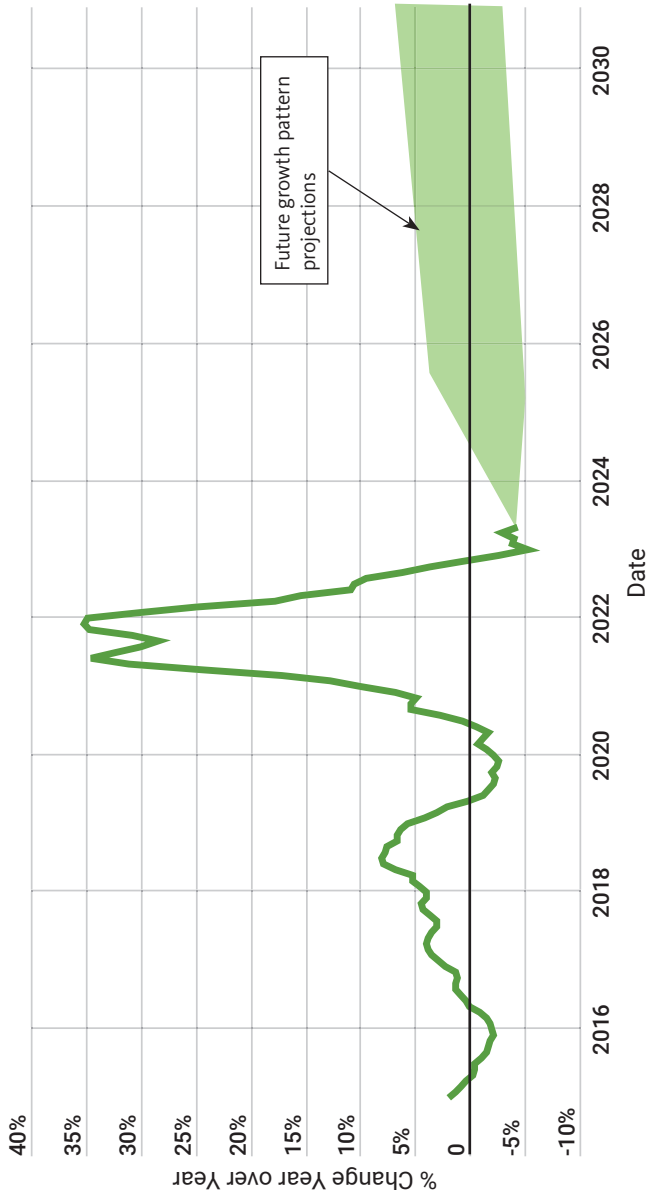
Source: Federal Reserve Economic Data (FRED)

it's downstream effects on material supply and consumption on the remainder of the world market will remain a difficult factor to forecast with confidence.



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The chart to the right highlights the by-year price movement of all construction material costs over the last 3+ years through the worst of the pandemic woes. At it's peak, the spike from pre-COVID pricing levels reached +40%. At present, the net change from January 2019 to today sits at just under 35%, with many materials and commodities seeing stabilization over the last 3-6 months.



● Construction Materials Cost Index PPI

Construction Material Cost Index

Source: Bureau of Labor Statistics

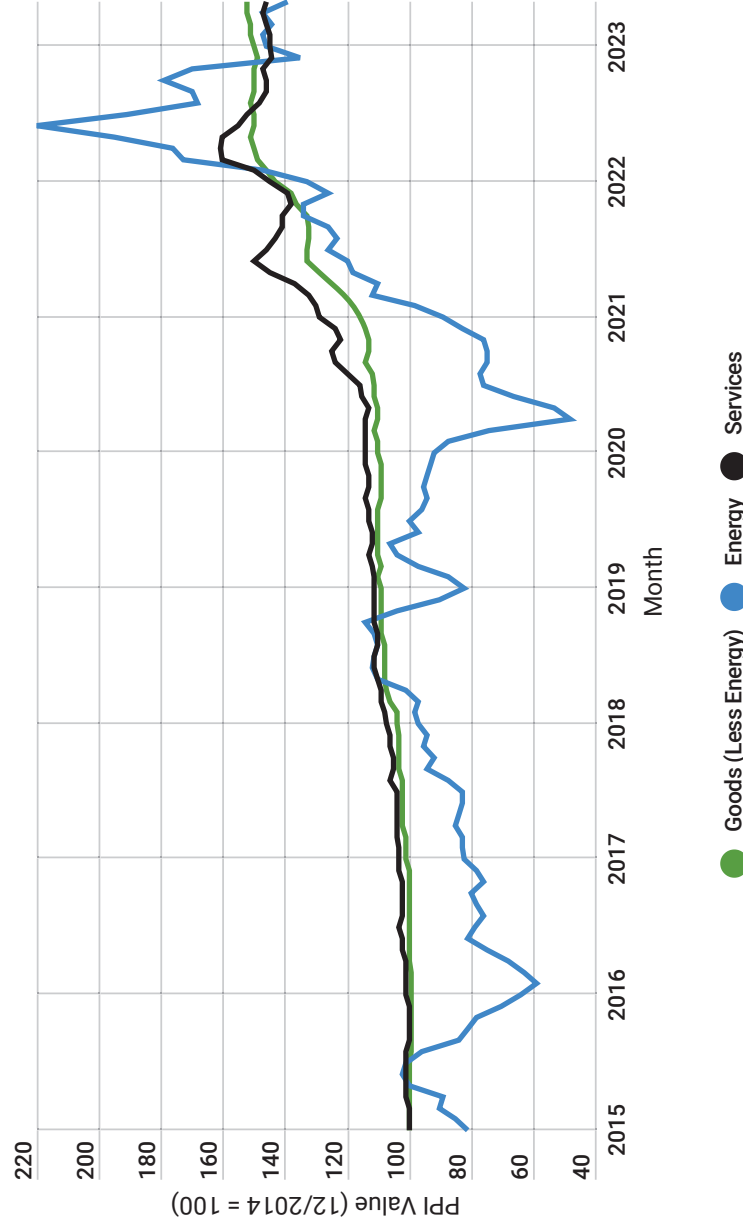
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Role of Energy in Construction Costs

Energy, specifically by way of petroleum products, is one of the largest contributing factors to the cost of construction of any type. From concrete manufacturing to plastic products and material delivery, energy is a cost applied to nearly every construction activity. Accordingly, it is important to note that any potential improvement in the cost of other raw inputs will be partially, if not fully, offset by sustained, elevated energy prices. As seen in the chart to the right, energy was already the highest fluctuating input to construction. Low cost oil and natural gas through much of 2020 muted some price hikes in costs related to domestic transportation and delivery operations.

At present, the war in Ukraine is likely to continue for months, and the international trade frictions even more likely to persist for years thereafter. Short of major, international collective action to force the global price of oil down, the current rise in overhead and transportation costs are representative of another new normal for the foreseeable future.

Current developments in the Middle East would appear to indicate a potential easing of tensions between several different significant OPEC countries, which will serve to lower concerns about the viability of shipping through the Straights of Hormuz and, correlatively, the world supply of light sweet crude. However, longer term, substantial diplomatic and economic ties would need to manifest in order to be able to firmly extrapolate this trend.



Inputs to Nonresidential Construction

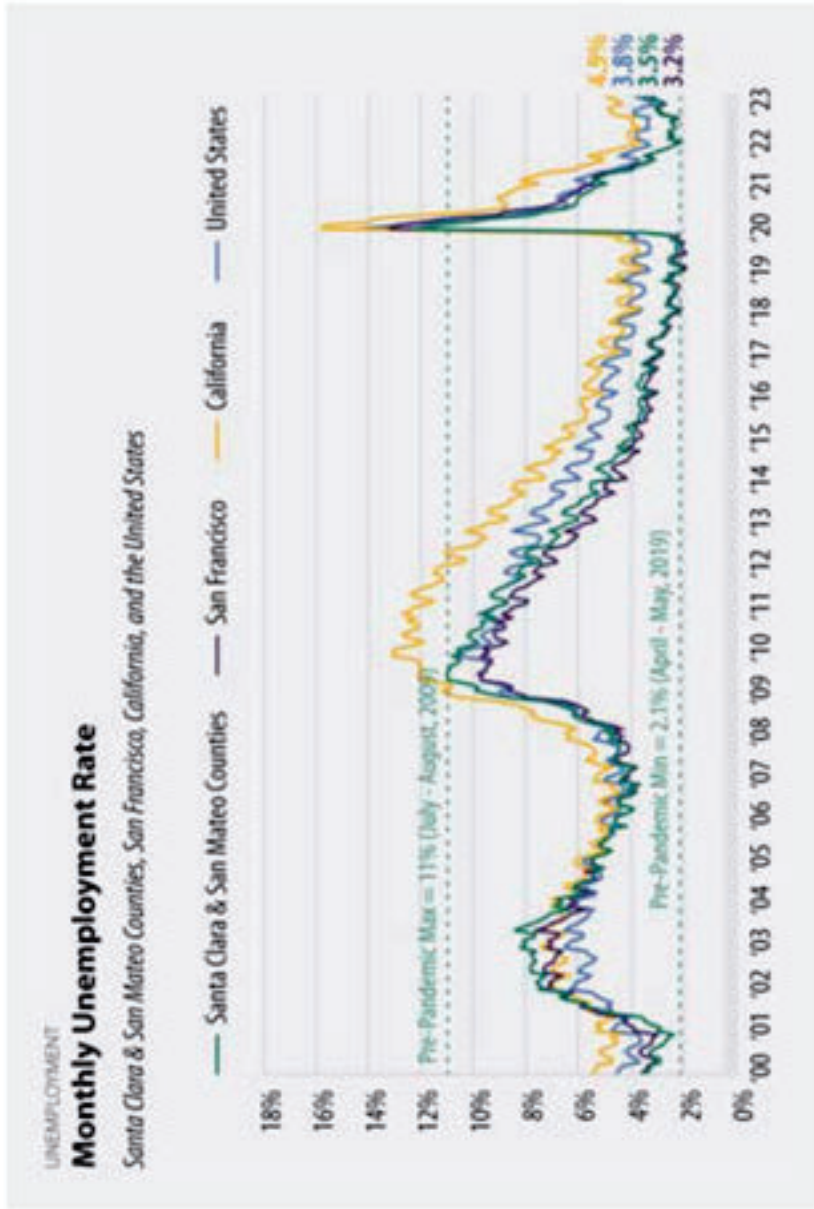
Source: Bureau of Labor Statistics

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Local Investigation

Santa Clara County covers a large portion of the southern Bay Area and runs from Palo Alto in the north past Gilroy at its southernmost point. and is the most populous county in Northern California and the 10th most populous county in the United States. Because of the size of the area and its proximity to San Francisco it is often evaluated in tandem with wider economic trends that effect the area broadly, but the density of both local construction volume and population necessitate a more tailored, specific approach to evaluating its current and future economic conditions. Santa Clara's status as the home of Silicon Valley and the technology revolution has created an extremely competitive economy in the region over the last 20-30 years that leans heavily into higher end, new economy jobs.

Professional and business services, which is the category that technology, advertising and other assorted high wage professional offerings are sorted into, occupies slightly more than 25% of the full time jobs in the area, with Health and Education services coming in at number two. Indeed, the San Jose MSA (Metropolitan Statistical Area) currently boasts the highest average household income of any county in the United States and, depending on year, one of the top five largest GMP (Gross Metropolitan Product) levels in the world.



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The high wage rates for these types of positions has created a situation in which *the economy has dramatically outpaced average construction sector wages' ability to keep up*, which has forced a significant number of workers in lower wage sectors including construction to relocate their residences outside of the area. Although the area is rated as being an extremely desirable place to live, its high cost of living has also restricted population influx, and since 1980 population growth in the county has been below both the growth rate for California (20% below) and the United States at large (1.3% below).

More than half of the adult residents of the area hold college degrees, and since 1980 the percentage of residents that are of primary school age has declined by 22% while the percentage of population that are Seniors (65+) has almost doubled. The net result of these factors is a county that is getting, on average, older and possessing of a less diverse range of skillsets than 30 years ago.

Local Employment

From a cross-industry perspective, overall labor supply in the wider San Jose-Sunnyvale-Santa Clara market increased steadily from 1990 up until the COVID pandemic in 2020, rising from roughly 870,000 to 1.1 million. Over the same period, unemployment vacillated between a high of 9% in 2003 to a low of 2.3% in 2019 with overall average unemployment sitting at 6.19%. When the pandemic materialized it had a marked, weakening effect on the supply of San Jose's labor, as was the case in most other areas. Overall labor supply fell by almost 50,000 workers between Q1 and Q2 of 2020.

While this dynamic is not dissimilar from past economic downturns, both the speed of the fall and the fact that these workers have, as of now, not entirely returned to the labor pool is, and as of the writing of this report *the current total labor pool in the overall San Jose market has yet to regain its pre-pandemic levels*.

While Santa Clara County's overall unemployment rate is sitting at its highest point since January 2022 at 3.7%, this also gives it the 6th lowest unemployment rate in the state and puts it just 20 basis points above the national average. In addition, it should be noted that the larger Northern/Central California area boasts all 6 of the lowest unemployment rates in the state, with Marin, San Francisco, San Mateo, Napa and San Luis Obispo occupying the other spots.

The Education/Healthcare and Leisure/Hospitality sectors have led in employment growth over the last 12 months, up 12,200 and 11,800 full time jobs respectively, while construction has grown at roughly 1/6 of that rate, adding 2,000 jobs over the same period.

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Local Construction Employment

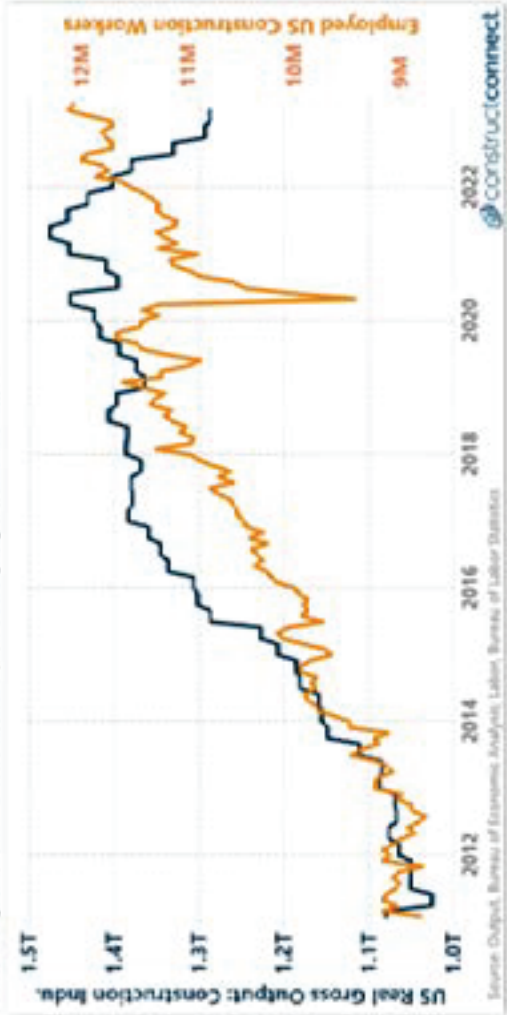
Overall construction employment in the greater Santa Clara county area has increased over the three years since the pandemic, rising to approximately 55,800 full-time workers as of June of this year and, as of 2022, surpassed pre-COVID highs. This growth in overall employment has come at a cost, however, as many of the new tradesmen entering the industry are entirely new to it, and as such will require a three (3) to five (5) year training period to be able to maintain traditionally expected rates of productivity. Because of the large number of new workers entering the field more experienced workers are, and will continue to, command a premium for their services.

The construction sector, from the employer's perspective, has also undergone significant changes over the past twenty years that have shifted the dynamics of attracting new workers into the business. The sector, along with civic employment like firefighters and police officers, used to represent the best opportunities for good wages and long term, steady employment in the country if someone didn't have a secondary degree - this is no longer the case. While this is being driven by a number of factors, the largest two are the fall in the purchasing power of the average construction wage and the proliferation of warehouse employment. Wages in the construction sector have been falling steadily relative to the cost of living for the last 30 years and have declined by

Cost Input #2: Labor

U.S. real construction output contrasts with labor levels

Inflation adjusted 2012 chained dollars, seasonally adjusted annual rate



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almost \$5/hr when you adjust for inflation from 1973 to now. This is, in many ways, being driven by the decline in union participation in the trades. The rise of "Right to Work" legislation and the corresponding toll that has been taken on union participation has also weakened workers' ability to collectively bargain, which has lessened the rate of increase in pay year to year and lowered the number of advocacy groups that are dedicated to introducing these types of jobs to young people just entering their working years - the net upshot being that construction sector wages don't provide the living that they once did for a large portion of the industry.

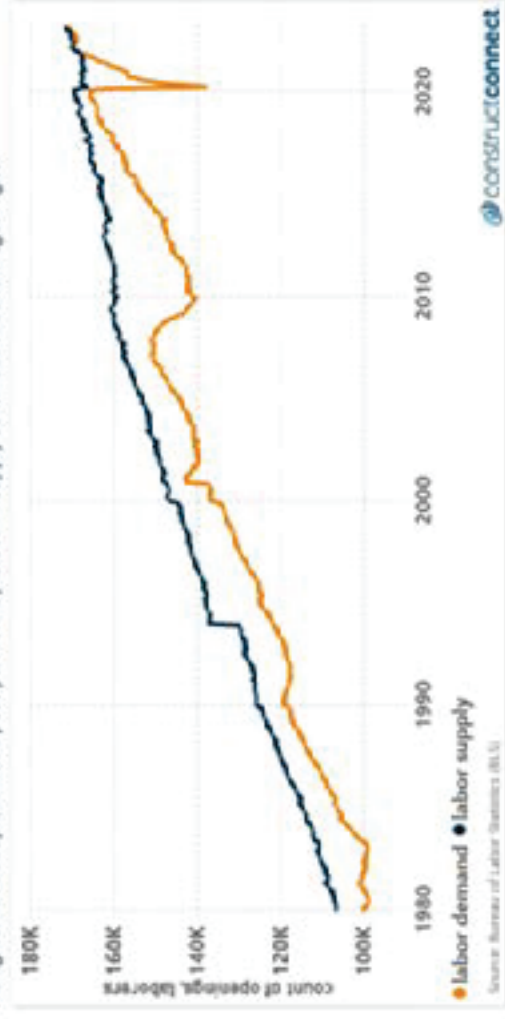
This is then paired with a significant upshift in both the number of, and wage rates for, employment opportunities in the warehouse and logistics industry. The appeal of these types of positions are significant and include factors like relatively low amounts of training required to make a full salary, high levels of pay (\$20/hr+ starting wages) and immediate benefits like healthcare and vacation. Warehouses are also in fixed locations, which provide an employee the ability to plan on having a routine work commute, and the locations are typically conditioned spaces that have a much higher level of comfort for workers than construction sites. All of these factors have combined to create a much higher level of competition for the worker pool that construction would typically attract candidates from, which is translating to a much lower degree of influx of new workers into the industry than in previous generations.

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Cost Input #2: Labor

The balance of construction labor supply and demand has never been tighter

Rising demand coupled with a post-pandemic plateau in supply continues to send wages higher



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The COVID pandemic has also had a significant effect on construction labor in the greater Santa Clara County area due to changes in the dynamics of where people live, and, correspondingly, where construction jobs are available. For large sections of the economy, especially for the Professional Services workers that make up a large portion of the San Jose/Santa Clara county market, the pandemic made it possible to live in more remote locations with less access to major metropolitan areas without necessitating a change in career. This was attractive to many for a wide range of reasons, especially cost of living, and people relocated accordingly. Large sections of what has become known as the “Inland West” that include places like Idaho, Nevada and the eastern parts of Oregon and Washington saw double digit increases in terms of percentage of population growth over the last four (4) years, and the level of relocation to these areas has created a need for more housing, retail and other services than they could/can currently support.

The demand for construction services in these areas is correspondingly high, and as they also represent an opportunity to lower the cost of living they have proved to be very attractive as relocation opportunities for construction labor as well. This is further exacerbating trends previously seen in the San Jose market, namely a lack of labor relative to demand, and though remote work has died down over the last six (6) months there remains little reason to believe that these trends will reverse themselves.

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Some of this disparity in job growth is attributable to weaker construction starts in the greater Santa Clara County area over the course of the year. Layoffs in the technology sector combined with a slower than anticipated return to full time office employment have combined with significant increases in interest rates to create a situation in which private side vertical construction volume has largely drifted sideways over the last 12 months, with overall growth anticipated to come in at 1% y/o/y (year-over-year) by the end of 2023 and remain at or near that same level in 2024. These same conditions are being observed in the vertical construction market in nearby San Francisco as well, and current estimates for total construction volume growth over the next two years for the larger Northern California market (4%) are significantly below the 10-year average. In spite of this relative paucity of increase, the region is still anticipating multiple large vertical construction projects in the near term, with over 25 large (\$50M+) projects currently in construction and approximately 9 more in the current planning stages.

This same trend, however, is not being observed in public sector construction sectors. According to IHS Global Insight, the overall Infrastructure construction sector for the larger San Francisco-San Jose MSA is expected to see close to double digit increases in volume for the next two (2) to four (4) years, with 2023 expected to see approximately 10% before dipping slightly to 8.4% in 2024. This explosion in growth is

predicated on several different factors that include an aging infrastructure system, the overall economic climate over the last ten (10) years, and federal COVID relief in which the County received approximately \$400mil. in additional funding. Because of this large uptick in available funding for public projects area infrastructure systems, including power generation, sewer and water management and road/traffic circulation, are all slated for significant investment over the next four (4) years. Over \$2B. in upcoming projects currently are in either the planning or bidding stages of design, and all of which would serve to compete with the Districts’ construction priorities, and there are currently approximately \$500M. in infrastructure projects not related to District projects that are already underway. The largest upcoming project that stands to directly compete with District construction projects is the BART Silicon Valley Ph II Tunnel and Track project, which is a \$235mil. project that is in the final stages of design and will be bidding soon.

MICRO MARKET ANALYSIS

Conclusion

Overall, the Santa Clara construction market is and will remain very tight in terms of the balance between volume and laborers' ability to support. Reductions in the near term in the vertical construction market will help to ease some aspects of the construction labor shortage, but the large amount of public infrastructure investment slated for the next five (5) years will continue to put steady pressure on local labor suppliers to keep up with demand, particularly in trades that infrastructure utilizes heavily like concrete workers, pipe fitter and equipment operators. While material pricing continues to recover across most categories, as documented in our previous sections, certain materials like concrete and piping remain at elevated levels of consumption. In the overall we forecast above average escalation conditions for the next five (5) years, with 2025 expected to see 7% before trending down to 5.5% for the next three years thereafter.

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Year	FY25	FY26	FY27	FY28	FY29	FY30-39
Construction Cost Escalation Rate	7.0%	5.5%	5.5%	5.5%	5.0%	4.8%

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