

The rising costs of construction

FEB23

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At a glance

- The construction industry across Australia has been under significant pressure since the pandemic began and those challenges are set to magnify over the coming months.
- We expect that contract works insurers will start seeing requests for sums insured to be increased by as much as 45% – if they have not already.
- The challenges could be even starker on the claims side.
- The key to managing the surging costs of property-related claims is a proactive and creative approach to claims management.



Supply chain issues that hit the construction industry during the initial waves of the COVID-19 pandemic remain just as acute. The prospect of another COVID wave also looms, threatening to stretch an already strained labour market. Fuel and electricity prices have soared in recent months, further constricting builders' cashflow. Additionally, significant rain and flooding events on the east coast of Australia have delayed projects and caused significant damage to work in progress.

The result? Construction costs have soared. Research from Corelogic and Cordell shows that residential construction costs have increased 10% in the last 12 months. The commercial sector is experiencing similar price rises. For example, the cost of steel has increased 40% over the last two years.

The increased cost of doing business across the commercial and residential sectors has already pushed several building companies into insolvency, with the prospect of more to come.

Insolvencies reduce the number of players in the market and dilute competition – with a natural upward pressure on prices. The same issues will affect insurers across several product lines at both the underwriting and claims levels.

We expect that contract works insurers will start seeing requests for sums insured to be increased by as much as 45% – if they have not already. The declared duration of works is likely to double in certain cases.

The challenges could be starker on the claims side. Most obviously, the cost of reinstating damage has already increased significantly over the past few years and there is no sign of relief in sight.

The supply chain and labour market pressures will only compound the costs to settle material damage claims and will result in larger and more extensive business interruption claims as reinstatement works take longer to complete.

What options do insurers have to deal with these issues?

More than ever, the key to managing the surging costs of property-related claims is a proactive and creative approach to claims management.

We are already seeing some players in the market shift to using 'costs plus' contracts, rather than the traditional 'fixed price' model, to reduce the risk of price volatility for contractors. The costs plus model, coupled with carefully crafted incentive packages, provides greater certainty that the builder will be able to complete the project on time and within the estimated budget.

We expect this trend to gather pace over the coming months as a way of keeping contractors engaged on outstanding work. There is merit in offering other incentives to contractors too, such as tiered bonuses for completing work early or meeting other agreed milestones. This could help guard against the risk of blowouts in the reinstatement program.

Creative thinking should extend beyond reinstatement 'works' into the procurement phase too. Claims handlers should work closely with adjusters to identify opportunities to accelerate the delivery of critical path items of plant/machinery. This might involve:

- using different transport/logistical solutions to get replacement plant/machinery to the insured
- identifying opportunities to incentivise vendors to expedite production, and
- using substitute materials for reinstatement in circumstances where lead times for a like-for-like replacement are significant.

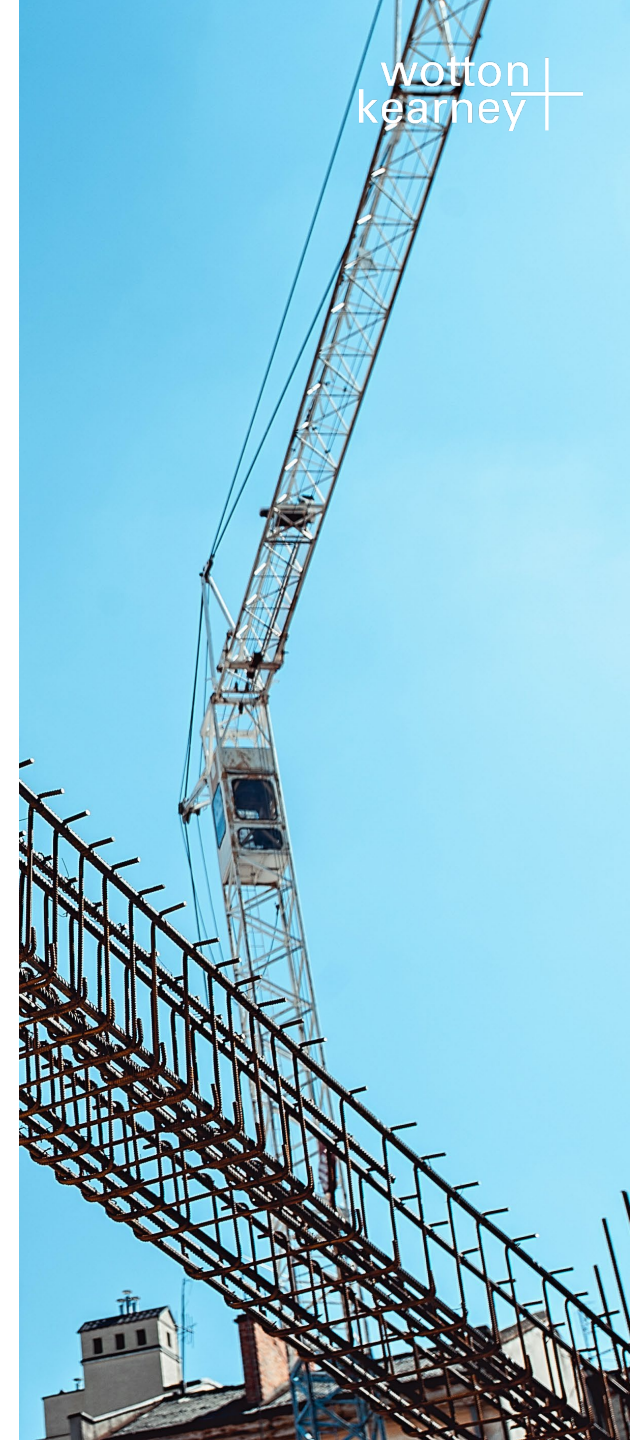
On larger and specialised projects where insureds have lead control over reinstatement, there is real merit in appointing a quantity surveyor, construction programmer or disaster management consultant early in the claim to ensure reinstatement works are moving as quickly as possible and to identify opportunities to accelerate works.

Creative settlement opportunities also mean that reinstatement can occur sooner, reducing significant Section 2 losses. In some cases, taking a proactive and creative approach to claims management might mean incurring slightly higher costs on the material damage component of a claim to minimise Section 2 exposure, as insureds will be able to resume normal operations sooner.



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