COST ESTIMATION ACCURACY FOR INDUSTRIAL PLANT ENGINEERING VS. BUILDING CONSTRUCTION PROJECTS

Summary. Ongoing pressure on prices for construction projects adds to the significance of cost estimation accuracy in building construction. Due to competition from Asian entrants, main contractors in the plant engineering industry are facing a similar situation. In the present paper, the cost estimation standards for industrial plant engineering are analyzed and compared with the respective standards for Building Construction (BC). In particular, cost estimation guidelines by the Association for the Advancement of Cost Engineering (AACE) are checked against a guideline known as the ‘cone of cost’ following the Official Scale of Fees for Services by Architects and Engineers (German: HOAI) for comparable phases of performance. It is shown that the plant engineering industry cost estimation guidelines are much more tolerant in terms of accuracy than the ones for Building Construction in Germany, especially in the early phases of a project. A set of possible reasons is identified and categorized by (1) competition intensity, technology impact and frequency of project occurrence, (2) demands on cost estimation professionals, (3) materials and supplies, (4) duration of project execution, (5) certainty of projected cash flows. Finally, the study marks starting points for further research: First, to use non-German BC estimation standards for the comparison, and second, to empirically validate and extend the set of reasons.

Keywords: industrial plant engineering, building construction, cost estimation.

SZACOWANIE KOSZTÓW W PRZYPADKU PORÓWNANIA PROJEKTÓW DLA ZAKŁADÓW PRZEMYSŁOWYCH I BUDOWNICTWA

i częstotliwość zdarzenia projektu, (2) żądania w stosunku do profesjonalistów szacunku kosztów, (3) materiały i zaopatrzenie, (4) czas trwania projektu, (5) pewność przewidzianych przepływów gotówki.

Słowa kluczowe: inżynieria zakładu przemysłowego, budynek budowa, szacunek kosztów.

1. Introduction

In the present paper, cost estimation standards and their accuracy requirements are for Major Industrial Plant Projects (MIPP) are compared with the respective standards for Building Construction (BC). The study is motivated by two reasons.

First, continuing pressure on prices for construction projects leads to an increasing importance of cost estimation accuracy in building construction. Recently, main contractors in the plant engineering industry are starting to face a similar situation due to increasing competition from Chinese and South Korean entrants (c.f. Knauthe 2013: 9).

Second, cost deviations, and in particular cost overruns, happen in MIPP, i.e. industrial process facilities, as well as in Building Construction (BC) projects. However, due to the inherent risks in the realization of process facilities, including completion and performance of process design risks, the probability for the occurrence of cost overruns of MIPP is considerably higher than for building construction (c.f. Rapp 2004: 52ff.){1}. It is coherent to assume that these inherent risks as well as the comparably high probability of cost deviations for MIPP are reflected in the respective cost estimation standards.

2. Research Objective and Method

The objective of the study is to find out, on an indicative level, how tolerant MIPP cost estimation standards are versus BC standards. Therefore, the research method used includes a literature and standards review, comparing MIPP cost estimation guidelines by the Association for the Advancement of Cost Engineering (AACE), headquartered in the United States.

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{1} In this respect, the author noted that opinions of MIPP vs BC industry experts vary as of which budget deviation a project might be considered a success or failure. Aiming to divide project failure from success in Major Industrial Plant construction, the 50% rule had been suggested (c.f. Erbe 2012: 4; AACE International 2005: 3, 7). The rule states that a MIPP may be considered a failure if, among other conditions, the project’s budget is overrun by more than 50%. Some contractor’s representatives, in particular from the BC sector, discussing the topic with the author on several occasions during 2012-13, were of the opinion that a MIPP is a failure already if the budget overrun amounted to considerably less than 50%. Others, particularly from the MIPP industry, felt the 50% rule could be an applicable rule-of-thumb for the success of a MIPP.
States, with a guideline from Germany known as the ‘Cone of Cost’ following the Official Scale of Fees for Services by Architects and Engineers (German: HOAI) for comparable phases of performance.

3. Conceptual Demarcation

3.1. Characterizing a Major Industrial Plant Project (MIPP)

A Major Industrial Plant Project (MIPP) is characterized by the following features (c.f. Erbe 2013: 3-6): It involves planning and realizing\(^2\) (but not operating) an industrial process plant. It is a “Greenfield” investment requiring a Total Investment Cost (TIC) of a minimum of USD 100 million. TIC, for purposes of simplification, is understood to include the Engineering, Procurement and Construction (EPC) of a process plant. TIC comprises process engineering and equipment of over 50%, typically 65-75%, which, in simplified terms, represents the Engineering and Procurement (EP) part of the project. The remaining percentage of TIC is the Construction (C) part.\(^3\) The purpose of the process plant to be planned and realized is to produce a tradable product by material conversion. Typically, a minimum of 100 suppliers are involved in a MIPP, and the phase of Project Execution lasts for at least 12 months (2-5 years on average). The duration of Project Development amounts to a minimum of 6 months (12-24 months on average). Examples of MIPP include the planning and realization of power plants (fossil/biomass fuelled), chemical as well as metallurgical plants.

3.2. Defining Building Construction (BC)

Building Construction (BC) is the part of civil engineering that deals with the design and construction of buildings that are mostly above the ground line, e.g. buildings such as houses or towers (Grütze 2007: 126). As such BC forms a part of a MIPP (i.e., the “C” part – as elaborated above).

\(^2\) In simplified terms, the realization of a MIPP is also known as Engineering, Procurement and Construction (EPC).

\(^3\) Owner’s costs of any kind are disregarded for the purpose of this study.
3.3. Cost Estimation

Cost estimating is the predictive process used to quantify, cost, and price the resources required by the scope of an investment option, activity, or project. Budgeting is a sub-process within estimating used for allocating the estimated cost of resources into cost accounts (the budget) against which cost performance will be measured and assessed (Hollmann 2012: 48). With the complexities involved, it is not surprising that many business practitioners consider pricing an art (c.f. Kerzner 2013: 677). Because of the considerable risks involved, this is particularly true for cost estimation for MIPP, which, apart from costing various engineering trades (process, mechanical, electrical engineering, etc.), also includes BC cost estimation.

4. Cost Estimate Classification and Accuracy for MIPP – EPC

Principles of estimate classification specifically to project cost estimates for engineering, procurement, and construction (EPC) work for the process industries (MIPP) are provided by the AACE\(^4\) in their Recommended Practice No. 18R-97 (2005).

According to AACE International, the term process industries is assumed to include firms involved with the manufacturing and production of chemicals, petrochemicals, and hydrocarbon processing. The common thread among these industries (for the purpose of estimate classification) is their reliance on process flow diagrams (PFDs) and piping and instrument diagrams (P&IDs) as primary scope defining documents. These documents are key deliverables in determining the level of project definition, and thus the extent and maturity of estimate input information (AACE 2005: 1).

Estimates for process facilities center on mechanical and chemical process equipment, and they have significant amounts of piping, instrumentation, and process controls involved. The cost estimates covered by the AACE International Recommendation are for engineering, procurement, and construction (EPC) work. They do not cover estimates for the products manufactured by the process facilities, or for research and development work in support of the process industries. The guideline also does not cover the significant building construction that may be a part of process plants (ibid: 2).

The five AACE estimate classes are presented in the table below. The level of project definition determines the estimate class. The other four characteristics are secondary characteristics that are generally correlated with the level of project definition. The characteristics are typical for the process industries but may vary from project to project.

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\(^4\)AACE stands for the Association for the Advancement of Cost Engineering, formerly known as the American Association of Cost Estimators. (c.f. Peurifoy and Oberlender, 2002: 5; AACE 2014: Article 1).
### AACE Cost Estimate Classification Matrix for Process Industries

<table>
<thead>
<tr>
<th>ESTIMATE CLASS</th>
<th>PRIMARY CHARACTERISTIC</th>
<th>SECONDARY CHARACTERISTIC</th>
<th>END USAGE</th>
<th>METHODOLOGY</th>
<th>EXPECTED ACCURACY RANGE</th>
<th>PREPARATION EFFORT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class 5</td>
<td>0% to 2%</td>
<td>Concept Screening</td>
<td>Typical purpose of estimate</td>
<td>Capacity Factored, Parametric Models, Judgment, or Analogy</td>
<td>L: -20% to -50%  H: +30% to +100%</td>
<td>1</td>
</tr>
<tr>
<td>Class 4</td>
<td>1% to 15%</td>
<td>Study or Feasibility</td>
<td>Typical purpose of estimate</td>
<td>Equipment Factored or Parametric Models</td>
<td>L: -15% to -30%  H: +20% to +60%</td>
<td>2 to 4</td>
</tr>
<tr>
<td>Class 3</td>
<td>10% to 40%</td>
<td>Budget, Authorization, or Control</td>
<td>Semi-Detailed Unit Costs with Assembly Level Line Items</td>
<td>L: -10% to -20%  H: +10% to +30%</td>
<td>3 to 10</td>
<td></td>
</tr>
<tr>
<td>Class 2</td>
<td>30% to 70%</td>
<td>Control or Bid/ Tender</td>
<td>Detailed Unit Cost with Forced Detailed Take-Off</td>
<td>L: -5% to -15%  H: +5% to +20%</td>
<td>4 to 20</td>
<td></td>
</tr>
<tr>
<td>Class 1</td>
<td>50% to 100%</td>
<td>Check Estimate or Bid/Tender</td>
<td>Detailed Unit Cost with Detailed Take-Off</td>
<td>L: -3% to -10%  H: +3% to +15%</td>
<td>5 to 100</td>
<td></td>
</tr>
</tbody>
</table>

**Notes:**

[a] The state of process technology and availability of applicable reference cost data affect the range markedly. The +/- value represents typical percentage variation of actual costs from the cost estimate after application of contingency (typically at a 50% level of confidence) for given scope.

[b] If the range index value of "1" represents 0.005% of project costs, then an index value of 100 represents 0.5%. Estimate preparation effort is highly dependent upon the size of the project and the quality of estimating data and tools.


### 5. Cost Estimate Classification and Accuracy for BC

While MIPP as process plant projects rely on PFDs and P&IDs as primary scope defining documents, civil engineering documents used by building cost estimators draw on design schemes and bills of quantities (c.f. Möller 1996: 119-20; HOAI 2013: 5, §2).

So, one of the key differences between MIPP and building construction is that rather than **process engineering**, which has also been referred to as “planning” in the MIPP/ process plant industry (c.f. Bernecker 2001: 4ff.), building construction uses civil and **architectural planning**. Unlike MIPPs, which typically represent multi-national endeavors, building construction can be considered a local business (c.f. Brockmann 2009: 173). In Germany, building construction planning is regulated by the “Official Scale of Fees for Services by
Architects and Engineers”, also known as HOAI\(^5\) as well as the German Industry Norm DIN 276 (c.f. HOAI 2013: 5, §2 (10), (11); Werner 2013: 150; Kalusche and Dusatko 2009: 139; Lechner 2013: 2f., 9ff.; Siemon 2012: 3).

Competition in building construction is comparably intense\(^6\) versus process plant EPC construction: While GCs for MIPP usually act in an oligopolistic market, GCs in building construction, at least for standard building projects, such as residential housing, may find themselves confronted with hundreds of competitors\(^7\). Actually, in 2010, the total number of building construction firms in Germany amounted to 73,290 with an average number of ten employees per firm (BWI-Bau et al. 2013: 66). The eminent “atomic market structure” (ibid: 119) is one of the reasons why building cost estimators are under considerable cost and accuracy pressure in their calculations even in the early phases of a project, the pre-calculations or concept phase (c.f. Jacob, Stuhr et al. 2011: 11, 31; BWI-Bau et al. 2013: 125ff.).

There are no clear legal or normative provisions for the required accuracy of a cost estimate according to DIN 276. From case law and literature, common practice values for permissible cost deviations can be derived (c.f. Kalusche and Dusatko 2009: 142; Kochendörfer et al. 2010: 150; Werner 2013: 256 ff.; BWI-Bau 2013: 75). These are presented by performance phase in the figure below, which is also known as the “Cone of Cost” (German: “Kostentrichter”) of building construction cost estimate accuracy.

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\(^5\) HOAI stands for Honorarordnung für Architekten und Ingenieure (HOAI).

\(^6\) Runeson (2000:170) considers perfect competition to be the appropriate model for the most of the building construction sector.

\(^7\) For example, in the building construction (Hochbau) sector, in Germany the on-line trade directory “Gewerbeverzeichnis Deutschland” alone shows over 550 results in searching for a GC specializing in building construction (GvD 2014). Meanwhile, companies specializing in HBI plant or other MIPP construction are hardly found in trade directories. Worldwide, only three companies world-wide specialize as a GC in HBI plant construction (Mattusch 2013).
6. Comparison and possible reasons for differences

6.1. Comparing cost estimate accuracy for MIPP vs BC

The results of the cost estimate accuracy comparison for MIPP versus BC are presented in Table 2 below. As noted by the ACCE (2005: 2), the level of project definition determines the estimate class. Levels of definition for Building Construction (BC) performance phases according to HOAI (German: Leistungsphasen, abbreviated LPH) are described, for instance, in Kochendörfer et al. (2010: 147ff.). As they vary from project to project, the BC LPH shown in Table 2 represent only rough indicative ranges of the MIPP estimate classes as provided by the AACE. The same is true for the End Usage: the purpose of the cost estimate depends on the individual endeavor. The table presents the maximum accuracy tolerance ranges for international MIPP versus BC in Germany by estimate class/performance phase.
Table 2

Comparison of Cost Estimate Accuracy Ranges for MIPP vs BC (Germany)

<table>
<thead>
<tr>
<th>MIPP (AACE) Estimate Class</th>
<th>BC Performance Phase (HOAI LPH) Equivalent*</th>
<th>End Usage: Typical Purpose of Cost Estimate</th>
<th>MIPP (AACE) Accuracy Range max.</th>
<th>BC (Germany) Accuracy Range max.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class 5</td>
<td>1</td>
<td>Concept Screening</td>
<td>-50% to 100%</td>
<td>+/-  40%</td>
</tr>
<tr>
<td>Class 4</td>
<td>2</td>
<td>Study or Feasibility</td>
<td>-30% to +50%</td>
<td>+/-  30%</td>
</tr>
<tr>
<td>Class 3</td>
<td>3 … 4</td>
<td>Budget</td>
<td>-20% to +30%</td>
<td>+/-  20%</td>
</tr>
<tr>
<td>Class 2</td>
<td>5 … 7</td>
<td>Bid/ Tender</td>
<td>-15% to +20%</td>
<td>+/-  10%</td>
</tr>
<tr>
<td>Class 1</td>
<td>6 … 9</td>
<td>Check</td>
<td>-10% to +15%</td>
<td>+/-  5%</td>
</tr>
</tbody>
</table>

*indicative equivalent ranges depending on project, LPHs in Class 2 & 1 Equivalent may overlap

The comparison shows that in the MIPP industry cost estimation is much more tolerant in terms of accuracy than for BC in Germany, especially in the early phases (Concept Screening and Feasibility Study). Due to the above mentioned limitations concerning the variance of LPHs from project to project, the present comparison may serve as an indication only. Nonetheless, it may help to understand the different reactions of MIPP vs BC industry experts as from where a project might be considered a success or failure (50% rule) noted in Chapter 1. If a MIPP is 50% over budget, this represents a back fall to a Class 4 Estimate (“Study or Feasibility” Level) which could be accepted as a threshold between success and failure by a MIPP professional. Meanwhile, a building construction (BC) project, in particular a standard building like a residential house, which is 50% over budget may understandably be considered a total disaster by a German BC professional, as this kind of inaccuracy in a cost estimate would not even be acceptable at the level of “Concept Screening”.

6.2. Possible reasons for accuracy differences

There are various reasons why for (German) BC, represented for this purpose by residential housing construction, cost estimation tends to be more accurate than the one for MIPP, represented by Hot-Briquetted-Iron (HBI) plants. The author takes on, but does not empirically validate the following, mutually interdependent, possible reasons:

1. Cost and accuracy pressure due to competition intensity in BC (hundreds of competitors in housing construction in Germany alone) vs MIPP (a general contractor

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8 In fact, the fulfillment of the customer’s specifications and the compliance with time schedules, in particular the accomplishment of Mechanical Completion on time, may be at least as important adherence to budget for the success of a MIPP.
(GC) acts in an oligopolistic market structure; for HBI plants: three competitors (globally) which in turn is reasoned by the following:

a) **Technology licensing** impact (e.g., globally, two companies own the shaft furnace process technology for HBI plants, which is subject to constant research and innovation; in contrast, hundreds of companies are able to build a standard residential building/ house)

b) **(in)frequency of occurrence**: world-wide contracts to build residential houses are awarded frequently, assumedly several times each day; EPC contracts to build HBI plants are awarded less than once in two years

c) **Company size**: In Germany, the average number of employees in building construction (Bauhauptgewerbe) is ten (c.f. BWI-Bau 2013: 66). GCs for HBI plants, for instance Danieli, Siemens VAI or Kobe have ten thousands of employees.

d) **Barriers of entry** are rather low in standard residential housing construction (c.f. BWI-Bau 2013: 137) while they are high in HBI plant construction (a know-how, technology driven business).

e) **Standardized product.** A customary residential house (in its extreme form: prefabricated) is a standard product with an openly available market price. Therefore, a BC contractor will have to use target costing to be able to compete in the market. An HBI plant project is a tailor-made high-risk endeavor, allowing the EPC contractor to use much higher mark-ups.

2. **Demands on the cost estimation professional**: building construction estimation can comparably easily be taken up by anyone with a commercial background and some IT skills by using standard calculation software (e.g. RIB iTWO Stuttgart/ Germany; RIB 2010). In contrast, cost estimators for chemical and other process plants are rare experts, oftentimes using proprietary, self-developed spreadsheet and/or database models. Officially marketed IT solutions (Cleopatra Enterprise from the Netherlands, Aspentech/Icarus from Cambridge, Massachusetts; Aspentech 2000) became available in Europe only comparably recently. Becoming a MIPP cost estimation professional requires a process engineering degree plus long-term MIPP commercial experience (especially concerning contingency and risk planning) to be able to estimate the cost of a MIPP which includes various types of engineering (mechanical, electrical, process and others) plus Civil (building) construction (c.f. Chapters 3.1, 3.2).

3. In BC, standard readily available materials and supplies (e.g., **concrete** reinforcing steel bar (**rebar**)) are used. In contrast, piping and instruments, made of specialty steels and alloys like **nickel-based alloys** are a major part of MIPP (process plants). The prices for standard materials (e.g. rebar) fluctuate to a lesser extent than the prices for special materials (e.g. Nickel) as presented in Figure 2 below.
4. **Local vs. international supplies** (e.g. concrete for BC vs. stainless pipes for MIPP) resulting in lower vs. higher risk.

5. **Short vs. long term of planning** and realization: A standard residential building can be erected in a short term (some months); a MIPP is built in several years, typically two to five (c.f. Chapter 3.1).

6. **Uncertainty of projected Cash Flows** (CF). Income, i.e. rent from residential housing projects in Germany, is typically fixed by the private residential rental index (German: “Mietspiegel”) with often minor deviations. So, the projected CF is rather certain. In contrast, the CF from a MIPP depends on prices of inputs, which are globally traded commodities (for HBI plants: iron ore and natural gas) and the end product (HBI), which are subject to considerable fluctuations on world markets resulting in an uncertainty of projected CF.

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**Price volatility comparison: Nickel vs. Rebar**

USD/t, April 1999–Mar 2014

Source: IndexMundi 2014.

Fig. 2. Price volatility comparison for Nickel vs Rebar
Rys. 2. Porównanie zmienności cen niklu i prętów zbrojeniowych
Source: IndexMundi 2014.
It should be re-emphasized that the above list of possible reasons for differences in cost estimation accuracy of building construction versus MIPP is not exhaustive and just partly validated. The list is intended to serve as a starting point for further research in the area. For example, rather than using the extreme examples of standard residential housing vs. HBI plants, more complex BC projects could be used for a cost estimate comparison with MIPP.

7. Excursus: Reliability of Cost Estimates in Industrial Feasibility Studies

The UNIDO Manual for the Preparation of Industrial Feasibility Studies (1995: 36-7), widely used in the industrial plant engineering practice, defines the following “ranges of reliability” for estimates of investment and production costs to be considered acceptable:\(^9\):

<table>
<thead>
<tr>
<th>UNIDO Manual for Industrial Feasibility Studies: Ranges of Reliability</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Opportunity Study</strong></td>
</tr>
<tr>
<td><strong>Pre-feasibility Study</strong></td>
</tr>
<tr>
<td><strong>(Bankable) Feasibility Study</strong></td>
</tr>
</tbody>
</table>

Source: UNIDO (1995: 37)

As can be seen from the table, an Opportunity Study would correspond to an AACE Class 4 estimate, a Pre-feasibility to a Class 3, and a Bankable Feasibility to a Class 2 estimate, conservatively referring to the accuracy ranges in Table 2 of Chapter 6.1.

8. Conclusions and Starting Points for Further Research

In the present paper, AACE cost estimation standards for Major Industrial Plant Projects (MIPP) have been compared with German cost estimation standards for Building Construction (BC) according to HOAI. It is shown that the AACE cost estimation guidelines for the MIPP industry are much more tolerant in terms of accuracy than for BC in Germany, in particular for the early phases of Concept Screening, Study/ Feasibility and Budget (Class 5 to Class 3 estimates).

\(^9\) The authors of the UNIDO Manual note that the given ranges differ from project to project depending on the applied method of cost estimates, for example how components of foreign and local currency origin are accounted for (c.f. ibid: 37, 151).
Using examples for MIPP versus BC projects, Hot-Briquetted-Iron (HBI) plants versus residential housing, a set of possible explanations has been identified and categorized by (1) competition intensity including technology impact and frequency of project occurrence, (2) demands on cost estimation professionals, (3) materials and supplies used (international versus local), (4) duration of project execution, (5) certainty of projected Cash Flows.

The results of the study, however, are to be seen as indicative and are intended to serve as a starting point for further research. Potential topics yet to be explored include but are not limited to:

First, comparing MIPP cost estimation guidelines to non-German Building Construction (BC) standards, such as for example **BC standards in the US, the UK, or Poland**.

Second, an empirical investigation using examples other than HBI plants and residential housing resulting in a possible extension, restriction, confinement of, or deviance from the above-mentioned set of explanations for the higher accuracy tolerance of MIPP versus BC standards would be useful.

Third, it could be further investigated whether or not, facing the situation of increasing cost competition, cost estimation guidelines for the MIPP industry may become subject to adaptation in terms of accuracy.

**Bibliography**

Omówienie

Artykuł koncentruje się na kwestiach szacowania kosztów w przemyśle budowlanym. Pokazano w nim, że wytyczne przemysłu maszynowego dla szacunku kosztów są dużo bardziej tolerancyjne pod względem dokładności w Niemczech niż dla budowania konstrukcji, szczególnie dla wczesnych etapów projektu. Zbiór możliwych powodów: (1) intensywność konkurencji, wpływ techniki i częstotliwość zdarzenia projektu, (2) żądania w stosunku do profesjonalistów szacunku kosztów, (3) materiały i zaopatrzenie, (4) czas trwania projektu, (5) pewność przewidzianych przepływów gotówki.

Wyniki przedstawionych badań należy traktować jako case study i mają służyć jako punkt wyjścia do dalszych badań.