A Steady State of Play

Surety capacity, contractor confidence and the value of the bond

By Vicki Speed
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Hank Nozko, Jr.
nozkojr@acstarins.com

Henry Nozko, III
nozko3@acstarins.com

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Construction employment is high, as is the total dollar value of construction put in place, and just as importantly, profit margins are rising—this is mostly good news overall, according to a quick survey of industry professionals.

“Early apprehension about an imminent economic cooling off has not been reflected in our industry,” says Ken Simonson, chief economist of the Associated General Contractors of America (AGC). “Overall, construction is still running flat out. As well, despite tariffs and workforce shortages, we’re not hearing about owners postponing, scaling back or cancelling projects, with a few exceptions, because of rising costs. Contractors tell us they have as much work as they can handle—and they’d be happy to take on more employees if they could find them.”

Along with plentiful work for contractors, the surety market remains strong while contractor failures are low, though workforce shortages, volatile material prices and stalled federal infrastructure investment now threaten continued growth.

Capacity, Credit and the Bottom Line

Across the board, surety capacity is high, premiums are low, and underwriting terms and conditions are softening. Surety premiums have more than doubled over the past 20 years, and the industry has seen six years of steady growth. The Surety and Fidelity Association of America (SFAA) reports that 2018 direct premiums grew from $6.2 billion in 2017 to $6.6 billion in 2018.

“Surety bonds help to build America,” says SFAA President Lee Covington. “Whether on a federal, state or local construction project, a P3 project or private construction, surety bonds play an important role in the success of construction projects. No other risk management product provides the same comprehensive protection as a surety bond—ensuring projects are completed and subcontractors are paid.”

The megaproject sector (more than $250 million) is the only market segment with signs of problems. “We’re seeing some stress in this sector with limited capacity,” says Geoff Delisio, senior vice president and head of surety at Berkshire Hathaway Specialty Insurance (BHSI). “From a surety perspective, it’s stable, but with ever-tightening underwriting conditions.”

Looking at other sectors, capacity is plentiful for small (under $10 million), medium ($10–$100 million) and large ($100–$250 million) contractors. “If anything, there’s more surety capacity available today than there was is 2018,” says Kevin Waldron, Chubb’s senior vice president and surety director.

Merchants Bonding Co. Vice President of Contract Underwriting Jason Dettbarn adds that he sees wide market availability for medium and large contractors, “though many of these organizations are pushing aggregate limits with the large amount of work available to bid.”

Looking at the small contractor market, Dettbarn and others note that surety capacity is high, with sureties competing aggressively on program and underwriting standards. Additionally, there’s been a rise in credit-only
programs, with increasing limits making it easier for small and emerging contractors to secure bonds.

Darrel Lamb, regional vice president for Old Republic Surety Co., says, “While credit-based bond programs seem like they could become a vehicle for default, that’s not happening. The credit-based bond programs are very successful with excellent loss ratios.”

However, as Jeff Cose, associate vice president of the National Bond Center at Nationwide Surety, outlines later in this section, credit-based programs should ultimately be used as a stepping stone to more traditional bonding solutions.

**Signs of Stress?**

Along with strong surety capacity, contractor failure has been low. Just as importantly, profit margins seem to be on the rise thanks to increased opportunities and increasing backlogs.

Michael Groman, vice president of CNA Surety, says he’s seeing some increase in contractor failure rates in the market, which are resulting in $10- to $50-million surety claims, though “not at a level that will stem the run of strong results for the industry as a whole.”

He adds, “There has not been a meaningful combination of high-frequency and high-severity losses in the surety industry since 2000–2003, and we don’t see any signs of that changing in the near future.”

Delisio has a slightly different perspective, adding that he’s seen a slight increase in failure in 2018. “I think that will continue to increase in 2019 and 2020. Profit margins are improving but are still not strong. In particular, large multiyear civil projects have had extremely poor performance in 2018 and the first part of 2019.”

Chubb’s Waldron warns, “There appear to be some large contractor failures accruing that may affect the broader market once they become fully realized. There also appear to be some issues/concerns in the middle contractor market, but none that I expect will change surety underwriting behavior in the short term.”

All those surveyed about the surety trends and challenges noted that while the contractor margins and amount of work are increasing, labor shortages, onerous contract provisions, scope changes, compressed schedules and poor owner financial metrics threaten the current market strength.

**Public Investment**

One of the disquieting issues for construction and surety remains the lack of a long-term federal infrastructure bill, which puts considerable stress on both state and local agencies to come up with funding sources themselves.

Nationwide’s Cose adds, “Estimates range in the $4–$5 trillion of investment needed to get our nation’s infrastructure and transportation system modernized. If deterioration is not addressed, we will put ourselves in a dire situation in terms of public safety.”

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The Current State of Bonding Thresholds

**State bonding thresholds**—or the amounts above which are required to work on state construction projects—are meant to make state work cheaper, easier and more accessible to small contractors. In some states, the threshold amount for supplying a performance bond has moved from $100,000 to $150,000.

Merchants Bonding Co.’s Regional Vice President of Contract Underwriting Ed Sipfl sees rising thresholds clashing with other industry trends. He notes, “With the skilled labor shortages in most states, it’s extremely risky to leave even smaller amounts of taxpayer money unprotected. In the event of contractor defaults on projects costing less than $150,000, there will be no surety to ensure the work is completed and the suppliers paid. That puts the taxpayer money at risk, not just for the work but also legal costs that usually accompany construction disputes.”

More recently, some state legislatures, such as North Dakota, have sought to increase bond thresholds to $250,000 or more.

The Ohio budget bill as passed in the House would increase the bond threshold for the Ohio Turnpike Commission projects from $150,000 to $500,000. The bill also would allow the Commission to waive the competitive bidding process when it determines that it’s not practical or advantageous to the Commission. The Commission oversees three major interstate highways and is funded by revenue from the tolls collected and any revenue bond issued.

The Surety and Fidelity Association of America (SFAA) believes that the provisions in the budget erode both the payment and performance protections of the bonds and the level of transparency in the process from competitive bidding.

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Merchants Bonding President

Larry Taylor, who is also the current board chair for SFAA, says, “I’m not optimistic about an infrastructure bill passing in 2019 or 2020. On the positive side, more funds could be attached to the highway bill (though not near the amount that an infrastructure bill would require) that will probably just simply renew again this year. With the lack of progress, or very slow progress, at the federal level, many states are finding ways to fund infrastructure needs on their own. Several states are doing so by adding a new gas tax or increasing an
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existing gas tax. I expect to see more of this in the next few years.”

With regard to federal-funded construction through the Transportation Infrastructure Financing and Innovation Act (TIFIA) and Water Infrastructure Financing and Innovation Act (WIFIA), there are significant efforts to assure that bonds for the full amount of the construction work are required.

SFAA believes that to ensure the federal investment in such projects is protected, TIFIA and WIFIA should be modernized to include the same payment and performance bonding requirements that currently protect all other federal infrastructure funding—particularly in light of the growth of public-private partnerships (P3s) for transportation and other agencies.

The P3 Potential
At last count, 39 states, the District of Columbia and Puerto Rico have passed some form (broad to limited) of P3 legislation and enabling statutes.

CNA’s Groman says, “Nearly all of the states that have enacted P3 legislation have addressed bonding provisions in a constructive and positive manner for both the construction and surety industries. We also feel that private-sector bonding has continued to grow, albeit it’s difficult to accurately estimate in terms of percentages versus public works.”

Over the past year, SFAA has partnered with other industry organizations to advocate for bonding on P3 projects to state legislators. Through advocacy and education, the Indiana Finance Authority (IFA) and the Indiana Dept. of Transportation both agreed to 100% payment bonds and performance bonds of at least 50% for P3s for road and transportation projects.

Also of note is that Colorado signed Senate Bill 19-38 into law in April 2019, clarifying that surety bonds are required on P3 construction projects. Recent North Dakota legislation amends all three of the state’s P3 laws to require a 100% payment bond and a 50% performance bond.

Speaking on the more general topic of bonding and private construction, Ed Sipfle, Merchants Bonding’s regional vice president of contract underwriting, notes that the use of surety bonds in private construction has grown somewhat, with lenders requiring the bonds to mitigate their risk. He adds, “We’ve seen this shift especially on multifamily housing projects. Additionally, we’re now witnessing general contractors requiring more sub bonds on private construction—as opposed to subcontractor default insurance.”

Sure-Footed Future
All indications show that the rest of 2019 will be profitable for the surety sector and construction in general. There’s ample surety bonding capacity, and the construction forecast looks good through the end of the year.

Waldron from Chubb anticipates the percentage growth for surety bond premiums in 2019 to be in the single digits. “While margins may not have improved as much as anticipated, backlogs are relatively healthy so the main concern is building backlog for 2020 and making sure overhead does not exceed what the market can sustain.”

Merchants Bonding’s Senior Vice President of Contract Underwriting Josh Penwell warns, “While largely well balanced and sufficiently capitalized, the balance sheets of some contractors are beginning to show signs of distress due to inadequate planning when managing rapid growth.”

Most of those surveyed for this midyear report believe that both the frequency and severity of losses will likely increase in the next few years, largely because subcontractor and labor markets are currently stretched tight. “There’s considerable work in the pipeline—so it’s difficult to see how all of the work will be completed without issue,” confirms BHSI’s Delisio. “Loss activity will have a constraining impact upon capacity, but not to the extent where strong credits are shut out of the market.”

Old Republic’s Lamb concludes, “While we’re in a soft market and bonding is relatively easy to get, don’t neglect the importance of building a strong team with your partners—from accountants to bonding agents to surety underwriters—who have a vested interest in your success.”

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SFAA Careers
Established in 2005, the Surety and Fidelity Industry Intern and Scholarship Program for Underrepresented Students provides awards of up to $5,000 to outstanding underrepresented students to support their studies in the areas of insurance/risk management, accounting, economics or business/finance and encourage their consideration of the surety industry and surety/fidelity underwriting as a career choice.

Additionally, the scholarship winners participate in a six-week paid professional internship. This program is administered by The Surety Foundation, the educational arm of The Surety & Fidelity Association of America (SFAA).

Tim Mikolajewski, president of global surety at Liberty Mutual and member of the SFAA Board of Trustees, summarized the purpose of the organization: “There’s no way we can meet the demands of the future unless we have talented, diverse people coming into our industry and providing that different perspective and ways of meeting the challenges that we face today.”

SPECIAL ADVERTISING SECTION

SFAA Careers
There’s no loss needed to access our claims service. Our claims professionals are by your side even before your policy is issued—‘level-setting’ on coverage intent, helping you mitigate potential claims, and drawing up a plan to address your specific needs and preferences when a loss occurs. All so that when a claim happens, our claims handling excellence is there right on schedule. At BHSI, claim time starts day one.

Claim time.
Surety underwriting—and virtually every construction partnership—is built on three Cs: character, capital and capacity.

While assessing capital is driven mostly by math and assessing capacity is evaluating experience, schedule and resources (labor and equipment), character is in many ways the most important of the three, at least to surety underwriters. Assessing character is a judgement call where we put into practice a strict adherence to our known laws and customs.

Stephen Covey summed it up nicely with these words: “Our character is basically a composite of our habits. Because they are consistent, often unconscious patterns, they constantly, daily express our character.”

Understanding an organization and its leaders’ character is why top surety underwriters spend time getting to know what drives their contractor clients, listening to stories, and paying attention to their interests and habits.

Outside the Lines
I remember receiving a particular account submission some years ago. The agent told me I was going to see some distress in its financial trend but that there were extenuating circumstances. The contractor’s significant other had been very ill for some time, and the contractor’s focus had shifted to her, so things slipped on the management side of the company. Sadly, his love had passed away, and he was now back fully engaged in his business. Would we consider bonding his company?

When discussing the preparing of the indemnity agreement with the agent, I clarified that Mr. Smith was owner, and I should leave Mrs. Smith (who was listed on the application) off the GIA as a personal indemnitor. The agent said that Mrs. Smith was willing to indemnify. I was confused. I thought the agent had told me that Mr. Smith’s wife had passed away recently. The agent quickly clarified, “No, I said his significant other had passed away.” His longtime girlfriend was the one who was sick and distracting him. His wife, on the other hand, is still alive and willing to indemnify. The agent explained that the wife was unaware of the girlfriend.

Assessing character is a judgement call where we put into practice a strict adherence to our known laws and customs.

I passed on this opportunity. It seemed to me that the contractor had defaulted on one contract already and had not disclosed critical information to all relevant parties with whom he was contracting. His business had already suffered as a result of his subterfuge. This isn’t the character of a contractor with whom I would want to do business.

Common Grounds
General contractors do the same when building partnerships with subcontractors and suppliers. If you know a subcontractor is willing to color outside the lines in his or her personal life, would you trust that person to stay within the lines professionally? You may also rethink a relationship with a competitor that tells stories of a competitor it was able to sabotage or the insurer company claim it exaggerated to its benefit. In essence, every contractor ‘underwrites’ its project partners.

Judging character is not always easy, and it doesn’t always feel politically correct. However, it’s a critical part of both our jobs and our industry when establishing partnerships.

I’ve had the pleasure to work with many contractors whose character is so strong that I have little doubt that they would step up and resolve any dispute because simply it’s the right thing to do—even if there wasn’t a contract or general agreement of indemnity compelling them to do so. As you build a portfolio of quality clients, like a garden, it’s important you pick out the few weeds that could ruin it all.

Similarly, your surety underwriter is looking to build a trusted relationship with individuals and organizations built on character. Much like you do in your daily operations, build a stronger bond with your agent and your surety underwriter for long-term success—and a better surety bond program.

The Importance of Character for Underwriting Surety Bonds and Building

By Darrel Lamb, CPCU, AFSB, Old Republic Surety Co.
Liberty Mutual Surety provides you with the construction insights you need to succeed. Through knowledgeable underwriters, customized data-driven reports, and specialized engineers and accountants, Liberty Mutual Surety’s suite of client services can help you optimize your business and win in the marketplace.

Learn more about our enhanced service offerings by talking to your agent or visiting www.libertymutualsurety.com.
Selecting a surety partner that’s the right fit for your company is a critical decision. The standard considerations tend to be about the financial strength of the surety; for example, whether you felt a good connection with its local representatives, its pricing and terms were competitive, or it had the capacity to increase its commitment to you as you grow. If you can’t check all those boxes, you should consider other options.

But should you be looking for more services as well? The answer to this question is an unequivocal yes. A surety should do more than just write your bonds. Is it recognized as a leader in the industry? Does it provide a broad perspective on what’s going on in the market? These considerations should be taken into account as well. But perhaps the most important value-added services you should expect are in the claims and legal area.

Consider this: Does the surety have a claims department that’s staffed with experienced attorneys who specialize in surety and construction? Surety claim attorneys can be a valuable resource for proactively working with all parties to resolve challenging and potentially expensive problems on jobs. Having a strong surety claims professional on your side can give you a major advantage when it comes to managing a problem with an owner, general contractor, subcontractor or supplier.

The legal services that your surety offers are equally important. Contract terms are stacked against the contractor, and your surety should be able to augment your own contract review capabilities and offer commentary. It can tell you what an industry standard is and what is over the top, plus make you aware of any legislative changes that can potentially impact both the surety sector and your company.

Weigh all the services a surety has to offer before you select a partner, as there’s more to what it does than just issuing bonds. ◆
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The construction industry is changing rapidly, and there are many challenges that we as an industry are facing today. We’ve witnessed the return of a healthy construction industry, and backlogs are at the highest we have seen in years. Because of this, the primary concern the industry now faces is the labor pool and finding not only skilled labor but also qualified management to effectively handle the backlog. This is a common cycle in the construction industry and nothing that we haven’t seen before.

However, there’s another concerning trend that should give us pause. As we move toward much larger project size, duration and complication, we’re witnessing the utilization of a multitude of delivery methods. With that, we’re seeing an attempt to shift more and more risk to the contractor contractually. This seems most prevalent in the infrastructure space, with large P3 and gap finance projects causing some to exit the P3 arena entirely.

Some examples of the risk transfer that we’re currently seeing include expansion in the utilization of delegated design, time-only allowance for delays outside of the contractor’s control, consequential damages, no mutual waivers of subrogation, responsibility for preexisting conditions and disproportionate indemnity provisions. What’s most troubling as an industry is that we’re now willingly taking these risks with no material improvement in margins, a taxed labor force and a great deal of exposure to political volatility in material pricing for projects that are running four to five years in duration. Therefore, it’s critical for the industry as a whole that we thoroughly read and understand the contract provisions we’re being asked to sign and take a stand against onerous provisions that might place us and our companies at any unnecessary risk. A truly sophisticated owner will understand that a more collaborative equitable contract benefits all parties in the end.
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Attract and Elevate Our Industry Through Learning and Development

By Kevin M. Waldron, AFSB, Senior Vice President and Director, Surety, Chubb

Developing talent for the future is of critical importance to the perpetuation and success of the surety business. We not only need good underwriters but also individuals who can articulate the benefits of surety bonding to the public.

Surety bonding often comes under threat from alternative products that don’t provide the same benefits as surety bonds, as well as options available to the private sector on mitigating the risk of contractor failure. However, this is not an article about the virtues of using bonds over other products or risk-mitigation techniques.

The purpose of this brief piece is to encourage all new underwriters who are working in the business or entering it soon to pursue any continuing education and professional designations available to them.

Today, it’s much easier to be a student of the business for your entire career, as we can quickly access information on the internet about our product, construction projects, competition and customers. When I was introduced to the surety business nearly 30 years ago, I had to go to the local library to research the product and sector, as it was not and, in some respects, still is not commonly known. When I researched surety many years ago, the only reference I could find to surety bonds was bail bonds, which wasn’t the career I had in mind at that time. Fortunately, I did more research and was able to access additional information on surety at a local college library—and my surety career was born.

In summary, let’s all continue to elevate our industry by always learning and developing our skillsets and making surety a more attractive business for new talent. There is a wealth of information at our fingertips today, so let’s take advantage of it.

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The old adage, “Just because you can doesn’t mean you should,” might well apply in these times.

The construction market is overall strong, as is the capacity and strength of the surety market. For many contractors, the first reaction will be to build backlogs as much as possible.

However, workforce shortages continue to plague nearly all market sectors and could directly affect your organization’s future success. We’re already seeing a rise in contractor defaults as a result.

There was a time in our industry that leadership would assume project managers, superintendents and craft workers were readily available. While most organizations certainly know that their people are the most important asset of their companies, organizational leadership must now assess those skills in much more depth. We’re entering a period when industry professionals may not have the right people available at the right time to complete a given job.

Take a thoughtful approach to matching projects to people.

Because an abundance of these terms have crept into construction contracts, there appears to be a trend for awarding parties to be less cooperative and more combative when it comes to settling disputes. Construction contracts have become so one-sided, the performing contractor might wind up losing even if an equitable resolution would be in favor of the performing contractor.

Performing contractors should exert more effort to negotiate onerous terms and conditions before agreeing to a contract. If unable to negotiate terms, consideration should be given to walking away. You never have to worry about the contracts you didn’t do.

Likewise, on public bonds, contractors should review contract terms before deciding to bid and consider not bidding projects that have very onerous contract provisions.

The pendulum needs to move back a little toward the performing contractor—otherwise the awarding parties might be left with few contractors to do the work.
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To learn more, contact your independent agent or visit www.cnasurety.com.
Surety Is Common Sense for Construction
By Jason Dettbarn, Vice President, Contract Underwriting, Merchants Bonding Co.

Here is the simple fact: Surety bonds protect everyone involved in the construction industry, from the project owners to the suppliers, subcontractors, lenders and taxpayers. No doubt that’s why surety has been the risk-mitigation tool of choice for nearly 5,000 years.

Even the best construction companies may face a project default at some point. The industry saw century-old companies reach that point from 2009 to 2013 during the Great Recession. But, surety bonding may save your company’s reputation. Performance and payment bonds make sure that the project is completed, subcontractors and suppliers get paid, and taxpayers or lenders aren’t left with a large bill.

As a contractor, your surety provider is your ally in finding solutions in case default simply can’t be avoided. Your surety can save your project and possibly your company. It also doesn’t hurt that qualifying for bonding from a reputable surety is like a stamp of approval that says you’re financially stable and your work is reliable.

Another simple fact: Sureties can’t save a project if it is not bonded properly. For those that rely on subcontractor default insurance or letters of credit, be aware that those do absolutely nothing to complete the work if there’s a default. There’s also no obligation to pay subcontractors, laborers or suppliers—but a traditional surety bond would.

Qualifying for bonding from a reputable surety is like a stamp of approval that says you’re financially stable.

Surety Is Common Sense for Construction
By Jason Dettbarn, Vice President, Contract Underwriting, Merchants Bonding Co.

The Value of Surety
By Greg Horne, Underwriting Officer, Liberty Mutual Surety

The unique three-party surety relationship inhibits an obligee’s understanding and appreciation of the surety product. Most obligees think only of the bond and claims. However, the true value of a surety stems from its relationship with the contractor.

A surety performs two valuable functions. The primary function is prequalification of a contractor in general, and specifically for the proposed project. The secondary function is guaranteeing successful project completion and payment of subcontractors and vendors in accordance with the terms and conditions of the contract and bond.

A surety’s results are traditionally measured by loss ratio. Analysts use surety loss ratios to illustrate and predict construction industry trends. When surety loss ratios are low, obligees question the bond’s value and begin to explore alternatives. Forgotten is the fact that low loss ratios reflect the benefit of prequalification—but not the surety’s effort or expenses for providing prequalification.

Sureties have amassed large quantities of data over a long time. These organizations have developed Expert and Predictive models from that data and incorporated them into the portfolio management and underwriting processes. These tools improve early identification of pre-default intervention opportunities for underperforming and outlier accounts. Intervention takes many forms, from simple coaching on job selection and acceptable contract language to cash flow projections, improvement of internal controls or even direct financing by the surety. Intervention results in an improved contractor that’s better positioned to successfully perform.

Collaborative relationships with surety professionals reduce contractor failures and surety losses. Unfortunately, the confidentiality of a surety relationship prohibits sureties from sharing specific successes of intervention. The surety sector has the opportunity and challenge to improve the obligee’s understanding and appreciation of the surety value proposition.

Reaching the century mark isn’t easy – you have to be quality-driven, client-focused, and have a vision for the future. At 100 years, STV is looking ahead. As an employee-owned firm, our planners, architects, engineers and construction managers have a stake in the business, and are committed to quality performance. We provide personal attention and timely solutions, with an eye toward sustainability. And with more than 40 offices, we are a local firm with national resources.

When it comes to getting your project delivered right, choose the firm that has the drive and vision to be the best.
During the $590 million expansion of Phoenix’s Sky Harbor International Airport, Terracon provided quality assurance consulting, quickly verifying and reporting the conformance of construction materials.

Our dedicated aviation team brings a combination of powerful resources together to create lasting value for airports of all sizes. We combine a broad range of services with technical expertise and proven management experience to deliver excellence for our clients’ vital infrastructure projects.