

Submission

By

**THE
NEW ZEALAND
INITIATIVE**

to the Commerce Commission

on

**the Market study into Residential Building Supplies
Preliminary Issues Paper**

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1 INTRODUCTION AND SUMMARY

- 1.0 This submission in response to the Commerce Commission's (**Commission**) *Residential Building Supplies Market Study Preliminary Issues Paper*¹ is made by The New Zealand Initiative (the **Initiative**), a think tank supported primarily by major New Zealand businesses. In combination, our members employ more than 150,000 people.
- 1.1 The Initiative undertakes research that contributes to the development of sound public policies in New Zealand and the creation of a competitive, open and dynamic economy and a free, prosperous, fair and cohesive society.
- 1.2 The Initiative's members include businesses involved in construction and building materials supply, including Downer and Fletcher Building. However, the views expressed in this submission are the views of the authors, not those of our members.
- 1.3 In summary, we submit:
- (a) that the Commission should begin its inquiry with a simple question: if building material costs in New Zealand are higher than the Commission believes to be warranted, what prevents new suppliers from entering the market?
 - (b) that the Commission should look through current Covid-related supply chain constraints except to the extent that they point to fragilities induced by regulatory arrangements making it very difficult to shift supply chains in response to circumstances;
 - (c) that the Commission should put itself in the place of a potential new entrant wishing to build homes using imported materials from trustworthy comparable markets like Seattle, Vancouver and Tokyo. What, if anything, would stop that entrant from building houses, townhouses, and apartments here?
 - (d) that the Commission should not end lines of inquiry with observations that imply a substantial restraint on competition elsewhere in the system that itself needs to be investigated. For example, the Commission observes that architects and engineers seem to prefer some standard materials. If the Commission also believes that those materials are overpriced relative to their quality, surely there is an opportunity for a developer to deliver higher quality homes to market at lower prices by hiring engineers and architects who are more competent. If they are not, what barrier prevents it? Potential explanations should not imply that substantial profit opportunities sit unexploited unless they also explain the real barrier that prevents those opportunities from being taken up.
 - (e) that the most plausible and fruitful line of investigation for the Commission runs as follows.
 - a. Councils face joint and several liability, along with builders, if a building fails. If other parties under joint and several liability have ceased trading by the time a building fails, Council can be left to bear the entire cost of any settlement. Councils are also liable if they approve buildings in which builders substituted equivalent materials rather than follow architect plans exactly.
 - b. Councils seek to limit that potential liability by exercising far greater diligence and more expensive (to the developer and builder) process when faced with less familiar building materials or building techniques.
 - c. Consequently, architects and engineers will wish to provide councils with plans that are easy to consent, with standard features applying standard solutions using standard materials. Even if the resulting home is more expensive and lower quality

than it otherwise could be, that path of least regulatory resistance is attractive for developers facing very high compliance cost in the alternative.

- d. Councils fearing joint and several liability guard against the downside risk of less familiar materials; they see none of the upside benefit. Council risk aversion, caused by liability rules, creates a regulatory barrier to entry against novel building materials unless those materials provide a very substantial advantage over existing materials in large-scale developments.
- e. The up-front fixed costs of bringing new building solutions to the New Zealand market are high. They include sourcing supply chains, ensuring batch quality for materials delivered from far-away markets, securing appraisal for parts requiring it, training work crews in construction methods relying on new materials, and building council confidence in the use of those materials when councils are very nervous about bearing downside risk and know that they are not particularly competent in assessing the merits of new materials and methods. When only small-scale building is allowed under restrictive council zoning, few builders would find it worth the cost. Zoning constraints will ease substantially with NPS-UD and the Enabling Housing Supply legislation. The scale of building now enabled may make it more worthwhile to secure competitive sources of materials from abroad. Easing formal regulatory constraints and informal consenting barriers is critical.
- f. The Commission could spend all of the coming year exploring vertical separation of material retailers, builders, and material manufacturers; estimating profit margins in any of those businesses and deciding whether they are high relative to overseas competitors; arguing with existing businesses about how the Commission has failed to account for differences affecting weighted cost of capital and profit margins here as compared to abroad, and tying up critical staff in each of those companies for months when they should be helping to get more houses built. Or, it could spend the coming year delving deeply into the regulatory and consenting constraints that may together form a substantial barrier to entry. It could make recommendations that would enable far stronger competition from overseas material suppliers and developers. And it could thereby help open the market so better houses could be built more cost-effectively. The latter would enable *market discovery* of whether excess profits exist in building material supply by enabling greater competition for them.

2 THE COMMISSION'S QUESTION-BEGGING OBSERVATIONS

- 2.0 The Preliminary Issues Paper notes several features of the New Zealand market that may affect the cost of building materials. In many cases, these observations should be the starting point for further investigation, rather than end-points.
- 2.1 At 62, the Paper notes unique characteristics of the local building market that may make it harder for international suppliers to export into New Zealand. Each of these observed characteristics is endogenous: they arise from somewhere and may point to an anticompetitive barrier upstream.
- 2.2 At 62.1, the paper notes performance and durability requirements to mitigate the risks of earthquakes and wind. Are there no other places in the world that face earthquakes and wind? Surely building standards in Vancouver, Seattle, and Tokyo take earthquakes into account. Hamamatsu, Japan, is about as windy as Auckland. Is it plausible that building materials meeting building standards in Hamamatsu would be inadequate for Auckland? Are New Zealand's performance and durability requirements set appropriately? Or do they

constitute a non-tariff barrier to entry against quality, lower-cost materials from trustworthy overseas markets?

- 2.3 At 62.2, the paper notes a more bespoke housing stock with made-to-measure windows with fewer standardised sizes. Why would architects specify bespoke window sizes at a higher cost to their clients rather than use standardised sizes mass produced overseas? If those alternative materials would be cost-competitive, what prevents builders here from using them?
- 2.4 At 62.3, the paper notes plasterboard providing bracing functionality and consequently, presumably, not comparable to overseas plasterboard offerings. But why would engineers and architects here use that building solution if it is not cost-competitive with alternatives common overseas? If perfectly acceptable buildings abroad use other bracing solutions, what impediments prevent those techniques and materials from being used here?
- 2.5 At 62.4, the paper notes that engineers and architects specify brands when presenting plans for building consent. If they are specifying brands and materials that are not cost-competitive, surely an opportunity exists for a developer who contracts with engineers and architects able to provide plans for better quality buildings that can be delivered at a lower cost. Either the Commission is wrong about the cost-competitiveness of the materials specified, or a regulatory impediment makes inferior materials more cost-effective when the costs of consenting are considered, or some other barrier to entry and competition exists elsewhere in the system.
- 2.6 The implications for competition (paragraph 63) of architects who specify bad plans are less interesting than how that outcome can obtain in markets that should be competitive. What allows that outcome to persist? What underlies it? To put it most bluntly, if Commissioners believe that architects and engineers are just being lazy and erring in specifying those materials, or that they have some untoward relationship with suppliers, and that there is not some other barrier in the system resulting in that outcome, the Commissioners should get out of the Commissioning business and set themselves up as developers. They could make a great deal of money by hiring foreign-trained architects and engineers who are unencumbered by New Zealand building material prejudices.

3 BARRIERS TO ENTRY

- 3.0 Markets seek to kill excess profits like bears seek to devour honey. When an industry earns higher than normal profits, that profitability sends a signal to other firms to enter the market if they can. Entry increases supply; the increase in supply and increased competition erode profits for existing players. Entry happens until the next entrant can expect only to earn normal profits by entering.
- 3.1 Even in the absence of entry, the potential for entry can limit excess profits even in otherwise uncompetitive environments. Baumol (1982) demonstrated that potential entrants can induce duopolists or oligopolists to price at marginal cost.ⁱⁱ The extent to which contestability induces marginal cost pricing has been empirically disputed. But that excess profits attract entry, all else equal, is axiomatic.
- 3.2 Maintenance of persistent excess profits is consequently more difficult in the absence of barriers to entry. If substantial regulatory barriers to entry exist, removal of those barriers, where possible, should be a first step in any remedy aimed at improving competitiveness. If the identified excess profits are real, removing regulatory barriers to entry can help in encouraging new entrants.

- 3.3 The Paper asks a series of questions about pressures on demand and on supply chains. Changing customer demand for different types of building require changes in material supply chains. Covid pressures on global supply chains can substantially affect particular parts already appraised or certified for the New Zealand market. Prefabricated housing options will also have effects on the system. Frequent changes to building and fire codes mean ongoing changes to materials used.
- 3.4 Rather than try to assess which materials are most important to focus on, or how climate change may affect construction methods, the Commission should determine whether New Zealand's regulatory and consenting systems are sufficiently flexible to enable suppliers to respond to changes. Resilient systems do not try to anticipate each and every possible change in consumer demand. It is an impossible task. They instead make sure that it is easy for everyone in the system to adjust and adapt as conditions change. What systems are consistent with enabling more green building if consumer demand shifts toward those materials – as well as enabling responses to any other kind of change?
- 3.5 As illustrative example, suppose that the Commission focuses on one set of green building materials and determines that those materials have an easy time entering the New Zealand market because they have already gone through appraisal processes. Such an assessment would not necessarily mean all is fine. What happens if the factory overseas supplying those materials burns down? Would it be easy for builders here to flip to another product meeting the same overseas certification standard, or would it be difficult? What more could New Zealand's systems do to recognise overseas certification regimes so that any material meeting appropriate foreign standards are easy to use in New Zealand, rather than just particular materials that have been previously appraised or certified? Are there ISO standards that could be relied upon? Does it make more sense for New Zealand to rely heavily on local standards for building materials, and to assess individual products from foreign markets against local standards, or for New Zealand to instead assess foreign standards to see which could be considered suitable for local needs? The latter would remove a substantial potential barrier to competition.
- 3.6 The Paper asks, at questions 23-27, about the Commission's intended high-level approach. We strongly urge that the Commission focus attention on de facto barriers to entry facing unfamiliar materials. The Commission simply does not need to come to any assessment of international prices or local profitability if it is simple for overseas competitors to enter the New Zealand market. If entry is simple and is not happening, it is unlikely that the local market is earning undue rents. If entry is very difficult and is not happening, it is possible that the local market is enjoying undue rents. But the problem is not solved by measuring local profitability; it is solved instead by ensuring that the market is effectively open to new potential suppliers.
- 3.7 At Questions 39-45, the Commission asks a series of questions about vertical arrangements within the construction industry and building material supply system. The Commission should also ask whether any of those questions would be relevant if it were simple for someone to show up in Auckland Harbour with a containership filled with building materials that meet the relevant Canadian, American, British, Japanese or Australian standards and to start building. The Commission may recall that, when parallel importation began, The Warehouse was able to simply route around a whole host of complex tying arrangements – to the benefit of consumers. Nobody needed to assess each of those prior arrangements.
- 3.8 Imagine, for sake of argument, that the most anti-competitive explanation for all rebate and loyalty programmes, exclusivity arrangements, and vertical integration were the true explanation. Could any of those matter if buildings and materials could be parallel imported? If New Zealand made it simple to build houses and apartments that met Vancouver's code, or Tokyo's code, or Seattle's code, by recognising materials fit for use there were good enough

for use here, we could, in effect, parallel import buildings. An established builder from any of those places could simply show up in Auckland Harbour with all of the materials and crew needed to start putting up apartment buildings or houses that meet overseas standards recognised in New Zealand. If existing New Zealand arrangements either produced excessively costly building solutions, or anticompetitive outcomes providing high rents for existing players at consumers' expense, or both, parallel importation routes around the problem. And if outcomes here actually are efficient, with any higher local costs simply due to inherent difficulties in supplying a small market at the end of the world, opening up entry does no harm. Potential entrants decide that no profits are to be had and do not enter.

- 3.9 We consequently urge the Commission to focus its attention on the questions it raises at Q49-54. Begin with the incentives facing councils under joint and several liability for defects. Sapare's 2018 report for MBIE found that Building Consenting Authorities faced over \$300 million dollars in cost, under joint and several liability, between 2008 and 2018, because other liable parties had disappeared in the interim. In 48% of cases, Building Consenting Authorities were left to pay 100% of all damages as 'last man standing'.ⁱⁱⁱ Liability drives council risk aversion which favours plans that use familiar supplies in familiar ways. The effects are systemic.
- 3.10 Because councils favour familiar materials used in familiar ways, architects and engineers prefer to set plans that use familiar materials in familiar ways. It makes consenting easier. In a better world, engineers and architects could simply specify materials meeting particular standards, which would include international equivalent standards, enabling builders and developers to find the most cost-effective solution. In that world, builders would provide council with evidence that the materials used met one of the specified standards.
- 3.11 Because councils can be liable if a builder substitutes an equivalent material for a name-brand material specified by the engineer or architect, council will fail to approve buildings where substitutions have been made. This discourages builders from seeking new materials that might be more cost-effective – a barrier to competition.
- 3.12 Frequent revision of building codes and fire codes might also impose a barrier to entry if those revisions are defined in terms of standard New Zealand materials and if foreign materials would need re-assessment. Alternatively, if those revisions specified international standards that met New Zealand code, they could assist in opening markets to competition by reducing the need for product assessment.

4 Conclusion

- 4.1 We thank the Commission for the opportunity to provide comment on its preliminary issues paper. The discussion of barriers to entry at Paragraphs 119-138 is timely. The Commission should begin its work with robust examination of those barriers. The Commission could imagine itself as a property developer. If it sourced all of the materials necessary for building an apartment tower or home in Vancouver, or Tokyo, or Seattle, or elsewhere with trustworthy materials that are designed for shaky and wet conditions, could it use them to build? What barriers would it face? How would councils treat the consent applications? The result of that kind of investigation could prove very important in enabling the government's housing supply agenda.

ⁱ Commerce Commission. 2021. "Residential building supplies market study: Preliminary issues paper". 17 December. Available at https://comcom.govt.nz/__data/assets/pdf_file/0025/273553/Residential-building-supplies-market-study-Preliminary-Issues-paper-17-December-2021.pdf

ⁱⁱ Baumol, William J, 1982. "Contestable Markets: An Uprising in the Theory of Industry Structure," American Economic Review, American Economic Association, vol. 72(1), pages 1-15, March.

ⁱⁱⁱ Davies, Preston and Linda Tran. 2018. “Liability outcomes in the building sector – glimpses from available data.” Sapere. Report to the Ministry of Business, Innovation and Employment. Available at <https://www.mbie.govt.nz/dmsdocument/4960-liability-outcomes-in-building-sector>