



Building supplies market study—Issues raised at Consultation Conference

Submission to the Commerce Commission on behalf of the Affordable Building Coalition

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Definitions

ABC	Affordable Building Coalition
CBA	Cost-benefit analysis
MBIE	Ministry of Business, Innovation, and Employment
OSM	Offsite Manufacturing

Executive summary

Castalia has been appointed by the Affordable Building Coalition (ABC) in respect of the Residential Building Supplies Market Study (the Market Study). ABC represents a group of civic minded New Zealanders, building sector participants, property owners, and civil society organisations. ABC has been an active participant in the Market Study. The Commerce Commission (Commission) conducted a Consultation Conference (the Conference) in Wellington on 27, 28, and 29 September 2023. Castalia participated on behalf of ABC. The Conference raised several key issues and questions that ABC wishes to submit on and clarify for the Commission.

This submission calls for the Commission to amend its draft recommendations by ensuring these four recommendations feature in its final report:

1. New Zealand's building supplies costs are very high by international standards and the government should make it a high priority to reach the international cost frontier
2. The regulatory system is fundamentally flawed. Two high-level changes are needed:
 - a. The building regulatory system should have two additional objectives to foster both competition **and** efficiency
 - b. Major institutional change should ensure that consumers' interests are promoted. Regulatory interventions currently have little regard for least-cost interventions. We recommend that BRANZ's building consent levy funding for research be reviewed. BRANZ's technical focus and its subsidiary building consultancy services business means it is incentivised to focus on product technical problems rather than the optimal cost-quality trade-off. This detracts from consumers' interests
3. Vertical integration of two of the three trade-focussed merchants appears to embed market power
4. Government procurement should focus on lowering costs and improving competition by procuring large orders of dwellings from scale house assembly firms.

The submission covers each point in more detail.

1 Introduction

This submission makes four key points.

- Section 2 outlines how the scale of the cost crisis in building supplies has been poorly understood in this Market Study. Unfortunately, the Commission's evidence base and submissions from participants have overlooked the competitive market frontier that other countries show is possible. This is unfortunately to be expected when there have been no substantive submissions from consumer representatives
- Section 3 focusses on the regulatory system. Generally, the current regulatory system adds undue costs and complexity to supplying building materials—this hinders competition by embedding the market power of incumbents
- Section 4 outlines how two of the three trade-focussed merchants have the potential to abuse their market power
- Section 5 sets out how the Commission should recommend that government procurement be used as a tool to lower costs and improve competition by procuring large orders of dwellings from scale house assembly firms.

2 Scale of cost crisis is poorly understood

The Market Study has unfortunately not focussed on resolving the scale of the building supplies and construction cost crisis in New Zealand. Industry insiders and incumbents have been allowed to dominate the Market Study and the Conference.

Cost of building supplies are extremely high by international standards and ABC's evidence in this regard has not been rebutted

The cost of building in New Zealand is high. The Commission must acknowledge that ABC's evidence of widespread high prices has not been rebutted. With limited resources, Castalia has provided evidence showing that building supplies prices are consistently higher in New Zealand than comparable jurisdictions. Unfortunately, no other parties, nor the Commission, have reviewed reliable evidence on the scale of New Zealand's construction cost crisis.¹

International cost benchmarking would enable the Commission to understand how far away New Zealand is from the frontier. Presently, there appears to be a gap in understanding how far away New Zealand is from peer countries. This means that the Commission's findings and recommendations lack context.

We encourage the Commission to describe the scale of the building cost crisis in New Zealand in its Final Report. This should provoke greater urgency in its recommendations.

¹ Other participants have also expressed concern. For example, in its submission on the Draft Report, Consumer NZ suggested that the report would be strengthened by a detailed analysis of building costs, and how they compare to other jurisdictions.

Very limited consumer perspectives at the Conference

We are concerned that the Commission has heard limited consumer perspectives. At the Conference, only ABC and Monopoly Watch provided any input from the perspective of consumers. The Commissioners mainly heard from industry incumbents, although we note that Carter Holt Harvey did not send a delegate (it is the vertically integrated supplier of structural timber, manufacturer of trusses, and owner of the merchant chain Carters). We are concerned that the Commission may overweight the submissions and concerns of industry incumbents. Therefore, we urge the Commission to critically consider the submissions of incumbents in light of the market position they might seek to defend.

3 Regulatory system embeds market power

The Conference established that the regulatory system adds costs and complexity to supplying building materials to the New Zealand residential building market. There was widespread agreement among participants in the Conference that the regulatory system was seriously flawed.²

ABC submits that two key enhancements to the Commission's draft recommendations are needed:

- Embed competition and efficiency objectives in the building regulatory system
- Require institutional change to promote consumers' interests.

ABC also makes two further points on the regulatory system which justify the two key enhancements to the draft recommendations:

- The clear regulatory capture throughout the formal building regulatory system and its supporting industry bodies preserves market power
- Not all widely used products are "tried and tested", rather they benefit from regulatory barriers.

Competition and efficiency objectives will ensure reform of regulatory system meets consumers' needs

The Commission notes that the government plans to review the Building Code and regulatory system. The Commission's Draft Report recommends adding "competition" as an objective to be promoted in the regulatory system. We submit that more is needed.

The regulatory regime should also have an objective to promote an **efficient** building sector. An efficiency objective will require the regulatory agency, currently the Ministry for Business, Innovation, and Employment (MBIE), to have greater regard for both the costs and benefits of its standard-setting and other regulatory decisions in building supplies and construction markets. The practical effect of this will be an institutional requirement to properly understand the benefits and potential costs of an intervention. Below we also explain why BRANZ is the wrong institution to fulfil this role.

² [John Small, Day 1 page 14, line 468, Chelydra Percy, Day 1 page 56, line 1929, Derek Johnston, Day 1 page 62, line 2154](#)

The benefits of regulation are generally well understood. These can include:

- Overcoming information problems related to the quality of building supplies
- Managing externalities of using building products or systems, such as higher emissions from higher energy consumption

However, the costs are not fully understood. Costs can include administrative costs (such as record-keeping costs), compliance costs (such as more expensive materials), and other indirect costs (such as reduced building activity). Businesses, communities, consumers, and the government are likely to bear these costs. No-one in the current system has an institutional incentive to lower costs, or ensure that the benefits (for example, lower emissions due to higher spec building products) are proportionate to the costs.

Institutional reform will enhance competition for building supplies—consider diverting levy funding to consumer and cost focussed entity

The Commission notes that the government plans to review the Building Code and regulatory system. The Commission would assist the government's review by identifying the institutional barriers to improving the building regulatory system. More fundamental institutional change is needed within the building regulatory system to ensure the intent of the Commission's current draft recommendations 1 to 4 are met.

The Commission should recommend that MBIE consider institutional reform as part of its review and recommend that BRANZ's building consent levy funding for research be reviewed. BRANZ's technical focus and its subsidiary building consultancy services business means it is incentivised to focus on product technical problems rather than the optimal cost-quality trade-off. This detracts from consumers' interests.

Current arrangements ensure incumbent interests are heard, but the long-term interests of consumers are ignored

Presently, the regulatory system only hears from incumbent interests. MBIE is responsible for the Building Code and building performance. It mostly interacts with building sector peak groups, building sector professionals, building supply firms, and industry standard-setting organisations. Consumer interest is not taken into account.

The institutional arrangements in the building regulatory system favour incumbent interests, are prone to regulatory capture, and preserve the status quo. In order to address regulatory barriers to entry, institutional change is needed.

BRANZ role should be reviewed and levy funding considered for consumer interest body

Currently, the Building Research Levy Act 1969 authorises the levying of building contractors. Builders must pay to BRANZ 0.1 percent of the contract value of every construction project seeking a building consent. BRANZ carries out various research assignments, publishing technical and research reports and making these available for free. While many of these are worthwhile contributions to building sector knowledge, BRANZ has no institutional incentive to consider costs, the optimal cost-quality trade-off of building supplies, or the efficiency of the market for building supplies. In fact, BRANZ is institutionally incentivised to err on the side promoting higher quality building supplies, and favouring products that are already present in the market.

BRANZ also carries out other functions. Its wholly-owned subsidiary assesses building products for private firms and its BRANZ Appraisal endorsement carries weight. Since it earns commercial income from product appraisal, it logically follows that there may be an

institutional incentive to promote the use of higher quality and therefore higher-cost products. It has an incentive to promote the need for new products to have technical assessment prior to being used, because this generates commercial income for the appraisal service.

Finally, BRANZ has frequently been appointed to conduct cost-benefit analysis (CBA) for changes to building regulation. For example, in MBIE's 2021 Building Code update, BRANZ conducted a CBA of options for thermal envelope performance settings and Carbon Impact Analysis of options for thermal envelope performance settings.³ The CBA is currently the only institutional tool that can ensure the regulatory agency (MBIE) the cost of a regulatory intervention into account, compared to other options. Given BRANZ's institutional incentive to err towards incumbent products and products that are over-specified (and therefore not optimising for the trade-off between cost and quality), it is inappropriate for it to play this role in the regulatory system.

Incumbent firms benefit from the cost and complexity of regulation

It was acknowledged during the Conference that cost and complexity in the regulatory system embeds the market power of incumbent interests. Incumbent firms are far better placed to incur the cost of regulation and invest resources in maintaining relationships with regulators, industry bodies, and professional associations. There is clear evidence of the regulatory capture that pervades the building industry.⁴ One participant at the Conference listed the over 20 professional standards bodies, building officials organisations, and other industry bodies that Fletcher Building provides significant financial support to.⁵ Several participants in this Market Study⁶ receive most of their financial resources from industry incumbent firms with market power. Because of this, the Commission needs to go further on its recommendations on the regulatory system.

The idea of "tried and tested" products is a misconception

We urge the Commission to discard the phrase "tried and tested" for building products that currently enjoy high market share. This implies the products are high quality, fit for purpose, and meet consumer costs and quality preferences. However, this has not been established under the Commission's own analysis. The Commission has identified that many products

³ <https://www.building.govt.nz/assets/Uploads/building-code-compliance/background-report-on-h1-energy-efficiency-branz.pdf>

⁴ The textbook definition of regulatory capture is:

Regulatory capture is the result or process by which regulation, in law or application, is consistently or repeatedly directed away from the public interest and toward the interests of the regulated industry, by the intent and action of the industry itself.

(Carpenter, D. & Moss, D.A., (2014) Preventing Regulatory Capture: Special Interest Influence and How to Limit It)

⁵ Kevin van Hest at the Consultation Conference (page 61 of Day 2 Transcript of the Consultation Conference). These include the National Association of Steel Housing, the Designers Institute of New Zealand, the Acoustics Society of New Zealand, the Institution of Fire Engineers, the New Zealand Institute of Buildings, the New Zealand Institute of Building Surveyors, the New Zealand Institute of Quantity Surveyors, New Zealand Certified Builders, Architecture Designers of New Zealand, the New Zealand Institute of Architects, the Registered Master Builders Association, the Waterproof Membrane Association, the Tile Association of New Zealand, the Fire Protection Association of New Zealand, the Association of Wall and Ceiling Industries, Construction Management Services, the Building Skills Maintenance Organisation, the New Zealand Metal Roofing Manufacturers Association, the Roofing Association of New Zealand, Offsite NZ, and the Building Officials Institute of New Zealand.

⁶ Building Industry Federation, National Industry of Steel Framed Housing, New Zealand Metal Roofing Manufacturers' Association, Roofing Association of New Zealand, Offsite NZ

enjoying significant market share benefit from a self-perpetuating regulatory “moat”. The moat stops alternative products entering the market in significant quantities.

4 Vertical integration discussion missed key points

The Commission should further scrutinize the impact of vertical integration on competition in the building supplies market. While vertical integration can lead to efficiencies in some cases, the Commission must take steps to ensure that vertically integrated suppliers are not abusing their market power.

Vertical integration could promote customer foreclosure and have a material impact on competition between suppliers

The Commission needs to consider the possibility that customer foreclosure tactics may limit independent suppliers from supplying the large-volume end of market (such as PlaceMakers and Carters which supply trade and group home builders). The assured pipeline of demand gives vertically integrated suppliers the power to price independent suppliers out of the market. This may be exacerbated by retroactive rebates, disincentivising merchants from stocking products from independent suppliers. For example, Winstone secures a significant pipeline of demand from downstream Fletcher-owned PlaceMakers. Winstone does not sell directly to builders (they must order via a merchant). This could give Winstone the advantage of being able to price rival plasterboard suppliers out of the market. Independent suppliers that could only serve smaller merchants (such as ITM in some locations) may find it difficult to achieve the scale needed to compete with integrated suppliers.

Vertical integration is a structural driver of shortages

Current and recent shortages of building supplies are not necessarily one-off—vertical integration may play a structural role in increasing the risk of product shortages.

Shortages have been driven systematically through preferential allocation between aligned suppliers and merchants. For example, Gib brand plasterboard has been preferentially allocated to Fletcher Living building sites. Independent plasterboard suppliers have historically struggled to get stocked by merchants.

Some vertically integrated players have used supply foreclosure tactics by withholding “hero products” from independent merchants. For example, ITM has demonstrated that Carters stockpiled timber and failed to have a fair allocation model. This misconduct was made possible due to the vertical integration of Carter Holt Harvey. Box 4.1 below further elaborates on potential risks posed by vertical integration.

Box 4.1: Question from Commissioner to ABC during Conference

During the Conference, the following question was asked by one of the Commissioners, and Castalia’s Andreas Heuser was to reflect on it and respond following the Conference:

Question: “To the extent that this (regulatory capture) is an issue, is it a vertical issue or do you think it would be also there in a vertically separated world that otherwise had similar structures top and bottom?”

Response: A firm present in all segments of a supply chain (vertically integrated) has more opportunity to influence government policy, regulation-making, and the conduct of regulatory compliance and

enforcement agencies (for ease of reference we refer to these all as “regulators”). Firms that manufacture or import building supplies can have relationships with regulators on the quality and relevant standards— influence can be established and reinforced via various formal and informal mechanisms. Business units within a vertically integrated entity that sell those building supplies can also develop relationships with the same regulators and their compliance staff. Business units that carry out construction can have the same relationships. They will advocate for the interests of the vertically integrated firm, not necessarily for the interests of a firm in the supplier, merchant, or construction layer of the supply chain. These mutually reinforcing interests can work against consumers’ interests. Products become “tried and tested” (that is, commonly used) because of mutually reinforcing favouritism throughout the supply chain. For example, the construction business unit has no incentive to seek approval for an alternative building product to one manufactured by a business unit within the vertically integrated firm, and is more likely to recommend the ‘in-house’ product.

5 Scale house assembly firms and government procurement are a key solution to improving market structure

ABC commends the Commission for the detailed discussion at the Conference on the role of scale house assembly and government procurement. It was especially pleasing to see a rare instance of international evidence in the form of Mark Farmer’s contributions being included in the Market Study. Supporting the introduction of scale vertically integrated assembly firms and changing government procurement practices can help create a more competitive building supplies market.

Therefore, ABC suggests that the Commission make the following recommendation:

- Government procurement should focus on lowering costs and improving competition by procuring large orders of dwellings from scale house assembly firms.

5.1 Scale vertically integrated assembly firms

The evidence at the Conference established that scale house assembly firms can significantly lower the cost of construction. A vertically integrated house assembly firm can procure building supplies in parallel to the current supplier-specifier-merchant-building contractor-subcontractor supply chain. The key question is how such firms might enter the New Zealand market.

Vertically integrated assembly firms have the scale to drive down costs for consumers in economy class

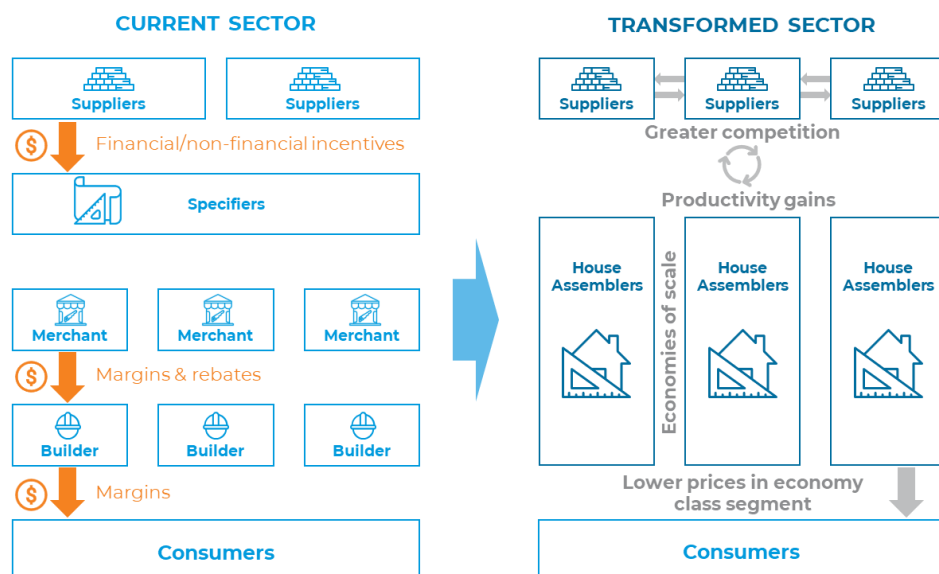
New Zealand’s peer countries have vertically integrated house assembly firms serving the ‘economy class’, combining specification, distribution, delivery, and building in one entity. In contrast, a lack of integration in the current New Zealand market structure reduces countervailing power against suppliers, hindering efficiency and competition. New Zealand has

some firms operating across multiple vertical levels, but they are not truly integrated to deliver efficiencies and scale.⁷

New Zealand builders, due to a range of regulatory and market structure factors canvassed in ABC's earlier submissions, serve the premium and luxury bespoke market. It is wrong to assert, as the industry incumbents and the Commission have done,⁸ that New Zealanders prefer bespoke housing. In other markets, the economy market segment is where innovation and efficiencies are developed which the premium and luxury segments benefit from when costs are lowered. ABC has repeatedly pointed out that given the option of lower cost and high quality available from a functioning economy class market segment, New Zealanders would most likely have no problem with replicable building typologies.

If vertically integrated assembly firms were to be introduced in New Zealand, they could have the scale needed to negotiate with suppliers and compete with other dominant players in New Zealand's building supplies market. This will help drive down the cost of building supplies and construction services. Figure 5.1 below compares the current supply chain arrangement in New Zealand with those seen elsewhere. It shows how vertically integrated assembly firms can promote competition and benefit New Zealand consumers by reducing prices and increasing productivity.

Figure 5.1: Model international supply chain for building supplies



⁷ At the Consultation Conference, representatives from Fletcher stated that their business units make decisions independently at arms-length. Fletcher Living is treated the same as other construction firms of its scale. While Fletcher operates vertically, it is not necessarily integrated.

⁸ Commerce Commission, 2022, Market study into the building supplies sector draft report, page 36, available: https://comcom.govt.nz/data/assets/pdf_file/0028/289360/Draft-report-Residential-building-supplies-market-study-4-August-2022.pdf; Fletcher Building Response to the Preliminary Issues Paper, page 2

Offsite manufacturing can help improve building efficiency but is not a necessary condition of scale house assembly

The Conference heard from the offsite manufacturing (OSM) sector. OSM has the potential to improve building efficiency. However, it is not a necessary condition of a scaleable house assembly firm. OSM is a helpful factor in lowering construction costs and providing an alternative delivery mechanism but might not lead to economies of scale on its own. For OSM and scale house assembly to deliver cost efficiencies, a predictable pipeline of demand is needed.⁹

5.2 Role of government procurement

Government procurement policies or practices can improve competition and outcomes in the building supplies market. The Commission acknowledged the role for government procurement in the *Additional Paper on Scope*. The inclusion of the topic in the Conference was welcome. Participants at the Conference have called for support from the government through strategic procurement.¹⁰

Government procurement can enable a more efficient building supplies market

The government can play a key role in shaping competition in the building supplies market because it is a large end user and direct purchaser of building supplies, construction services, and housing.¹¹

The Plasterboard Taskforce is a useful case study in the benefit of procurement policy. It recommended that Kainga Ora order plasterboard via an alternative provider to Winstone Wallboards. Kainga Ora has secured supply from an alternative supplier. The size of Kainga Ora's order was sufficient to enable that supplier to supply other builders, and had demonstration effects on the rest of the market that alternative approaches were possible.

There is precedent for the New Zealand government using procurement strategies to improve efficiency in building and construction. For example, the Second Labour Government issued exclusive licences and partnering agreements with construction firms aimed at improving the efficiency of building supplies production. This was integral to the success of state housing construction during the 1930s and 40s.

Strategic procurement can enable change by facilitating the entrance of innovative practices and creating an environment where scale can be developed.¹² For example, Mark Farmer demonstrated how Homes England is driving scale and demand in the OSM market by

⁹ For example, in its submission to the Draft Report, Offsite NZ stated that the government has an essential role to play in supporting the offsite industry. Committed pipelines and large long-term contracts can help increase certainty

¹⁰ Multiple participants identified the key role of government procurement in improving competition in the building supplies market. For example, Mr. Fisher acknowledged the importance of procurement guidelines, but also questioned whether these guidelines are being applied in practice (page 105 of Day 2 Transcript of the Consultation Conference). Participants also highlighted how procurement can support further outcomes, such as the uptake of innovative, efficient, and sustainable housing.

¹¹ Through Kainga Ora, the government is building around 12 percent of all new houses. Further, the government is a major procurer of building supplies across the construction sector, including defence, health, and public administration facilities.

¹² In its submission to the Draft Report, NZ Green Building Council stated that "The Government can also use its role as a market participant to drive behavioral change in advance of regulatory change."

changing its commissioning behaviour for social housing. Mr. Farmer also identified procurement as “an enabler of change” to translate high-level government policy into behavioural and cultural change in the construction sector.¹³

Poor procurement practices risks reinforcing inefficient market structures

There is a risk that poor government procurement practices could reinforce the dominant position of existing players and inefficient market structures. In the past, procurement has entrenched incumbent interests in the building supplies market and at the merchant level.

Social housing has rapidly increased as a share of the total new dwellings in recent years (refer to Figure 3.1 in ABC’s submission on the Draft Report).¹⁴ However, Kainga Ora and community housing providers tend to procure the new social houses in small consignments. This perpetuates a fragmented construction industry. It results in sub-scale and inefficient building operations. It results in many builders competing with one another for building supplies from a small number of merchants (two out of three of which are vertically integrated). The building firms do not have any countervailing power, nor can they generate economies of scale to reduce unit costs. In most cases, the end-client (Kainga Ora) is the same. This procurement practice tends to increase the price of building supplies.

The government can also risk embedding market power of incumbents and high costs by procuring from incumbents. Box 5.1 below discusses how government procurement decisions have contributed to the failed entry of Knauf Gips, a leading plasterboard supplier, to the New Zealand market.

Box 5.1: Failure of Knauf Gips to enter the New Zealand plasterboard market

Government contracts can have the effect of bedding in market power. Knauf Gips was specifically invited by the government to participate in the plasterboard supply contract for the Christchurch rebuild. The Minister for Economic Development hailed the entry by the German multinational at the time as being important for competition and diversity in building supplies. However, the contract was tendered to two parties, one of which was Fletcher with 94 percent market share. This meant that Knauf had to compete with Fletcher in the Christchurch rebuild market.

This resulted in Fletcher Building effectively quarantining the competition to that specific contract and tender, leaving it with market power in the rest of the market.

In contrast, and highlighting the role of government policies in impacting market shares, the nationwide “Warm Up New Zealand” programme wide launched after the 2008 financial crisis ushered in a rival insulation supplier. Now, a variety of insulation products are available and market concentration has fallen markedly since 2017 (as Fig 5.3 on page 128 in the Commission’s Draft Report illustrates).

Source: Castalia evidence for Affordable Building Coalition cross-submission on building supplies market study

¹³ Mark Farmer at Day Two of the Consultation Conference, available pages 95 and 118 from the transcript: https://comcom.govt.nz/_data/assets/pdf_file/0026/294182/Residential-building-supplies-market-study-Day-2-transcript-of-consultation-conference-28-September-2022.pdf

¹⁴ Castalia (2022) on behalf of ABC, Submission on Draft Report, available: https://comcom.govt.nz/_data/assets/pdf_file/0033/292596/Affordable-Building-Coalition-Submission-on-residential-building-supplies-market-study-draft-report-1-September-2022.pdf



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