DAY 2 - RESIDENTIAL BUILDING SUPPLIES MARKET STUDY CONFERENCE

28 September 2022

Session 4/5: Addressing strategic business conduct

Dr Small: Good morning, everybody, let's get this second day of the Conference underway. Welcome back for those who were here yesterday and welcome for those who weren't.

So, the first session today and the second session actually, are about strategic business conduct. We're going to be flexible about the timing on these. We will stick to the times that are in the stated agenda but the topics will fluidly run across the two sessions, depending on where the discussion takes us. And if we finish early, we will finish early because the afternoon session is reserved for competition and green building supplies and other innovative products and there are some people who are just coming specifically for that. So, that's the plan for the day.

So, it's my pleasure to kick off on this session about strategic conduct of market participants and how that may be affecting competition for key building supplies.

We intend to cover two topics in this session; one is about vertical integration, which we will start; and the second one is about the impact of rebates on competition, particularly rebates from suppliers to merchants.

So, in our draft report, our overall assessment was vertical integration did not appear to be having a material adverse impact on competition. For rebates, on the other hand, we did find there were some highly concentrated building supplies, where the rebates given from suppliers to merchants have been contributing to barriers to entry and expansion and therefore leading to less effective competition.

Our recommendation in that area was to encourage suppliers to consider their use of rebates against the Commerce Act and to ensure compliance, particularly following incoming changes to the misuse of market power provision in section 36 of the Commerce Act.

So, we received a range of submissions on these topics. And, in particular, a number of submitters thought we should further consider the impact of vertical integration. In the case of rebates, many submitters were in agreement with our recommendations and highlighted that rebates were likely to be only problematic in limited circumstances.

Whereas, others suggested a broader range of rebates and terms should be considered further, including the impact of rebates from suppliers directly to builders, bypassing the merchant channel.

I will provide a short summary of our preliminary position on these areas ahead of each of those topics and then frame up some specific questions, starting first on vertical integration and followed by rebates.

Before I get started, we acknowledge there may be some aspects of this discussion that participants feel unable to discuss in a public forum and so, if that happens during a conversation, feel free to let us know if there are things you'd like to talk to us directly under confidentiality.

Topic 1: Vertical Integration

Dr Small: Okay. Starting first with vertical integration, the draft report, our preliminary view was vertical integration did not appear to be having a material adverse effect on competition. In reaching that view, we considered vertical integration between manufacturers of building products and the merchant chains that on-sell to builders and, in this context, we studied the two main competition risks, both of which are related to what economists call foreclosure, which is the denial of some crucial aspect that's required for competition.

This discussion in the draft report was split over two chapters. In chapter 5, we considered what's called customer foreclosure. If practised, this would involve a vertically integrated merchant favouring its upstream affiliate. For example, by refusing to stock products or by arranging prices so they're unattractive to buyers. Customer foreclosure is merchant conduct that restricts competition between suppliers.

We found no evidence of this conduct, possibly because there are five main chains of merchants, so attempts at customer foreclosure by one merchant chain might simply divert trade to the other merchant chains.

We did observe some suppliers having difficulty getting stocked by merchants but those difficulties seem to be attributable to a combination of the broader regulatory issues that we discussed yesterday and potentially also to merchant rebates in some cases.

Two of the five merchant chains have got upstream manufacturing interests, so those ones are vertically integrated to parts of the supplier level. If customer foreclosure was a competition problem, we would expect suppliers to complain that one of these two or both of these two merchant chains was more difficult to deal with than chains that were not vertically integrated. There was no evidence of that type, so that didn't happen and so, that's why we concluded that customer foreclosure doesn't seem to be a problem.

So, the second half of the vertical integration competition risk story is discussed in chapter 6 of the draft report, and that's known as input foreclosure. This is conduct by suppliers that favours their own downstream merchant, thereby starving its rival merchants, either directly or indirectly through their terms of trade.

We did find one example of this conduct. During the recent supply chain stress, several suppliers implemented what they called "allocation models" to ration out their products between merchants. Obviously, such rationing can be done in a competitively neutral way, for example by pro rata allocations based on recent buying patterns.

We are aware of three rationing models, so three supplier firms implemented rationing models. Two of those were implemented by vertically integrated suppliers. Of those two, one was competitively neutral and the other was not.

So, this led us to conclude that while vertical integration can lead to and facilitate input foreclosure, it need not necessarily do so. So, our preliminary view was the observed input foreclosure was a temporary event but there is a contrary view expressed in submissions particularly by ITM and I am pleased to have Darrin with us today to talk about that.

We are keen to explore stakeholder views further on the impact of vertical integration on competition generally but I hope that preamble frames up the two main issues that we see there and how we interpreted the evidence on those.

Okay, so, to the questions. I will start with a reasonably general question, we will come to the allocation model issue second. I want to start with a more general question. It has been suggested that vertical integration is a key factor that prevents independent merchants from winning national deals and larger projects and so, I'm interested in people's views on this, particularly there was a suggestion in the Monopoly Watch submission and I am keen to hear what you think about that. And since ITM are with us, maybe I'll start with you; do you feel that your lack of vertical integration puts you at a disadvantage from winning national projects and larger deals for supply?

Mr Hughes: Thanks, Commissioner. In short, no, we don't believe that not being vertically integrated excludes us from competing in that market.

The only question that we have had in the past is in relation to margin spread across vertically integrated players and whether that is allowing a lower cost solution to be offered to national accounts which might exclude us but we don't have significant evidence of that, that's simply a question that we have asked.

Dr Small: Okay. To the extent that happened, maybe we could refer to it as cost shifting, if you like, that would relate presumably to one or depending on which merchant you're talking about but we're really only talking about two products?

Mr Hughes: Two, yep.

Dr Small: When we talk about national deals or really large deals for construction supply, how important are those particular products in securing, for example, would that be - if that was to happen, would that be enough to put you at a material disadvantage on a large deal?

Mr Hughes: Yes, it would, yes, particularly in the frame and truss area which is the lead product into bidding for what we call large national volume customers.

Dr Small: That would be the structural timber issue?

Mr Hughes: Yes.

Dr Small: Okay. So, there's the potential there but is it a concern for you?

Mr Hughes: It's definitely a concern but, as I say, we've not seen any evidence yet where we've physically lost business as a consequence of not being able to compete. There was an incident a couple of years ago where we did lose a customer and we were given price indications that suggested that it was below our cost price but, again, we don't have any hard evidence to support that.

Dr Small: Right. You seem to be saying you are concerned about it but you can't actually prove anything?

Mr Hughes: Correct.

Dr Small: When you say you lost a customer, should I interpret that as being one project or one customer for an ongoing series of projects?

Mr Hughes: One customer for ongoing supply.

Dr Small: Okay. I want to come back when we talk about the allocation model issue to this question of longevity of impact which was raised in your submission.

Mr Hughes: Sure.

Dr Small: Thank you. Anybody else? Maybe Tex, this was raised in your submission, this question about large deals, would you like to comment on this?

Mr Edwards: Thank you, Commissioner. The Monopoly Watch position was that there wasn't - in the draft report, there could have been some more granular analysis of the custom ecosystem of the three players in what I call wholesale.

If we push Mitre 10 and Bunnings into consumer facing businesses and we looked at the trade where the big productivity gains are, when we see what ITM is, it's very much a third operator. It's creating the marginal consumer benefits or trade benefits and Monopoly Watch noted yesterday that it's not just price that ITM are giving you, it's giving you better service, which equals better productivity, which equals lower price for the end user.

And it was our observation that in some of the very big projects, and possibly the customer that ITM lost that might be canvassed off-line, was that the incumbents who are vertically integrated are grooming their customer base.

The rules of being a third operator are to try and become like-for-like infrastructure and like-for-like customer ecosystem and that's fantastic for the consumer because it's forcing competition. And when you have a third operator that isn't vertically integrated, hasn't got like-for-like infrastructure, its customer ecosystem is groomed to more profitable projects.

There is third party media evidence that in the Fletchers' debacle over the Convention Centre, that it actually made rational sense for a building materials monopoly - which is its castle - surrounded by its mote, the construction company that can fight off scalable projects, to maintain that very attractive business, building materials. Everybody wants to be in building materials because it's lower risk, it's more easy, a rabbit could run a big plywood plant because it's all automated, it's low risk. Being a constructor, assembler, being on building cites shovelling dirt and shit, that's tough.

The incumbents are using the mote of construction companies to fight off and groom their customers because a dominant player does not want a series of scalable contracts going to a challenger.

Dr Small: Okay, I hear what you're saying. I’m going to come to Fletcher Building for comment on this but before I do, could I ask, please, I notice that we have got Carter Holt Harvey online as observers and it would be very valuable to us, I am not going to force you to talk, we can't force you to talk, but it would be very valuable to us if you would contribute to the conversation. So, if you're willing to do that, can I ask you to signal that to the webinar organisers, so we can bring you into this conversation perhaps after we hear from Fletcher Building on this point?

Mr Clarke: I am not sure what to respond to really. I think the evidence is fairly clear in the submissions. We disagree with my friend here on the Convention Centre. Pull through of product is quite different to preferring or allocating.

To the extent that our construction business is by-product from other parts of the business, they do so as an independent thing but their job is to buy the best and the cheapest product for their job. We have submitted to you over the last 6-12 months on exactly how our businesses operate and how they do so on an independent stand-alone basis.

The concept of vertical integration is one I think we do need to actually define. I think there is quite a difference between a truly vertically, and the emphasis now is on the word "integrated", as opposed to people who operate at multiple levels of the supply chain which we do. Those two business models are quite different. If you are an orchard and you sell orange juice, that's vertically integrated but that's not how we operate and that's never been the way we operate. So, the concepts that are coming through in the vertical integration discussion are getting conflated a bit.

Dr Small: So, can I just pursue that a little bit? I certainly hear what you're saying. In the, sort of interface, if you like, between Winstone Wallboards and the construction company, what you're saying, and you've provided some evidence on this point, is that those contracts are structured as if they were unaffiliated and so, if I'm hearing you right, you're saying whilst the construction company is a very large construction company and a successful one, it gets treated as just another company of a similar size? It might get volume discounts, but it doesn't get anything that another construction company of a similar size would get?

Mr Clarke: And depending on the job, would source its materials through PlaceMakers or wherever it chooses to source it, through Higgins, exactly.

Dr Small: Would it tend to source through merchants? Would it not go direct?

Mr McBeath: We do not sell direct to a construction company. So, Winstone Wallboards would sell to a merchant and that merchant, whoever they would be, would sell to Fletcher Construction.

Dr Small: Winstone Wallboards sells everything through merchants.

Mr McBeath: Correct.

Dr Small: What about we've heard about rebates to builders, this is a rebate discussion perhaps but whilst we're following the thread, how would that work in that context if you were selling through a merchant, does that mean that Winstone Wallboards doesn't supply any rebates to builders?

Mr McBeath: Are you getting into end user rebates now?

Dr Small: Yes.

Mr McBeath: So, yes, we do have end user rebates.

Dr Small: The product that's traded through a merchant?

Mr McBeath: Correct.

Dr Small: And the rebate goes directly?

Mr McBeath: The rebate for the product will go to the merchant and then, depending on the nature of the end user agreement, the end user has an ability to claim a certain amount back at some point.

Dr Small: From the merchant or from Winstone?

Mr McBeath: From Winstone Wallboards but that's nothing to do with Fletcher Construction, where we started.

Dr Small: Just while we're on that point, sorry about jumping around.

Mr McBeath: Just for clarity, Fletcher Construction does not have an end user rebate.

Mr Clarke: Fletcher Construction does not have one. Fletcher Construction, that's just not who they are. They don't use wallboards.

Dr Small: Oh, okay.

Mr Clarke: They build highways and bridges.

Dr Small: Fine, I'm with you. But if it was a residential construction company owned by Fletchers, then you would?

Mr Clarke: No, they don't.

Dr Small: You discriminate against your affiliates, do you?

Mr Clarke: They don't get an end user rebate from Wallboards, they get what they get from PlaceMakers or Carters or wherever they buy -

Dr Small: I think we might have to pick this up in the rebate session.

Mr Clarke: We treat everybody, the simple proposition for this conversation, is that they're treated at arm's length and they have to negotiate their arm's length deals and they have their own profit targets and production targets. And so to achieve those, they have to operate and source their product from where they can best source it.

Dr Small: I understand the basic proposition. I am still curious about something that we just touched on there but we'll come back to it shortly.

Did you want to say something, Tex?

Mr Edwards: Can I urge the Commission analysts to review the factual media statements and the shareholder statements from the ex-CEO of Fletchers, ex-head prefect who got fired, when there was a substantial - a series of substantial losses in vertical construction, the message to the shareholders of Fletchers was that there was a certain amount of cross-subsidisation going on in the business and there was a shareholder row in the board as a consequence of these massive losses from vertical construction. When canvassed aggressively - it was his career at stake, he was about to get fired - of what was taking place on these vertical construction undercut jobs, the Convention Centre being one but there was of a series of catastrophic losses from vertical construction, it was a clear and present response from the incumbent CEO who later lost his job, that there was a level of cross-subsidisation going on and they were protecting their building products dominance, he didn't use "dominance". I urge the Commission to reference those shareholder disputes that became public two or three years ago, the ex-head prefect of Fletchers.

Dr Small: Okay, thanks for that. Okay so, let me go, unfortunately my understanding is that ITM is the only merchant participating in this discussion, apart from to the extent that Fletchers are represented.

Mitre 10 is here? If Mitre 10 are here, they are not on my list, but if you are here, I would similarly encourage you to identify yourselves, please, to the webinar operators so we can bring you into the discussion?

I would just like to go to ITM again and ask, again staying at a reasonably high level, ask whether you consider that you have enough scale to, if you like, sponsor or promote entry into the New Zealand market by independent suppliers in competition with vertically integrated suppliers as a way of ameliorating any issues associated with vertical integration? So, we're really talking about these particular products, do you have the scale to do that? And have you considered that?

Mr Hughes: Yes, we do have the scale to do that. We don't have the infrastructure distribution centres, logistic services, etc. Ultimately, what ITM is about is supplying what our customers ask for, and our customers, if they want an alternate building product, we have the ability to make that available through our network.

For a lot of the dominant products, the customers and the recent example being the plasterboard crisis, we imported a significant amount of plasterboard. Even though we had the ability to do that, the customer preference remains to purchase the Gib Board product and that's where they'll revert to once they've satisfied their immediate demands.

Dr Small: I see, you could plug a gap but it wasn't going to be sustainable?

Mr Hughes: Correct.

Dr Small: Why is that? What do they tell you about that preference?

Mr Hughes: There's a couple of points. One is it's a brand that's trusted, it's got longevity in the New Zealand market. More importantly though, the logistics model of the product being delivered into the premise, up the stairs, into the appropriate room. The risk of breakage on a fragile product is such that the builders prefer or don't see the benefit in saving a few dollars. They would rather have the certainty of that product being delivered in good shape to the right place.

Dr Small: Right. That risk point, I'd heard about the delivery into the rooms but you make an interesting point about the breakage risk which, presumably, in the Winstone Wallboards model is carried by Winstones?

Mr Hughes: Yes, correct and I can tell you having now been an importer of Gib Board, we faced substantial losses for fragile product in containers being moved around the world.

Mr Chapple: Can I ask a question about your comment about the customer preference and so on, does that vary depending on the state of the market? Because recently the construction market has been really strong, customers have been, you know, exceeding demand for the supply, so builders are in a particular position. Is it different when it's not like that?

Mr Hughes: Yes, it is. Again, the builder's preference is to go for the easiest path, which is, as we discussed yesterday in regulation, the easiest path to get through Council is to use product they are familiar with and the Council is familiar with.

However, in a time of shortage, they'll go to whatever method they can or whatever product they can, so long as it satisfies the regulations to get that house built. Interruption in construction, is significantly more costly to them.

Mr Chapple: Thank you.

Dr Small: So, I see Grant Fraser from Mitre 10 is online and perhaps I could ask you, Grant, to respond to these two issues that we've just been discussing so far? The first one being whether you feel that your lack of vertical integration puts you at a disadvantage on large or national projects?

And the second one being, about your ability to sponsor entry.

Mr Fraser: Yeah, sure. Perhaps answering the first question regarding us being able to play in that large customer or national space. That's something that we don't necessarily have as much presence, compared to some of the other merchants but are looking to increase in that space, and do feel that we are able to do that but there is always probably a degree of disadvantage in being able to do that. We continue to try and grow in that space and I think it's the comment made before regarding our focus in the residential space, it's obviously a big part of our business but we are looking to grow trade more increasingly and in that national customer space too. We don't feel we are necessarily prevented from doing that but it does make it more challenging.

Turning to the second question regarding looking and bringing new suppliers in, that's something we've been quite active in looking to try and do that. In our earlier submissions we have given examples of doing that, particularly with the likes of say Bradford Gold, I would echo and support the comments made by ITM just regarding the familiarity and the general nature in terms of builders, others in the market that are looking to probably more go back towards the tried and tested which does make that more challenging.

Dr Small: Yeah, thanks for that. Another point ITM made, perhaps I will get your comment on this, was the idea that if you lose a particular piece of business, it's more likely to be a customer that's an ongoing relationship than a single project; is that your experience as well?

Mr Fraser: Yes, I think that is a fair comment from our experience as well, yes.

Dr Small: That suggests that there is a tendency at the builder level for a degree of loyalty to a merchant?

Mr Fraser: Yeah. Look, I think it does vary from builder to builder but I think there is definitely a tendency for that.

Dr Small: Right, thank you, that's great, and we'll come back to you for some more comment later, thank you.

Perhaps now I'll go to the second bunch of questions here, which are about the allocation model and particularly about ITM's submission on that.

Your submission indicates that the impact of losing access to Carter Holt Harvey's structural timber is unlikely to be short-lived. I am interested if you could please elaborate on this and how you see the market for structural timber evolving from here in the medium-term?

Mr Hughes: As the Commission is probably aware, the number of consented homes in New Zealand remains at all time high levels, even through this predicted time of recession, so just under 51,000.

The capacity to build sits somewhere below 40,000, so there remains a pipeline backlog in the market. So, structural timber continues to remain in short supply. There has been some recent evidence of minor loosening from some mills but on the whole, it remains a constrained supply product for us.

Dr Small: So, how do I interpret that? Do you feel currently disadvantaged in that area from the continuing lack of access to Carter Holt Harvey's supply?

Mr Hughes: Yes.

Dr Small: Okay. And do I take it from that, that you don't see this situation improving until the overall demand supply balance between demand for housing and capacity to build is eased?

Mr Hughes: Yes, to a degree, that's correct, yep.

Dr Small: Okay. I wonder if Carter Holt Harvey could perhaps comment on any of these issues? I believe that you're there as attendees and I would be really quite keen if you could get yourself promoted to panelists so we could get some comment on that. I will leave that as a request for you, thank you.

Back to you, at the moment, Darrin, if you could, do you agree with my characterisation at the start of this session that only one of the vertically integrated suppliers took actions in the time of stress that was not competitively neutral?

Mr Hughes: Yes, I do and I contrast the different types of allocation models that were made.

Fletcher Building through their allocation models ensured there was a fair and equitable distribution of product across the various merchants that they supplied.

We, of course, weren't happy that we didn't get enough of what we wanted but we were happy that we were treated fairly and communication and contact remained strong, as you would expect with a normal supply customer model.

I also contrast James Hardie. James Hardie non-vertically aligned, played in the same manner. In fact, they were one of the first to go to an allocation model, that was done equitably and fairly and, again, contrasted to the allocation process that occurred with Carter Holt Harvey, which foreclosed supply on both ITM and a number of other merchants and retained supply to themselves. And, of course, the other vertically integrated player, being PlaceMakers.

Dr Small: Right, thank you. Are you aware of any other allocation models? Those were the three that we know of. Were there any others that we should be aware of?

Mr Hughes: Well, Fletchers had Laminex, Pink Batts and Gib Board but they were all largely based on the same principles.

Dr Small: Right, thank you, that's very helpful. So, some people have, in submissions at least, suggested or seemed to suggest that there should be some kind of structural remedy here but given this difference between the conduct of vertically integrated parties, I would be interested in your thinking on that. Do you think this is a conduct issue? I suppose related to that, given that the normal threshold for conduct matters is whether the conduct amounts to a substantial lessening of competition, rather than just something I don't like, do you think the conduct, first of all start there, do you think the conduct came to that threshold of a substantial lessening of competition?

Mr Hughes: Yes, we do, yep.

Dr Small: Could you talk about that a little bit? Tell us why you think that?

Mr Hughes: Well, because at close to 45% market share and a dominant supply, in fact one of our largest suppliers, the conduct was not what you would expect a normal arm's length commercial supplier to make at a time of crisis. Again, as I contrast the allocation models of the other suppliers, it was inconsistent with that. It was done in a manner that was without warning. It was done in a way that was effectively an immediate impact and there was no commitment to writing, nor was there any pathway forward described by that supplier.

Dr Small: Going to the previous point about the duration of impact, is this a case where losing customers means that they're gone for a long time, rather than a project based thing?

Mr Hughes: Yeah, there's two things. We certainly had a number of questions from our key and loyal customers as to whether ITM could sustain their business through that period, especially given the media attention to the matter.

Secondly, we were presented with a number of opportunities with dissatisfied customers from other merchants that we couldn't take advantage of.

Now, again, we all accept the supply crisis being what it was. Nobody could take advantage, be it structural timber, be it plasterboard, whatever. What concerned us was the damage to our reputation and questions from core customers as to whether we could sustain our business.

Dr Small: Thank you for that. Perhaps, Grant Fraser could comment on any impacts on Mitre 10 of particularly the Carter Holt Harvey allocation model for structural timber? Have you got anything to add on that for us, Grant?

Mr Fraser: Yes, probably what I would add, is our experience was pretty similar to ITM's in terms of the allocation models, the costs, the various suppliers or particularly those vertically integrated. As I say, very similar. Probably the one thing I would observe, I understand the Commission did look at the particular issues surrounding Carter Holt Harvey and we did provide some information at that stage but, yeah, the sense I had was that decision was made not to take that further.

Dr Small: Okay, thanks for that. Okay, so, look, I think we may have exhausted that particular issue. If anybody has got any - I prefaced these comments by saying we hadn't seen any issue that was related to vertical integration of suppliers having difficulty getting their product stocked, that is the customer foreclosure thing we talked about first. Now would be the time if I got that wrong.

Mr Edwards: Looking at the Commission, Commissioners, the market structure is about to change. We have section 36 changes coming up April next year, that will change the behaviours of our incumbent friends, Fletchers, Carters and others. We have rebate changes, rebate behaviour changes coming, so I urge the Commission to look forward, not backwards, on the impact of vertical integration.

What we heard yesterday, which I found really helpful and my industry colleagues at Fletchers very helpful on this matter, so was BRANZ, they discussed the complexity of regulation and how it impacts everything. When we're joining the dots, when looking at structural separation, it's one of the few tools that the Commission has in its toolbox that can make a genuine impact.

We're dealing with an industry which is death by a thousand cuts. We are dealing with an industry that my Elephant Board colleagues might talk about, how complexity plays into the arms of the incumbent, and we haven't yet discussed the structural timber case study where there is a clear and present cost competitiveness in a dominant two player market which is for another day.

I urge the Commission to join the dots and to look forwards, not backwards, on these new behaviours, in terms of considering whether there's structural separation.

I also urge the Commission to look at the literature of when we look at what's happened in Saint-Gobain and in the European markets, particularly small markets like New Zealand and the Scandinavia countries where there's been structural separation and structural separation rules, where there's only a building materials manufacturer and a building materials distributor. I put to the Commission that, in this instance, we have a building materials manufacturer, a building materials distributor, a construction company, and a roading company all in one, which is not playing into the arms of the best interests of consumers.

And so, I just urge joining the dots and looking at the new environment when the Commission is making a decision on structural separation.

Dr Small: Thanks for that. Certainly, our analysis, the market study analysis is very much forward looking, so we take that point.

I might just ask Kevin van Hest since you're here about this customer foreclosure issue. Have you found with Elephant Board any pattern, shall I say, in the ease with which you can deal with merchants according to whether or not they happen to be vertically integrated?

Mr van Hest: It's all anecdotal, of course, but over the years, certainly projects that you would want to, especially large commercial projects that you would want to tender for or try to get, you know, if the client or if the construction company was, say, a PlaceMakers customer, it was much harder because, you know, clearly we felt that those days that PlaceMakers would steer the customer more towards the sister company, Gib, Winstones. That sort of stuff did happen a lot, although I have to say that we do notice, especially in the last 12 months, that PlaceMakers has become a very good customer of ours, interestingly, and we note that they're paying premium rates for importing board directly from our manufacturer and I am just hoping that it's just not a short-term thing for this case that's going on at the moment and I hope it carries on into the future, so let's just keep a watch on that.

Dr Small: Okay, thanks for that. That's interesting, in the sense that you've linked the potential issue, not so much to supplier merchant integration but to the downstream to the building end, which is interesting. And it actually brings me onto the next point I was going to raise about this whole topic, which arose from the ABC submission that was written by Castalia, where there's a completely, I guess, contrary to many submissions that said vertical integration - or some submissions that said vertical integration is a serious problem you should be really worried about it. There was an aspect of ABC's submission that said we need more vertical integration of builders upstream into, as I read it, builders upstream into supply and perhaps through merchants.

Could you speak to that, Andreas, and help us understand why that's different, if it's different to the supplier merchant nexus?

Mr Heuser: That's really around looking at in overseas markets where vertically integrated assembly firms exist that deal directly with suppliers and assemble homes and put them on-site. So, there's no merchant layer in there.

Dr Small: Complete bypassing of merchant? So, are you saying that, using Andrew Clarke's characterisation, that it's vertical integration by contract, rather than by ownership? Is it really about bypassing the merchant layer and contracting directly with merchants or is there actual ownership integration up there?

Mr Heuser: Ownership integration.

Dr Small: Okay, right, that's interesting. That arises in a context where offsite manufacturing is a major force?

Mr Heuser: That's right.

Dr Small: It has to be of sufficient scale that the offsite manufacturer can afford and it's commercially practical for them to buy in or to actually manufacture their own materials?

Mr Heuser: Manage their own supply chain, yes.

Dr Small: Okay.

Mr Edwards: There's a substantial cost out and other markets, I would suggest to the Commission OECD best practice is the economy market segment of social house construction is almost dominated by own vertical supply chain, and that's where in looking forward, the ITM third challenger perspective is in flux because it actually equals a vertical integration decision mechanism because should Fletcher and Carters be excluded from social house construction because the capture of state house building contracts is perpetuating this building materials dominance.

I may handle that off piste in submissions but it is a very important point that the go forward Kâinga Ora procurement model, which is joining the dots, it's a discussion topic this afternoon. But if we look at government procurement very carefully, it is an order of magnitude issue because a cynic might insist that regulating merchants is actually regulating black and white TV industry, because going forward there's competition in premium market segments and luxury markets segment because economy market segment is vertically integrated assembled mechanisms. I point to industry best practice here in the UK where 50% of all houses in the economy market segment are built by six operators, have vertically integrated supply chains, it has massive downstream implications in green and massive environmental benefits because a lot lower waste, vertically integrated. Another point but I'll handle it in submissions.

Dr Small: Thanks for that. We do have Kâinga Ora online, so if, as attendees, if anyone from Kâinga Ora wishes to comment on this, now would be a good time to get yourself promoted up into the talkers list.

But, in the meantime, I think we're at the point where I'd like to ask if there's any other issues that anybody wants to raise about this topic of vertical integration, whether it's about things that we've discussed here that we haven't quite bottomed out or whether it's about things that were missing from our draft report or any other just general comments that you'd like to make because I feel like we've got to the end of the key issues that I really wanted to look at but the floor is open for anybody who would like to speak? Kevin, you look like you might want to say something?

Mr van Hest: I guess there's some things that have happened in the real world, again that example of you're trying to win a job through a merchant, through whatever, and obviously, pricing, if you're pricing or trying to win a tender, so to speak, obviously these things are supposed to be secret. And again anecdotally sometimes you felt your price, because it was going through say somebody like PlaceMakers or something like that, that your pricing was then revealed to the manufacturer, so that they knew what the target was for them in order to get the project.

So, if you said, "Look, we'll do this for $5", then the merchant could ring up the local manufacturer and say "They've gone in for $5, go in for $4.50 and we'll get it". That type of thing. Again, that's all anecdotal but I've been doing this a long time and have seen some interesting things. That sort of thing could happen or has happened, I believe. I don't know what's going on at the moment. I think everybody seems to be really behaving themselves, which is great, and maybe we should do these sorts of things all the time.

Dr Small: That is actually an interesting point. I mean, in other sectors where there's vertical integration and there's issues about downstream competitors or upstream competitors, the question about control of information does frequently come up, so maybe I'll just pop this over to Fletchers since you're here. Maybe I’ll frame it like this, would you agree there's potentially a risk of information leakage of the type that Kevin has characterised or would you say there's no risk or that you manage it well? What would your reaction be to that?

Mr Clarke: We are alive to the risk and we manage it well.

Dr Small: Okay. And so, you would accept that - yep, okay, you accept there's a risk, yep, that's okay.

Mr Hughes: What I'd say, Commissioner, is what this time of stress in the industry has shown, is what we rely on with vertically integrated companies is a high trust model, that companies who are vertically integrated will behave in a correct and appropriate manner. We have seen instances where I outlined before where that hasn't been the case and has been potentially used to advantage the vertically integrated player.

We don't, for the record, support structural separation. We agree that, and again I'm not being a Fletchers fan boy here but Fletchers do structurally actually partition their businesses in a way that allows for confidence and transparency from a merchant's point of view. We don't necessarily have the same view with the other vertically integrated player. And we do wonder whether some form of moving beyond the trust bar, moving to some form of information transparency or oversight, especially in times of stress, might be warranted.

Dr Small: That's interesting, that was going through my mind as well, whether there's some way of improving the basis for trust, if I put it that way.

Mr Hughes: Especially, we have to accept that dominant supply of New Zealanders is probably a real thing. We would much prefer local manufacturer than imported product, for all the reasons we have seen over the last couple of years, with difficulty in accessing product but that infers a responsibility from those with that dominance to act in a fair and transparent manner and that should be open to scrutiny.

Dr Small: Thank you. Grant Fraser, have you got any comment on that question about the issue, if you like, about information ringfencing or how to improve trust and confidence about the management of the boundary between those vertically integrated entities.

Mr Fraser: I think from a Mitre 10 perspective, a similar position to ITM, I wouldn't necessarily see the need for structural separation but the degree of transparency of processing information is something which is important and, you know, often I think we've seen examples of that and where it works but when there are particularly pressured situations that we have experienced over the last two or three years, it hasn't always played out that way, so if there could be a way to either encourage that or create a regime to support it, we could see that as a positive step.

Dr Small: Thank you. Any comment from Andrew?

Mr Clarke: I understand all of this but it was prefaced on this is all a bit anecdotal and that was the premise upon which this whole discussion kicked off, so I would be careful to create something that introduces a bunch of structures and costs and processes that discriminates based off something that is admittedly, at best, anecdotal.

Dr Small: It is not completely anecdotal. You know, there has been some - there is one allocation model that's not yours, I am not saying it's yours.

Mr Clarke: I was reacting to the comment that we understand completely that we compete at many levels and information at one level needs to be carefully managed to not create a disturbance of competition at another level. We completely understand that and we completely manage that.

What I think that conversation drove to, was introducing a structure to create or improve that trust. We spend a lot of time creating trust with our customers and we feel like we've earnt that trust. For that to be challenged and some supervisory process put over the top of it, simply on the basis of an allegation of anecdotal evidence, feels an overreach.

Dr Small: I hear what you're saying, thank you. Bryan, Derek, any thoughts before we wrap on that?

Dr Johnston: There's been a lot of noise about vertical integration but where we're sitting we're still struggling in terms of much evidence, be it customer foreclosure or supplier foreclosure. As John said, if people have concerns, you know, now is the time to give us some evidence because at the moment, you know, as our draft report shows, we don't really have any.

Mr Edwards: I would urge the Commission in the final report to analyse the ecosystem of customers and to see whether vertical integration isn't being used as customer grooming. All customers aren't at the same level of profitability, Commissioner, and I would suggest to the Commission that the vertical integration ecosystem, particularly post rebates, is one where you can get the best customers into your basket because you have to ensure that ITM breathes and lives and is in a different system. You have to have a position for Bunnings and Mitre 10.

I respect and understand your comment about market harm but we're also talking about market performance here because we're not a high performing construction industry, in terms of the benefit for residential house assembly. And so, I urge the Commission to look at customer ecosystem and the data grooming that takes place with these big accounts.

Dr Johnston: Can you elaborate on that in terms of the data grooming?

Mr Edwards: Data grooming means that Mrs Smith buys $1,800 worth of plumbing fittings and buys 20 sheets of Gib and she's fantastic but she is a customer for Bunnings or Mitre 10. Ngahere Raharaha buys 30 tonnes of plasterboard, 80 tonnes of structural timber, 100 tonnes of concrete, he's a customer of Fletchers, PlaceMakers or Carters. If we look at the customer ecosystem, all the customers aren't the same and are not the same level of profitability and we need to do a profitability and customer ecosystem analysis to see if there isn't some structural vertical integration problem.

Also, when we look going forward, when we see scalable contracts come out of Kâinga Ora, we see the Clever Core vertical integration business have a clear and present advantage over other challenges to get these embryos of scalable house assemblers like my colleague.

Dr Johnston: Thank you for clarifying that.

Mr Edwards: I will work on it in final submissions.

Dr Small: Gary?

Mr Hughes: If I might supplement and link back to a question you asked earlier about conduct or structure. Firstly, on the anecdotal evidence, these things may be anecdotal but seem reasonably widespread around the allocation and supply shortages recently. This is not a case where there's a burden of proof or anything like that. It is an inquisitorial process, so the Commission is at liberty to wrap up those anecdotes and see them as having value.

The other point in terms of your question earlier around we typically see input foreclosure as being, from ITM's perspective, the bigger issue here and we've given some examples of why that was a problem, what the concerns were that Darrin saw.

I think the reality is that our abuse of dominance provision, section 36, has been very difficult if not a dead letter for a while. The Commission is pinning a lot of hope on the new law and we will still see that take some time to work through but there might be a range of other remedies that could be considered of a market oversight or information disclosure measure. In the interim, rather than waiting for a test case on input foreclosure or something like that to come along, because the reality of the market power is it's not vertical integration that's the problem, it's the ability to use that in times of stress and supply shortages.

And the only other comment, Commissioners, about perhaps market structure, is that this should be a more relevant issue when the Commission is looking at things in its merger control jurisdiction as well.

And Barry can give you an example, if time permits, about acquisition of mills and sawmills in Northland, for instance. But what that does over time, it's almost getting into a scenario of creeping acquisition problems, and what that means is that over time if you already have a rope of vertical integration you can thicken that, add more strands to it over time. And each one of those might not in isolation be a problem but I think there might be room for the Commission to consider in this sector, you know, more focus on vertical power in its merger clearance role.

Dr Small: That's very helpful, thanks, Gary. Are these mergers notified? Are these ones that meet the threshold for clearance?

Mr Hughes: The Northland one wasn't notified. A more recent one, the acquisition of a merchant group part of ITM was notified to the Commission.

Dr Small: Okay. Thanks for that, that's really helpful.

I think we may be at the end of that particular topic. We still have a few minutes to go for this session, so I might just roll straight into the questions about rebates and then we will take the break at 10.15 as normal, and then finish off rebates after that.

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Topic 2: Quantity-forcing rebates and other rebates

Dr Small: Our preliminary view in the draft report on rebates, is that rebates paid by established suppliers to merchants appear under certain conditions to be making it difficult for new or competing products to access distribution channels and increase sales.

We identified two rebate structures that have seen most likely to make the introduction and expansion of competing products more difficult due to their quantity-forcing effects. These were tiered retroactive rebates; and share of wallet rebates.

And we found that rebates in other areas of the supply chain appeared to be less likely to be adversely affecting competition.

Recognising that rebates are often benign or pro-competitive, our draft recommendations in this area were limited to dealing with any potentially problematic rebates through the existing provisions of the Commerce Act and the forthcoming ones, obviously, rather than any legislative change to prohibit the use of certain rebate structures.

So, we're really talking about the structure of these rebates more than their level, although obviously those two things are inter-related.

So, perhaps I could go first to Fletchers on this topic and ask you about the commercial rationale for using the rebate structures that we talked about in the draft report. Why are they structured like that, rather than in some other way?

Mr McBeath: Yeah, I mean, they're pretty standard across the industry. Essentially, it comes down to the acknowledgment that essentially exists between suppliers and merchants primarily. I am talking about the retroactive rebates. It comes down to the premise where the purchaser, being the merchant, wants to see some recognition of buy more, pay less. It gives you a mechanism of achieving that, essentially.

Dr Small: But there's multiple ways in which that desire, you know normal desire for buy more, pay less, could be implemented. For example, why couldn't you have, sort of, forward looking price discounts? So, you'd say, you know, once you hit a tier, your price falls to buy 10% or something of that sort? Would that not achieve the same general incentive and could you not calibrate a structure like that to achieve broadly the same objectives?

Mr McBeath: Essentially, to date, the merchant would like to know what they can get now upfront with a view. The problem with that is if they don't, you know, they have to work their way to it from a competitive perspective. If they back themselves through the retroactive, they can see themselves through.

Dr Small: I mean, either way they've got to get to a tier, don't they, before the pricing changes? Are you saying that once they get to the tier, they need a large lump sum as a reward for getting to the tier? I am not sure I completely understand.

Mr McBeath: I am not sure I completely understand what your structure is.

Dr Small: My structure would be, I don't know, $20 a sheet for the first 2000 sheets and then $15 a sheet after that, for example.

Mr McBeath: The income tax model. It's not what's been demanded.

Dr Small: Right. So, it's not what's being demanded, that is a negotiation between you and the merchant though, isn't it?

Mr McBeath: Yes.

Dr Small: And you have merchant specific negotiations about these, I presume?

Mr McBeath: Of course.

Dr Small: And so -

Mr Chapple: Is it not being demanded because it's never been offered, so it's not the norm?

Mr McBeath: I don't know if anybody else is offering it. We haven't. It depends on what way the merchant wants to achieve a desired price and having a recognition of if they buy more, that they get a cheaper price essentially. And having a view of what they can do to get that and then of course they work on the principle that they expect fair and equitable pricing across the chain relative to their size.

Dr Small: Yes.

Mr McBeath: The current model basically achieves that.

Mr Clarke: The other thing to think about is the rebate band is reasonably wide. If you follow the income tax model and its lineated, every board gets a cheaper price or you can step in it, in a retrospective rebate model, you step it through negotiation, the merchant says this is what we think we can sell. We go if that's what you think you can sell and then there's a band plus or minus in the range. It's quite healthy. If they don't hit the last target, they don't fall immediately, so there's quite a comfort zone in the rebate range. If you go to the next one, the benefit is for the full year.

Dr Small: I guess underlying my question is, you know, because we see a competition risk in this area in some situations with the use of rebates of this structure, we're really interested to know if there's an efficiency rationale that kind of offsets that in some way? If there's a reason why it needs to be that way? Some efficiency based argument. It sounds as though it's more a case of this is the way it's always been done and it's simple and it's comfortable for everybody, rather than -

Mr Clarke: There is a bit of that and because it's ubiquitous across not just large market share players to merchants, it's right across the product range. If you ask the merchants who gives you retroactive rebates, they'll say a lot of people.

Dr Small: Yes, I know.

Mr Clarke: A lot of people and not all are in the position of - I mean this conversation will descend very quickly to a Wallboards conversation but it's not just Wallboards who does this.

Dr Small: No, I know that.

Mr Clarke: The structure is understood, finance departments all understand it, the marketing departments understand it, the customers understand it. There is something to that point that it is efficient and effective.

Dr Small: Yep. It's definitely, you know, a focal point. We know it's common across the industry.

We know it's not just wallboards, absolutely. So, perhaps I'll just go to ITM and Mitre 10 about this and ask you about - let's start generally, what's your view on the way that these are structured? And the potential, you know, would it be problematic for you if you got the same rewards but in a different structure, such as the way I outlined before, or is there something special about this approach that is valuable from your point of view?

Mr Hughes: Yeah, we suffer, ITM suffers as a co-operative of 91 members, we suffer from 91 independent computer systems, for a start. So, managing the flow of information back and forth from members to our central buying office, this is certainly a very easy mechanism for us to operate because it allows us to anticipate what purchasing volume discounts we will actually achieve. And that we pass that back in near real-time to the stores, which allow them to pass those benefits back on to their customers.

So, it creates a known environment, a less volatile environment. The counter to that is we buy independently through 91 stores who have to hit certain purchasing threshold to get to that discount that would disadvantage a good percentage of our stores who are smaller.

Dr Small: Thanks, that's helpful. I probably should know this actually but do the thresholds, the tiers at which these rebates kick in for ITM, are they assessed at the network level, rather than the store level? Yeah, they are.

So, you need, in those negotiations you need some expectation of total sales across your network in order to talk about what's an appropriate tier level and that sort of thing?

Mr Hughes: Yes, we anticipate what our annual volume is likely to be. We sit down with our suppliers at that time and negotiate what those discount levels look like for scenarios, which are banded effectively in a retroactive tier infrastructure.

Dr Small: When you do that, is it fair to say, I mean, implicit in that, and getting away from wallboards to talk about a sector that's less concentrated, you must have some expectation in your mind about the market share of that product in that category?

Mr Hughes: To a degree but we worked in the net net pricing scenario out anyway. We understand what the bottom level dollar is in each of those positions. Our members aren't directed to purchase. What we simply try to do is reflect what we anticipate the market might look like over the coming year and make sure we're optimising our purchasing negotiations for that.

Dr Small: Right, okay.

Mr Chapple: Over the course of the year as you're tracking against whatever volumes you've noticed, you know, you're varying your price guidance based on whether or not you're going to hit those thresholds because you don't actually know. So, in another model, say as Fletchers described, the income tax model, you'd know as your volume hit the thing that that's the new price you're going to get that you can charge? But in this one you're constantly juggling that uncertainty and pricing through the year, is that right?

Mr Hughes: I wouldn't describe it like that. I think we - ultimately, we are pricing at a level that we are anticipating.

Mr Chapple: Yep.

Mr Hughes: The advantage of that is passed through to each store. The store in turn takes a decision around how they pass that product pricing onto their customers. We don't control that bit at all. What we do do, is give them rebate forecasting through the year which helps them anticipate what that lump sum, sorry what the progressive payments will be. And we have an end of year wash-up process which balances up what our expectation was versus what our reality was.

Mr Clarke: From Fletchers' point of view, it is important to us our customers early in the year get the same price, assume everything is static and this is the only topic we're talking about. The market would find it very disrupting to be told early in the year your product is higher priced because that is the income tax model which directly translated out produces high prices early in the calculation period than late. What we all do is work out the year in advance, rely on it, trust ourselves to know what our products are going to be, what our customers want. We have a pre-ITM, Mitre 10, we all have a sophisticated process to be confident in that. Yes, there's risk up and down but we allow builders to buy the price in that static world I just described at the same price at the beginning of the year as the end.

Dr Small: Can I just check -

Mr Clarke: The rebate model allows that.

Mr Chapple: Based on a forecast?
Mr Clarke: Yes.
Mr Chapple: With a wash-up at the end?
Mr Clarke: With a wash-up of cash at the end. Because the bands are confidently negotiated, top and bottom of the band, people feel confident to operate that way.
Dr Small: That's great.
Mr Chapple: It's fascinating.
Dr Small: It is fascinating. That is a really good intro to the topic. We've reached 10.15, so we're going to take the break but that gives us all some space to think about this and we'll pick it up again in half an hour at 10.45. Thank you very much.

Conference adjourned from 10.15 a.m.
until 10.43 a.m.

Dr Small: I have been given the thumbs up there, so it must be time. Welcome back.
Just to continue this conversation about rebates, I wondered whether, where we got to before the break was that, as I understand it, we were talking about, I guess, a thought experiment that compared the current way of structuring these rebates, which is retroactive, a payment that happens towards the end of a year, and the discussion was being framed on an annual basis.
I think ITM indicated that this was convenient from an administrative point the of view and we also had the discussion with Bryan about the complexity potentially of changing, merchants changing their prices through the year as the input cost changed with some other model.

Let me start with a different alternative, which seems a bit simpler, and it's not based on an annual reconciliation or annual sales, it's based on a monthly reconciliation. I'll just lay it out so you can think about it and then I'll get you to react to it.

So, the idea would be that you look across, that a supplier looks across its merchants or the merchants that it's selling to and assesses their monthly flow of sales. And merchants that sort of have a high monthly flow of sales, get a lower price. And merchants that have a low monthly volume of sales, get a higher price. You could easily imagine that those definitions of high and low being adjusted for seasonality to take account of whether it's Christmas or whatever else is fluctuating in the during year in a normal pattern of demand.

And then if a merchant was to increase its sales, its price might go down, and conversely. And that seems like a reasonably simple, administratively simple, way of achieving pretty much the same thing but without the retrospective payment that, in our analysis, is potentially problematic - potentially problematic - depending on other factors.

So, would that work? Perhaps I'll start with ITM and then I'll come to Grant Fraser from Mitre 10. Administratively, could that work for you?

Mr Hughes: In short, no, not easily. Part of the problem is the build process occurs over a 12 month period, so certainty of pricing that's needed by builders is over that period of time. If we would have that level of fluctuation in volatility in our pricing month to month, it would be extraordinarily difficult to manage costs and margins effectively onto a building job.

Dr Small: Why would the price fluctuate? If you're in your normal range of sales for that product, your price wouldn't change at all?

Mr Hughes: Perhaps I misunderstood what you were suggesting then. I thought you were implying that would be something you would negotiate on a monthly basis?

Dr Small: All I was saying was there doesn't need to be an annual reconciliation. There doesn't need to be price changes through the year. That price changes would potentially be quite rare and only happen, for example, as a result of significant changes in market share or unusual changes in your demand. The sort of things that would also put you at risk in the current structure. But in normal times, your network would sell, you know, normal amounts of the product and the price wouldn't change but it would be - the difference would be that you'd be - the discount or the rebate that you are getting would happen via the product price on an ongoing basis, rather than once off at the end of the year.

Mr Hughes: I'm not sure that achieves anything substantially different than what we do today.

I mean, at the end of the day, we're taking the rebate on a monthly basis anyway and passing that back to our members, so we take that as a discount off purchase, off statement. And, as I say, collect that and pass that back to our members, so it's effectively the same thing, with an additional administration burden.

Mr Clarke: We would agree with that. The cash recognition is monthly or quarterly, depending on negotiation. Even if we move to the monthly set model you tried to describe then, the negotiation would be once a year. So, you'd be setting the rebate levels once a year in a negotiation, which is the same. Cashflow would be the same. Because the once a year negotiation would have an annual view and you'd be setting the band for the rebate. Whether you were in and out of the movement monthly would be very sensitive and merchants would be quite anxious that big orders would come in once a month and it's a smoothening.

So, we achieve the same ambition as that by dealing with cash differently to the negotiation and then dealing with the width of the band.

Dr Small: Okay. What you're saying is, in practice, you pay these rebates monthly anyway?

Mr Clarke: Or quarterly.

Dr Small: Or quarterly?

Mr Clarke: Yes.

Dr Small: Mitre 10, does this chime with your understanding of things? Grant, could you comment on that?

Grant Fraser: That's pretty consistent for Mitre 10 as well. I am not sure that necessarily an alternative model, forgive me, I missed the first minute or so when you were explaining but I think I have the gist of it but I don't think necessarily that would create a material difference.

Perhaps, this is where the conversation is going to go next but I think the comment was made before that these types of rebates, and there are different rebates across the industry, but these types of rebates are relatively common and not just with suppliers that have concentrated market share/market power. So, our experience is we don't necessarily see them as limiting the ability or discouraging us from looking to bring other suppliers to the market and looking to introduce innovation, particularly if there's that consumer demand for it.

So, I guess, I would be interested in having a little bit more of a discussion around the, I guess, the pro-competitive benefits versus what the risk could be with these. Probably our view would be that there are existing mechanisms under the Commerce Act to deal with, you know, the behaviour if it's seen as being problematic.

Dr Small: Yeah, thanks, and that of course is where we got to in our draft report.

Could I just ask you, Grant, as a matter of fact, do you get, in general do you, bearing in mind I know these are common across many products but, in general, does Mitre 10 get washed up on these rebates on a monthly or quarterly basis?

Mr Fraser: It varies depending on the supply. That is part of the negotiation with the suppliers but the actual rates or the mechanisms are typically done on an annual basis.

Dr Small: The negotiation is done annually but the payments are rarely annual, would that be fair?

Mr Fraser: Yes, based on my understanding. We can always come back and confirm that but that is my understanding.

Dr Small: Would that be the same with ITM?

Mr Hughes: Rarely annual.

Dr Small: Occasionally but not very often?

Mr Hughes: Not very often.

Dr Small: Thanks, that's new information for me, really helpful, thank you. Okay. Kevin, did you want to comment on that?

Mr van Hest: We might have lost sight what the reason for rebates was in the first place. Rebates on plasterboard were around before there was any competition at all. That's going back 34 years, of course. And the reason for the rebates is so that the merchants, the merchants are effectively all selling the same can of coke, I am talking about the exact same can, actual same can, in a sense, and therefore, they all worked on, the merchant with the lowest margin won the sale.

So, the merchants work, and they still do, at invoice moment very low margins. Typically, prior to this plasterboard crisis, if we go back a year, in Auckland merchants would make 5% or 6% gross profit on the invoice when they're dealing to the trade, so really there's nothing in it.

So, the purpose of the rebates was a little bit so that the merchants don't keep throwing away their margin. That was the original reason for it.

The discussion about, you know, oh, if we can sell a bit more, one merchant can sell a bit more, they will get their rebate. Obviously, that's robbing Peter to pay Paul. If you look at a geographical area like the East Coast, Gisborne, there's only one plasterboard available in that entire market. I can't remember the last time we sold any plasterboard into that region.

For every extra sale Carters store is getting, obviously it's less sale of a Bunnings or Mitre 10, so the way the rebate structures are concerned with Winstones, they're only moving things around. Winstones aren't creating any more sales out of this. It's not incentivised for them to actually say, "Look, you sell more board and we will give you a higher rebate". Obviously, that must be, when they are such a dominant player, it must be to the detriment of another merchant because they must be making a bit less.

What's happened with these rebates, as we've said in our submission, it's actually really all about maintaining, it's not about volume, "Please sell more of our board", it's about the share.

As I've said in my submission, I want to re-emphasise that, it's now really become an issue about if you sell too much of not GIB, that's when you're going to feel it and that's probably what really is going on.

Dr Small: That's a really interesting contribution. It actually goes to the comment I was trying to get at before, which is the efficiency rationale for any rebates, I guess, and particularly for this structure, which normally would be associated with selling more product, so that's an interesting observation, Kevin.

Mr van Hest: Can I say one more thing? It is not like trying to sell more TV sets. You know, if you are a merchant that sells TV sets, we want people to have three televisions, not two. Let's put one in the bedroom and another one there.

Plasterboard, you know, it's directly proportional to the activity of the building industry. I remember after the 2008 Global Financial Crisis, we went from 26,000 new builds in 2004 to 11,000 or 12,000. That would have had a directly proportional impact on the manufacturers' supply of plasterboard. You can't sell any more board than the market actually needs. You are not going to use it to line your yacht. You know, it's just what the industry needs, you can't sell any more. You maybe could meet with a Lockwood home that perhaps uses timber but generally, it is what it is.

So, the rebate system, it's not about efficiency, I don't believe, at all. It's not about quantity efficiency or that sort of thing, you know buy more and therefore - it can't be that because you're only robbing Peter to pay Paul. You're only taking it from one merchant to another. I believe it's cynically unfortunately based around making sure you don't sell too much of not Gib.

Dr Small: There's two things going on in here potentially. One you could think of as being about pass through, which is the jargon term for whether or not rebates end up benefitting the consumer or not.

And then the other one is about, and you know that's something that we may have mentioned in passing in the draft report but it's a little bit secondary to the key competition question that's of interest here, which is whether or not these rebate structures do have an effect of making life difficult and lessening competition for rival products.

Even though it's a little tangential, can I start with the pass through question and ask ITM and Mitre 10 about that? Just an open question, do you think these rebates end up in consumer prices or do you think they end up somewhere else? I will preface that by saying not necessarily in your pockets but they could be a contribution to your Head Office costs or some other fixed costs. We have heard of that. Could you give us your view on that, where they end up?

Mr Hughes: Certainly, a small component of it does end up funding the central support office in our environment, in a co-operative environment, which all it does is avoid the levy we would otherwise charge members for being part of our co-operative.

The rebate pass through, it's not necessarily granular, in terms of how it impacts the actual price, but rebates collectively talk to the profitability of any store which then helps them determine how they price to market.

So, it does contribute to the consumer through the totality of that supply chain and the totality of the offer. When a builder is building a home, he's not just selling pieces of plasterboard. It's the net cost, with the impact of rebates contributing to the profitability of the merchant, that allows us to price that home to a level that benefits the consumer.

Dr Small: Right. So, when you say contributing to the profitability of the individual store, to an economist that sounds as though it's not showing up in retail prices?

Mr Hughes: That is exactly what I'm not saying.

Dr Small: Okay.

Mr Hughes: A business isn't charity, so you do have to make some money.

Dr Small: Of course.

Mr Hughes: What we're saying is, the level of pricing that goes from the merchant store to the customer depends on the ability to sustain at least a basic level of profitability in their business. Rebates contribute to that basic level of profitability.

Dr Small: Right.

Mr Hughes: And they do impact how we price to market.

Dr Small: Okay.

Mr Hughes: Obviously, the tension of a competitive landscape sets how much price the market will stand.

Dr Small: Yes, I think that's a really good point. Ultimately, this is about competition between merchants, so yeah, that's right.

Gary Hughes: That will happen at the local level, that contestability, if your concern is a store is not passing through those savings to builders or consumers, then builders can go down the road to Carters or PlaceMakers at a regional local level. So, I think the draft report finds that level is generally workably competitive and we seem to all agree, so that would create pressure presumably for pass through to happen.

Dr Small: I agree with that analysis, Gary. The way I think about that is there are two separate functional markets and we're concerned primarily here about competition for building supplies, so we're naturally more concerned about competition between suppliers. We did obviously look at retail level competition between merchants as well in the draft and that's a separate issue.

This pass through matter kind of links the two but, as I indicated previously, I think they are very distinct issues.

Grant Fraser, have you got any comment on this question of pass through before we move on?

Mr Fraser: I think the last point that I think Gary made from ITM, which is actually you know a lot of these key products will need to be very competitively priced in the market, as there is a significant degree of competition between merchants.

From a customer point of view, be that a builder or whatever, they are looking for the best net pricing, so ultimately, the pricing needs to be able to meet that customer demand.

There was some information we provided in our submissions actually which we identified as confidential which may be relevant to this, in terms of how some of that does work, so probably I'll just leave it at that.

Dr Small: Thanks for that.

Mr Heuser: I think there's evidence, survey evidence from builders, I think it's part of Fletchers' submission, that builders aren't necessarily competing on price, that they care more about a service that they're getting from the merchant.

I just wonder if some of the bigger customers are demanding that pass through from the merchants, for example, Kâinga Ora, that might be a question for them if they're getting their passthrough

Dr Small: That is one of the concerns we identified in the draft report and it is connected back to the regulatory system that we were talking about yesterday and the incentives that creates as well. One of the features of this study is there's no one thing that - there's no-one silver bullet here at all, to the extent that it's a multidimensional set of issues.

Can I just come now though to the key competition issue that we are concerned about and we were concerned about in the draft report, which is the potential impact of rebates on stocking of rival supplies?

Maybe I'll frame this as, to the extent that there are volume specific rebates at the merchant level, does this mean that because you're risking falling below the tier and, therefore, putting a significant cash payment at risk if you stock someone else's product, that it makes you less keen to stock someone else's product? And does it mean that that someone else may have to insure you against that risk and in some sense buy-out the rebate that you might otherwise expect to earn?

This is really a question, I guess, for Kevin from Elephant Board and for both Mitre 10 and ITM. In those pricing negotiations, with a rival supplier, do you look to being compensated for the risk of losing a rebate? And for you, Kevin, do you feel like you have to buy that out in some sense?

Mr van Hest: Well, I mean that hurdle is always so huge, you know. If your competitors provide a very large rebate because of a very large volume, you sort of have to match the rebate. Even if you match the rebate on your tiny little volumes, the behaviour, the thing that you're talking about, if the merchant starts to sell a bit too much of brand B, they fall into a lower tier than the rebate structure of their dominant supplier, and we've seen this anecdotally, a lot of times you can see the sales rep of Bunnings or Carters being told, just don't promote the other brand at the moment, you know, we still have to make sure we sell enough of the other brand.

And it's obviously, and I think even especially ITM stores and that, most or all of them privately owned, they are looking at, I'm sure, you know, they can't sell too much of the other brand because it will cost them too much and we couldn't match it.

So, if we - you know, we'd have to give them 50% rebate or more rebate than we actually would sell them in order to plug the gap in what they're missing out in their bottom line. They are private businesses, they want to make money. I can understand why they want to get those rebates, they're really handy, they look forward to those cheques, so to speak, every month or every quarter. If they sell too much of another brand, that will dry up and we can't match that absolute dollar difference, that absolute dollar loss, even if we match the percentage.

Dr Small: Can I ask you, do you sell, for example, to ITM and Mitre 10 that are franchise operations, do you sell to the Head Office or individual stores?

Mr van Hest: With ITM, we do. We are in negotiations at the moment with Mitre 10 to do the same thing.

Dr Small: To sell to Head Office?

Mr van Hest: Yes, through the support office or whatever you call it. We've already got that with ITM. Like Winstones, we only sell through the merchants, we don't sell direct.

Dr Small: You don't sell direct?

Mr van Hest: No.

Dr Small: It's not a store specific negotiation? It's normally a network specific negotiation?

Mr van Hest: Well, I mean, with Carters and Bunnings, there are rebate structures in there but they are all being relooked at, at the moment, for the very reason of what's come out of this whole thing. In some ways, we ourselves have gone, oh look, if you do X dollars with us, you'll get X%, and if you do a little bit more with us, we'll give you a little bit more. So, that's like, are we doing the same thing? You know, are we part of the same problem? But we're such a small market share, I don't think in our case it makes any difference.

Dr Small: Okay.

Mr van Hest: What I'm trying to say is, we might be looking for some guidance or how to structure the renewed or renegotiated rebate systems in order that we don't violate any sections as well.

Dr Small: Yeah, okay. Section 36 does have a threshold in there about having substantial market power, so you may be - well -

Mr van Hest: I don't know. What I'm saying is we don't want to be accused of doing the same thing.

Dr Small: I hear what you're saying. Thanks for that. ITM? I'll come to you, Grant, for Mitre 10. When you're negotiating with another, it doesn't have to be plasterboard but, in any other context, is there that sense that brand B or brand C, or whatever it is, potentially puts your rebate at risk for brand A, if I can put it that way?

Mr Hughes: We certainly do the evaluation but, at the end of the day, our stores operate independently. As I said, it's a co-operative. They make sure procurement decisions around the products they need.

Kevin's point is, yes, there is a level of negotiation at our support office or Head Office level but the real negotiation occurs with the local store around whether they're prepared to carry stock and sell that product or not, and that will be again based on what their customers are asking of them.

So, rebates, while we have an understanding of the impact of it, it doesn't form part of our decision criteria.

Dr Small: That's really interesting because one of the things that was on my mind was whether, to the extent that it's pricing and rebates are negotiated at the network level, whether there's a risk that individual stores will undermine let's say the collective interests of the group by not stocking the brand B or brand C; is that something, an internal issue for you? You have a smile.

Mr Hughes: Yes. But, again, our role as an aggregator is purchasing and if a store chooses to stock a brand for whatever reason, all we're trying to do is reflect and aggregate that volume up at a network level to be able to give them the best commercial terms that they can have.

Dr Small: Right, okay, thank you.

Gary Hughes: It is a question of how to get your countervailing bargaining power to its fullest extent, isn't it? Obviously, with 91 member stores and Mitre 10 with however many they have in a similar co-operative, Kevin would probably love it if we keep going and negotiating individually with each store on a much smaller basis but to maximise the bargaining power against the big suppliers, it makes sense for these co-operatives to negotiate that level at a central point. I think what Darrin is explaining, is that still leaves plenty of discretion and flexibility for individual stores as to what they stock.

So, if builders in a local town are clamouring for Kevin's product, there's no impediment to that.

Dr Small: Yes, thanks. Grant Fraser, can I bring you in on this particular set of issues as well?

Mr Fraser: I think what we'd add from a Mitre 10 perspective, is when it comes to rebates, actually we don't really see them as being determinative or overly material in overall assessment regarding dealing with suppliers and product stock and choices. Slightly ironically, some of the discussion yesterday around regulatory barriers can often be a bigger barrier, rather than necessarily, you know, rebates.

So, yes, they're something that are factored in, in discussions, but generally the overall commercial relationship and other factors have a far greater influence than rebates themselves.

Dr Small: Thank you, yes, we certainly realise that they're one part of a complex mix of issues here, so thanks for that.

I'd like now to pick up on where I diverted the conversation in the previous session with Fletchers, and this is really about the rebates not to merchants but to builders. As I understand it, essentially, what's happening here is that in many cases, let's take plasterboard as the example, in many cases the plasterboard is going direct to site, with the efficient delivery model, popping it into each room, just what's required. The invoicing is passing through a merchant and then, depending on the builder and your relationship with them, the builder can then claim back from Winstones a volume based rebate; is that the essence of it?

Mr Clarke: That is the essence of it, yes.

Dr Small: And did I - so then there was this question about whether, if the builder is part of the Fletcher Building group, exactly the same rules apply? I thought I heard you say if the builder is part of the Fletcher Building Group they don't get to claim back any rebate; did I hear that right?

Mr Clarke: You did. So, our builders, if you ask David Thomas, they don't ask for it. They don't need it. The type of builder who asks for a rebate is typically home builders looking for a source of finance to operate their group home operations. Fundamentally, that's a line of revenue into an organisation for their own purposes, and so they will be slightly differently structured but those end user rebates tend to be asked for by particular types of builders for their own particular reason. We don't stand there and offer them, we wait to be asked for them. And our construction business doesn't need to do that because we have a group structure that funds itself.

Dr Small: So, you can see why I'm interested in this, I'm sure. So, you have a group, a house building operation in your group that is presumably quite a large user of plasterboard. We have heard, incidentally, from group home builders exactly what you've just said, which is that supplier to builder rebates are often used to fund head office type functions. I really am intrigued to know why your operation doesn't request those? It's not because they're getting the product cheaper, is it, in the first place?

Mr Clarke: No, Fletcher Living business will source its procurement for wherever it sees it, they will buy from PlaceMakers but they will buy from Carters, Raymond Truss if it's cheaper or more available. They operate independently and by arm's length terms.

Dr Small: Yeah, I get that through the merchants and that's the invoicing base model, the product goes around the merchant but the invoice goes through them. Yeah, okay. It is intriguing.

Mr Clarke: It's no more complicated than that.

Dr Small: Okay, all right. I will leave it, unless anybody else has got something to contribute to that topic?

Mr Edwards: My contribution, slightly humourous, I have to compliment the Fletcher organisation on the quality of hospitality, rugby tickets at conferences. And we are at a conference today and I am intellectually engaged in this conference but there's no dancers, there's no rugby tickets. It is essential that we look at these other incentives and the package of relationship tools available to a dominant player here. I'm a beneficiary and I compliment all of my Fletcher colleagues wholeheartedly on excellent hospitality, thank you.

Dr Small: Thank you. All right, well, strange as it may seem, we may perhaps have bottomed this out.

Mr van Hest: Can I have one more say?

Dr Small: Yes.

Mr van Hest: We do know with large group home builders, there are some parts of the market we can't look after. For example, we're not very strong at all in the South Island, so there's sometimes a geographical problem. And if they're a national group home builder, and I can tell you when this plasterboard crisis started last year, lots of them came to us and said "My God, we'll never put all our eggs in one basket ever again". But then when it came down to the crunch we could see they were concerned if they gave us 20% of their business, they may not get the same great price on the last 80%. Or conversely, if we could do 80% of the business but not the last 20%, they will not get the same deal on the last

20%. So, that's another part that we put in our submissions.

Dr Small: Yes.

Mr van Hest: There is CSQs contact specific quotes or deals made with group home builders and, yeah, that's there. If you can't do it nationally say or everywhere, we can't go to you because we'll be disadvantaged overall, if we only did some with you but not all or whatever.

Dr Small: Yeah, yeah, thanks. I mean, the CSQ was actually on my list, so since you've brought it up, this is another form of what we term vertical arrangements. So, perhaps I should ask Fletchers about this. And, maybe just as a factual matter, you could help me understand how they work, given this invoice, given what we just talked about, which is the invoice, the product and the merchant goes through them. How does that work in a CSQ environment? Does it go through the merchant or does it go around them?

Mr Clarke: It still goes through the merchant.

Dr Small: Still goes through?

Mr Clarke: Yes.

Dr Small: The merchant asks you for a specific price for a particular customer?

Mr Clarke: Yes, and we reach an agreement.

Dr Small: And it goes straight through?

Mr Clarke: Yes, it's up to both of us to sort of track it obviously.

Dr Small: Okay. Has anybody got any comments on the role of CSQs in the markets, relevant markets generally?

Mr Hughes: Only they're a lot less prevalent than they were prior to the supply crisis.

Dr Small: You take the drop off as being at the time of the supply crisis?

Mr Hughes: Yes.

Dr Small: Okay. Kevin?

Mr van Hest: Well, there's a supply crisis, no-one is getting any deals anymore. It's natural, isn't it? There's not enough bread in the market, so no-one is getting a discount on bread at the moment but that will change. We'll go back to in a few months time, it will all be back to where it was.

Dr Small: Right, okay.

Mr Clarke: Commissioner, I have one comment on rebates?

Dr Small: Please.

Mr Clarke: We encourage the Commission to look in the round at this. I think the evidence in front of you at the merchant level, it's not a big decision driver and there's reasons why they're saying that. Earlier, you were encouraged to think of everything as a can of coke and we would encourage you to see what in fact is the case. Products aren't exactly fungible and the conflation of this discussion down to plasterboard runs a risk of thinking it's a simple product and everybody's product is the same and everybody's service and other things, and therefore rebates is the evil.

It doesn't quite work like that and we just encourage you to look at all the evidence and all the submissions in front of you on that, as to where rebates really fit.

Dr Small: Yeah, that point is well made and definitely taken. I mean, as you saw in the draft report, we thought that, I mean we did three case studies, plasterboard, cement and structural timber, as a way of, sort of, getting a little deeper into some sectors. So, the interesting thing about plasterboard is it does happen to wrap up and exemplify a number of things, including the regulatory issues which are about, you know, Acceptable Solutions and so on. But, no, we certainly take that point. It's not the same as other products, partly because it's the system, yeah.

Okay. So, Gary?

Gary Hughes: ITM would probably also encourage you to look in the round at the other topics, maybe at a slightly different reason to Fletchers. There seems a lot of attention on maybe a small number of rebates that theoretically or potentially could be a problem in the economic literature but the evidence seems to be that the bulk of the industry are tied to volume and certainly for somebody like ITM and Mitre 10 as well, they can bring significant countervailing bargaining power to bear and so they're going to make informed choices, depending on what their merchants and builders need, rather than somehow becoming beholden to a supplier on the ground.

If you look at the other topics that we've canvassed, including this morning's discussion about choices that vertical integrated players make when there's a shortage or allocation model, ITM said in its written submission that that's had a far greater competitive impact than anything they see arising from rebates.

Dr Small: Understood, thank you.

Mr Edwards: We urge the Commission in the final report to consider not the rebates, not the plasterboard market, but the data attached to plasterboard sales and what that means for industry stewardship and industry management of what's happening where in the industry. And it's the absolute dominance of the plasterboard data, who's building what, where and how, that enables somebody to manage competitive outcomes. A little bit like the central bank is always looking at bank lending. If you're the central construction activity, you're looking at plasterboard.

Dr Small: Yes, okay, thank you. I will just check with my colleagues here, has anybody got any other points to raise here? Have any staff got anything they want to raise on these issues? No.

Excellent. Well, we get an early lunch and, as I said earlier, we still will stay on the schedule to start after the break at 1.00 because people are coming especially for that, so thank you very much for those contributions, it's been really helpful.

Conference adjourned from 11.26 a.m.
until 1.00 p.m.

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Section 6: Competition for 'green' building supplies; offsite manufacturing; Government procurement

Dr Johnston: Good afternoon, welcome back everybody. This afternoon's session is dedicated to talking about competition for 'green' building supplies, offsite manufacturing and government procurement.

Before we get into that, I want to circle back to one issue that's been niggling at me, I am not sure we completely closed out this morning, it comes from Tex's comment about supposedly tongue into cheek comment about ancillary benefits that people get, in terms of various benefits that are given to potential purchasers of products to incentivise them to buy products aside from rebates.

When those sorts of comments are made, they strike me as a bit of, where there's a bit of smoke there's perhaps some fire. I wondered if anybody else wanted to make any comments on that or, Tex, whether you wanted to expand at all on your comments or anyone else wanted to respond to those comments before we launch into the 'green' building supplies discussion?

Mr van Hest: It is just in a general area of, what would you call it, benefits that people may get for supporting a particular brand or not. And yesterday I thought it would be of interest for you guys just to list some of the institutions, for example, that the manufacturer is associated with and my concern about how that affects also behaviour buying, decision-making around compliance and that sort of thing. It is a small list, just bear with me.

It's just interesting that the local Gib manufacturer is either an intimate or a conference only sponsor of the National Association of Steel Housing, Designers Institute of New Zealand, the Acoustics Society of New Zealand, the Institution of Fire Engineers, they are a full sponsor of the New Zealand Institute of Building, top tier sponsor, national partner. They are a gold sponsor of the New Zealand Institute of Building Surveyors, the New Zealand Institute of Quantity Surveyors, platinum sponsor. New Zealand Certified Builders, strategic partner, Architecture Designers of New Zealand, principal partner. New Zealand Institute of Architects Conference, gold sponsor and New Zealand Institute of Architects in general, silver sponsor. Master Builders House of the Year, exclusive club of nine in the sponsor family. The New Zealand Commercial Projects Award which is managed by Master Builders. They are the sponsor of the Residential Projects category. The Tile Association of New Zealand, premier sponsor. The Waterproof Membrane Association, Code of Practice sponsor. Fire Protection Association of New Zealand, platinum sponsor. New Zealand Building Industry Awards, sponsor. Design Experience, which is part of CMS Construction Management Services, one of just four key sponsors. The Association of Wall and Ceiling Industries, principal sponsor. The Building Skills Maintenance Organisation, silver sponsor. Open Christchurch, whatever that is. The Crusaders, shit, that's okay, that's all right. And of course last and most concerning to us, BOINZ, the Building Officials Institute of New Zealand, they are a top tier gold partner.

And I'm bringing all that up because I think we have rebates influencing things and other incentivisations but this is bringing up a whole web of interconnected industries, industry groups, architects, Building Officials, and on and on and on, and all of them are - I mean, what is the point of sponsorship? It's not a charity. There's nothing wrong with it, if you want to sponsor the Architectural Designers New Zealand, you are hoping to get loyalty from the members, that you will be specified by the members, that's the whole point of sponsorship and that's fine in a free market. But what concerns us most, and I talked yesterday about our concern about why is it that when we are specified on the plan, why anybody switches to us, that we get such a hell of a time from the Building Inspectors and the processes?

Well, the big concern is those processes and Building Inspectors are part of the Building Officials Institute of New Zealand, that's their organisation. And, you know, the principals, they go to conferences you get wined and dined, you get looked after by sponsors and it's human nature to have a feeling of loyalty towards those brands because that's what you do. Someone takes you out for dinner who wants your business, you have a sort of beholden feel towards that, this is what we do, it's why we sponsor.

But the Building Officials Institution is my biggest concern. I would like you guys to have a close look at that one, let alone all the others I have listed off there, because I have looked at the Building Officials Institute website and one of their, like their technical discussion forum, this is straight from the website, is "a place where members can connect with other members, ask questions and share ideas and knowledge. The Winstone Wallboards technical help thread is monitored by Gib technician experts for advice at your fingertips".

That is the technical discussion forum for all the Building Inspectors and processes who belong to the Building Officials Institute of New Zealand.

So, we mentioned this a few times, we know that Building Officials contact my competitor about getting advice on stuff. You wonder what they say.

The Buildings Officials Institute's mission is "supporting the professionalism of our membership through effective leadership, quality education, compliance with legislation, creation of industry partnerships and relative products and services", so the creation of industry partnerships. If you go on the Building Officials Institute's website, you see the word "partnership" again and again and again and again, "partnership", "partnership", "partnership".

So, the people who decide when our product is put on a plan, is it okay or not, we believe that there could be this loyalty, as happens when you sponsor those organisations.

wou I mean, BOINZ probably/possibly should be a little bit like BRANZ, perhaps so that they don't have to rely because it's like having, you know, the Police Association Conference sponsored by a large New Zealand gang. I am not saying they are a gang but my point being that if you have - you have the Judges being sponsored by people who have special interests and this is what we see was happening with the Building Officials Institute. It's a very important one. If they need money, perhaps they can get some of the levy that like BRANZ get through the Building Consent process but I really want to bring up this point. This Building Officials Institute, gold platinum sponsor is Gib Board and it affects everything.

Dr Johnston: Thank you for that. Tex?

Mr Edwards: Thank you for closing off the last section by saying it's a vertical arrangement because in a vertical arrangement, it's not just rebates. I would put to the Commission that in the final report you might consider what would happen if rebates were shrunk. Perhaps you would get Formula 1, the rugby and Jo Berg, Flushing Meadows Tennis and front World Rugby seats. But I bring to the economist's perspective and maybe Andreas wants to speak on this but this is really an illustration that we have network effects in this unique product and in this absolutely globally unique market share dominance.

And the economists in me bring, Andreas will speak to it as a professional economist, not a bush economist, but with network effects the possibility that rebates might shrink, regulators can look towards structural separation as a way of remedying network effects. Because I put to the Commission that the evidence that Kevin has produced here is showing that we have sort of network effects in this product and it moves a discussion of structural remedies into a different category as a consequence of its absolute dominance and these other vertical arrangements. Thank you.

Mr Fisher: Scott Fisher from Offsite NZ, I am representing a member organisation. And I think it kind of highlights, kind of, a broken funding model for a lot of industry organisations, whether it's membership subscriptions, the corporate dollar, the event dollar, which is associated with sponsorship as well. And, in many ways, the structure and the way the industry organisations kind of contribute and add value doesn't get access to the funding that's required to do the work properly. And so, in many ways, you're kind of forced down a sponsorship avenue to keep the lights on, to pay the staff, to employ the researcher, to think about some advocacy positions and the like.

So, it's broken in many sense, even for the member organisations who find it very difficult to access BRANZ funding or building levy funding. Many organisations say, "Yeah, we would like to support you but we can't", there's not a mechanism in place where they can fund kind of impartial objective work that the industry is trying to do.

In our case, the corporate dollar does not buy our opinion. If we don't agree, we don't agree, and we would walk away from a relationship.

Even member subscriptions don't buy consensus. Quite often members don't agree in a member organisation and often the governing body, the board, needs to come to a point where they take a particular line, and quite often that might be against views of a membership part of their organisation.

Then it kind of feeds on itself, that member gets dissatisfied with the member organisation, doesn't renew its subscription, therefore there's this constant downward pressure on that revenue side.

Mr Heuser: I will add, if I may, Commissioner, I think the technical term is regulatory capture. There's obviously a spectrum of regulatory capture and if the building officials are, there's that non-financial benefits there, that falls on the spectrum of regulatory capture.

Dr Johnston: Thanks for that, Andreas. Have you got a comment or response to that at all or leave it for another day?

Mr Clarke: Look, we provided all that information to you. You've had that information for a long time. I'm a bit exacerbated. This is a market study. One competitor in one product has an awful lot of air time. They've had 34 years in this market. I am a bit exacerbated by the implication. The people accused of taking money for other things are not here to defend themselves. I will just stop there. I'm quite frustrated.

Dr Johnston: Thank you. Just one follow-up, perhaps I will address it to you, Andreas. To the extent that this 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?

Mr Heuser: I will reflect on that and come back.

Dr Johnston: Okay, thanks. It strikes me that it may be the latter but I am interested in your thoughts, thank you.

Mr van Hest: Can I clear one thing up? I don't think I said anybody was given any money. I was saying that people become subconsciously or consciously loyal to a brand. It's just a human thing. I am not talking about any money.

Dr Johnston: Gary?

Gary Hughes: Possibly taking a different view to Commissioner Small, I was going to opine that it does seem to be we're dealing with a whole lot of restraints in different ways. This one is around regulatory capture or sponsorship of institutions but many of the things that have come up through the course of the Conference have a vertical element because there is a much greater incentive to apply these things or use these types of conduct or if what's going on is suggested to be sponsorship or whatever, then the parties who are not vertically integrated have less incentive to do that. That's not to say that they couldn't.

Mr Chapple: Why would that be?

Gary Hughes: Because perhaps harping back to day one, and I wasn't present, but the degree to which there's customer learnt behaviour or regulatory and systematic, sort of, impressions that will keep not singling out any one product for three, four, five key products, keep them at the forefront of the mind of builders in every possible way. You might think there's more of an incentive to keep doing that in many different ways.

One of the challenges may be in a market study, is there's no one or two single issues emerging. In my view you have four, five or six or a range of different aspects of conduct and behaviour and many of those seem to be more likely from vertical integration.

Dr Johnston: Thank you, Gary. I think I'll close off this discussion there and move to the topic of this afternoon on building supplies.

In this session, we're going to be focusing on three separate but inter-related topics; competition for 'green' building supplies; competition from offsite manufacturing; and the relevance for competition of government procurement of key building supplies.

Chapter 8 of our draft report discussed impediments to the entry or expansion of new or innovative building supplies, focusing on 'green' building supplies and offsite manufacturing.

Green building supplies contribute to reducing emissions of the construction sector. Offsite manufacturing covers a range of products and processes that utilise some form of manufacturing and standardisation in the construction process.

Some submissions also refer to the relevance of government procurement, primarily through Kâinga Ora, to competition of key building supplies, particularly in promoting the uptake of green building supplies and offsite manufacturing.

We will discuss these three topics in turn.

I think there's quite a lot to try and get through in this session and we might be limited by time. I will try to move through this material as quickly as I can but if we run out of time, I guess my inclination is just to keep the session going for a little while this afternoon, rather than use tomorrow morning's extended session. If people have to leave, you know, we fully understand that but we will press on as best we can.

First of all, coming to competition for green building supplies.

There's considerable work underway, as everybody will be aware, to transition the construction sector to near zero emissions, notably through MBIE's building for climate change programme. By capping carbon emissions of buildings, Building for Climate Change will call for considerable innovation from the sector. Impediments that exist currently, if not addressed, could well inhibit the entry or expansion of innovation in green building supplies.

We expect that our draft recommendations aimed at improving competition for key building supplies more generally, will also support entry or expansion of green building supplies, primarily through enhancements to the regulatory regime.

Submissions have commented on how the regulatory system impedes new or innovative building supplies, including green building supplies. Common themes of submissions include the lack of alignment with international standards; product certificate verification and appraisal costs; and decision-makers and BCAs preference for domestically tried and tested products.

Many of those issues have been canvassed already in yesterday's sessions on the regulatory system and decision-making.

Submissions have commented that there would be benefits in aligning with international standards, as long as checks are in place to ensure those standards are appropriate for the New Zealand context.

I now want to focus in on the use of international standards in relation to green key building supplies.

We discussed pathways yesterday for a broader range of key building supplies, including greater acceptance in the use of international standards when bringing in or adopting building supplies.

And I am interested to open the floor to any thoughts on how relevant that is in the context of green building supplies? And if there are any particular green key building supplies that should perhaps be most beneficial to focus on initially.

Does anyone online or in the room want to respond to that? Did people think it was adequately canvassed in yesterday's discussion?

Mr Eagles: Kia ora, I am Andrew Eagles, Chief Executive of the New Zealand Green Building Council. Can you hear from me okay?

Dr Johnston: Yes, welcome, good to hear from you.

Mr Eagles: Thanks for all the work going on in this space. I guess I would highlight a couple of opportunities, in terms of green. There's a large focus on energy efficiency, and there has been for some time. Those are products which can help like SIPs panels and more energy efficient windows. We know from some of our clients that they've had challenges sometimes with BCAs saying this is a new product and being uncertain about that. So, we think that having Building Control Offices sharing knowledge and having a repository, particularly as we drive towards a lot of change fast, so over the next 10 years there will be three ratchets to far more lower operational carbon, and I think there's quite a strong sense that Building Control Officers and entities could be faster at learning and sharing best practice and approval for products. That's the first thing.

Then the other thing, the really even more emerging field is the embodied carbon space, and that's where things like green concrete, lower carbon concrete, or structurally, I mean, CLT, those types of things, I think there can also be hesitation here. Green concrete takes slightly longer to set but where we can encourage lower embodied carbon, that really helps, it's about half of our carbon impact. So, having the knowledge, having the sector have knowledge and be accepting of these products is really going to help.

Dr Johnston: You would suggest that's an area of primary focus?

Mr Eagles: Yeah. In particular, the embodied carbon. You know, a lot of the sector is still learning about this but there are products that work and are proven overseas and can work here in Aotearoa as well and I think we all need to up the knowledge and be quick to facilitate those products coming to market in Aotearoa New Zealand.

I would just note a further item of our submission, maybe you're going to come to it, but we think the joint and several liability clauses in New Zealand at the moment are limiting the ability of Building Control Departments to be accepting of new products and that there are regimes overseas which reduce that risk for Councils and that's really going to hold it back.

Dr Johnston: Thanks for that, Andrew. You have a follow-up question?

Mr Chapple: Andrew, thank you. I just have a question about your comment about embodied carbon. So, is that, you know, with the Emissions Trading Scheme, the aim is that, you know, that will help these things be reflected in price, which should drive people towards those things; how do you see that working?

Mr Eagles: Yeah, I guess, so we haven't seen - it will be really good to see the Emissions Trading Scheme working well and effectively, so it's not clear to us that that is going to drive enough change at the speed that we need to go to. So, the goal is around 40% or 50% reduction in embodied carbon by 2050. And then also, there's an issue of cross-boarder issues with imported products. A regime where you require at the consenting stage the importing of embodied carbon and then over time, which is what is proposed under the Climate Change Programme, and then you gradually ratchet that down at the consenting level. It provides a really clear indication at the consumer stage and then incentivises that through the supply chain and I think that's a useful supplement to the ETS.

Mr Chapple: Thank you.

Dr Johnston: Andrew, just in terms of your example of green concrete, are there particular overseas jurisdictions or standards where that's been adopted that we should be in New Zealand looking at?

Mr Eagles: Yeah, we have quite a few examples from overseas and I am happy to send those through.

Dr Johnston: If you could, that would be good.

Mr Eagles: The cement is the issue and you can reduce that by 30% or so. There are moves in New Zealand, I do think we need to work on the standards to enable that in New Zealand and get that out for faster and greater uptake. Where we get to scale, we can reduce the additional cost.

Dr Johnston: Are there other products like that, that you think we should be putting an early focus on? Again, if you can deal with those in your submission, that would be helpful.

Mr Eagles: Yes, yeah, I'll pull out more of those. A really good one, I think, is (a), the potential for steel to be designed, to be redesigned in terms of how it's - the I-beams don't always need to be as strong as - we create standard I-beams and our work with ThinkTech found that you could redesign those and reduce the embodied carbon for many instances of building in New Zealand and still have a very big leniency for strength, that is the actual form of the beam.

And then, clearly, large scale timber for structure, you know, I think the more we can share best practice there and push those examples through, the better for everyone, yep.

Dr Johnston: Thank you for that. Tex?

Mr Edwards: Monopoly Watch would like to answer the question from the Commission. The Commission question was the regulatory system slowing down the adoption of green building materials? I would answer that question by saying it's not necessarily the regulatory system; it's the market power of incumbents.

I refer to a previous industry in New Zealand where the CEO in a shareholders meeting said, "It doesn't matter what technology it is you have, if you have market power you can transfer from one technology to another technology and maintain the current level of profitability". I share that with you because there would be implied benefits if you had structural separation in the progression to green.

And I close off my observation here by saying setting ratios on several level of greens would be a good outcome in the final report.

And setting ratios would be not just waste, not just products, to Andrew Eagle's comment, but also EPC ratings because inevitably, New Zealand will go to Building Warrant of Fitnesses and Energy Performance Certificates in buildings, it might only happen in 2040, but the mere setting of a date helps the market adjust because there's a whole series of premium buildings being built in New Zealand that aren't able, and particularly residential, this is about residential building supplies, that if we had these ratios or this rating system, even if it was never going to be adopted until 2040, and there was a debate whether it was 2040, 2035, whatever, it would really help achieve the stated aim of this Commission's Inquiry, which is the migration to green standards in building by setting ratios, and by setting standards that premium and luxury constructors could achieve these certificates.

Dr Johnston: You've raised the question of EPCs which is something I was going to come on to and I acknowledge it could be some time before being brought in. If EPCs were to be brought in, in terms of residential construction, how do you think the information those would provide would change residential consumers' behaviour.

Mr Edwards: If I could FYI, my organisation has constructed six EPC B-rated buildings in London. It is a fascinating process and I see this transition that it almost creates 500,000 new builds, retrofits or new buildings, half of which would be new builds, half would be retrofits. And initially, the standard would be absorbed by property developers in luxury and premium who would state on their LIM that they had an EPC rating of an A or B. And remember we're talking about very attractive industry transformation proposition here because this transition almost pays for itself in the improved energy performance of the building.

When we touched on it yesterday and talked about the complexity for brands and complexity from our industry colleagues at Fletchers, that is the reason why we need this line in the sand, possibly structural separation, because we would start from a clean sheet of paper. It would be a sensible output of the final report to discuss these ratios that we might achieve and the EPC ratings would be a public debate because people talk about the end of the world coming, rents going up, housing crisis. But it's an inevitable progress, the debate would end up whether it's introduced in 2040 or 2035.

If there's truly market segments of residential assembly, quite quickly luxury and premium would adopt these standards and people would understand that these regulatory ratios being imposed on them would pay for themselves. Thank you.

Mr Eagles: Is it possible to step in and support Tex on this because we're one of the few countries in the OECD without Energy Performance Certificates. And it's very clear that if we have these sorts of ratings, it helps the market drive change. So, let's just address a couple of things.

Currently, the average home we build is five times our carbon budget aligned with 2 degrees, five times. So, we've got, you know, we're in a climate crisis. I think the report should significantly increase the emphasis on carbon. There's nothing in the summary documents or upfront early on in the report. That is the first thing.

Absolutely supportive of Energy Performance Certificates. A similar regime for office buildings has, by enabling the market to drive change, once you put labels on homes or buildings, is a push towards some more energy efficient homes because people don't want to be selling a home that's performing badly.

And the scheme in Australia for office buildings, a voluntary scheme to label office buildings has delivered $1 billion worth of energy savings as people self-invest in improving the energy efficiency of the buildings.

So, this can really drive change and I agree with Tex about a drive towards offsite which can reduce health and safety issues, improve performance and reduce waste to landfill, which are equally significant issues for our sector. Kia ora.

Dr Johnston: Thank you, Andrew. Just before I come to Mark, if I come back to you, Andrew, I guess the focus of our study is on competition for supply of building supplies, so my question is, what you're talking about is the benefits in terms of reduction of carbon emissions and the long-term move to green buildings. The question is, what impact is that going to have on competition for building supplies?

Mr Eagles: Yes. So, what we found in other countries is when you have the energy labelling on the homes or buildings, what that does is shift the market towards the higher performing homes, and that increases the interest and engagement and energy efficient or green products.

So, for instance, in Australia you saw a huge uptake in more energy efficient heating and ventilation products. You saw a huge engagement in commissioning buildings and more energy efficient facades as the market moved from 10% of buildings being energy efficient to within 9 years over 50% of buildings being at an energy efficient level, and that saved the market $1 billion worth of energy bills.

Dr Johnston: Thanks Andrew. I come now to Mark Framer.

Mark Framer: I wanted to come in on this point regarding EPCs and energy performance regulation and just give a very brief UK perspective.

It's been quite an interesting transformation in our market even in the last few months, no doubt related to the energy crisis we've had in Europe linked to the Ukrainian conflict which has had a huge impact on the pricing of heating homes and power.

But what it's done, is it's started to drive an arbitrage in the market in terms of the domestic consumer propensity to purchase or to rent properties that have higher performing energy credentials.

So, certainly the EPC rating, as it's called for driving consumer awareness and for driving better outcomes around carbon, after many years actually of that green credential aspects of certainly domestic housing not being price sensitive, so actually not driving values and actually being seen as a cost to housing developers, as opposed to the right thing to do.

So, I mention that in the context, it's relevant for what I'm going to come on to say on offsite manufacturer because the two agendas are linked but all too often this degree of agenda is seen as a cost, where in reality I think it will drive value which is an important reflection point in the UK and I think it's increasingly going to be an international trend.

Dr Johnston: Thank you for that, Mark. We are at the moment talking about the benefits of some of these technologies. I guess the question for my mind is also what are going to be the costs for rolling out EPCs? I am not sure if people have got a view on that. I don't know if we have anyone from Auckland Council online who might have a view on that?

Mr Eagles: I can comment briefly on that. And I would just say that we had the Ambassador to New Zealand from the EU speaking at our Housing Summit yesterday and about two-thirds of the policy initiatives that the EU has to dramatically decarbonise their sector were based around Energy Performance Certificates of homes.

So, you know, they have regimes where you won't be able to rent out by a certain date if you're not at an Energy Performance Certificate level. You can't gain funding subsidies for solar if you're not at a certain Energy Performance Certificate level.

So, I just highlight also that an advantage of EPC is it creates a regulatory lever to drive change towards lower carbon and greener products, which is what the Commerce Commission is looking at.

In terms of costs, there would be, I would suggest, one or two years working with the sector to create a regime that could work but most of the OECD has ratings in place that we can easily lift up, utilise and amend for Aotearoa New Zealand.

And then in terms of actual costs, the standard costs in the UK when I was there, range between under 100 pounds up to 200 pounds or so per house for that assessment, potentially more. But that's the kind of indication for Kiwi whânau and families when they're looking to sell their home or rent out. That would be the implication day-to-day, if that helps.

Dr Johnston: Thank you for that, Andrew. Anyone else got anything they want to contribute on the EPC issue before we move to offsite manufacturing? Tex?

Mr Edwards: I'll just close off, I'm going to start with 75 quid per property to get an EPC rating but essentially, it's a 20,000 pound, 50,000, 100,000 pound refurbishment or rebuild number.

In New Zealand, I would argue with the Commission that if you owned a vertically integrated aluminium window manufacturer or you had an exclusive aluminium extrusion business, it would be really strategic if you went to EPCs because we have discussed plasterboard at this conference but we haven't discussed aluminium windows and the exact number, for ease of conversation, is three or four times international costs on aluminium windows. And that's where a lot of the EPC discussion is held because you're going to mandatorily double or triple glazing.

And you're also changing the structure of the industry in New Zealand because remember a pathway to EPC ratings, even if you're giving residential landlords, including Kâinga Ora, 10 years notice that you can't rent out a house without an EPC rating of B in 2035, you've got your runway, today we're building 50,000 homes, 10 years ago we were building 25,000, you're really changing the structure of the industry. I don't want to bore everybody, I'll manage it in the cross-submissions, but it is quite an exciting time for a reset of the industry and it does come back to the structural separation issues, particularly in aluminium windows, plasterboard, because you're talking about an industry reset, not dissimilar from 1936 when we had Fletchers talk to Stuart Nash's grandfather.

Mr Clarke: The conversation about green products generally, one of the challenges you've asked us a couple of times is how will this generate competitive outcomes. Can I suggest in three ways?

We're experiencing genuine demand upwards from customers demanding better green - what I would say, climate change approved price from asphalt that will change with the changing environment to cheaper and lighter weight concrete, all through the product mix that we see, genuine interest from customers demanding new things.

So, that's a real hotbed of a competitive opportunity for everybody to pivot their products, pivot their manufacturing towards something, and that's genuinely occurring across the industry.

The second I see is we're trying to stimulate that as a manufacturer level or distributor level, we are trying to find the product and then stimulate and that creates a competitive opportunity. We're trying, for example, at Fletcher Living we're trying to build a home that over its lifetime will operate at 1.5 degrees. It is a pilot project that we are really proud of. It will literally be sold to the consumers in the next few months. It's taken a co-operative and collegiate effort right across Aotearoa to get the architects, the right objects. We've learnt a lot in that project. I think we've submitted to you some evidence of that but I would encourage you to literally go and see it. It changes the way people live, as opposed to what they buy. It changes the house they live in. There is a top down stimulation, into Andrew Eagle's point, that needs a knowledge and education component to create the competitive.

And then I think the third way that competition is being stimulated is regulatory. The example I will give there is insulation. The government changed the regulatory standard and instantly everybody has got to try and find a better or different product to meet that and you see the builders all going, "Can we have 6 more months?" because actually, that regulatory change is pretty big and it's causing quite a shift and we're seeing that as a real opportunity, who's going to be the successful competitor on the other side of that shift? We have announced to the market that we will have to reinvest in our operating plan.

So, there is quite a vibrant competitive process and it might come as a surprise for you to hear me say I actually agree with Tex but we agree there is this pivot moment, where we transition over the next few years. I don't think it's 25, I think it's in the next 3 to 4 to 5 years. We have put our concrete business on a low carbon diet and they really have to genuinely change the way they operate.

And so, that's going to change everything at all levels.

Dr Johnston: Thank you for that, Andrew.

Mr Clarke: It's very exciting.

Dr Johnston: My sense was that was on the horizon.

Mr Clarke: It's here and now, it's absolutely here and now. There's more to do on all three fronts but it's genuinely present.

Dr Johnston: That is very encouraging and, as I say, exciting to hear. So, perhaps on that note, we'll move to offsite manufacturing.

Offsite manufacturing is the process by which any part of a building is made away from the final site of the building, it includes a wide spectrum of products and processes.

OSM can include the factory assembly of a basic floor, a wall, a roof truss or frame, components such as windows, more complex panel products such as structural insulated panels and full modular buildings or hybrid pod and panel components ready to deliver to site.

In our draft report, we noted that offsite manufacture offers a range of potential benefits, including speed of construction, better building performance, such as air tightness, less waste and improved employee health and safety.

In the past, offsite manufacturing has faced some challenges with the consenting system being designed for bespoke builds but we hear there are significant steps underway to address that.

And offsite manufacturing has the potential to increasingly compete with traditional key building supplies and, over time, to disrupt some of the existing supply chain structures in the industry.

Submissions on the draft report generally agreed that the headwinds or impediments for offsite manufacturing relate to the scale of investment required and the certainty of the pipeline required to support that investment in offsite manufacturing but indicated the report could go further to identify government support as a key measure. Our draft report also referenced the idea that offsite manufacturing can potentially disrupt a fragmented construction industry and traditional supply chains. Some submissions agreed that offsite manufacturing could have this indirect impact on the market for key building supplies, but emphasised scale and government support is required for that.

So, I guess the first thing I'm keen to get a handle on is the extent to which the existing consenting system still creates some impediments or headwinds for offsite manufacturing or are things on the improve via the Modular Component Manufacturing Scheme?

We've heard that MBIE is making significant progress through its Modular Component Manufacturer Scheme to address issues within the regime, the consent environment, but is compliance with the regime the requirement for audits, the need to establish the manufacturer has adequate means, still likely to impact its effectiveness and uptake?

Has anyone got any thoughts on the steps going forward?

Mr Fisher: I will open with some comments. I think, first off, congratulations to the Commission. This is probably the most comprehensive formal conversation we have had about offsite in over 3-5 years, so it's great to be having this sort of conversation, it's long overdue. Encouraging that Mark Farmer is online, so congratulations. Good morning, Mark, you must be up late.

The lack of pipeline remains the major handbrake on the industry.

Interesting about competition for but also complimentary to the construction industry. It can deliver solutions to the traditional industry. One thing I would like to raise also is mandating and incentives and talk about that a little bit more as well.

The work that MBIE has done is significant, as far as BuiltReady, the certification scheme, 5 years in the conversation, BuiltReady being launched two weeks ago. We, from a sector, are excited about the potential and the opportunity of it but if all of the other issues are not dealt with, that potential will not be realised and we will be having this conversation in 10 years time.

And our advice to MBIE is that policy is one thing, execution is another. And I think over the years there's been a long list of good policies that have failed.

BuiltReady has the potential to be yet another one which would be disastrous I think for the offsite sector and also for the traditional construction industry. So, the advice is to make sure that

BuiltReady works. Companies need to be either sponsored through, funded through the certification process to de-risk it for them to get learnings for MBIE and to then encourage others to come into that.

A big part of it will be that if someone applies for it, they need a competitive advantage. You are not going to put that resource, time, effort and money if you don't come out of it with a competitive advantage.

And if that advantage is clear, then that drives competition. The first mover will get a competitive advantage. And then the competitors will quickly follow and lift the whole industry up.

So, top marks for a good idea. The jury is out whether it will work. I hope it does and the industry is very, very supportive of the work that MBIE is doing and will do everything that it can to make sure that it does work.

Dr Johnston: I want to come back to mandating incentives.

Mr Fisher: Please do.

Dr Johnston: Because that is an intriguing topic for discussion later. But if you had to sort of list the top three issues to be addressed, to really achieve progress in this area, what would they be?

Mr Fisher: Commitment and scale, and Mark no doubt will contribute to the conversation.

There's a lack of understanding, the difference between construction and manufacturing and what makes manufacturing work, and you need certainty, you need pipeline and you need commitment going forward.

I think there's been some casualties in the market who have entered into the market on the hope that that pipeline would be there and maybe some of the promises that KiwiBuild promised the industry, lots of people jumped in pretty quickly on the promise, it doesn't deliver, they tip over.

And there's other companies that have kind of held on for a very, very long time and ultimately at some point they just step out of the market.

We are excited about the industry because there will be other players that come in and pick up those businesses that do fail if they are not there.

So, when it comes to, in some ways it ties it back into mandating and incentivising, which drives the pipeline and the commitment going forward. And I think out of the UK, there's some prime examples of how Homes England supports the industry. I met with an offsite manufacturer in the North of England, Homes England provided them 30 million pounds to guarantee capacity. There's a grant system to community housing groups, so that price is no longer part of the discussion because they understand the difference between construction and manufacturing and they also understand that there's a stage, and Mark will talk about it no doubt, will be around the start up to scale up stage of a manufacturing operation.

Dr Johnston: Thank you for that. Just while we're on the existing regime, life as it is at the moment, a couple of very specific questions I wanted to dig into.

And that is, how you're encountering your experience with BCAs at the moment? In the sense that I get the impression that some BCAs have moved reasonably away and are open to this, whereas others are a bit reluctant?

Mr Fisher: The Building Act was never designed for the offsite sector but credit to the offsite sector, they have in some ways flourished in many ways over the last 20-30 years, with a lot of friction in the system and have built a product and a business to overcome that.

If you take that friction out, those businesses could do so much more, so much quicker. Yep, there's very pro Councils, Auckland City Council is a great example of really being on the front foot but we often find the industry will say "There's a personnel change at the local Council, they used to understand us, they no longer do and I'll spend the next 6 months going through the whole process for them to understand the business".

So, I think BuiltReady will help with that. The consenting process in the Building Amendment Act is splitting, the proposed is to split the consent into a part A and a part B. So, again, great idea, let's make sure that it works.

Dr Johnston: Thanks for that. I would like to come to Fletchers for a moment, just one very specific recommendation in your submission, which was related to the Licensed Building Practitioner requirement and how appropriate that was in the context of offsite manufacturing or otherwise. Can you speak to that, Andrew?

Mr Clarke: Yes, thank you. It's similar to the previous point, the Act isn't really built for this. So, what we've got is we're swimming against the grain is the way I like to think about it. It's a bit of hard work and one of the clear examples is at the moment you're meant to have a licensed builder standing on a machine. We don't have fully qualified engineers in car manufacturing plants. There's a difference between manufacturing. So, we're working around it. I totally agree with the previous point, that if it was easier to do, it would be cheaper and more accessible. They're little wins.

We support, we think most BCAs and particularly MBAs really want this to work. We think there's genuine interest to make it work. Our Clever Core operation should work better than it does. Byside is still the problem, so if we had more customers and more opportunity to sell that would create more volume but then the regulatory issue you just described would then become the number one issue, so it's genuinely an impediment or a resistance point but I don't - yeah.

So, we get it and we think New Zealand needs this industry to work, we think it needs to work better than it does at the moment.

Mr Fisher: Just to follow-up, often that friction removes all of the value that's created in the offsite process. All the benefits can quickly evaporate. An example, an offsite builder up in Tauranga had a house ready to go on the back of the truck out of the yard. The receiving Council refused to approve and therefore that house sat there for four weeks.

So, all of the value that was created in kind of an offsite process through a Council's decision to be difficult or to not understand evaporated all of that benefit for the business, for the client. And ultimately, for the Council as well. I think they need to understand that if they can get their houses built quicker and tenanted quicker, that's actually good for them, good for the community. People start paying their rates a lot quicker.

Dr Johnston: I just want to throw out the question of what opportunities exist to make New Zealand's building sector more efficient and cost effective by greater use of offsite manufacturing, particularly the construction componentry?

Mr Fisher: I might jump in and start off. Look, I think the offsite sector, there's more players coming into the market, there's good operators there, they're doing really well.

I will give credit to government around regulation and about trying to make the system work and address those things.

I actually think one of the biggest handbrakes is the construction industry itself not putting it through as a solution. And then we come back to mandating and incentivising. It's a couple of levers that, you know, for the offsite sector to become mainstream, you need four things to happen. You need a good offsite sector. You need the traditional construction industry pulling it through as a solution because it can be both competitive and also an improvement to the traditional industry. You need government making sure the regulations all align and take all the friction out of the system. And you need clients demanding it as their preferred build solution because they get all of the benefits, speed of completion, less disruption on-site, all of those things.

The price point has always been we've stopped talking about price because it's conditional upon so many other things which are not being addressed. So, until we address the fundamental challenges withholding the industry back, you won't get to the price discussion.

Mr Edwards: Kiwi Infrastructure has spent millions of dollars modelling transformation of economy market segment houses at scale. There's a chicken and egg situation here. We note in the final report that it's scale pipelines and standardisation and big dollops of capital. I don't want to sound boring but actually, with regard to my Fletchers colleagues, if they were to participate in this industry at a government contract level, there would almost absolutely have to be structural separation because otherwise, on a game theory basis, you would perpetuate the supply chain and equities that we have today.

A scalable OSM industry in New Zealand, would almost inevitably create new vertically integrated supply chains and it wouldn't bring down the cost of construction in economy market segment by 20%, 30% or 40%. It would be a minimum circa of 50% reduction in cost per square metre, so Kâinga Ora could be building scalable houses on a standardised basis of 1100.

I put to the Commission that it would be a sensible thing to spend some of your analysts to Mark Farmer's best reference sites in Europe, and thanks again Mark for turning up at 2.00 in the morning. My industry colleague Scott Fisher could come up with international best practice where industry analysts could catalogue the difference between some of the Mt Roskill, Takanini, Albany, Kâinga Ora building sites and some of international best practice to get a vision for this.

Closing off, our vision of an offsite manufacturing entity is one or two businesses with $200 or $300 million worth of capital, which is currently four or five times more capital than Fletchers Residential has. It would have a dramatic impact on the third operator, ITM, because they would almost have to engage in it.

It is not a pipe dream because you have seen Kâinga Ora going from building 100 houses there to

7,000. And, as a consequence, there's a nice 1,000 houses a year pipeline that could easily be targeted to OSM.

I urge the Commission in the final report to have OSM targets for government procurement. And it's very important that the government transform this industry because the private sector isn't going to do it.

What we've heard in this conference is that the private sector has vested interests at stake. And the private sector has a scale, no scale in funny places. It's really important, and we've covered it off in submissions and we will do it again in final submissions, that we talk about the margin and margin culture.

If our Commerce Commission analysts were to go to international best practice OSM under the guidance of Professor Farmer or Scott Fisher, and then they went to some of our Kâinga Ora building cites, they would see this margin on margin culture, where the electricians and plumbers are supplying their own kit. There's 20 houses here, there's 20 houses here, that are very similar configurations. The moment they travel to international best practice, they would see dollops of 200 houses going in, with very similar standardised designs and all the benefits of OSM that we haven't canvassed.

I really urge the Commission to look at the business case of scale and the new culture at Kâinga Ora. Thank you.

Dr Johnston: Tex, just while we're on that subject, in the perfect world, if you look 5-10 years out, what do you see the OSM world view in New Zealand being? Would it be one or two big players in that space or a number of smaller players?

Mr Edwards: Thank you for asking that, thank you. If we're building 50,000 houses a year, I see luxury and premium being built pretty much bespoke as they are now. But I see luxury and premium benefitting from the new economy market segment which is OSM. I see 20-50% of Kâinga Ora houses being built in OSM. I see almost 50% of the EPC rate of houses, the houses that need to be retrofitted or replaced to meet EPC ratings being built in OSM.

I see a world class wood products business coming out of the 25 year rotation pinus radiata forests we have in New Zealand, like Sweden, building panels. I would see ITM would be selling panels. And we would see 30-50% of economy class market segments. So, if there's 50,000 houses per year being built, there's 25,000 in economy, I would see 12,000 houses being built in OSM.

And the impact for the consumers of New Zealand, who are not represented at this conference, it's like $3.5 million on your pension because the net present value of the cost of construction difference over your pension time, I know that's an Andreas-style equation but I thought I'd put that out there. So, thank you for asking that question because I find it desperately therapeutic and I will catalogue it.

Dr Johnston: Okay. I'm interested to hear from Scott or Andrew or Mark in terms of any thoughts on this topic?

Mr Fisher: Another part of the vision, so at the moment 100% of residential new builds use frame and truss. Why in 10 years time does every new build not use a panelised system? Why is every new build not weathertight within two weeks, within one week?

If we want to talk about productivity, sustainability, workforce health and safety, physical and mental, we need to aspire to a built environment that performs far better than it does. That's where the offsite sector can both be a competitive driver but also it can lift the whole industry up by improving, by giving, and in the UK, Mark will no doubt talk about it, kit parts. If there was a panelised system that was universal, standardised, your builder in the van could use that system as much as any group home builder. That is a vision worth saying, "How do we do that?" And I think the challenge within the construction industry, there is no vision, there's no 10 year vision, no-one is saying, "This is where we want to be and how are we going to get there?"

I think we're just thinking constantly about this rolling 6 month challenges that we seem to have and I think if we have these kind of more lofty visions and then the whole industry tries to work that out so that panels are available to every builder, I think that's a vision worth pursuing.

Mr Farmer: Just to add my thoughts here. So, you know, I echo a lot of what Scott and Tex have both said. If I give the UK context here, the main driver for the British Government wanting to drive OSM and modern methods of construction FMC from 2017 onwards when it really started to come to the top of the agenda in housing policy terms, is probably twofold. One was about market diversification which is directly relevant for your Commission and the questions that you're asking about market shape and structure.

The other thing was about market and industry productivity, so there was a real feeling that productivity and construction in home building was pretty poor and that was having an economic impact in terms of the scalability to deliver homes and infrastructure in the wider construction sector.

So, I think for me, you know, I start by saying, it's been said already, that this is a hugely complex subject. There's a lot of different things going on that drive industry change and transformation that you have to address. And probably the best way so to sort of set the context of this is how the UK have started to go on this journey and we are not there yet by any stretch of the imagination.

There's five fundamental building blocks at the MMC strategy in the UK. The first element, they're effectively five S's; stable, stimulation of market, standardisation, safety and soft levers. And I will very quickly go through each of the five so you understand what it's about.

So, scale is this point about the need for market aggregation and numbers.

Industrialisation is a numbers play. So, if you make it work economically as a model, you need to have demand, numbers that are aggregated and bulked up to underpin investment in different modes of delivery. It is one of the biggest barriers to market change and transformation because the construction industry, and I know having been to New Zealand several times, it's very similar in structure in terms of its fragmentation in particular. It is a hugely fragmented market. The supply chain is characterised by a few big players in a massive tower of MMCs.

So, that ability to aggregate or demand and put it to market in a way that's very different to how the market currently works, is a huge challenge. And that's where the government comes in and that's why scale is the first and foremost element of the UK policy, in that the government has recognised it needs to play a role in driving that scale through its own commissioning behaviour, acting as a client through its social housing programme, so our equivalent of Kâinga Ora which is Homes England have got pretty muscular in this space around mandating and driving the commissioning of MMC through its own funded programmes and we have about 16 billion pounds UK sterling of social housing that has various influences around creating demand for the OSM market.

Stimulation is about supporting the supply chain. So, the worse thing you can do is stimulate demand and then find your MMC supply chain is not mature enough to deliver to it. Then you just have another version of traditional industry failure, the market can't deliver. So, you have to be supporting the responsible, high quality players who are active in this market, both big and small.

So, you need to have different measures in place around working capital funds, the ability to support investment and machinery, training etc. on the supply side of the equation.

Standardisation, really important because it leads to scale. So, the idea of coming up with more commonality around how you design homes, how you design buildings actually, and coming up with more uniform approaches to elemental and whole home design is critical because then you can aggregate your scale against pattern books, design codes, things that are hugely influential in terms of driving a different commissioning model.

Safety, highly relevant in the UK post the Grenfell fire, in terms of making sure when you innovate, you innovate responsibly and it has to be a quality first culture. The work in New Zealand around the Amendment Act that you've done, I would say is world leading. You are right out there in terms of having taken an international leadership position here. I have reference to the UK government, I brought together the Department for levelling up housing and communities with MBIE to drive a discussion about international collaboration. Your work in driving the regulatory environment support offsite is excellent, it just needs to be implemented and it needs to have these other facts overlaid on it.

The last element around soft levers is the indirect policy approaches that can drive OSM. For me, there's three primary areas. One we've already spoken about, which is carbon, so there is an implied proxy in construction and moving to a manufacturing model, which is less wasteful. If you use less carbonised materials, you will reduce the whole life carbon footprint. If you have a carbon policy, which the UK has, it becomes indirect proxy for a move towards an MMC or OSM.

The other way of doing it is incentivising for building control which you can do through your Amendment Act, so implementing that to fast track Building Code permitting and the ability to get on-site quicker. Scott's point about planning, and planning is over here because you're only as fast as the weakest link, so you have to attack on all levels, Building Code, building permitting and planning all needs to be lined up to drive towards the outcome.

But for me, just in closing, I would say that the opportunity here to disrupt the market is a critical element for your Commission to think about because if a move to MMC is done well and it's supported well by government and it's a long-term strategy that isn't stop start staccato, then you will diversify the market. You will drive a different mix of building materials, so the new innovative technique will use a different concentration of raw materials. And if you leave that to overseas partners, you can drive the alignment of different supply chains outside the domestic supply chain, all of which should co-exist. This is not binary and this is not, you know, you turn one off and turn another on, everything should co-exist to drive a healthy competitive environment and an innovative environment that drives better outcomes.

Dr Johnston: Thank you for that, Mark. I just would like to lead on from an issue I think you've just touched on, that is the impact of disruption on the traditional building sector. What degree of scale was required before you get that level of disruption in the traditional sector?

Mr Farmer: I think there is a really important point to make here about the move to MMC is not binary. One of the measures we have adopted in the UK, is a term called pre-manufactured value, PMV. And what that effectively is a percentage of a project that's manufactured as opposed to in-situ site constructed. Every job has a PMV, a traditionally built job in the UK has a MPV of about 40%, if you think 40% of its value is materials. 60% of it is on-site labour, preliminary overheads, temporary work etc.

So, this transition from traditional construction to OSM is incremental and it actually in many respects is happening under the radar. So, the impact on the traditional market should be negative, in the sense that you have a huge disruption landing at this place's employment, it creates negative, you don't want negative disruption, you want positive disruption.

Our experience in the UK is general contractors in the supply chains are moving to a high pre-manufacture value. Primarily, in the UK we have a growing labour crisis, our very skilled trade labour is under pressure at the moment. So, contractors will be working this out for themselves and they are moving incrementally to a higher PMV.

Where you have housing that's being delivered by vertically integrated and MMC manufacturers that are turnkey providers, then what you do is you create additionality into the market. Rather than incremental change of physical construction, you are bringing new players in to actually co-exist with the traditional market.

But, in my experience, this is not - this should not be seen as a frat to traditional construction. It should be seen as something that moves traditional construction to a different place and then has a different method and more choice for the market to actually decide how it wants to deliver homes in the future.

Dr Johnston: That's ultimately what we want, I think. We have a couple of other people who want to contribute.

Mr Eagles: I was just wanting to build on that, Chair. Sorry, Andrew Eagles here and I was about to speak, Mark said it far more eloquently than I would. I was at the Homes and Communities Agency in the UK for 13 years in London before I came back to Aotearoa New Zealand, and I really appreciated their scoring mechanism. Of course, offsite, you know, pre-verification is a continuum. They have weightings as the further you went up but I think in getting excited about the final step, which is complete prefabrication offsite, we shouldn't miss the considerable wins you can get just from, for instance, the prefabrication of some elements. So, for instance, pods for bathrooms, or, you know, as Scott has mentioned, panelised systems.

And I think I would urge Kâinga Ora community housing providers to have a similar weighted system, whereby the further up the OSM continuum they go, the more heavily weighted those proposals are to build projects. I think that's a really easy step.

I absolutely agree with Mark. When I was there, we saw a move towards greater OSM on the back of greater carbon and waste reduction targets. Something government is already pursuing. So, the more the market is required to reduce waste going to landfill, currently 50% of our landfill, filling up of our landfill comes from construction and demolition. We should be driving that down.

And greater air tightness. Those things and carbon reductions, those things drive us towards OSM. So, it's to be supported by this Commission and will help the uptake and investment of OSM providers. Kia ora.

Dr Johnston: Thanks Andrew. I think, Scott, you're wanting to -

Mr Fisher: Just an extension of that kind of PMV example. So, 40 years ago we used to deliver 4x2 to a building site, make up our frames individually on each site. Frame & Truss industry came along, now 100% of new builds use the Frame & Truss system. Why don't we just put something extra on that frame before it gets delivered? That's just a PMV example. At a minimum, put a rigid air barrier on it, put windows in it, clad it, put doors in it, plumbing, electrical if you want to but it's this incremental step is not happening within the construction industry. There is an advancement, then a stop for decades, or if not a generation. And I think we are now really having the proper conversation of what is the next step?

And I think PMV is a great way to describe it because then the traditional construction industry will start to put it through as a solution because it will fix a lot of the problems that they currently face.

Dr Johnston: Thanks for that, Scott. I want to move on. We've talked about the need for offsite manufacturing to need certainty of a pipeline, given the extent of capital investment that's required, so I am just interested to hear from people in the room how they sense the availability of a pipeline at the moment or what's needed to get a pipeline in place? And certainly, if Kâinga Ora is online, if they're able to contribute their perspective as well, that would be useful. Scott or Andrew, do you have particular views, Andreas?

Mr Heuser: I think Tex referred to it as well but Kâinga Ora procurement arrangements seem to result in a range of small contracts and builders completing small consignments of houses. And possibly all converging on the same two, for example in South Auckland, the same two merchants to buy products for the same end consumer or end buyer, the state.

I think Kâinga Ora and the Commission could consider this as a recommendation to look at a long-term secure pipeline of a procurement process that secured a pipeline of builds from say one or two large house assembly firms.

Dr Johnston: Any other comments?

Dr Small: Can I just jump in here on that one? Is there a distinction between that approach that you just outlined, Andreas, which sounds as though it might be, sort of, explicit procurement of a full OSM house or a couple of hundred full OSM houses of something of that nature and contrast that with the existing situation which you've said is like 20 houses here, 20 houses there. If we have this approach where the target, where there was a target of, say, I don't know, 20-30% of OSM by build value in the house, then would it be so much of a problem if they were 20 here and 30 there, as long as each one of those was driving? Do you see - am I making myself clear?

Mr Heuser: I don't know if we need to specify OSM but you could design a contracting model which was results based. So, deliver a certain number of houses for a certain price point and deliver that in whichever way you want, whether OSM is the most efficient way, and you organise your firm in such a way that you have your supply chain secured and whether it's offsite or onsite but you do it in the most efficient way. We've heard OSM is a really efficient way of building houses, cost effective, cuts out all the margin on margin that we've heard about. So, I think ABC is agnostic on the practicalities of how you do that.

Mr Edwards: I think it is essential because we're talking about industry transformation. We need to take a leaf out of the Fletchers playbook here. And Fletchers are absolutely constructive and I want to read a paragraph from the Fletchers history book where Fletchers, Sir James Fletcher told a group of Canterbury housing advocates that if there was to be a choice between standardised comfort and individualised mystery, then there would be standardisation.

And I refer to the fabulous conversation that Sir James Fletcher had with Lee, James Lee, and Walton Nash back in 1936, because they transformed the industry and they got standardisation in place. Unfortunately, well fortunately for whatever reason Fletchers used the profitability of their standardised housing where they got 50% of the government contract in 1936, they built a building products business around that and then they later monopolised that and pushed it to one side. From 1936 all the way to the mid '60s they delivered an economy market segment. Unfortunately, they bought new housing in Beazley and then shut that down.

We are talking about a fundamental revisit of 1936 principles because the economic impact statement of OSM, where we got 20% or 50% of economy classes built in OSM, we're going to go from $4,000 a square metre, which is world's best practice, to $1,000 a square metre, even if we went from $4,000 to $2,000 that's quite a lot of economic displacement. What we've heard in the conference to date and joining the dots of how this all fits in with the conference and why it's relevant to this study and some outputs in the final report, is that we've got a margin-on-margin culture. Although I would be the first person to declare that we have monopoly rents sitting in Fletcher profitability, that's not the issue. We've got the difference between $4,000 a square metre and international best practice of $1,000 is actually this inefficiency smoke where we've got the state having margin-on-margin concepts.

And so, how it leads to the output of the recommendations in the final report, joining the dots, is we need these scalable pipelines that create capital. We need fresh players.

Dr Johnston: What are the impediments to those pipelines at the moment or what do we need to achieve that?

Mr Edwards: I get frustrated listening to my own voice but the issue is, in New Zealand we have Kâinga Ora and we have CHPs, and we don't have a, sort of, united economy class market segment. And some of the really important evidence that we collected, if this is my imaginary whiteboard and this is a picture of South Auckland, that is a picture of the Sky Tower there, Harbour Bridge there, PlaceMakers there, Carters there, if we've got this many social houses being built, some of them are Kâinga Ora, some are CHPs, they are competing amongst each other to buy through the same supply chain. The opening principle of the Terms of Reference of the study was discussing whether we like bespoke or standardisation. That's why that 1936 politician statement pertaining to the '36 transformation construction is important because we are talking about a government intervention here and we do need to set targets at the scale.

And I put to the Commission, it's circa 200 million to 400 million of equity capital and you're talking about billion dollar orders in the context of City Rail Link or Transmission Gully. And those type of transformation projects with international best practice that my industry colleague Scott could talk to or ITM could talk to, would create this transmission. But it's going to create a displacement of the existing plumbers, sparkies, drainlayers, roofers, plasterers. Those people are going to go to premium market or luxury.

Dr Johnston: Scott?

Mr Fisher: Was the question was how do we drive scale?

Dr Johnston: Basically, it was in terms of how do we get the pipleline there at the moment.

Mr Fisher: First, you need to channel the existing into a pipe and into a business who's screaming out for that commitment. It's as simple as buying capacity within an offsite manufacturer but not 100%. But, again, if you think of Ilke Homes in the UK, Homes England, here's 30 million pounds to get your capacity as high up as you can. They've been operating for 5 years, they probably haven't quite got 100% capacity yet but it's about a proper commitment by the government and government agencies, and that commitment will demonstrate that they understand the difference between construction and manufacturing. And because there's no understanding really of between manufacturing and construction, that commitment, whilst the industry has been screaming out for that commitment for probably 5 or 6 years, if not longer, it just really hasn't materialised in a meaningful way.

So, that's part of the challenge around scale, it's just no-one is stepping forward and putting money on the table and saying we're going to commit to this part of the industry to support it because they don't understand the difference between start up and scale up.

The other part of scale is about consolidating orders. So, currently in New Zealand, all of those CHPs have an individual relationship when they purchase. Whereas, in the UK they will either collectively come together, consolidate orders and then go to the market. And if you are able to do that, then that would drive that commitment further.

You talk to the CHPs, in many ways they should be incentivised to adopt an offsite strategy, so that they drive the industry forward.

Another example is MOD. So, we had a conversation with them last year, half a billion dollar rebuild. The conversation kind of went along the line, "Persuade me why we should do offsite". It was kind of the wrong conversation to be having. It's kind of offsite and onsite should be in many ways joined at the hip. It should be both.

And again, if we talk to our UK colleagues, they say offsite really got traction also when Treasury got involved because Treasury would come along with the purse and say, "You can have this money on the condition that you have an offsite strategy. If you don't have an offsite strategy, you don't get the money".

So, again, and I don't know where Treasury is in the conversation, are they at the table having the conversation? You know, we've got the government procurement guidelines but, you know, are they just guidelines? Is anyone following them?

Because if you're following the procurement guidelines about what was good for the industry, what was good for society, what was good for the workforce, then a lot of those agencies should be going down that offsite track anyway

Mr Edwards: I haven't discussed it with my colleague Scott but actually this is a Treasury discussion. I would have thought that the final report would have these draft recommendations similar to other market studies. I know we're in new territory with market studies but this is a Cabinet discussion item like City Rail Link, Transmission Gully, that fantastic tunnel they built on the freeway in Auckland because this is an infrastructure transformation and it's a government intervention into a very broken industry and hopefully the final report will show how broken this industry is by - we had a great draft report where we talked about $2,632 per square metre versus international best practice $1,100. But we aren't discussing the weather here on OSM. We're talking about scalable transformation to meet international best practice and we're talking about turning death by a thousand cuts, the industry so complex to understand we've had had all vested interests discuss this, to a sensible transformation programme.

Mr Fisher: Credit where credit's due; there is a lot of good people in government doing some really good work. I feel sorry for them because they're doing it in isolation. There's no overarching strategy to where the industry needs to go. MOE is doing some work in the offsite space, a great time in MBIE, KO have an offsite team, Ministry of Defence are starting to think about it but they're all individuals kind of doing their own thing and, again, the irony is that we've - whilst Mark was complimenting New Zealand on this regulatory position that we're taking, which is kind of world leading, at the end of the day the substance that sits underneath to make that work is missing and it's been missing for such a long - it's never been there, to be honest.

So, as I say, there's all these pockets of good things that are happening but it's really not delivering the full potential of what we're requiring.

And also, we're not connecting the offsite conversation with everything else that we're talking about as sustainability, reducing the carbon footprint, workforce development, all of those things.

I read so many White Papers and discussion documents talking about all of the problems in the construction industry and the first thing I do is a word search on "offsite", "MMC", "prefabrication" and often all of those documents, it comes up zero. They're just not referenced. In some ways, it is tied into how do we drive scale? We drive scale by making sure that the conversation, right from the top down, is consistent in how it works.

Dr Johnston: What I picked up from your submission, is you sense there's a lack of government being joined up across government?

Mr Fisher: They're just not backing up the policies that they are developing. Again, it's a KiwiBuild example, great idea, just not executed, and then you lose the faith and the trust of the industry as well. So, the next great policy that comes along, everyone is oh, that's just going to be another KiwiBuild.

I genuinely hope, I think it will be an indictment on this country if BuiltReady is collecting dust in 10 years time. That would be an absolute crime.

Mr Edwards: I have to speak up and call a success where I do see it. I know it's not very popular public policy discussion subject, people will throw rocks at me, but actually, the KiwiBuild aspiration and the Kâinga Ora delivery has the green shoots of a fantastic public policy success. 7,000 houses will be built this year. Tens of thousands of houses have been built. A new organisation has been built. You have to be on the record not just the organisations being built but skills have been built. We need fine-tuning in it and essentially, a deal ticket from Cabinet is not a $500 million deal ticket, $100 million deal ticket. It is a $3 billion deal ticket. It is surrounded by the safety process of government procurement rules but also, the fact that any qualifying institutional OSM operator will have such a commitment to have such a large block of capital, they will have to have $5 million at risk to do all the risk mitigant because OSM isn't a silver bullet; scale is. And, in my mind, the dialogue and debate here is about industry transformation and what can be done with a policy toolbox that we have. It's a Cabinet deal ticket for scale and resolution.

Dr Johnston: I think we're transitioning from offsite manufacturing to the third topic on the agenda which is government procurement, so it's an appropriate segway I think.

Mr Fisher: Just one last comment, and it's always been my observation. I think New Zealand has to be really - actually, the construction industry needs to be really careful because BuiltReady and the change in the regulatory scheme, offshore has an opportunity in New Zealand and, you know, there is the potential that offshore operators could settle a bit of a march and I think if the New Zealand industry does not embrace the potential that's been offered to them, then you might find that there's going to be offsite solutions might be more dominant and whilst we are pro New Zealand, we are not anti offshore. I think it's all part of a competitive market. But I think that's just an interesting observation to make.

Dr Johnston: It is an interesting one. I am a bit surprised the offshore players aren't here already actually.

Mr Fisher: Well, they are here already and even working with Kâinga Ora. But, quite often, the offshore solution has to have an onshore partner but often, and we already know in the market, there are onshore operators that are looking at offshore solutions.

Dr Johnston: Having transitioned onto government procurement, Scott, we'll come back to you and I want to come back to that topic of mandating use of offsite manufacturing and incentives for offsite manufacturing. Do you want to let us have your thoughts on that?

Mr Fisher: To date, every time I raise it, it's like I'm raising two dirty words. No-one wants to talk about it, no-one wants to have a discussion of how it may work. And, as set out in my submission, it might seem counterintuitive that it's going to drive competition but I believe in a selective way it absolutely will.

And again, if we look at other jurisdictions, Singapore, parts of Australia, definitely the UK, there is the mandating lever to pull selectively. That is saying to MOD, "Here's the half a billion dollars you have to have an offsite strategy, what is it?" It's all contestable.

So, that's really as simple as how the mandating lever can work.

For a healthy industry, we need also the clients to pull through, offsite is their preferred solution, either in full or in part. And again, incentivising can help that and we only need to look at the film industry, the electric vehicle market, it's used constantly and why are we not thinking about that? And I get a lot of pushback from the traditional construction industry who actually have some offsite operations that don't want to talk about mandating incentivising and I kind of wonder why.

I think we just need, I haven't got the solutions. I just get really disappointed when I raise it as a discussion point, it gets shutdown so quickly and I think we need to debate it, work out how it works.

We all get hot under the collar about single use plastic bags and there's mandating and incentivising around those. Why aren't we using the same sort of levers to build more sustainably particularly?

And, again, I go back to the Homes England example where, you know, there's direct funding specific to offsite operators because the offsite operators tick many of the boxes the government is trying to achieve and there's this recognition, if you want to shift an industry you need to give some assistance for that shift. The challenge will always be you don't want to overstimulate it, you don't want to over-incentivise it, that doesn't work, but you do needs to de-risk it.

Dr Johnston: I see Brent and Alistair both have their hands up, I will come to them in just a moment. As we've been thinking about the incentivisation issue you raised in your submissions internally, the analogy that was raised was that of the electrical vehicle subsidies which you've mentioned, subsidies for consumers, the grants for manufacturers and that's dramatically changed competition in the automotive industry.

Mr Fisher: Exactly. Another example, so I think ANZ Bank, I can get a cheaper mortgage if I have a high energy performance, I don't know what star it is. It's simply taking that same thinking and applying it to actually, if we're applying that thinking to what the house is made of and how it performs, all you need to do is take one more step back and say, well how is it made? If it was made in a much more sustainable way. So, there's a whole bunch of levers that you can actually then drive consumers to make it their first choice.

Another one, for example, if I have an offsite manufactured house, as a home builder, why don't I get a 6 month rent holiday? Because in my community I've built my house quicker, I've been far less disruptive, there's been less waste go to landfill. So, as a home builder, I should be rewarded for that and Council would say, well actually, if you complete your house 6 months earlier, you will then tenant it quicker and you will pay rates quicker.

So, you know, why don't we just share that gain with the homeowner?

Dr Johnston: Thanks for that, Scott. Brent, can we come to you and hear your contribution to the discussion.

Mr Reihana: Hi, Brent Reihana, National Mâori Authority. Just going back a step into the OSM. We're aware and have been in discussions with a couple of operators, offshore operators. They have been - talking about incentives because it steps into that space as well, what they've done is bypass New Zealand. Their first target was New Zealand but they actually went to Australia. And why they went to Australia was because of our regulatory regimes. In Australia, it was a lot easier for them to implement, given the standards that they have and the product that we're talking about had UN use and was for rapid deployment use in Military operation, used by the UN but New Zealand was resistant to it.

Whereas, in Australia, in the mining industry specifically, they have ratings that were absolutely bang on for across New Zealand, not just one part of it, and I think that's another key. We can't just target areas that are built up that have easy accessibility, good transport. We have to look to the outer areas where housing is substandard and going to Tex's point where he's talking about an economy market, I think OSM ticks a lot of those boxes.

But then just traversing over to the incentives. I think the Crown does need to have a look at this as a matter of urgency, in the same way they're looking at cars, as you say. But I think you need to be a little bit careful about how much do we over-incentivise but where do we incentivise? I think that's a point, where do we incentivise because, as Tex was talking about, we can't be doing building when we're talking about numbers of 20. We need to be doing things that have economies of scale that does add value to those areas and not just because it increases our stock of housing in those cities.

And I think we're on the right track but I think it's across all of these aspects joined up together, the regulatory, looking at the innovation and looking at incentivising.

And I just think, you know, listening to Fletchers as well, it's not 25 years down the track. I think we need to do better and we need to do it faster. Thank you.

Dr Johnston: Thank you, Brent. I think we all agree with those sentiments.

Alistair, you have your hand up?

Mr Fleming: Yes, good afternoon. I'm just going to make an observation that's the situation in Auckland. Apartments make up 50% of the new builds. So, ultimately, the challenge in that market is going to be modular construction for apartments, which is going to be a change in the way that we build and the way that we think about modular construction.

Examples where it's been used overseas has been in the use of bathrooms in hotels, for instance, where they are completed offsite and then craned in on each floor of the hotels.

So, this is the challenge that we're going to have in Auckland from a modular construction point of view. It's just something that we have to bear in mind going forward in the planning.

If you're going to get scale, it will probably only take place in Auckland, especially for modular construction. Just an observation.

Dr Johnston: What are the challenges with that, either nationally or in Auckland?

Mr Fleming: Well, at the moment, from our point of view, is that steel is actually a better product because it's actually dimensionally stable, especially when you're doing that sort of modular construction.

Dr Johnston: Are there any other ways in which the government can be assisting with procurement we haven't already touched on, Tex?

Mr Edwards: I think we need an agency outside Kâinga Ora to co-ordinate and choreograph economy market segment, similar to 1936 with Fletchers, and we need to reference - that this is an actual diagram of South Auckland, I apologise for the whiteboard, but this is Kâinga Ora contractor A competing with Kâinga Ora contractor B, competing with Kâinga Ora contractor C, who's also competing with CHPs, housing producer 5, all buying from PlaceMakers or Carter Holt Harvey and the dispatch clerk at PlaceMakers South Auckland needs a promotion and they need to be, they should be on the Board because they're doing such a good price at getting the pricing and the profitability up of that unit.

The onus is on the government to see that this is world's worst practice at procurement. The numbers speak for themselves. I urge the Commission in the final report to catalogue what price per square metre Kâinga Ora is building at and to compare that with international best practice.

Your further question of where the international players have come, I have taken international players to Mt Roskill, Hobsonville, Takanini and Lower Hutt. They have a funny accent but actually, they were in disbelief that there were 25 contractors at the house construction level at Hobsonville because "In Germany, we only have three contractors for a size of that stake" and they couldn't believe there weren't any cranes there because of the 30 kitchens they looked at that were pretty much all the same, the 30 bathrooms were all the same, and what we've got is international worse practice as a consequence of kick starting this economy market.

And I urge in the final report to have some specific ratios of what international best practice is.

So, point one is Kâinga Ora and other government agencies, CHPs, Kâinga Ora, Defence Department, Education Department, Corrections, all in one ecosystem.

Also, Kâinga Ora dealing with very difficult tenants. People are proud of being Kiwis because generally, people are housed well, they're not sleeping in cars.

Kâinga Ora are dealing with difficult tenants. The construction industry transformation is a really complex matter and it needs to be dealt with more by Treasury or some other agency.

And I close off my comment by an actual real life description by a third party international consultant, is that, "Hey, Tex, New Zealand is building Toyota Corolla's using Aston Martin construction techniques". And I leave that point with you because nobody wants to drive an Aston Martin, everybody wants a Toyota Corolla because they're much more reliable and they're more fuel efficient, healthier. But, actually, that is the problem we have in the construction industry.

Dr Johnston: Thanks for that, Tex. Scott?

Mr Fisher: I think, again going back to the UK, the UK's Construction Innovation Hub was setup 5-6 years ago, so it basically became the home of that conversation. So, a new home for government and industry to sit together and extremely well funded to the tune of about 150 million pounds with a four to five year programme of work. Kind of, again, one of these well resourced, well committed, long-term programme of work versus the New Zealand example which is, there's no money, we've got a good idea and let's just deal with problems in the next 6 months.

It's not until you lift your head up and you look, you have a longer term vision, you take everyone, you are all having the same conversation, there's proper funding to take you there. I thinks that's the only way it will happen as well, otherwise it will continue to be disjointed.

Dr Johnston: Thanks for that. Andreas?

Mr Heuser: You know, we think there will be between 6,000 and 7,000 homes built next year by Kâinga Ora and it doesn't look like that's going to go down in the future, so there's a significant pipeline of demand from the state and a lot of these things about capitalising the industry could be done through the contractual model by a contract for results provider, one or two, delivers a pipeline of homes over many years at a price point. And that would create all the incentives to generate the efficiencies at a firm level.

Mr Fisher: Just one other comment. I think in the last period of time, there's this Mexican stand-off that's been happening for 5 years and the Mexican stand-off is that, you know, you'll get the industry saying, "We operate at this size, we can scale up". On the other side, you've got the likes of Kâinga Ora saying, "Actually, we need 200 houses but you're only doing 50, how are you going to scale up?" And, kind of, there's no commitment between the two parties.

So, there's this big stand-off between those large procurers that look at the industry and say, well, and all you need is a long-term commitment to strategic relationship between those two parties to say, "Well, here's a whole chunk of money, it's available if you scale up your business this way".

That is just another observation.

Dr Johnston: Thank you for that. I think this has been a really useful discussion. I am, sort of, keen to draw it to a close. John, anything else?

Dr Small: Nothing further from me, thanks.

Dr Johnston: Bryan? Anyone else got any last final comments?

Mr Eagles: Sir, I would just add an additional comment, and that is it's something that I think will help drive the pursuit of green products, is an emerging trend overseas, and that's towards large scale deep retrofit.

So, what we heard yesterday by the EU Ambassador to New Zealand, is that most countries in the EU now have a funded programme for low carbon energy efficient retrofit of homes and what that's all predicated on is Energy Performance Certificates. So, I'll give you some examples.

Ireland plans to retrofit, they have the same population as us, 500,000 homes by 2030. Germany is putting in place a funded programme of 50 billion dollars to retrofit homes to make them low carbon and healthy. Italy has 110% subsidy for people who retrofit their homes. So, if you spend $NZ100,000, it would be the equivalent of the government giving you $110,000 to retrofit.

And I just thought I'd note that this is going to happen in New Zealand also and those Energy Performance Certificates will be the item which you can deliver the performance against and the improvement of homes for a low rated home to a high rated home is what will drive the uptake of greener products, which is what the Commission is focused on; lower carbon products and materials. So, this would further support a future change to our housing stock.

30-40% of New Zealand homes are damp and mouldy. 30,000 children a year going into the health sector as a result of our damp or cold homes. Many of our homes are under the temperature they should be. So, the pursuit of Energy Performance Certificates as you are starting to indicate, will help support this policy drive and initiative for deep retrofit change in New Zealand. Thank you.

Dr Johnston: Thank you, Andrew. Mark Farmer?

Mr Farmer: Yeah, just one final comment that spans both the procurement agendas that you covered. I just want to really underline the importance of procurement as an enabler of change and it links to the point previously made about the importance of having Treasury sitting behind any policy interventions. If Treasury is not driving it around the funding allocation and believing in it, and having wider economic benefits, then sometimes you're not going to realise the full potential and there's really important learnings from that in the UK. We've had a very supportive Treasury. Treasury have driven a mandate towards MMC for government social infrastructure programmes. They've supported the Housing

Ministry's interventions into the market. But big picture government policy interventions only happen on the ground through educated procurers implementing policy in the right way. So, actually, it's a really important bit about the infrastructures needed about training and reskilling those people responsible for the decision-making, so they make the right decisions based on the right criteria. That's not just lowest price, it's not just about construction cost as well, it's about land value, so in public land disposal they will get book's land value and actually, sometimes there's a danger there if you get a cost benefit of reducing your construction costs, it residualises to the land value, so you have to avoid that happening. You have to have Treasury supporting a submarket approach to both book and public land value and also transferring those cheaper construction costs to the end recipients.

So, that procurement piece is so important in all of this and it becomes very much an issue about human behaviour and cultural change in the industry.

Dr Johnston: Thank you, Mark, those insights are very helpful. Can I thank you again for taking the time at the ungodly hour of the night that you are to actually contribute to this session, it's been very valuable, so thank you for that.

I would just like to thank everybody who stayed on for giving us this extra time. I think having the extra time to dig into this has been really helpful from our perspective, so thank you one and all, thank you for your contribution.

Is there anything else we needed to cover off, Ollie?

I don't think there's a need for a session tomorrow morning, just the Mâori session.

Thank you everybody.

Conference adjourned at 2.52 p.m.