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[PUBLIC VERSION]

SUBMISSION TO THE RESIDENTIAL BUILDING SUPPLIES MARKET STUDY DRAFT REPORT

1. ITM is a leading nationwide merchant co-operative chain, comprising 91 independent building supplies stores operating under the umbrella of a co-operative structure and brand of "Independent Timber Merchants".
2. We are supportive of the Commerce Commission's work to date, leading to its published draft report of 4 August 2022 ("Draft Report") that made preliminary findings about competition in residential building supplies markets. We make this brief submission on selected key issues arising from the Draft Report and thank the Commission for opportunity to provide feedback on the preliminary findings and tentative recommendations.
3. This written submission is by Independent Timber Merchants Co-operative Limited, the umbrella organisation which provides centralised procurement, marketing, and various other levels of HQ support to the network of independent member stores. Our members may each have their own particular views, variations, and different circumstances. We can assist the Commission in reaching out to individual member stores for specific information or views, but we are able to fairly summarise in this document the majority views as they were recently discussed at an ITM general meeting.

Main themes in our submission, after considering the draft findings of the CC

4. The Commission has determined that competition between merchants at ITM's level in the distribution market is overall working well, albeit potentially with some occasional regional problems. We agree with this view. ITM is one of 5 major nationwide chains of merchants, although each with obvious regional differences in store coverage. We also compete at local levels with well-established independent hardware and regional merchant stores who often have strong relationships with key local builders.
5. The constraints upon competition are mainly elsewhere, not at the merchant functional level of the market. **Our 4 main points of submission** on these other constraints can be summarised as:
    a. The regulatory system does not take into account competition properly as a relevant factor or potential benefit. It has become overly defensive or stagnant, for the various reasons the Commission has identified. Specifiers of products and those in charge of appraising and approving product or consenting of building solutions could do more to assist product entry and innovation, or at least not to deter it. Instead, the current regulatory system has developed over time in various ways that favour and therefore lock-in some of the incumbents' 'tried and tested' products.
        - *We agree with the Commission's draft findings on the Regulatory & Standards Systems* (chapters 3 and 4).

    b. Although we understand the Commission's view that certain types of rebates paid by suppliers to merchants, described as "quantity forcing rebates", might in particular scenarios end up harming competition in their particular application, we do not see those scenarios very often. A core part of ITM's work on behalf of members, our *raison d'etre*, is to maximise purchasing power and negotiate cost-savings from suppliers, including rebates, that can be passed on to our customers. We find the majority of rebates in the industry to be volume purchase related, and do not see this area as one

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that is strongly reinforcing any barriers to new or innovative competing products getting established. We would urge caution in the Commission's end findings, so that it does not end up criticising or limiting beneficial types of rebates in order to deal with a small minority of scenarios where they could be potentially troublesome.

- *We are mostly neutral on the Commission's draft findings on Rebates, Loyalty Schemes & Merchant Preferred Supplier Arrangements (chapter 7), but caution against outcomes that could throw the beneficial aspects 'out with the bathwater'.*

c. Restrictive land covenants or exclusive lease terms can potentially harm competition between merchants, particularly in areas where land supply is tight and availability of sites for large new retail stores is hard to come by. ITM does not use or advocate for such restrictive land or leasing conditions. During this Market Study, our stores were able to confirm to the Commission in statements that they do not use store covenants, land development covenants or exclusive leases.

- *We agree with the Commission's draft findings on Entry and Expansion constraints relating to land availability and restrictive terms* (part of chapter 6).

d. We were surprised by the Commission's draft conclusion that vertically integrated suppliers are not having a material impact on competition, beyond the current market scarcity supply problems. We are not against vertical integration per se, but believe vertically integrated suppliers could be a threat to supply and could manipulate competition at the merchant level. During the recent supply chain shortages ITM experienced how easy foreclosure of supply may be achieved. Dismissing this as a short term supply shortage issue risks ignoring the potential of foreclosure effects returning.

- *We disagree with the Commission's draft findings on Vertical Integration effects* (parts of chapters 5 and 6) *and would urge more attention on the foreclosure or supply squeeze outcomes.*

6. We briefly provide further notes and examples to support those submissions below.

Regulatory and Standards System needs to be reformed

7. We were pleased that the Commission recognised the number of difficulties and inconsistencies arising from our current regulatory settings in the industry. In short, we would agree with virtually all of the findings made in the Draft Report under this heading. Although clearly there are a difficult set of other central and local government agencies and compliance systems needing to be navigated here, in our view a serious attempt by MBIE and others to streamline/simplify those processes would be the single biggest helpful outcome from the Commission's Market Study in future.

8. Rather than attempt to revisit points made and findings reached in the Draft Report, which we endorse, we would note that the greatest gains may come from focusing on draft recommendations 4, 5 and 6:

- *Explore ways to remove impediments to product substitution and variations;*
- *Investigate whether the barriers to certification and appraisal can be reduced;*
- *Identify and develop methods to centralise information sharing about key building supplies.*

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9. These themes were evident in ITM's attempts to help suppliers import product alternatives from overseas during supply chain disruptions and shortages of 2020 and 2021 (some continuing currently). Product supply (either at all, or in volume sufficient to meet New Zealand demand conditions) was affected across a suite of important lines – plasterboard, structural timber, plywood, steel, cladding, fasteners, and other product categories.
10. Almost all our attempts to engage overseas suppliers to fill the gaps ran into some form of regulatory hurdle or delay. This was so even for large and well-established overseas supply sources. Issues included difficulties when attempting to help a supplier of ours ensure product was considered fit for purpose and up to New Zealand specifications. That required, for idiosyncratic reasons, minor thickness or tolerance differences to meet our local standards compared to mainstream overseas markets. We had to persuade suppliers to make special runs or adaptations to meet local NZ specs, or hope those tolerance divergences would have been accepted by Councils and BCAs.
11. Sometimes there were other import delays, even if the manufacturer would make a special product run. Many required BRANZ or BEAL appraisals of compliance. We were prepared to do that, and managed to import some products in the end, but it added considerably longer lead times on the product as well as the costs borne to get that alternative supply to market.
12. With particular note to the Commission's draft recommendation 6 (BCA process consistency around the country) we would strongly endorse that as an area worthy of ongoing improvement. Many times, we would make some progress with product entry and overcoming regulatory hurdles in one region only to be told, effectively, "but you won't get that through in XYZ region".
13. To an extent, local government and BCA risk aversion is understandable, as New Zealand has not had historically great outcomes in some construction quality aspects. But a near total reliance on products needing to be locally certified or receive BRANZ appraisal, or Accepted Solution status, leads to situations where a BCA does not have to think about the product and has little or no reason to go outside the big established brands. ITM's view is that there needs to be more prescription and more centralised information to guide and eventually narrow the variations our members and their builder customers report from around the regions.
14. ITM considers there should be more ability to rely on universal (globally or regionally recognised) standards to enable international incumbents to enter. There is a lack of even AU/NZ standards for many building materials, and so clear opportunities to harmonise our standards with other major markets. Currently, there is little incentive for international players to adjust their design to meet specific New Zealand performance standards to compete in what is ultimately for them a very small market.

Rebates and Loyalty Terms are mostly benign

15. The Commission has confirmed that most forms of rebate and loyalty incentives around product supply are likely to have benefits and be efficiency enhancing. We agree. We see the Commission has concerns about certain sub-sets of rebates in the industry and their complexity, but we perceive difficulty in clearly defining what situations are problematic, and then grappling with what can be done about this.
16. For the most part, ITM sees situations where there are strong economic arguments that rebates and loyalty arrangements can be pro-competitive, encouraging more brand investment and innovation, and cost savings ultimately passed on to customers. Ordinary existing competition

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law would seem adequate to normally address any types of problematic rebates – especially by large or vertically integrated suppliers possibly exercising market power.

17. We note that the law is changing in this area from April 2023, and that the Commission may look at individual situations for investigation following that. Such outcomes and signalling to the market will probably tend to curb any market strategic behaviour that carries concerns about adversely affecting competition between merchants or locking in product suppliers.
18. Our experience has been that rebates are occasionally tiered/volume-scaled but this is often tailored to the supplier and the particular negotiation, and that it is more common for the rebates to be flat. All kinds of rebates we receive are designed to increase the level of volume ITM will or can put through a given supplier, and for its stores to stock that product. However, for us that does not have the effect of locking in that product or hindering our ability to stock and sponsor alternatives. We see this as a recognition of the volume component of the relationship, rather than a supplier foisting those type of arrangements upon customers/merchants.
19. Rebates are important for ITM's customers in particular in the group home builder channel. Like ITM, we understand they tend to use these rebates to fund their head office, show rooms, cost-reduction measures and/or distribute to their franchisees to use for marketing and to drive other pro-competitive initiatives.
20. Looking at the table on pages 176 of the Draft Report (as a convenient summary), ITM's comments would be that:
    - The first three types of rebates are common and appropriate, never likely to be a competition impediment;
    - Share of wallet commitments would be rare to non-existent in our business, although variations might appear in some strategic marketing agreements;
    - Tiered and retroactive clauses usually work on a periodic or annual spend, but total volume applies as an incentive for our stores, not a reason to limit supply to just that supplier. For instance, to earn into a higher tier near the end of a period, stores can choose to run proactive sales or promotions, or choose to hold more product in stock, and apply the cost-savings of the tiered discount to arrangements and sales terms with their builder customers.
21. What we stand to gain is usually the incentive from those terms, via an increase in spend. We see that as incentive, not a penalty to lose or punitive step to drop down a tier. In any event, all discussions are done on the basis of net-net pricing, and a wide range of other factors go into our decision-making to stock other products or new innovative options. Whether it could meet a similar rebate structure would not mean a new product will definitely get stocked, and is rarely a decisive factor.
22. There is a strong propensity in the building sector to use brands that people trust, but there have been few experiences where volume discounts determine that view. Historically people want, for example, Pink Batts/GIB etc, as a market preference built up over many years or because BCA habits have locked it into the collective psyche. Rebates arise because ITM (and presumably others) are committing to certain volumes with the suppliers that are. in demand, to give them certainty of supply if possible. But that doesn't eliminate other suppliers – we stock what builders and customers want us to stock. So those other important factors include:

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- Does the product have suitable brand following and demand amongst builders
- Does it have necessary site delivery, logistics and systems, technical and installation guidance, and other attributes valued by builders.
- Can it assure quality and service, such that builders have their support queries answered and do not face mucking around (e.g. to get it to site and in DIFOT levels that builders need for timely supply)

23. We are therefore in favour of retaining the market flexibility to use volume purchasing power to ensure appropriate rebates and discounts can be obtained in the right situation. Those cost-savings are important to our members and to builders in dealing with customers at all levels in the chain. We acknowledge that in certain theoretical conditions, tiered and retroactive rebates can be a problem, but we see little evidence that this is widespread. Our view is that the rebates we can obtain are generally deserved by scale, and linked to volume, and appropriately negotiated at arm's-length.
24. Accordingly, we suggest reason for the Commission to be cautious in reaching findings that rebates may be anti-competitive. It could risk criticisms that would drive risk aversion or limiting beneficial types of rebates, in order to deal with a small minority of scenarios where they could be potentially troublesome. We agree that legislative intervention would be a blunt tool in what is a fact-specific matter and where rebates may well be pro-consumer. The baby could be accidentally ‘thrown out with the bathwater.’

Restrictive/exclusive land or leasing terms can be a problem, on occasions

25. ITM’s position on these form of contractual restraints is fairly clear - we definitely do not encourage or use those types of exclusive leasing clauses. And we have occasionally found them to be a problem when attempting to secure suitable sites to open a new store in a region or town needing market entry.
26. As part of this market study the Commission carried out surveys and information requests which we assisted in coordinating on behalf of our independent owner-operator stores. We were able to confirm it to the Commission that none of our 91 stores require or use the types of restraints described as being store covenants, land development covenants or exclusive lease arrangements.
27. We have come across one example of the type of exclusive dealing clause noted by the Commission as involving a land-owner with titles in areas zoned for residential development where preferential rights were sought to supply building materials for all houses to be built on those land-holdings. We suspect that may be somewhat isolated issues, and often may involve not outright exclusive terms but a last right of refusal or match pricing clauses relative to other merchant suppliers. From an ITM perspective, we expect any such artificial interference with merchant chain choices of supply should also be examined and potentially eradicated where they turn up.
28. In general terms, we do not see this is been such an acute competition issue in our industry as, say, was found to be a problem in the recent grocery supermarkets duopoly inquiry conducted by the Commission. Our analysis and discussions with members suggest it doesn’t have much impact, and so we were a little surprised at the number of these restrictive clauses the Commission has found in other companies or corners of the industry.

29. Since we have no interest in seeing our members use such restraints, or be on the receiving end of complying with them in future, ITM would happily see any remaining restraints eradicated from the industry.
30. We therefore endorse the Commission's draft recommendation 8 (pages 17 and 144 of the Draft Report) for further work to be done on the prevalence of restrictive land and site conditions, and would be happy to participate in the future work inquiries of that nature.

Vertical integration risk – recent events show key suppliers can apply foreclosure tactics

31. ITM has nothing against vertical integration in its own right. It can often lead to efficiencies in supply chains and, for example, some of our independent stores have over time chosen to invest in or develop their own in-house Frame & Truss capacity. But we were surprised at the Commission's draft conclusions that:

- "Difficulties that some suppliers face in getting stocked by merchants do not appear to be attributable to vertical integration. [Draft Report, page 113];
- Vertical integration does not appear to make it harder for suppliers to compete [Draft Report, page 140]; and
- Outside of the current supply shortages, any challenges faced by merchants obtaining access to supplies do not appear to be attributable to the vertical integration of suppliers and competing merchants. Vertical integration does not appear to be a factor affecting competition between merchants over the longer term."

32. Vertically integrated suppliers are a threat to supply and can manipulate competition at the merchant level. Recent supply chain shortages show how easy foreclosure may be achieved, even against a significant customer (who happens to be a rival) such as ITM. Dismissing this as a short term supply shortage issue risks ignoring the potential of foreclosure effects returning, or supply chain disruptions to be the 'new norm' in our economic conditions, or some vertical players being encouraged by the ease with which they could milk recent shortages to their downstream benefit.
33. There are two major entities ITM competes with in the important group home builder or nationwide builder chains market: Fletcher Group (PlaceMakers merchants) and CHH (Carters merchants). The last 18 months or so have provided a real-life example where our individual independent merchants faced significant difficulties and dealings with the vertically integrated players, especially in terms of supply of structural timber – an absolutely essential bedrock product in the industry.
34. Supply shortages have affected the market across a range of products, including plasterboard, insulation, cladding, laminated board, plywood and steel. None of that would have been intended or artificially contrived. But we would contrast two distinct approaches in how the vertical players chose to deal with the situation once it occurred.
35. Fletcher Building has had well-documented supply issues, and have been steadily (and currently) rationing product supply especially around GIB. Obviously this is challenging for ITM and all the other merchants given the importance of GIB as market leader and usually specified by name/brand. ITM found they were not on the whole unfairly dealt with during those difficulties; Fletcher had to come up with allocation processes to get some diminished supply out across the

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whole sector. A logical model was eventually developed, a way that most merchants could be given reduced (and insufficient) amounts of product but at least ‘enough to live on’.

36. On the other hand, any allocation of the limited supply of structural timber was handled in a very different way by CHH. It caused significant competitive damage to ITM last year where they stopped supplying structural timber and other products where they have supply dominance in a way that had no fair or objective allocation model. Instead, it ultimately preferred supply to just the two vertical players – Carters and PlaceMakers. That included a situation where:

- ITM stores loyal to CHH for over 20 years were told they would lose all timber supply overnight.
- Communications were typically by phone call only, nothing was put in writing, and no negotiations were willing to be entertained by CHH
- No significant amount was able to be given or made available over time, and no attempt was made, that we could see, to develop a fair allocation model.
- That contrasted starkly with efforts made at least by Fletcher Group and others, such as James Hardie group, to work up similar allocation models with a degree of market fairness.
- CHH was then ITM’s largest supplier of structural timber, and ITM was a very significant customer worth [ ].
- Essentially, other merchants were cut off from supply, so they could service Carters and PlaceMakers stores.
- Anecdotal incidents took place where sales team reps (whether authorised or not) used this in local areas to disadvantage other merchant stores, telling builders that, for example, Carters had guaranteed timber supply and ITM didn’t, or that PlaceMakers stores can secure GIB 6 months ahead of competitors.
- It was common knowledge in the industry that some Carters stores were overstocked for months in timber, essentially stockpiling, yet no supply was available to ITM and others.

37. There is still a shortage for the foreseeable future. While independents such as Red Stag have tried to scale up their supply, if some setback emerged in those alternatives New Zealand would soon be back in a real scarcity supply crunch situation.

38. It is possible to infer that CHH intended to improve the position of its own merchants and that of another conglomerate upon whom its merchants depend for supply of different essential products. They somehow managed to free up volume to their own entities, and only eventually made some drip-feed volumes available to others after regulatory or media scrutiny.

39. The clearest explanation of vertical integration risks to competition comes from the Commission’s Mergers and Acquisitions Guidelines (May 2022), in particular at paragraphs 5.3 to 5.10. This includes principles such as:

> 5.4. A vertical merger may substantially lessen competition where the merger increases the merged firm’s ability and/or incentive to prevent or hinder competition by:
>
> 5.4.1 refusing to deal with competitors completely (total foreclosure); or
>
> 5.4.2 raising prices it charges these competitors (partial foreclosure).
>
> 5.5. Foreclosure can either be:

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5.5.1 input foreclosure – where the merged firm refuses to supply an input to a downstream competitor or raises the price of the input; or

5.5.2 customer foreclosure – where the merged firm disadvantages an upstream competitor in the sale of that competitor's products by limiting access to customers.

…

5.8. A firm will only rationally foreclose competitors if it is profitable to do so. For example, for input foreclosure, a firm must weigh up an increase in profits in a downstream market against a decrease in profits in the upstream market where the foreclosure occurs. This is because:

5.8.1 the firm's profits in the input market falls as the number of units sold fall; but

5.8.2 the firm's profits in the downstream market may increase if it can win a proportion of the sales its competitors lose as a result of the foreclosure.

40. Although the context here is not the Commission's merger control remit (whilst an important prophylactic mechanism to prevent future conglomerates like Fletcher Building or Carter Holt Harvey from acquiring market power in the first place), the same principles apply to strategic conduct. ITM as a non-vertical, merchant-level only firm has been on the receiving end of such strategic conduct over the last two years.

41. The events of 2021 (and continuing currently) demonstrate a case where a large conglomerate or vertical player has ability (and commercial incentive) to make choices during a supply shortage that foreclose supply to other competitors, even large customers like ITM. We wish to contrast ways of dealing with that between the shortages of plasterboard/GIB and structural timber. ITM would ordinarily expect to have members' combined volume as a decent negotiating lever, but for over 18 months now that foreclosure of input by CHH has damaged competition by others trying to get product supply in enough volume to meeting builders' demands.

42. We see that as an example of a conglomerate/vertical player not acting as if it were subject to ordinary competitive constraint, and happy to damage a downstream merchant rival if the opportunity arises. We were disappointed that the Commission chose not to open a proper investigation in 2021 into the structural timber self-supply preferences (see pages 162-163 in the Draft Report), and would urge more attention on those issues.

43. These supply crises initially may have brought a temporary silver lining for alternative suppliers, as ITM was engaging heavily with other product suppliers and trying to assist importation or sponsor new entry. However, as explained above, the regulatory standards barriers encountered made that a slow and ultimately ineffective form of response. If a year has to pass without effective supply-side alternatives able to be brought on stream, that is an eternity in construction cycle terms. It is also not good for a population that is currently living through an affordable housing crisis.

44. The Commission appears to be approaching this issue narrowly on the basis that there is insufficient evidence of other suppliers failing to get their product stocked (e.g. Draft Report, page 143). It is correct that there can be a range of reasons why suppliers find it hard to get channel access and product stocked. However, the Commission's preliminary view that those stocking reasons do not appear to be attributable to vertical integration ignores the capacity,

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and incentive in times of product shortage, for essential 'hero products' to be exploited by the vertical players.

45. To sum up, the damage done to our ability to compete with Carters and PlaceMakers has been far greater from these supply foreclosure tactics than anything arising from quantity forcing rebates. We urge the Commission to reconsider the level of relative priority between those two issues in its Final Report.

Next Steps

46. We recognise the hard work done and diligent attempts made by the Market Study team to understand the building supplies industry, its characteristics, customs and nuances. We appreciate those efforts, and hope they will continue into a final report that sets out a clear and comprehensive reform pathway for government to proceed with.

47. We trust these submissions are helpful. ITM will continue to approach its discussions with the Commission as an honest broker, because we are interposed on negotiations with large suppliers and the needs of New Zealand builders, remain relatively neutral in the market as a procurement based co-operative, and have no vertically-integrated baggage or conflicts in this Market Study.

48. We are available to attend the planned Conference to discuss the Draft Report in September, or happy to answer any further questions that the Commission team may have.

Yours faithfully

[redacted]

Darrin Hughes
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[redacted]

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