Response to Housebuilding Market Study consultation questions

1. *Do you agree with our areas of focus for the market study, as set out in paragraphs 2.1 to 2.31? If not, what other matters should we focus on and why?*

4. *How can competition in this market be strengthened?*

It may be helpful to clarify the theoretical framework that underpins the scope of this market study. It appears to be predicated on the idea that the housing market should function in the same way as any other competitive market, where prices are driven to the marginal cost of production. The corollary of this (implicit?) assumption is that if house prices rise then supply should rise in response, cutting prices and constraining the profits of developers – as would be the case in any normal competitive market. The existence of large profits in the sector may, under this framework, suggest that the market is uncompetitive in some way.

But this would be a misleading framework to apply to housing building market because the majority of the value of the houses developed resides in the land rather than the buildings themselves. Changes in local residential land prices occur largely irrespective of the actions of any one developer but are a source of their profits. Developers, as the owners of the land, derive profits from two distinct parts of their role: part investment manager (with respect to land they own while developing a new site) and part house builder.

The house building part of their function can and should operate like any other market, and it may be the case that there is market power or regulatory barriers to competition that need addressing. But to the extent that developer profits are the result of management of their land assets, this is unlikely to be the result of inadequate competition, any more than is the case with other types of asset manager.

By developing a piece of land and selling the houses on it the investor (developer) is selling their asset (the land). For any given plot, this decision is a one-shot game and they face a choice: is it better for them to develop and sell this year or next year? The profit-maximising timing of development and sale is unrelated to past movements in house prices - if house prices have surged in recent years, this has no impact on their decision over whether to develop and sell this year or next. Instead, what matters for the timing of their decision to supply housing is their expectation of what will happen to prices in the future.

This is different to a market for regular goods or services, where if market prices rise faster than input costs, profits should rise, incentivising higher levels of supply from the industry.

That should lead us to be sceptical of the idea that higher house prices should increase housing supply at all. Whether land prices increased or fell yesterday is irrelevant to an investor's decision on *when* to develop and sell land.

This way of thinking also clouds the picture on developer profits. In any asset market, if prices increased yesterday, then selling the asset will result in the investor crystalising a capital gain. For a developer selling houses, this shows up as profit. Depending on what has happened to land prices, that profit may be large but isn't necessarily an indication of an uncompetitive market in property development.

19. Do any of the participants in the market (including but not limited to housebuilders, land agents, and land promoters) have market power? If so, what drives this and how (if at all) do they exploit it?

Since the ownership of land gives the owner a monopoly on its use and sale, they inevitably have market power. Hence developers have monopoly power as landowners, but not necessarily as housebuilders. This has big implications for the goal of making housing development more competitive. You could have a reasonably concentrated developer sector, or have a sector comprising five hundred SMEs, but both systems generate the same aggregate amount of profit to the extent that it is primarily derived from the appreciation of land value.

22. What are the key factors that determine the incentive and ability for developers to build-out new sites at a certain rate?

On the above way of thinking about how the housing market functions, an inevitable uncertainty over the future path of house/land prices, the optimal risk management strategy is to build out new houses at a steady rate year after year, as dictated by the sustainable absorption rate. This strategy also allows developers to manage their supply chains efficiently. Again, there is no theoretical reason why past changes in housing/land prices should directly influence the developer's profit maximising build-out rate.