



BRIEFING

Housing and Urban Development – System Level Settings

Date:	7 November 2017	Priority:	Medium
Security classification:	In Confidence	Tracking number:	0848 17-18

Action sought		
	Action sought	Deadline
Hon Phil Twyford Minister of Housing and Urban Development	Discuss with officials.	20 November 2017
Hon Jenny Salesa Associate Minister of Housing and Urban Development		

Contact for telephone discussion (if required)				
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The following departments/agencies have been consulted					
<input checked="" type="checkbox"/> Treasury	<input type="checkbox"/> MoJ	<input type="checkbox"/> NZTE	<input checked="" type="checkbox"/> MSD	<input type="checkbox"/> TEC	<input type="checkbox"/> MoE
<input type="checkbox"/> MFAT	<input type="checkbox"/> MPI	<input checked="" type="checkbox"/> MfE	<input type="checkbox"/> DIA	<input type="checkbox"/> TPK	<input type="checkbox"/> MoH
		<input type="checkbox"/> Other:			

Minister's office to complete:

☐ Approved

☐ Declined

☐ Noted

☐ Needs change

☐ Seen

☐ Overtaken by Events

☐ See Minister's Notes

☐ Withdrawn

Comments:

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Purpose

This briefing builds on our recent discussions with you about your housing and urban development priorities. It provides a framework that we have been using to think about housing and urban-development and discusses a number of the current constraints before identifying a set of potential initiatives for further discussion that would work to support your stated priorities.

Context

High-performing urban areas can provide New Zealand's people with access to opportunities, improve a range of social and health outcomes, drive economic growth and diversification and connect New Zealand to international markets. When done well, urban development has an important influence on human well-being and the productivity of our urban areas.

Successful modern cities are becoming increasingly centred around nodes of mixed-use social and economic activity. To attract, support and enable people to live, work and play, our cities must change to realise the potential of these new ways of urban living.

Given that our cities and urban planning systems were originally designed to separate accommodation from work, changing the prevailing paradigm requires a process of significant urban transformation, in particular by identifying and rectifying land-use patterns and infrastructure deficiencies that constrain urban growth and economic performance. This calls for significant urban development that integrates a wide range of objectives across affordable housing, health and education, local employment, public transport, economic development and infrastructure provision. In turn, this requires an urban planning system that supports these objectives.

It is in this context that a city the size of Christchurch needs to be built in Auckland over the next 10 years. In fact, if the Auckland population continues to grow at high levels, an additional city the size of Tauranga would also need to be built.

Auckland housing

Urban development in Auckland will need to be responsive to that population growth by providing enough capacity for new housing and business in the right places, supported by the right infrastructure. Ensuring sufficient capacity for housing development and responsive housing supply has been the most challenging and elusive aspects of urban development in Auckland and will require the most attention.

Currently, Auckland housing is significantly overpriced relative to its fundamental value, for two main reasons:¹

- **supply problem:** not enough houses have been built over the last 10 years relative to population growth; and
- **market performance problem:** until recently, investors using debt to chase capital gains created a positive feedback loop that incentivised more investors to buy houses, driving prices higher.²

Underlying issues

Underlying the lack of sufficient housing and urban development in Auckland are three types of issues:

Fundamental problem

There has been a materially inadequate supply of urban land with economically feasible development capacity, which has significantly driven up land values.³

The lack of sufficient development capacity is a product of a land use planning system that does not adequately recognise the fundamental need for dynamic change in urban land uses, and which does not give enough priority to urban development, combined with a lack of planned and funded infrastructure for that land. The regulatory system for planning⁴ is not well aligned and is struggling to meet the challenges and opportunities arising from population growth and economic change in urban areas.

Immediate problems

To deliver the additional housing supply required in Auckland, the average volume of new homes delivered each year must at least double from its long-term average prior to the Global Financial Crisis. Yet the housing supply chain in Auckland is slowing down.⁵

The two immediate causes are:

- **limits on development finance:** the main banks have capped or reduced their lending budgets and tightened their credit controls, reducing developers' access to finance; and

¹ In Auckland, the gross annual rent received from a rental property is about 4% of the purchase price, compared to 5% or more in the rest of the country. At the current median weekly rent in Auckland, the purchase price would need to fall by 20% to generate a rental yield of at least 5%.

² Rising house prices increased investors' equity in their existing properties. They borrowed against that equity to purchase further investment properties. That demand maintained house price growth, thereby continuing to increase investors' equity, enabling them to borrow more.

³ On average, land value accounts for over 60% of the capital value of existing residential housing in Auckland.

⁴ The principal components of the planning system comprise the Resource Management Act, the Land Transport Management Act and the Local Government Act.

⁵ Less than 500 more homes were consented in the year to July 2017 than a year earlier. In contrast, over 1,000 more new homes were consented in the year to July 2016 than the year before that.

- **limits on sector capacity:** the growth in the housing supply chain over the last five years has reached the sector's capacity in Auckland to rapidly increase its output:⁶
 - **higher volume:** although not sufficient, the number of new dwellings being consented in Auckland is now 30% above the long-term average prior to the Global Financial Crisis; and
 - **rapid growth from a low base:** during downturns the sector loses experienced workers and struggles to replace them when the sector returns to growth, which also affects productivity and quality.⁷

Similar constraints are weighing on other parts of the construction sector.

Emerging problem

In addition, the housing market is turning. Auckland prices are now static or falling.⁸ Cyclical drivers of market performance are currently outweighing the fundamental shortage of supply:

- Minimum loan-to-value ratios have reduced the volume of investors able to leverage their existing equity to chase capital gains.⁹
- Banks have tightened their supply of mortgage credit.¹⁰
- Mortgage rates are unlikely to fall further.
- Prices have grown too high for most rental households to afford to buy a house.¹¹

The result is an emerging problem for Auckland housing supply. Falling house prices and rising construction costs are undermining the commercial viability of residential development.¹² If these cyclical factors continue to weigh on market performance, fewer development projects will proceed. That will limit supply growth, over both the short and medium term (1-3 years).

If these factors remain, ongoing growth in the supply of new homes is likely to be muted in Auckland, with some risk that supply will actually fall during the next year.

Overall picture

Yet the housing supply shortage remains. If the cyclical factors reverse, the fundamental lack of sufficient housing can be expected to drive prices higher once more.

⁶ Construction sector labour costs have increased faster than those for the average worker, particularly over the last three years; and the cost of some construction materials has increased by up to 20% over the last 5 years.

⁷ Following the Global Financial Crisis, the annual number of consented dwellings in Auckland remained less than half of the long-term average for three years straight.

⁸ Auckland house prices have fallen 2.9% over the last year (REINZ House Price Index). Demand has dropped by over 20%, increasing the number of houses available for sale by a quarter.

⁹ In the second quarter of this year, almost 3,000 fewer houses were sold in Auckland than in the same quarter the year before. Over half of that drop is the reduction in the number of investors who purchased houses with debt.

¹⁰ Lending growth has dropped to 5.3%, down from 10% in August 2016. July recorded the smallest monthly growth in total mortgage lending since mid-2015.

¹¹ We estimate that over 80% of potential first home buyer households in Auckland would have below average income after housing costs, reducing effective demand from this group to less than 20%.

¹² If house prices fall 5-10% and construction costs rise by over 8%, that is enough to eliminate most or all of a developer's profit margin.

Especially if loan-to-value ratio requirements are removed, there is a risk that within 1-2 years the ongoing supply shortage could enable investors to re-establish the positive feedback loop, leading to renewed rapid price inflation.¹³

Recommendations

Overall, therefore, we make the following broad recommendations, which are discussed further below:

- **Supply problem:** We recommend that increasing the supply of new homes be the immediate policy goal, pursued through two broad roles:
 - changing the system-level settings to improve the functioning of the housing supply chain (indirect support); and
 - development of significantly more new homes through KiwiBuild (direct support).
- **Fundamental problem:** We recommend that the Government reform the planning system, by:
 - enacting new legislation that empowers complex urban development projects to access more enabling development powers and land use rules via the new affordable housing authority; and
 - building on the Productivity Commission's *Better Urban Planning* report towards changing the planning system.
- **Immediate problems:** We recommend the Government explore short term means:
 - to increase the capacity of the construction sector, especially in Auckland; and
 - to facilitate access to development finance, including your suggestion that the Crown act as a wholesale purchaser "off the plans".
- **Emerging problem:** We recommend that the Government ensure that, despite softening prices, the construction sector can have confidence in a sustained pipeline of construction, through:
 - large-scale urban development projects, enabled under the new legislation recommended above; and
 - larger scale implementation of KiwiBuild.

Jo Doyle
**General Manager,
Construction and Housing Markets**

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Hon Phil Twyford
**Minister of Housing and Urban
Development**

..... / /

¹³ Without restrictions, investors' ability to use high debt to purchase houses means they are more able to afford to purchase additional houses, despite rising prices.

Overview

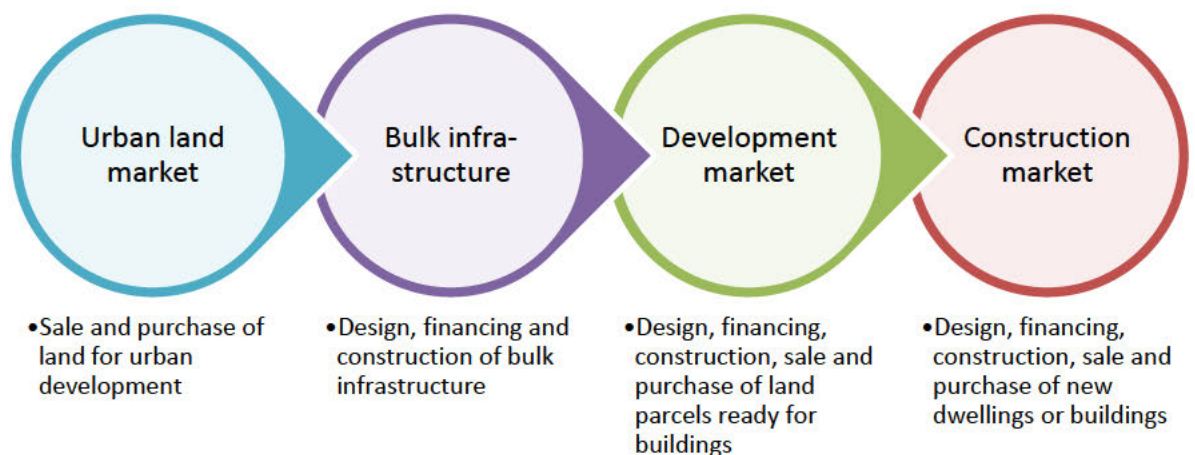
The balance of this paper describes the supply chain for urban development, with an emphasis on housing. It considers the system-level policies that shape its performance, addressing the immediate and fundamental problems introduced above.

Urban development supply chain

There are four main stages in the supply of urban development. (The following diagrams show the housing supply chain,¹⁴ but the same steps apply to the development supply chain for commercial or industrial land and buildings.¹⁵)



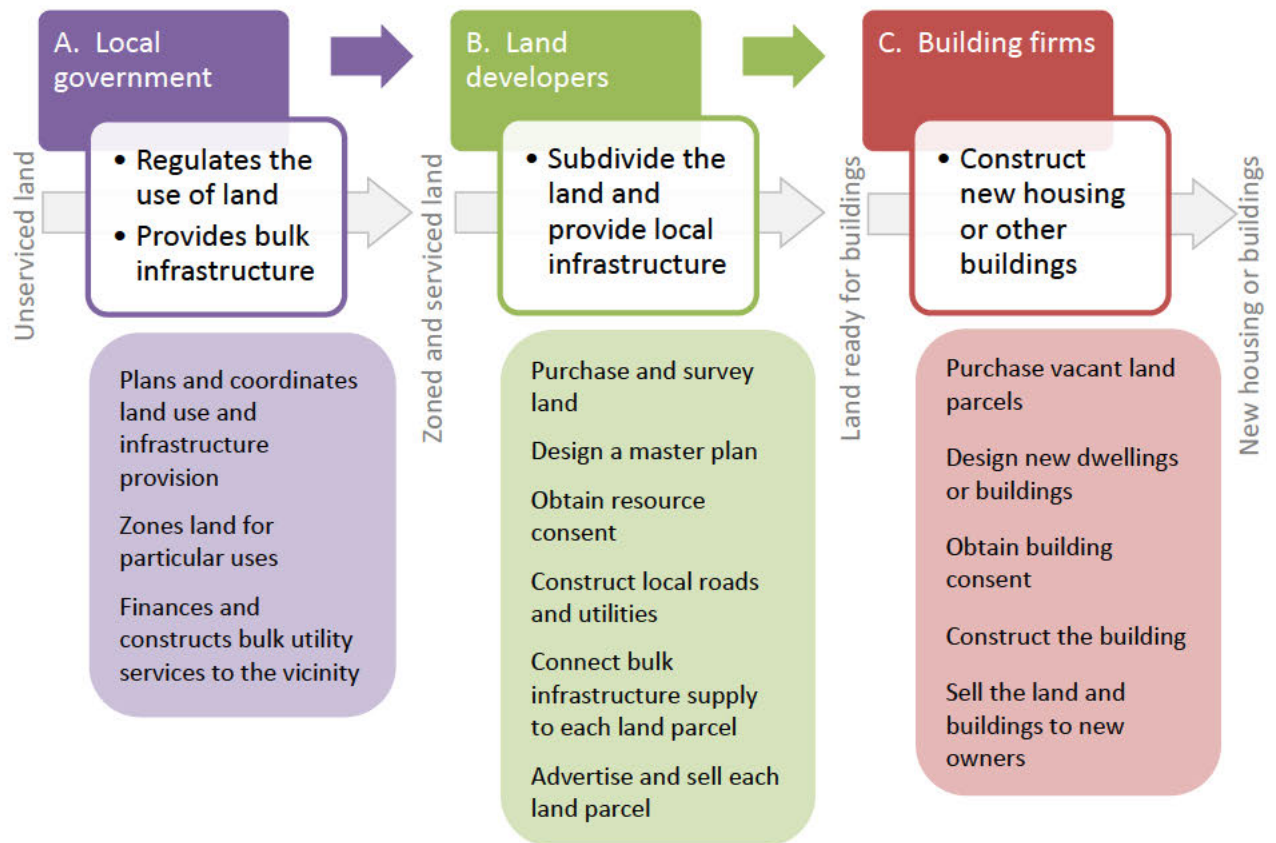
The four stages each correspond with a market that delivers that stage of the supply chain:



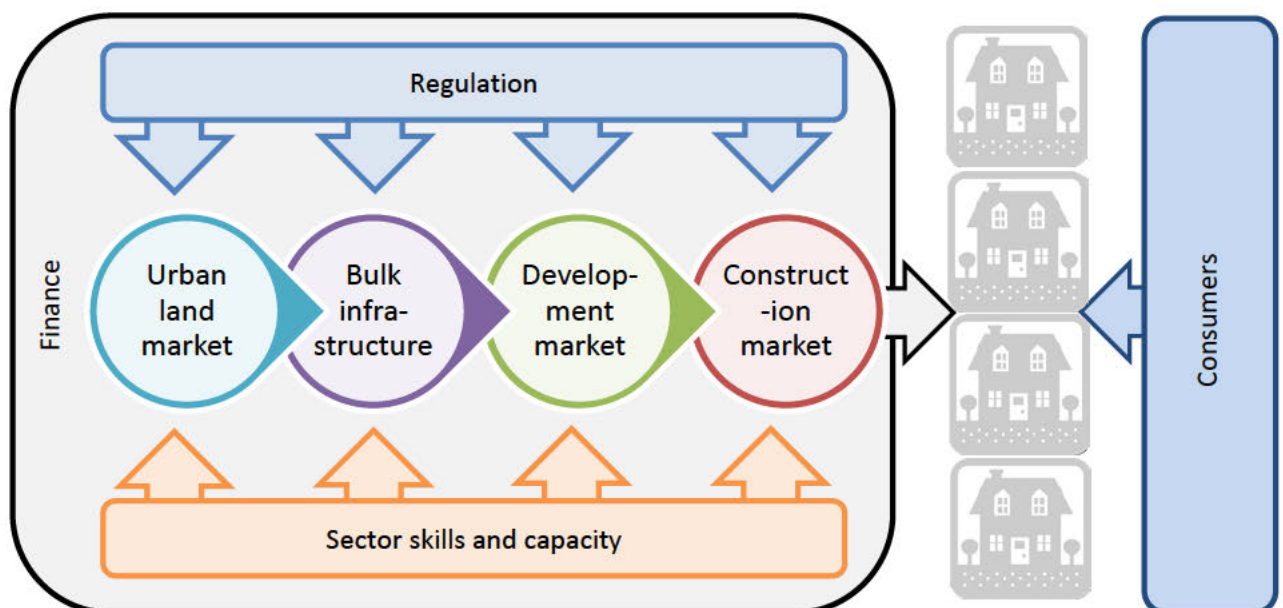
¹⁴ The four stages apply to housing developments in greenfield areas. (Re)development of existing built-up areas typically starts at the second stage, where the land is already serviced by bulk infrastructure, although the land may still need to be re-zoned.

¹⁵ For example: substitute “commercial land parcels” and “new commercial buildings” for “residential land parcels” and “new housing”.

The four main stages are connected by three steps, undertaken by the three main players in the supply chain:

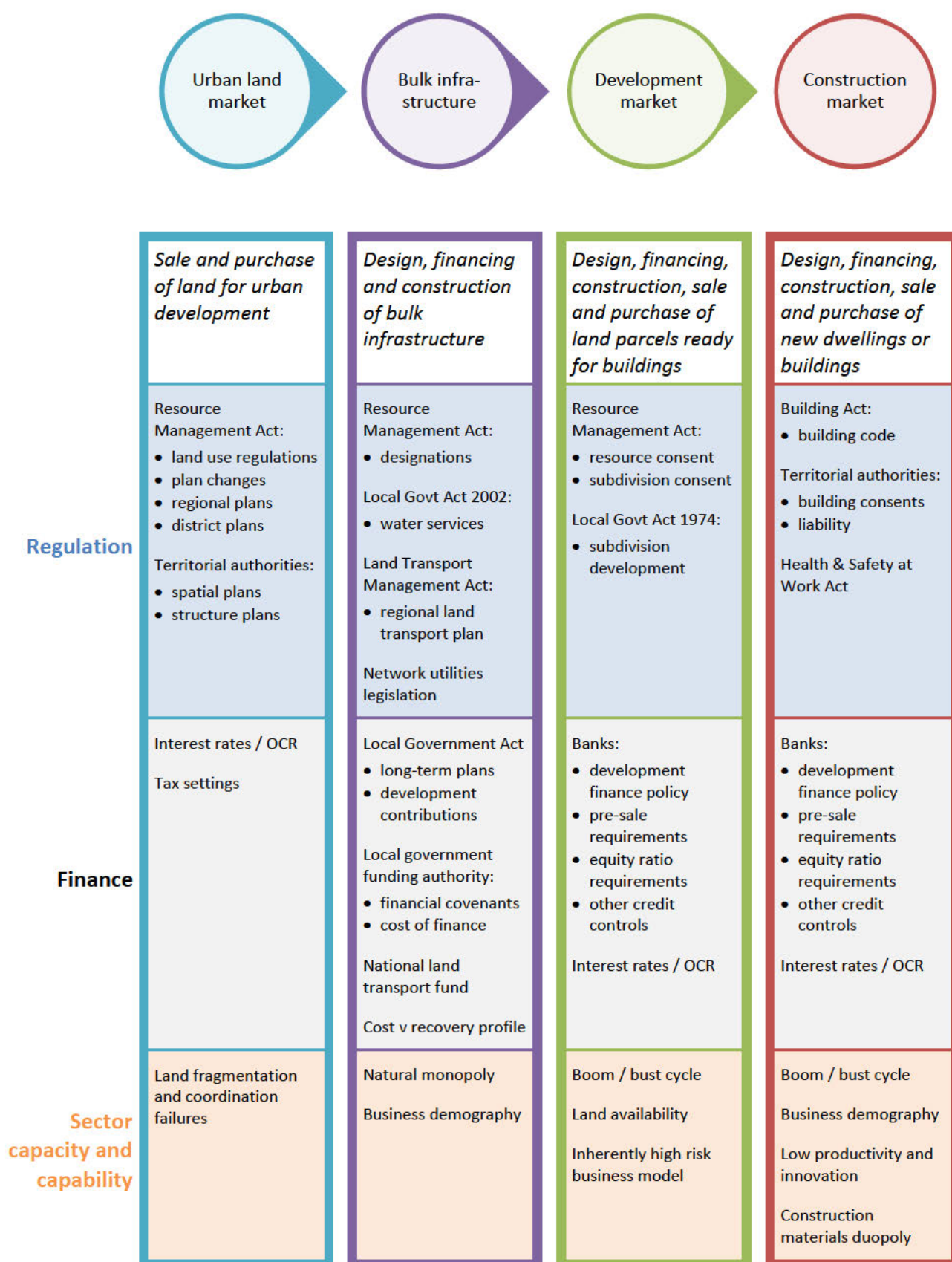


Finance, regulation, capability and consumers shape each of the four markets:



System level settings

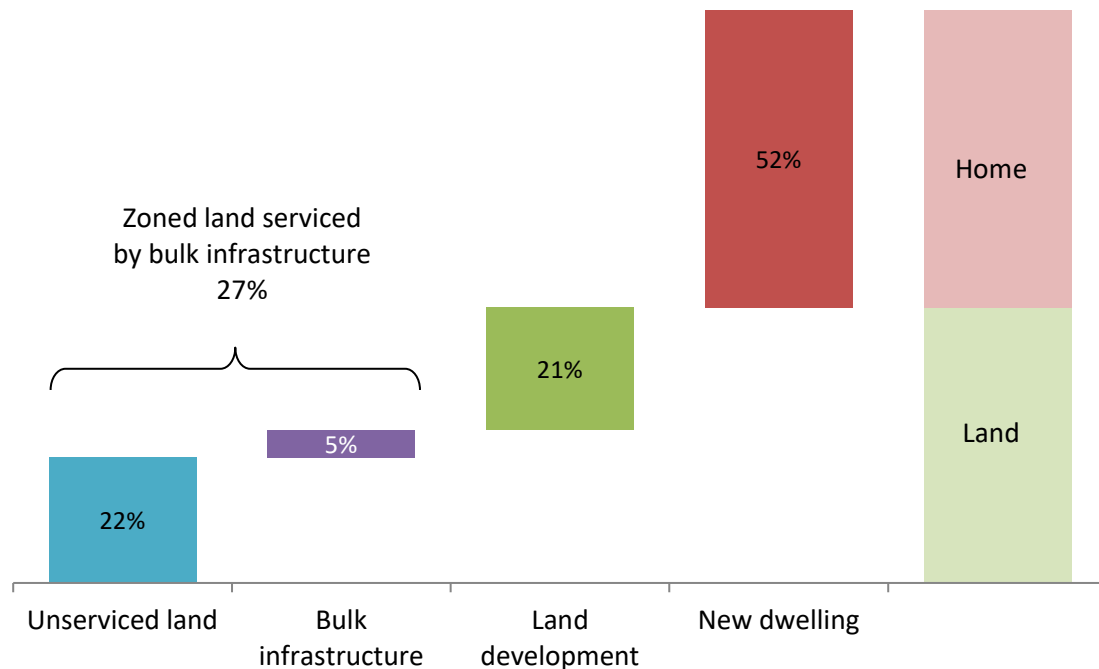
The governance, institutional and legislative arrangements that have the biggest impact on the urban development supply chain are set out below:



Significance

For housing, of the four stages, the cost of constructing the new home makes the largest contribution to the overall cost of a new house and land package:

Indicative costs of building a new 160m² standalone home on a 500m² section in Auckland:



- **Unserved land:** The value varies depending on the location of the land, meaning this cost can be a greater or lesser share of the overall cost.¹⁶
- **Bulk infrastructure:** The cost to the end user is incurred through the development contributions that territorial authorities charge. While the cost to them of delivering new infrastructure is very high, because those costs are shared across large numbers of households, the cost to the end user is a small share of the overall cost of a new home.
- **Land development:** Ranked in order of significance, these costs include the developer's profit margin, overheads and contingency;¹⁷ the cost of installing local infrastructure; the cost of finance; fees for professional advice; and the cost of regulatory consents and rates.
- **New dwelling:** The cost of construction depends on the housing quality the end user is seeking and the size of the dwelling, so its share of the overall cost can vary. High density housing needs much less land per home, increasing the significance of construction for medium-to-high level apartment buildings. Medium density housing also needs less land per home than low density housing, but fixed land development costs can still mean that a smaller land parcel represents a similar share of the overall cost of a townhouse or terraced house, as it does of a larger standalone dwelling.¹⁸

¹⁶ This model assumes the unserved land costs \$200 per square metre, which is very high relative to other regions of New Zealand, but could be exceeded in some parts of Auckland.

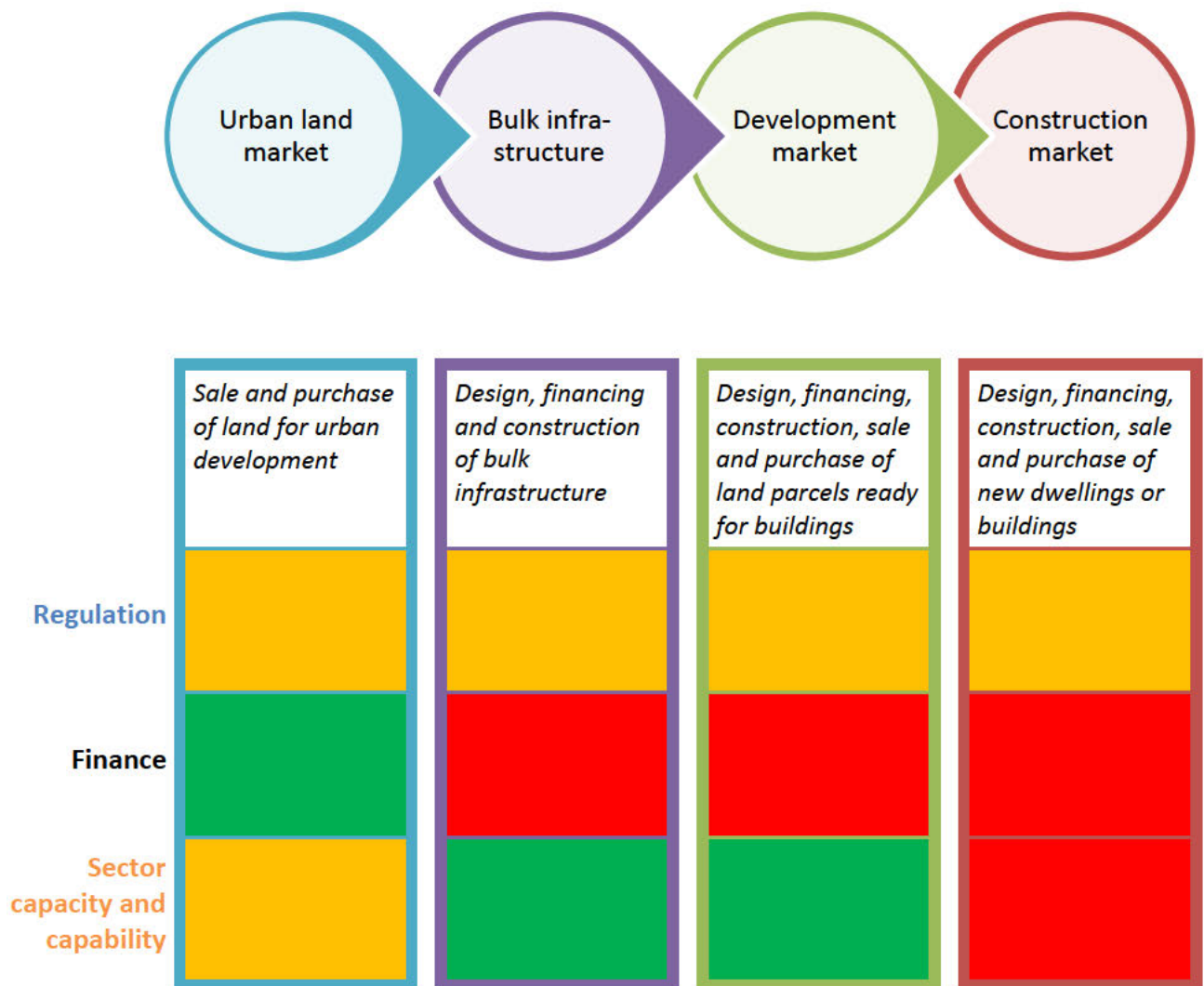
¹⁷ This model uses a profit margin of 18% for greenfield development. In contrast, development of an apartment building would seek a 25-30% profit margin, given the higher risks involved.

¹⁸ At prevailing prices for small residential land parcels in Auckland, a 120m² section would be likely to comprise over 40% of the cost of purchasing a 100m² dwelling on that section.

Underlying issues

The diagram below highlights specific problems in the urban development supply chain, which are then discussed further below:

- Immediate problems preventing greater supply in the short to medium term.
- Underlying problems restricting performance over the medium to long term.
- Not currently inhibiting performance.



Housing demand

Underlying problem – Finance There is not enough demand for newly constructed homes priced in the lower quartile of the existing stock (especially in Auckland), because even these prices are too high for middle income households, and higher income households want higher quality homes. Thus, while the *underlying* demand for additional housing remains high, because most of those household can't afford to pay prevailing prices, the *effective* demand is constrained.

Urban land market

Immediate problem – Unclear It's not clear whether there is an immediate problem with the volume of land currently available for urban development.¹⁹ In particular, the Unitary Plan has re-zoned large volumes of land for (re)development.²⁰

Underlying problem – Regulation The regulatory system for planning²¹ is not well aligned and is struggling to meet the challenges and opportunities arising from changes in urban areas, particularly in high growth cities.

Underlying problem – Sector capacity and capability Land fragmentation is a barrier to swift, high volume development of existing built-up areas, because developers struggle to assemble commercially viable land parcels in contiguous blocks.

Bulk infrastructure

Immediate problem – Finance High growth areas are at or near the debt ceilings permitted by local government funding arrangements. The high upfront cost of significant additional bulk infrastructure is likely to breach those funding limits. This in turn limits the amount of zoned and serviced land for development.

Underlying problem – Regulation The regulation of: land use (Resource Management Act), provision of roads and public transport (Land Transport Management Act) and provision of bulk water services (Local Government Act) are not well aligned.

Development market

Immediate problem – Finance The big banks have capped or reduced their lending budgets and tightened their credit controls for land development.

Underlying problem – Regulation The regulatory system is not well coordinated or integrated: Land developers must navigate a system of separate regulatory controls, governed by three different statutes, administered by multiple different branches and organisations within local government.

Residential construction market

Immediate problem – Sector capacity and capability There are not enough skilled workers to build the volume of houses and other buildings required at the pace they are needed.

Immediate problem – Finance The big banks have capped or reduced their lending budgets and tightened their credit controls for residential construction.

Underlying problem – Regulation As the construction sector moves towards greater off-site manufacturing, different processes and systems for inspecting this type of construction are likely to be required.

¹⁹ Under the National Policy Statement for Urban Development Capacity that is in the process of being implemented, territorial authorities are required to assess available development capacity. As a result of this work, a more definitive picture for high growth areas will be available by the end of the year, and for medium-growth areas by the end of next year (2018).

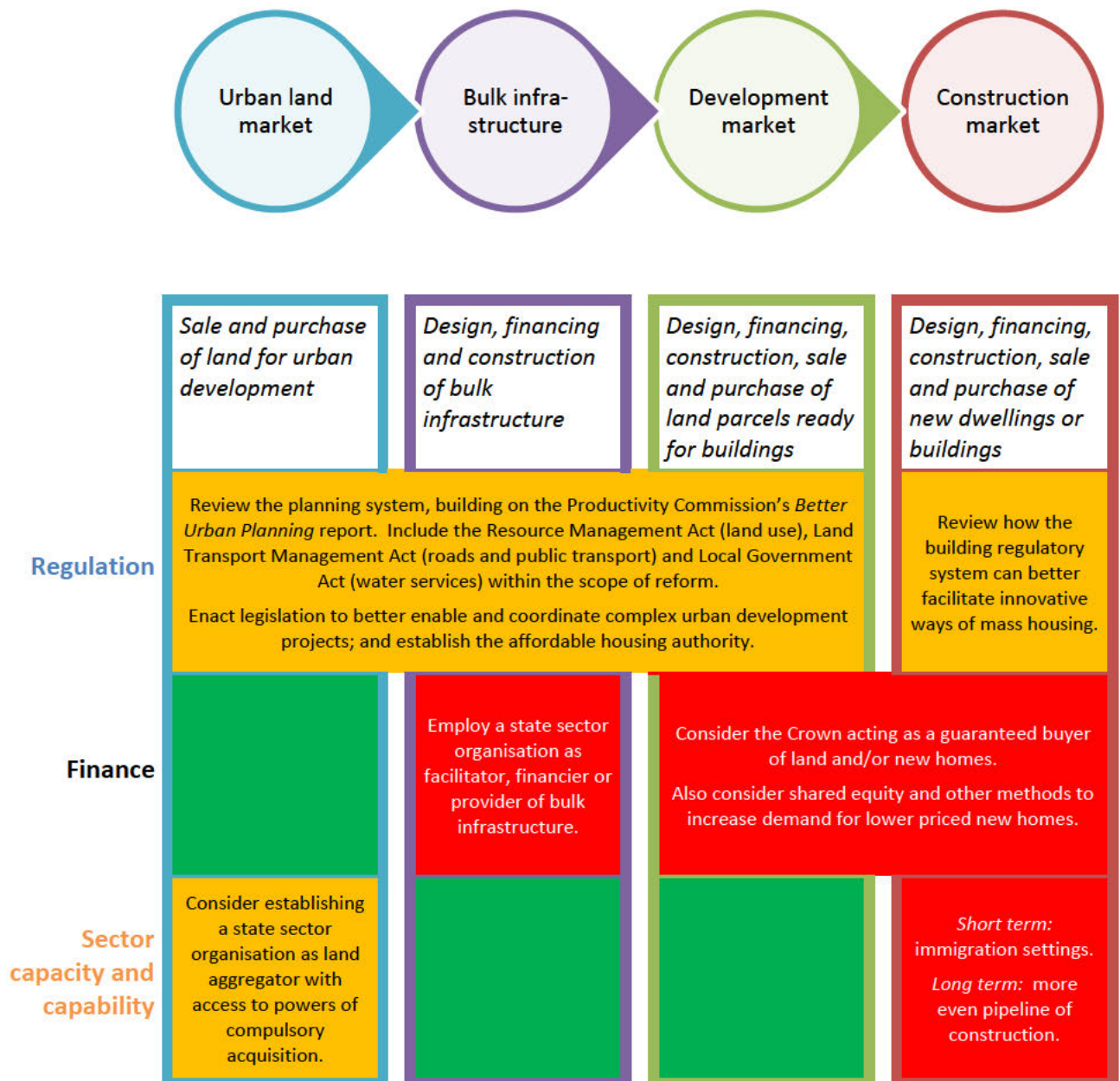
²⁰ Enough greenfield land to build a city the size of Tauranga is currently available in Auckland. Based on the Unitary Plan's assumption that no more than 40% of new homes will be built in greenfield areas, there is currently about 7 years' worth of greenfield land supply.

²¹ The principal components of the planning system comprise the Resource Management Act, the Land Transport Management Act and the Local Government Act.

Suggested areas of focus

For housing, addressing the fundamental supply problem requires a sustained increase in housing supply and sufficient demand to support it. KiwiBuild is the immediate solution. However, to address the fundamental problems that created the supply shortfall in the first place, the system-level settings also need to be addressed.

We identify key initiatives to focus on in the following table and discuss them further, below. These are consistent with, and would work to support, the priorities and initiatives that you have signalled.



Underlying problem – Regulation:

- **Undertake a review of the planning system with a focus on urban issues.** The regulatory problems in the land, infrastructure and development markets are interconnected, so need coordinated reform:
 - Because the planning system has such a significant impact on all elements of urban areas, it is important to focus on ensuring that regulatory settings are more coherent, agile and durable, and produce better decisions. We believe this will achieve the most significant improvement in the performance of urban areas over the medium to long term (5+ years).
 - We consider there is a strong case for beginning with a focus on urban issues. The rapid population growth in key urban areas has left these areas under pressure and puts at risk our ability to deliver inclusive and sustainable economic growth. Greater economic growth from urban areas would result in less relative pressure on our natural resources, helping with our climate change, water and other objectives.
 - Any review of the planning system would straddle a range of portfolios, including housing and urban development, transport, local government and the environment. You may wish to work collectively with relevant Ministers to decide how to progress a review, including decisions on its scope and governance.
- **Enact urban development legislation** that empowers complex urban development projects to access more enabling development powers; and establishes the affordable housing authority to support those projects where required:
 - This would help remove regulatory barriers and delays to large-scale greenfield and brownfield developments, and improve coordination of land use, transportation and financing tools for selected areas.
 - A considerable body of policy development has already been undertaken. Stakeholders have responded to a Government discussion document, and a Regulatory Impact Statement has been completed.
 - We recommend you give this legislation high priority, by seeking Cabinet approval for the policy proposals before the end of the year, towards enacting a Bill by the end of 2018.
- **Continue to implement the National Policy Statement on Urban Development Capacity.** Support councils to build their capability and explore a range of enforcement options if councils fall short of their obligations:
 - This is a form of national direction under the Resource Management Act 1991, whose purpose is to ensure regional and district plans adequately provide for the development of business and housing. It came into effect at the end of 2016. The aim is to enable urban areas to grow and change in response to the needs of their communities.
 - From June 2017 local authorities in medium and high growth urban areas have begun monitoring market indicators each quarter. From December 2017, high-growth urban areas need to prepare housing and business development assessments at least every three years. By December 2018, the same requirement applies to medium-growth urban areas.
 - The Government will need to continue working with Auckland Council to ensure that the development capacity it has identified in its Unitary Plan is fully enabled when and where required and that any ongoing signs of undercapacity are addressed.

- **Examine the current building regulatory system** to review how it can better facilitate innovative, mass production of housing, without compromising quality home building:
 - While there are no specific regulatory constraints that limit the development of mass volumetric house building and pre-fabricated houses, the building regulatory system is geared towards oversight of bespoke, individual housing.
 - Mechanisms have already been introduced to support the use of innovative design, materials and manufacture of home building (e.g. the product assurance system (CodeMark) and the national multiple-use approval for standardised house designs (MultiProof)).
 - A review would seek to understand why there is not greater adoption of these mechanisms by the sector and local authorities, and what modifications are needed to the building regulatory system to support innovative, mass production of residential housing.

Immediate problem – Finance:

- **Consider methods to increase demand for lower priced new homes** by enabling modest-income households to purchase newly constructed housing (e.g. **shared equity**). Developers are not serving this market segment. By enabling modest-income households to purchase modest new homes, it would broaden demand and catalyse the delivery of additional housing that the market is not otherwise providing. The capital required is significant, but there is potential to sell the equity to investors.
- **Consider the Crown acting as a guaranteed buyer of land and/or new homes** that meet certain specifications. Certainty that the Crown will purchase the new homes reduces the risk for developers and their financiers, thereby inducing greater supply of certain types of housing. The Government successfully used this method to increase housing supply in the 1950s. However, there are significant risks and fiscal implications.
- **Consider other funding options for infrastructure:** Attracting private investment to infrastructure projects could be facilitated in a number of ways. As you have already noted publicly, development contributions and rates, including targeted rates, could be combined in revenue streams tailored to each project that are funnelled to investors. Work is underway focused on developing two areas of Auckland using a model in which the Crown makes the investments and bears the risk of the projects via a restructured Crown company (Crown Infrastructure Partners). This and other models could be explored and expanded.
- **Consider regulatory changes to support third-party infrastructure provision**, which could increase the amount of capital available for bulk infrastructure. This would go beyond the model above to have private investors bear all the debts and risks from the investment and create their own revenue stream. Further regulatory and economic reforms would need to be considered in order to allow third-party investors to be able to generate revenues through fees, in order to credibly bear all the debts without the council being liable for them.

Immediate problem – Sector capacity and capability:

- **Facilitate migration of experienced construction workers** into New Zealand to overcome immediate labour shortages and build capability.
- Over the longer term, the key to attracting and retaining a sufficiently capable construction sector workforce is **a reliable pipeline of construction work** that continues at a reasonable level during cyclical downturns. Crown-led development projects can play an important role, including under the urban development authorities legislation.

Underlying problem – Sector capacity and capability:

- Use the strength of the Crown's balance sheet and its access (in the last resort) to powers of compulsory acquisition to **assemble commercially viable blocks of land** for urban development, particularly in existing built-up areas. The urban development authorities legislation provides one mechanism for doing so.
- Use Government procurement and large-scale urban development projects to **catalyse innovation and productivity improvements in the construction sector** (e.g. by procuring volumetric modular housing) and to leverage skill development in the sector. Pre-fabrication of standardised designs has the potential to reduce construction costs by 15% and time by 60%.

Summary

The table below provides a list of both current initiatives and the potential initiatives described above. We can provide further information on the current initiatives if desired.

	Option	Status	Commentary
Short to medium term	Urban development legislation	New	Explore objectives and options.
	Crown Building Programme Auckland Housing Programme Crown Land Programme	Implementation	Leverage or adopt for KiwiBuild.
	Funding options for bulk infrastructure	New	Explore other options.
	Access to development finance	New	Explore options for Crown to assist.
	Increase sector capacity	New	Facilitate immigration & explore other options.
	Enable demand for new lower priced homes	New	Explore shared equity and other options.
	Review building regulatory system	New	Focus on mass production of housing.
	NPS on Urban Development Capacity	Implementation	Consider stronger enforcement options.
	Housing Infrastructure Fund	Implementation	Continue rolling out.
	Auckland Plan refresh	Scheduled for 2018	Work with Auckland Council.
	3-waters review	Under way	Continue.
	Construction Pipeline & Occupation reports	Ongoing	Continue.
	Special Housing Areas	Implementation	Continue. Automatically disestablishes in 2019.
Long term	Review the resource management & planning system with a focus on urban issues	ProdCom report	Initiate reform. Include RMA, LTMA, LGA.