

Annexe D of Estate agency market in England and Wales

Competition case studies

A report on case studies of local markets for estate agency services in the sale of residential property

Prepared for the Office of Fair Trading
by NERA

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Full list of documents available on the estate agency study

Main report	Estate agency in market England and Wales	In hard copy from orderline (free of charge) and on web
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Due to legal obligations relating to the disclosure of information we are able to publish only two chapters of this annexe – Chapter 1 ‘Executive summary’ and Chapter 3 ‘Analysis and conclusions’.

1 EXECUTIVE SUMMARY

- 1.1 NERA was commissioned by the Office of Fair Trading to analyse competition in the provision of estate agency services in six localities in England and Wales: Cardiff (South West Cardiff), Coventry, Leeds (Harehills), London (Balham), the villages around Northwich, and Winchester. This paper sets out the results of our studies.

KEY FINDINGS

- 1.2 Our key findings are listed below.
- 1.3 We found significant differences in estate agency provision in our six localities, in terms of how wide the local market appeared to be, the degree of differentiation between estate agents in terms of geography and property price band, the level of market concentration, and the history of entry. We conclude from this that there are likely to be other models of estate agency in other localities that differ significantly from those we looked at, and that our sample cannot be taken to be representative of all localities of England and Wales.
- 1.4 In terms of market structure our six areas range from unconcentrated to moderately concentrated. There is evidence of significant entry and market churn in almost all of our areas, including churn in market leadership. We conclude from this that on standard structural indicators of competitiveness, local estate agency services appear to be broadly competitive.
- 1.5 In four of our areas we found that fees for higher value properties tend to be higher, and in general agents tended to express their fees as a percentage of the property value. Although in many cases they would consider discounts against this, the evidence pointed to absolute fees rising sharply for higher value properties. There was little evidence that these increases are cost related. There appear, therefore, to be rigidities in price setting by estate agents.
- 1.6 There is also evidence of rigidity in fee setting over time, with fees as a percentage of property value tending not to adjust quickly to movements in property values. The effect has been that as property price have risen, agents' fees have also increased. Estate agency accounting data tended to confirm that estate agency was a pro-cyclical business. We note a number of caveats

with a strong conclusion on these dynamic rigidities, but conclude that the balance of the evidence is supportive of a degree of rigidity in price setting over time.

- 1.7 We conclude that the combination of structural indicators pointing to a broadly competitive market and the existence of significant rigidity in price setting is an unexpected paradox that required explanation.
- 1.8 The differences between our areas seems informative. At one extreme is Coventry, which is the least concentrated of our six areas. It is also the least differentiated in terms of product positioning. We noted with interest that there is weak evidence that Coventry also appears (along with Leeds Harehills) to have had the least tendency for estate agents' fees to be higher for more expensive properties (and over time). Thus although the other markets are only moderately concentrated, that degree of concentration may provide part of the explanation for our paradox.
- 1.9 We conclude that there is some degree of product differentiation between estate agents, with some agents opting to focus on narrow localities, positioning themselves in different price bands, and the adoption of different business models that are likely to appeal (to some extent) to different groups of consumers.
- 1.10 We note that most property vendors only ask for quotes from a few agents, not all the agents in the locality. We also conclude that there is little evidence of overt price competition prior to the invitation to quote for a particular property, and that there is very little transparency in pricing prior to asking for a quote. Consequently price competition in any particular case tends to be between only a few agents. This two-stage form of competition is likely to exacerbate the impact of product differentiation and to dilute the intensity of competition on price.
- 1.11 We conclude that strong collusion was unlikely to be successful for a range of reasons. However, we were struck by the wide ranging quoting of fees as a percentage of property value where those fees tended not to fall for higher value properties. We consider that this may indicate a weaker form of collusion, with a degree of market 'understanding' that this is how fees should be quoted.
- 1.12 We conclude that the evidence on concentration and market entry makes it unlikely that estate agents enjoy market power in the classic anti-trust sense (in most localities). However, we consider that the evidence on pricing rigidities is nonetheless potentially damaging to consumers.

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3 ANALYSIS AND CONCLUSIONS

3.1 We have collected and analysed evidence on the structure and behaviour of the estate agency market in six localities. Two important themes have emerged. First, a combination of moderate market concentration and evidence of significant churn in suppliers suggests that these are broadly competitive markets. Second, estate agents' percentage fees display rigidities that do not appear to be directly cost related. If the market were truly competitive, as suggested by the structural analysis, we would expect competition to ensure that fees adjusted to reflect costs. That they do not appear to have done so is a paradox to be examined.

3.2 We consider five possible resolutions of the paradox:

- We have overstated the paradox, either because the simple structural indicators of market power understate the true level of concentration, or because the degree of price rigidity is lower than first appears.
- The broader structural indicators fail to capture a significant degree of *differentiation* between agents (or groups of agents). If each agent has a degree of pricing independence, this could explain rigidities in pricing.
- There are reasons to believe that *focal point collusion* is sustainable in these markets, the structural analysis notwithstanding.
- Even though fees display rigidity in relation to marginal costs, there are nevertheless other **cost based** explanations for fee rigidity in percentage terms. In particular, there is the possibility that fees and profits are pro-cyclical, but that only normal profits are earned over the cycle.
- A combination of two or more of the above.

3.3 In the following we review the arguments and evidence for and against these four candidate propositions, and draw out inferences and conclusions.

Evidence of the existence of the paradox

3.4 We might have overstated the paradox for two reasons. First, market structures in estate agency may be more concentrated, or barriers to entry may be higher, than we suggest. Second, the degree of pricing rigidity may be less than we have indicated.

EVIDENCE ON MARKET STRUCTURE

3.5 We have reviewed estate agency services in six localities. An overview of various summary statistics describing the size of these areas and the degree of market concentration associated with them is provided in Table 3.1 below.

TABLE 3.1 SUMMARY OF COMPETITIVE CONDITIONS IN EACH LOCAL AREA

	<i>Cardiff, Coventry South West</i>	<i>Leeds, Balham Harehills</i>	<i>Northwich</i>	<i>Winchester</i>		
HHI (Value)	1,441	748	1,852	1,076	1,283	863
HHI (Number)	1,624	681	1,988	985	1,292	889
Share of largest firm (Value)				[CI]		
Share of largest firm (Number)				[CI]		
Four firm CR (Value)	69%	44%	81%	57%	58%	48%
Four firm CR (Number)	72%	37%	83%	49%	58%	46%
Market size – value (£m)	121	635	37	170	188	223
Market size – number ('000)	992	6,532	812	560	1,021	879
Average Fees (%)			[C.I.] ⁴			
Average absolute Fees (£)			[C.I.]			
Number of active agents	22	39	7	18	13	18
Transactions/agent – number	45	167	116	31	79	49
Transactions/agent – £	76,907	202,764	52,545	184,020	196,862	220,523

Source: NERA calculations from property lists

3.6 We are reasonably confident that the geographical areas provide a reasonable frame of reference for considering competition, and that we have identified the elements of segmentation that arise in those areas. It is useful at the outset to give a thumbnail characterisation of each of our areas.

⁴ Confidential information.

Area	Characterisation
Cardiff (South West)	Served by a combination of highly localised agents, and agents that sell over our area and beyond. Generally low differentiation by price band.
Coventry	Low differentiation by either geography or price band. 'Market' appears to be the whole town. Lowest concentration of our areas.
Harehills, Leeds	Highly localized market, with sales dominated by a local cluster of four agents. Highest concentration in consequence, but recent examples of effective entry.
Balham, London	Evidence of price and geographic differentiation, but high level of overlap. Significant out-of-area sales by local agents and into-area by other agents. Strong presence of recent new entrant.
Villages around Northwich	'Doughnut' of villages around town of Northwich served primarily by agents located in the town. Minimal sales from outside. Limited differentiation by sub-locality or price, and strong presence of recent new entrants.
Winchester (town)	Agents located in town have substantial business in surrounding villages. No sales in town by agents located outside. Strong differentiation between agents serving high and low price bands. Low differentiation in sub-localities within town.

3.7 Our conclusion is that the levels of concentration we observe are unlikely to support single firm dominance or general collusion. But we do recognise that market supply is not wholly fragmented and that these are best characterised as 'moderately concentrated' markets (other than in Coventry). Moreover, although we have sufficient evidence on entry and exit over time to be confident that it is perfectly possible for agents to enter a local market and achieve a strong market position given time, we also believe that short term 'hit and run' entry is generally not feasible (although there are examples of rapid establishment of a strong position). These markets are not wholly contestable. Thus while we do conclude that these markets are 'broadly competitive' in structural terms, and that market dominance (monopoly or oligopoly) is not likely in the classic anti-trust sense, neither would most of them appear to be perfectly competitive. Some pricing rigidities may exist in other 'broadly competitive' markets, and perhaps this provides part of the explanation here.

EVIDENCE ON FEES AND COSTS

3.8 We have two important pieces of evidence. First, that absolute fees are higher for higher value properties and that the differences do not appear to be fully explained by differences in the costs of selling them. We term this *cross sectional pricing rigidities*. Second, absolute fees have fluctuated with the housing cycle in a way that is not explained by movements in costs. We term this *dynamic pricing rigidities*. We consider the possibility of different types of cost based explanations later in our analysis. Here we consider the robustness of the evidence that we have on simple fee-cost comparisons analysis.

Cross sectional pricing rigidities

3.9 We believe that there is persuasive evidence that absolute fees tend to rise substantially for higher value properties (within an area, and possibly excepting Coventry), and that this is not associated with corresponding changes in marginal costs.

Dynamic pricing rigidities

3.10 We are confident that estate agents' profitability is pro-cyclical in many areas, which supports the contention that movements in fees are not generally explained by cost-push factors. However, we are less confident of the *magnitude* of this effect, and note in particular that we do not have good evidence on ancillary revenues from financial services (which appear to be driven in part by the core estate agency business). We note that broader evidence on cost movements in our localities suggests that cost-push explanations may be more significant in Coventry, Leeds and Northwich. In the case of Coventry this supports the notion that Coventry is the most competitive market structurally. Northwich gives some pause for thought (but we stress that this evidence is weak). Thus we cannot rule out the possibility that the paradox is overstated.

3.11 Evidence on entry over the cycle also provides some evidence that the paradox is overstated. If estate agents' profits have indeed been rising rapidly with the housing boom, we might anticipate greater entry in consequence. However the evidence in our areas (and for the UK nationally) indicates at best only a weak association of net entry with the housing cycle, and the general conclusion is that entry is not particularly cyclical. Given our conclusion that entry appears to be feasible this suggests caution on overstating the dynamic rigidities.

Why cyclical profits, non-cyclical entry and low barriers to entry can coexist

- 3.12 There is, however, an alternative interpretation for why entry does not strongly follow the cycle. This is that there are significant dynamic rigidities that create substantial windfall profits when house prices and transactions are rising, but that potential entrants cannot predict when these are going to occur and how long they are going to last. The existence of rapid price and transactions increases in the past is not obviously a good indication of the future. Indeed given the possible existence of speculative bubbles, rapid increases in the recent past may be as much an indication that a crash is on the horizon as it is that further rises can be expected. Our evidence is that it takes time to become established in a locality, and 'hit and run' entry is not generally effective. In a market subject to as much volatility as housing, lags of one to two years to become established may provide an important reason why entry is less cyclical. This lack of cyclicity may be consistent both with entry barriers generally being low, and estate agents being able to earn higher profits in booms without necessarily attracting entry to compete them away.

The Coventry benchmark

- 3.13 Structural indicators suggest that Coventry is the most competitive of our local markets. Judged against the most reasonable proxies for local relevant economic markets, Coventry has the largest number of actively competing suppliers, the lowest level of concentration, and demonstrated the least amount of differentiation between agents. There is weak evidence that in Coventry absolute fees display minimal variation across properties of different value, and over time (despite the housing boom being significant in Coventry). The suggestion is that the rigidities that are observed are stronger in markets that are structurally less competitive.
- 3.14 We conclude that there remains a paradox to be explained in the other areas, and that the comparison with Coventry indicates that this paradox does require a structural or behavioral explanation.

Differentiation between estate agents as the reason for rigidities

- 3.15 If estate agents were differentiated to the extent that they have some independence in pricing decisions, movements in demand (greater transactions over the cycle) would be expected to have some impact on fees and margins over costs. In contrast to a competitive commodity market, where prices should rapidly adjust to reflect costs, where there is product differentiation this may not occur. Moreover, one dynamic effect that could

lead to a reversion towards at least average costs would be pressure from new entry (as demand increases, margins and profits increase, attracting new entry until market profits revert to normality). But as we have seen, entry does not appear to be strongly pro-cyclical and there are plausible reasons for why this should be the case. Thus a conclusion that estate agency markets are differentiated would be consistent with rigidities over the cycle.

- 3.16 Product differentiation could also be consistent with cross sectional price rigidities. It may be the case that vendors become less price sensitive the higher the value of their property. In a world of significant differentiation, this difference would be exploitable. Again, the existence of differentiation could be consistent with the observed rigidities.
- 3.17 Estate agents are differentiated in a number of ways. First, some agents focus more on up-market properties. This is in evidence in all of our local areas (except Coventry) and although there are large overlaps in most areas (Winchester being the main exception) some differentiation along these lines clearly exists. There is also geographic specialisation, especially in Cardiff and Balham (to a lesser extent). Agents may be differentiated by type. Estate agents provide a personalized service of considerable importance to vendors. 'Traditional' independent agents claim to offer a more tailored customer focus, while chains may benefit from a degree of brand presence or association with a financial institution. Length of time in the market and precise office location may also be significant. There are variations in advertising intensity and in opening hours. The personality of the individual agent is unlikely to be of trivial concern to consumers. In any given locality there are a multitude of different combinations of agents' characteristics, the importance of which is likely to vary across customers. We call this *standard product differentiation*.
- 3.18 There is also a more unusual element of differentiation that arises from the way in which estate agents market their services. While a consumer may have a large number of agents to choose from, they typically will ask for quotes from only a few agents. Thus estate agents engage in two-stage competition. At stage one they compete to be invited to give a valuation and bid. If successful, at stage two they bid against the, fewer, other agents also invited to bid. But our evidence is that in general agents **do not compete on price to be invited to bid**. Indeed levels of price transparency as far as consumers are concerned are very low at this stage. Thus the active **price competition** in the market on any instruction does not occur between all possible competitors, but only between a subset of them (although which subset and how large it is

will not always be known to the participants). This is a further form of 'differentiation' because on any individual transaction a large part of the market does not compete.

- 3.19 Moreover, the two-stage process will tend to **compound** the effects of the standard product differentiation that we have noted. If a vendor interviews twelve agents it is likely that they will 'feel comfortable' with, say, four of them. But if they invite only three they may find only one that they like.
- 3.20 We consider that the combination of standard product differentiation and the limited price competition in advance of being asked to bid for a property provides one plausible explanation for our paradox.

Focal point collusion

- 3.21 Price collusion provides an alternative candidate explanation for our paradox. Here we consider 'focal point' collusion, the form of tacit collusion that we consider most plausible in an estate agency context. We have not seen evidence of explicit collusion (although it was not part of our brief to look for it).
- 3.22 Focal point collusion on the level of percentage fees could in principle explain the rigidities that we have observed. Collusion could operate at two levels. There could be collusion across the market (or at least between the major players) and there could be collusion among sub-segments of the market (thus accentuating the observations made above on differentiation).
- 3.23 Estate agents mostly express fees in percentage terms and at intervals of 0.25 percentage points. In the context of percentage commissions of around 1.5%, these imply large pricing intervals and as such would be particularly useful for sustaining focal point collusion. However, we consider collusion across the market generally to be unlikely for the following reasons:
- There are too many agents in most localities and the markets are insufficiently concentrated. (With the exception of Harehills in Leeds, our markets typically have ten or more active players).
 - Differentiation between agents, particularly between different types of agents with different cost structures and profit focus, is likely to undermine the prospects for sustaining collusion.
 - The sheer volatility of the housing cycle would tend to undermine collusion around the focal points.

- With low levels of pricing transparency, imperfect knowledge of which agents were bidding for an instruction, the fact that a range of factors might influence the choice of agent, and the fact that there is a range of cost based factors that are not only subjective but also likely to influence the appropriate bid, would all tend to make both detection and punishment very 'noisy'.
- Fees are only one part of the package offered. The valuation also appears to be important. (Certainly, it was seen as being important by the estate agents themselves). Colluding around the focal point of a single fee rate can only ever be partial.
- Even where agents have a standard fee rate in percentage terms (and several do not) most agents are prepared to discount against this. Thus focal point collusion is not required against just one element of fees, but against a range of fees (and, arguably, how to choose along that range). Collusion in such circumstances is not wholly implausible, but these complexities further undermine the prospects for successful collusion. Moreover, our data on standard fees displays variation (although most are expressed in 0.25 percentage point intervals).
- There has been significant churn in each of our areas (with incumbents being replaced by new entrants), and this has caused the identity of the larger firms in the market to vary. Moreover, many of these entrants will have offered low fees when setting up in the market. Dynamics of this type would tend to destabilise a collusive outcome.
- Finally, there was only limited evidence that agents have a very accurate notion of their competitors' fees (although some did), but rather they have a broad idea to which they react in bidding for particular instructions.

3.24 While there are good reasons for supposing collusion to play a relatively small role, we do continue to find the general absence of lower percentage fees for higher value properties to be arresting. It is difficult to exclude the possibility that at least the convention of expressing fees in percentage terms that do not generally decline with higher property values indicates some degree of mutual 'understanding' by participants in the marketplace. This too can be considered a form of collusion, albeit of a general form. A combination of this 'understanding' with the rigidities that arise with differentiated supply (in the less fragmented markets) seems broadly consistent with what we observe.

Cost based explanations for the rigidities

3.25 There is reasonable evidence that movements in the direct marginal costs of selling different houses over time are insufficient to explain either cross sectional or dynamic pricing rigidities. But this is a very narrow basis for the cost assessment. Two further areas that could provide a partial explanation relate to:

- Average costs of quality.
- Cost recovery over the cycle.

Average costs versus direct marginal costs

3.26 One potential reason why fees are higher for more expensive properties is that although the *marginal* costs of selling the house might not be significantly higher than the marginal costs of selling a less expensive property, the *fixed* costs of offering a higher level of quality will generally be greater for agents dealing in higher value properties. In the long run all costs are variable, and fees would need to reflect these fixed costs in a competitive market. In short, vendors might be paying for value.

3.27 We do not have sufficient evidence to determine whether this can explain pricing structures for differently valued properties. We think it an unlikely coincidence, however, that any increase in the average costs of providing higher quality services should have a linear relationship with the value of the property concerned. Moreover, this explanation does not explain **dynamic** rigidities, and at best is a partial explanation.

Cost recovery over the cycle

3.28 The second possibility is that profits are cyclical, and this cyclicity involves losses when the market is weak. Remaining in the market at such times may be viewed as an 'investment' in maintaining a strong presence and local reputation, to be recovered over the cycle. This view relies on the existence of product differentiation in the form of rents being associated with reputation, and as such is a corollary of the general product differentiation conjecture. Accounting data, which shows negative operating profits for a number of agents during the trough, provides some evidence for this conjecture.

3.29 Our earlier observation that agents and potential entrants are unable to predict the cycle is also relevant here. Agents may make their decision to enter or remain in the market on expectations of profitability 'over the cycle' with the effect that supernormal profits are not expected to be earned (assuming barriers to entry to be low), but if the cycle is not known with

certainty (which it definitely is not), actual profitability over time will equal expectations only by coincidence. Thus even if it were shown that profits over the cycle have been particularly high or particularly low, we should still be cautious in inferring whether this would imply market power in the classic anti-trust sense.

Conclusions – a combination of factors

3.30 We have discussed four candidate resolutions to our paradox. We cannot rule out the possibility that all are in operation to some degree. But on the balance of the evidence and our analysis we consider that the following combination of factors is likely to account for a significant part of the answer:

- Market structures are moderately concentrated (rather than perfectly competitive), which itself is consistent with some lag in the reversion of the market to reflect costs in the face of significant cyclical effects.
- There is differentiation between agents, and there is a two-stage game in which *price* competition takes place between only a subset of the potential competitors in the market.
- While tacit collusion in its strong form seems unlikely to be sustainable, we do find the convention of expressing fees in percentage terms that do not decline with property values striking. Perhaps conditioned by the other rigidities in the marketplace, we find this indicative of at least some ‘understanding’ between market participants.
- The cycle matters, but is unpredictable and therefore slow to attract entry during windfall periods. It is possible that, while rigidities may result in periods of windfall profits, these are counterbalanced by low profits in the troughs.

3.31 We consider that the other factors may also play a part, but in addition to these features.

3.32 These conclusions imply the possibility that agents can have ‘market power’ in the broad sense of being able to price independently of competitors to at least some degree, that a broad ‘convention’ on fees rising with property values seems plausible, and that prices are above short run marginal costs. With low barriers to entry we doubt if agents are likely to have significant market power in the classic anti-trust sense. But this may be of scant comfort to property vendors who face the consequences of these rigidities.