

How will the electricity crisis affect property?

Prior to the recent paralysis of the mining industry, most South Africans probably did not fully appreciate the extent of the country's electricity problems and the implications they hold for the economy — and hence the property market.

Commenting on the relationship between economic growth and electricity consumption, property economist Erwin Rode, from Rode & Associates, notes: “We built a simple statistical model using data for the past 10 years, which shows that a 1% increase in economic growth was accompanied by an increase in electricity consumption of roughly 0,8%. This shows that in a modern economy growth in economic activity is highly dependent on the availability of electricity – in case we needed any reminding.”

Eskom currently has available capacity of some 37 700 MW. This is insufficient as peak-time usage has recently been as high as 36 000 MW in mid-winter, which means that the system has an inadequate reserve margin (which should be about 15%). This results in a strain on (old) equipment, which could lead to unplanned outages, especially during peak times. The situation is, of course, compounded when routine maintenance is undertaken – not to mention the widely reported dearth of skills at Eskom after more than a decade of an exodus of skills.

Thus, the current supply-demand situation is already untenable, and breakdowns in supply to users are inevitable, as we have seen so far this year. But things will probably get worse because when the economy grows at 4% per annum, Eskom needs to generate an extra 0,8% or about 1400 MW per annum just to maintain the already precarious status quo.

Eskom plans to increase capacity over the coming four years (starting 2008) by some 1155 MW, 2421 MW, 2450 MW and 1285 MW respectively (an average of 1 800 MW per annum). This it aims to achieve by bringing mothballed power stations back into operation and by erecting new open-cycle gas-turbine systems. However, the latter are meant to run only during peak times as they are driven by diesel, which is excruciatingly expensive.

From the above, we can see that that our salvation is not going to lie on the supply side, given the long gestation period of new base stations.

To increase the reserve margin in the short term, Government is pinning its hopes on a power conservation programme which will, inter alia, involve quota allocations, penalties and cut-offs.

“A major obstacle in the way of saving electricity is the fact that the cost of electricity has not kept pace with the cost of constructing new power stations. The disproportionately low price of electricity is the reason why businesses and households do not have sufficient incentives to save power and/or incur costs in generating their own power. If Eskom wants to succeed in freeing up capacity they will need to be allowed to increase the price of electricity drastically,” says Rode. “Think 50% or more, immediately.”

A few months ago — i.e. prior to the mining interruption and before financial markets started their volatility — economists expected robust growth of around 4% p.a. (or more) for the next few years. Given the electricity crisis, growth could be less, depending on how well the authorities manage the situation, as well as foreign investors’ reaction to the cocktail of a world slowdown, the SA political uncertainties and power outages.

“If economic growth in SA turns out to be notably lower than previously predicted, the demand for space would decelerate in tandem, and with new stock already in the pipeline coming onto the market in the next year or two, property vacancies will increase.”

As far as building activity is concerned, Rode notes that developers will probably take the biggest knock, as a lack of power capacity – not to mention other infrastructure – will hold up the passing of building plans. Anecdotal evidence to this effect has been around since before last year.

One of the crucial success factors for developmental sites has become the likelihood that electricity (and other services) can be delivered.

Contractors will, as a result of stronger tendering competition, be forced to slash their profit margins, which will bring down building-cost inflation somewhat. Notwithstanding this, building-cost inflation will remain under pressure – firstly, from a weakening rand and, secondly, because the authorities might start demanding from developers to construct more energy-efficient buildings, which will add to their costs.

On the residential front, house prices have been decelerating for some time now and are probably not growing any more. Slower economic growth will reinforce this trend. The unknown factor is when and how fast interest rates will come down.

“For planning purposes, I would advise against accepting a scenario in terms of which interest rates will come down this year or, for that matter, significantly soon, because there is the little matter of our bloated deficit on the current account, which exposes South Africa to the whims of foreign investors’ perceptions,” says Rode.

The net effect on the property market will obviously depend on the extent to which economic growth is negatively affected, and this in turn depends on the degree to which South Africans can in the short run adjust to a more electricity-efficient economy. “Without a quantum leap in the price of electricity a call on patriotic duty is likely to fail in the longer run. Be that as it may, the perceived risks to players in the economy are now much higher and investors will demand a higher rate of return to compensate them for the risk premium,” adds Rode, “and this is not good for economic growth.”

The bottom line is that power to the people will become much more expensive.