PROPERTY INSIGHTS – THE PROPERTY IMPACT OF ELECTRICITY TARIFF HIKING

Last week's NERSA announcement of a 9.4% electricity tariff hike in 2019 is likely to lead to a renewed increase in electricity's share of total property operating costs, after a mild decline at a stage of last year.

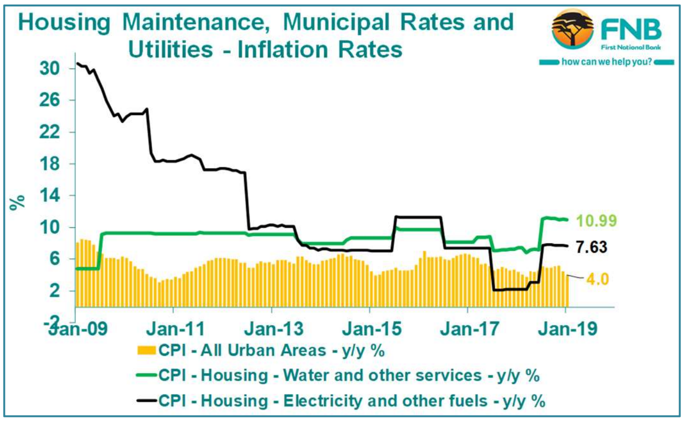
11 March 2019

Last week's NERSA decided to allow a further above-inflation tariff hike.

While the 9.4% increase granted for 2019 wouldn't appear too harsh in isolation, one has to evaluate the trend of tariff hikes well in excess of CPI inflation over more than a decade, which has significantly altered property operating costs and thus property affordability.

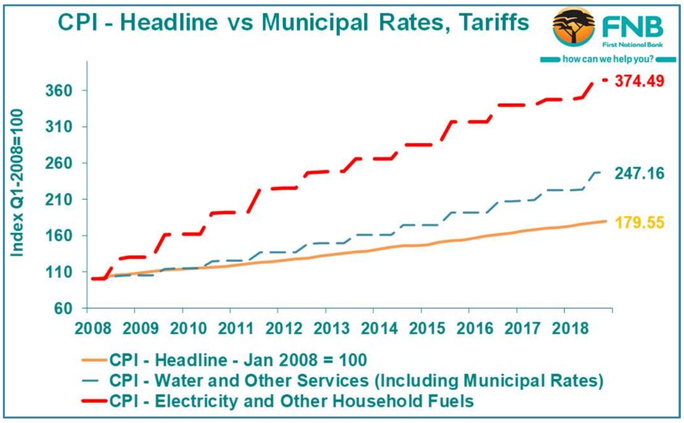
Since 2009, the CPI for Electricity and other Household Fuels has well-exceeded overall CPI inflation almost all of the time bar a short period from mid-2017 to mid-2018.

The latest tariff hike approval doesn't appear to alter this tariff inflation sharply from where it was as at January, i.e. 7.63% (when overall CPI inflation was at 4%).



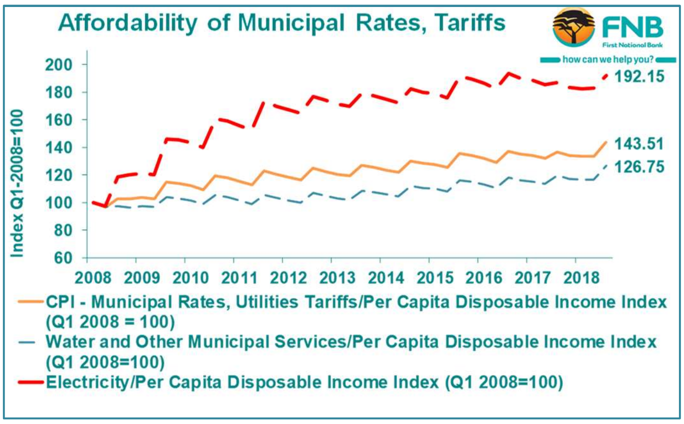
However, the cumulative inflation rate in the Electricity CPI since the 1st quarter of 2008 (about the time where the Eskom Crisis first gathered steam), to the final quarter of 2018, just over a decade later, was a massive 274.45%. By comparison, the CPI for Water and Other Services (meaning municipal rates and other non-electricity utilities tariffs) inflated by a lesser, though also sharp, 147.16%.

Both of these indices cumulative inflation rates over this period were well-above that of the Headline CPI, which inflated by 79.55% in what has actually been a relatively low moderate general inflation environment.



IMPLICATIONS FOR RESIDENTIAL DEVELOPMENT

On the Residential Property side, sharply rising electricity costs (along with municipal rates and other utilities tariffs) have long since become a housing-related affordability challenge. We use the Consumer Price Index for Electricity to compile an Electricity/Per Capita Income Ratio Index starting in 2008. It shows that the electricity tariff increases applied to consumers have far outstripped Per Capita Income growth, with this index increasing by a massive 92.15% from 2008 to end-2018 as a result.

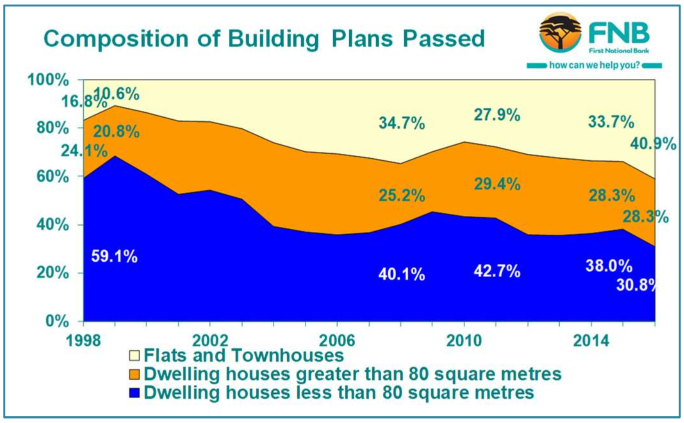


And it is important to bear in mind that the CPI for "Water and Other Services" also saw its affordability index deteriorate (rise) by 26.75% over the period, thus adding further upward pressure to home operation-related costs

This provides a strong incentive for households to lower electricity consumption or to cut broader operating costs on the home to compensate for the sharp electricity cost increases, and one way of doing it is to purchase a smaller home with less "frills", such as swimming pools" which can add to operating costs significantly. The other way is to cut electricity costs, either through more energy efficient homes or alternative energy sources.

Not surprisingly, therefore, building statistics show an increasing portion of building activity being Flats and Townhouses, much of this assumed to be sectional title, as opposed to free standing houses, the former being more land efficient and often more economical to maintain and run too.

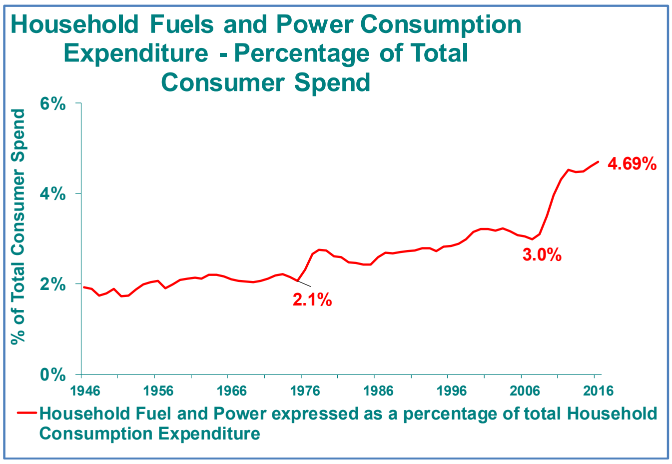
From 27.9% of residential units' plans passed in 2010, the "Flats and Townhouses" category of StatsSA's building stats rose to 40.9% of total units' plans passed in 2018. Not all of this increase in this category's share is due to municipal rates and utilities' tariff increases, but we believe that this is a key contributor nowadays.



We expect that average building size for new residential properties will decline, in part helped smaller by rising electricity costs.

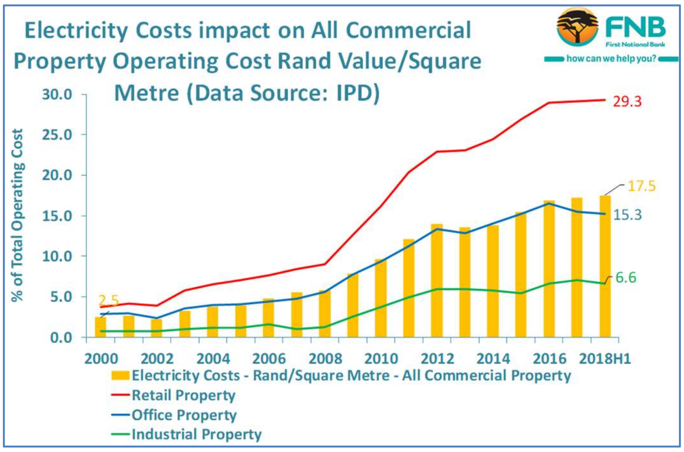
Over time, sharply rising electricity costs also "crowd out" disposable income, some of which would otherwise be aimed at funding property purchases.

Using SARB Household Consumption Expenditure data, we see the portion of total consumer spend being spent on "Household Fuel and Power" as having risen from 2.1% in 1975 to 3.0% by 2007, and then more sharply to 4.69% by 2017 in part due to sharp increases in power costs over the past decade.



IMPACT COMMERCIAL PROPERTY

The operating cost impact of electricity tariff hikes has been significant on the Commercial Property side too, especially in the area of Retail Property. For All Commercial Property, IPD data shows electricity costs in terms of Rand/Square Metre/Month rising by a sharp 216.4% from 2008 to the 1st half of 2018. This is compared to 115.7% for Total Operating Cost over the same period, and only 88.7% increase for total operating cost/square metre excluding electricity.

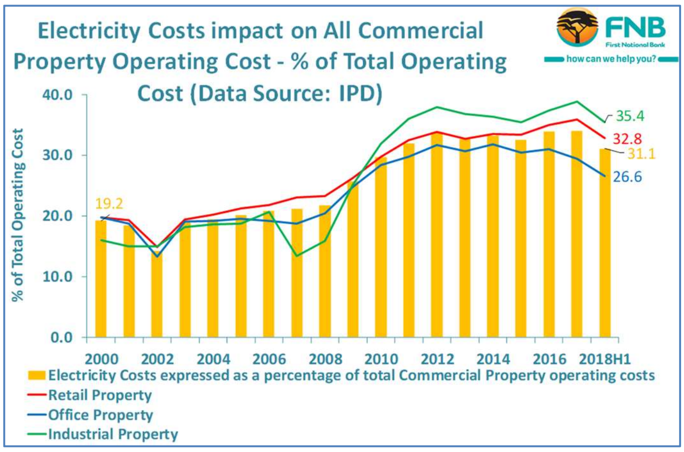


In the process, this has meant that the electricity cost component of property operating costs has risen from 21.1% of total operating cost in 2007 to a 1st half 2018 percentage of 31.1%.

Electricity has thus become a big deal for property owners and occupants over the past decade.

This most recent 31.1% estimate was slightly down on the 34% high of 2017, with electricity price inflation having been more moderate from mid-2017 to mid-2018. But the recently announced hike suggests the likelihood of renewed increase in electricity's share of total operating cost.

This then begs the question as to whether such operating cost increases, in a toughening economic environment, would “crowd out” a portion of rental growth that otherwise may have occurred in a stronger market, given financial pressure on tenants.



While the electricity cost portion of operating costs is highest in the area of Industrial and Warehouse Property (35.4%), Retail Property operating cost in terms of Rand/per square metre/month is far higher than Industrial and Warehouse Property, so the electricity cost/square metre/month in Retail Property averages R29.3, compared to a far lower R15.3 for Office Space and R6.6 for Industrial and Warehouse Space.

The potential impact of major electricity tariff hikes would thus appear highest in the area of Retail Property, depending on how one views it.

CONCLUSION

In short, electricity supply cost inflation looks set to accelerate once more.

For the Property Sector this looks like “more of the same” if one looks at high electricity cost inflation over the past decade.

On the Residential side, we expect this to contribute to the longer term trend towards building more land/operating cost-effective flats and townhouses (much of it being sectional title) relative to the number of free standing homes. We also expect the average size of units built to decline further, helped on in part by electricity tariff inflation, along with other rates and tariffs inflation which is also significant.

Each above-inflation tariff hike also adds to the motivation of households and businesses alike to become less dependent on the grid through finding alternative energy sources, and the upside of this is that it often promotes cleaner types of energy.

Electricity inflation can also be a boost for “green” building demand where energy efficiently can be improved.

And, of course, on the retail Property side, where Electricity Cost/Square Metre is highest of the major property categories, renewed hiking can further encourage the drive towards retail alternatives such as online shopping.

Above, we have focused on the magnitudes by which electricity costs have risen and the direct impact on affordability for households and commercial properties.

But there are potential indirect impacts too, via the economy. A lack of reliable and affordable electricity can impact negatively on near term economy-wide production (GDP, or Gross Domestic Product), and on longer term growth through dampening sentiment and future investment in production capacity.

It also exerts upward pressure on CPI inflation, although not a major driver of CPI inflation, and this can possibly mean that we have higher interest rates now than would have otherwise have been the case over the past decade (although we’ll never know for sure).

And interest rates and economic growth both feed back into levels of demand for property and thus its performance.

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