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NATURAL RESOURCES PRACTICE | EDITION 3 | OCTOBER 2020

BENEATH THE SURFACE

RENEWABLE ENERGY: THE NEXT PHASE IN SUSTAINABILITY

Does renewable energy address the three pillars of sustainability: People, Planet and Profit?

IN THIS ISSUE:

DOES RENEWABLE ENERGY ADDRESS THE THREE PILLARS OF SUSTAINABILITY: PEOPLE, PLANET AND PROFIT?....02

SOUTH AFRICA'S TRANSITION TO RENEWABLES SHOWS SOME PROMISING DEVELOPMENTS....04

WILL INVESTORS FORCE THE HAND OF THE MINING AND ENERGY SECTOR TO FOCUS MORE ON SUSTAINABILITY AND CLIMATE CHANGE?....06

REFINANCING INDEPENDENT POWER PRODUCERS....08

DOES RENEWABLE ENERGY ADDRESS THE THREE PILLARS OF SUSTAINABILITY: PEOPLE, PLANET AND PROFIT?

Renewables are the solution to reducing South Africa's impact on the environment. South Africa is still mainly reliant on coal powered stations for the generation of electricity. The inception of renewable energy in all forms will see this reliance declining and possible changes in legislation to reduce the reliance on and damaging impacts of our high dependence on coal fired power.

However, there will need to be a clever balancing act as the question remains, what will happen to the workforce and communities that are reliant on Eskom? Decommissioning coal powered stations will affect social capitals in negative aspect, whereas the continual use of coal affects the environment in a negative way.

The move from non-renewables to renewables will also open up a new economy, but the transition will take time and there will be a negative impact on the employment rate as this transition takes place and the renewables infrastructure is built. However, the benefits in terms of environment are clear, and in line with global treaties and the national development plan of 2030.

South Africa has signed global treaties such as the United Nations Framework Convention on Climate Change (Conference of the Parties COP), Sustainable development goals (SDG's) etc. where these treaties emphasise sustainability (economic, social and environmental) and has goals and targets that countries must work towards in order to be sustainable. South Africa is obliged to adhere to those signatories and respect its obligation to its citizens. The rate of unemployment is increasing and with the COVID-19 pandemic having a negative impact on the economy, the employment rate is higher than ever before and a topical issue in South Africa as the country tries to recover from the economic disaster that Covid-19 shutdowns have wrecked.

Stakeholder engagement in such matters is important. Education, awareness and contingency plans are needed now more than ever with regards to the transition to renewables in South Africa. Key stakeholders such as labour representation and union involvement is essential in ensuring that all key stakeholders are involved in key decisions that impact the livelihood of the workforce and assist them to see the opportunities that renewables offer them. This will also ensure a smoother transition and ensure that there is transparency and inclusion, with the added benefit of reducing any unrest and disruption.

Over the past 10 years, South Africa has increased its renewable energy substantially, and this increase comes with alternative job opportunities. The social impact of renewables as the next phase of energy might not be beneficial to all stakeholders, however, this next phase of energy will grow over the next 10 years and see more innovative ways of producing energy and increasing the economic benefits of the country.

Renewable energy is the answer to a more sustainable economy over the longer term. Dealing with the social aspect is critical in ensuring a smooth transition to the next phase of energy.

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SOUTH AFRICA'S TRANSITION TO RENEWABLES SHOWS SOME PROMISING DEVELOPMENTS

There is no doubt that South Africa has, in principle, embarked on a journey to transition its main sources of energy from fossil fuels to renewable energy.

Government as the sole shareholder of Eskom, is the key role-player here, as Eskom currently supplies all the electricity to the national power grid, either through its own generating capacity, or from procurement from independent power producers (IPP's).

Government has recently shown its hand on its commitment to renewable energy via a number of actions, including its 2019 election manifesto and the latest version of the Integrated Resource Plan, approved by Cabinet on 18 October 2019 (the IRP 2019).

There are some notable features of the IRP 2019 that are encouraging, including a scaling down of coal fired power (via decommissioning of existing power stations) and increased access to the grid for IPP's.

The IPP procurement process is run by an organisation called the IPP Office, which was set up jointly by the Department of Mineral Resources and Energy (DMRE), National Treasury (NT) and the Development Bank of Southern Africa (DBSA) for the purpose of delivering on the IPP procurement programme objectives, as set out by the IRP.

The IPP office also runs the Renewable Energy Independent Power Producers Procurement Programme (REIPPPP).

According to the latest quarterly report of the IPP Office, by the end of March 2020, the REIPPPP had made the following impact on energy supply capacity

- 6 422 MW1 of electricity had been procured from 112 RE Independent Power Producers (IPPs) in seven bid rounds2;
- 4 201 MW of electricity generation capacity from 67 IPP projects has been connected to the national grid;
- 46 946 GWh of energy has been generated by renewable energy sources procured under the REIPPPP since the first project became operational

The regulatory process for the IPP bidders to be awarded contracts to supply the national grid is not straightforward, but some hurdles have been lowered, for example an IPP can now install a generation facility on the same property as the user without obtaining a ministerial exemption before applying for a generation license from NERSA.

The new IRP can be commended in terms of its move to allow private participation in the energy sector and to move away from fossil fuels. We understand that rules and regulations are necessary to ensure that the national grid is not compromised. Perhaps the time has come for a review rules that restrict access to the grid by IPPs. There is no doubt that there are a number of competing policy issues here, such as the pace at which Eskom will continue to decommission coal burning power stations, with all the attendant knock-on effects for employment and local communities.

The government is on the right path here, and loosening of the regulations could unlock much needed investment. The IPPs have much to offer in the field of innovative energy solutions, and allowing freer access will create a favourable climate for this investment in a technology that is designed to alleviate climate change.

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WILL INVESTORS FORCE THE HAND OF THE MINING AND ENERGY SECTOR TO FOCUS MORE ON SUSTAINABILITY AND CLIMATE CHANGE?

In January 2020, BlackRock, the world's largest fund manager, announced that it will put sustainability at the heart of its investment decisions. As reported in the Guardian "BlackRock identifies several new measures in its investment approach, such as lowering its exposure to fossil fuel companies, which has been a major demand by environmental protesters.

These include: "Making sustainability integral to portfolio construction and risk management; exiting investments that present a high sustainability-related risk, such as thermal coal producers; launching new investment products that screen fossil fuels; and strengthening our commitment to sustainability and transparency in our investment stewardship activities."

The company said it intended to play an active role in solving the climate crisis: "BlackRock does not see itself as a passive observer in the low-carbon transition. We believe we have a significant responsibility – as a provider of index funds, as a fiduciary, and as a member of society – to play a constructive role in the transition."

BlackRock is not the only fund manager selling its stakes in mining companies. Norway's trillion-dollar sovereign-wealth fund, Norges Bank, UK based Aviva and French giant BNP Paribas Asset Management have all sold shares in companies that mine thermal coal.

There has been a lot of focus on what mining companies are doing to play their part in reducing climate change and their role in the wider ESG agenda. Key stakeholders, including governments and investors, are clearly putting pressure on companies to have sustainability at the forefront of their agenda. With investors become more adverse to investing in thermal coal, what does this mean for South Africa who relies on coal power stations for such a significant portion of its energy needs?

South African's carbon dioxide emissions are principally due to its heavy reliance on coal. The global mining industry is a significant contributor of energy-related greenhouse gas emissions, with South Africa being the world's 14th largest emitter of greenhouse gases - the country emits nearly 500 million tons of carbon dioxide each year.

However, it is positive to see that to ensure growth that is greener and less dependent on coal, South Africa is investing in its vast wind, solar, and energy efficiency potential.

In line with national goals to diversify its energy mix, South Africa has created a $500 million CTF investment plan that is helping to overcome high up-front capital costs, first-mover risks, and other barriers to public and private investment in wind, solar, and energy efficiency. CTF concessional financing has been essential in bridging the cost gap relative to coal power generation and providing positive incentives for national utility Eskom and its lenders to proceed with large scale projects. These include developing 100 MW of wind and 100 MW of concentrated solar power (CSP) generation capacity. The CTF is also supporting some of the first independent power producers in the country, including the 100 MW KaXu CSP plant, the first operational private sector utility-scale CSP plant in the developing world [1].

Investment in clean energy in sub-Saharan Africa jumped to $7.4 billion in 2018 up from $2.3 billion in 2017. South Africa accounted for $4 billion of investment driven by a major onshore wind project in 2018[2].

It is clear that if South Africa is to meet its 2019 IRP goal of "by 2030, South Africa will have an energy sector that provides reliable and efficient energy service at competitive rates; that is socially equitable through expanded access to energy at affordable tariffs; and that is environmentally sustainable through reduced emissions and pollution", then significant investment must continue to be made into clean energy. Both government and investors are key in providing the incentives, infrastructure and financing to transform the energy sector into one that is greener, cleaner and more efficient.

[1]https://www.climateinvestmentfunds.org/country/south-africa
[2]https://qz.com/africa/1807518/renewable-energy-investment-takes-big-strides-in-africa/

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REFINANCING INDEPENDENT POWER PRODUCERS

The increasing conversation around refinancing of existing Independent Power Producers (IPPs) shows that the renewable energy sector in South Africa is growing and developing. Elsa Strydom, senior project manager at the IPPO, states that "although the participation in the refinancing initiative is voluntary, by the end of May 2020, 70% of South Africa's 64 IPPs had indicated a positive response to the process." Clearly indicating the sector's appetite and confidence in the success of projects in the renewables space.

During the REIPPPP bid windows, prices were proposed by the IPP's based on the then existing cost and capital structures that incorporated the maturity and perceived risk of the renewable industry in the South African market. During the initial years of the REIPPPP, technology, expertise and funding were not at the more developed stages as current. Therefore, the costing and subsequent pricing offered by the IPP's were higher. In the most recent bid windows, the IPP's offered prices much lower than those in the initial bid rounds.

The improvement of the technology and local expertise within the renewable energy industry means that the generation cost is becoming cheaper. In addition to this the decrease in the perceived risk by equity and debt funders reduces the cost of capital that is required for the significant capital investments to be made in constructing these generation assets.

So what does this mean for the existing REIPPPP IPP's and their government client?

There are certain events that are viewed by the government as "changes in contract" in the world of IPP's. A list of such events were issued by government, with elaboration and clarifications being communicated throughout. "Change in contract" in financial terms could be IPP's getting a better rate from the bank, or the bank easing restrictions on the IPP's reserve accounts, releasing cash flow into the company that they didn't anticipate having and is now eligible for paying higher than anticipated returns to shareholders. Essentially, any benefit above the proposed profit margins are to be shared with the government, and a new bid needs to be created to reflect a forecast with greater returns due to the current successes of IPP's. For example, if you calculate that for the remaining period of the Power Purchase Agreement (PPA) you will make a return of 18% instead of the 16% that you predicted, the agreement is that you must adjust the price of the PPA downwards until your return is only 17%, which basically represents half of what the upside was from 16% to 18%. Essentially, the government is entitled to 50% of the extra 2% that you made over the period. The market has agreed to this as they understand that if they had predicted a 18% return, the agreed-upon margins would have been different.

These IPP's realistically only have one shot at re-evaluating and restructuring their project and creating a new proposal with adjusted predicted profits, as this is quite an expensive exercise that requires assistance from various third party industry experts.

The first thing to consider when taking the refinancing route is creating a new financial model. IPP's need to engage with their existing funders and notify them of their intention to embark on this journey, taking into consideration existing contracts and agreements that were signed between the original funder and the IPP's. There are several items that the IPP will have to look at, including whether they are allowed by their funder to refinance at all, or what the conditions are for the IPP to seek out new funding from other financial institutions and the potential penalties that could be involved. It is worth noting that commercial banks have seen the benefits of funding projects of this nature and are more open to financing and/or refinancing them.

The new financial model would outline all updated assumptions and forecasts that have been made. The banks/funders require these financial models to be audited by a third-party audit firm to ensure that the IPP has not bit off more than they can chew and has aligned with any updated IFRS and Tax laws, especially in regard to the treatment of certain capital expenditure that the IPP's incurred at the start of the project, bearing in mind that there was some uncertainty on what was tax deductible and what wasn't.

A lot of clarity has been obtained now and IPP's need to get their auditors and management involved to ensure that they are accounting for the correct tax treatment going forward and incorporate that into the financial model, which might not have been as accurate at its inception.

Further operational matters that will have to be assessed include the different types of funding changes.

The interest rates that were used in the initial IPP's proposals were mainly based on the Johannesburg interbank agreed rate (JIBAR) or Prime interest rate plus a margin/banking cost. Most of the commercial banks were offering those types of rates, with international funders offered the London Inter-Bank Offered Rate (LIBOR). In more recent years, the banks have started charging interest rates based on CPI inflation adjusted rate, which IPP's seem to prefer because it minimises their risk by linking the way they pay their debt to the way their revenue is growing. CPI debt also leaves the door open for a lot less risk that requires hedging, which will bring the cost of financing down as well.

The government has also indicated that that IPP's who will be undergoing this process will be allowed to relook the other expenses as well. There might be some operating expenses that the IPP's didn't take into consideration with their initial financial model. Whether it's the costs of operating and maintenance, or costs of hiring specalised personnel, or certain investments in working capital that they didn't estimate correctly. They can now build this into their new financial forecast.

The costs associated with this endeavor are not cheap, with all the third party financial and legal consultants that will be needed for the process, it is essential that the pros vastly outweigh the costs. IPP's are not advised to go this journey alone, as a misstep will mean that the process has to be started again from the beginning, with more costs to be incurred.

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