

The future of energy production in South Africa

COVID-19 has ravaged through the already weakened South African economy and have made a massive impact on the country's balance sheet. At the same time, the Presidency has emphasised on 30 July at a meeting for the reconstituted Council of the Presidential Infrastructure Coordinating Commission, that the recovery of the South African economy must be realised through infrastructure development in order to acquire the necessary investment potential and to gain momentum. Currently there are 51 infrastructure projects at a total value of ZAR 340 billion (approximately CNY 131 billion) announced.

In order to sieve the opportunities in the energy production space, Eric le Grange - Director of Projects and Project Finance – at ENSafrica had on 31 July 2020 hosted an online webinar to share important insights into the industry.

Making up the power shortage

Many of the older coal fire generators built in the 1970s have long exceeded their design age. Many of which will have to be de-commissioned in the years to come. In recent years, the 2 new coal fire generators have far exceeded budget and completion is nowhere in sight. According to the economic forecast prior to COVID, if South Africa is to reach its 2025 energy target, it must make up the shortfall of 18.5 GW.

Interventions

To resolve the problem of the shortfall, the government has already provided many mechanisms through the Integrated Resource Plan (IRP), encouraging private businesses to come up with innovative technology and finance models in an attempt to increase energy production in the short terms. These includes:

1. Assess the maximum capabilities of all current generation units to provide for a higher production rate as soon as possible. The estimated additional capacity is at 150 MW;
2. The Department of Energy has already in March of the publication of the IRP exempted owners or producers from application for permits or even notification requirements to the National Energy Regulator of South Africa (NERSA).
3. Permitted the procurement of power by owners through Independent Power Producers (IPP).
4. Permitted the procurement of power through the Emergency Procurement Program (to be published in August) and through round 5 of the Renewable Energy Independent Power Producer Procurement Programme (REIPPPP). The Minister of Energy has indicated in the regulations to NERSA and have since received confirmation from the later. We are only waiting for the implementation.

We are of the view that reputable power generation projects can still be adequately funded by local South African financial institutions (be it through banks, trust or the stock market). More often than not, a project's

feasibility is not hindered by technical or financial problems, but rather the placement of the project under existing legal and regulatory frameworks.

Prospect of future coal fire plants

Despite the global reduction in the use of coal fire plants, it will be very difficult for South Africa to rid of this reliance given its own economic factors, natural abundance of coal and geographical conditions. The makeup of the South African energy structure goes hand in hand with its economic structure. This is can clearly be seen in the IRP. The current technology supports the upgrades of coal fire plants, making it burn cleaner and more efficiently. It could even be emit zero pollutants. Naturally the reduction of pollutants also means the need for greater capital expenditure. However, for South Africa at least, coal fire is the most reliable baseload.

Restructuring of Eskom

A vertically integrated generation and supply structure is a dinosaur in today's power market. The government announced last year that it will break up Eskom into 3 companies focusing on generation, transmission and distribution respectively to improve operation efficiency, opening up new financing channels and capabilities. Other goals include the reduction of unnecessary cross-subsidisation, improved transparency, so as to ensure reform and an energy trading market. We are of the view that the government has the intention to speed up and stimulate the creation of a competitive generation market. Interested investors should take a macro and long term view of the future of the power generation market in South Africa, laying out a plan. The South African energy market has limitations. The national transmission network has under the auspices of international financiers been upgraded. Both however are classic public companies with limited profits. The management of future transmission networks will evolve around facilities and joint management with operators. What is worth noting is that aside from the national legal framework, provincial and local governments have their own different and complication regulations. Businesses interested in taking part in the transmission and distribution of power should be alive to these requirements.

Broad Based Black Economic Empowerment Act

The Act is intended to boost the economic interests of black people through indexed participation of black people in projects. In EPC matters, foreign companies primarily use incorporated or unincorporated JVs to conduct business with local enterprises or entrepreneurs. Under the incorporated form, companies can for the JV with suitable black entrepreneurs, through black employee incentive schemes, or through trusts whereby black people are beneficiaries. Under the unincorporated JV form, besides the traditional partnership relationship, businesses could utilise equity equivalent investment structures, opting for the sale of assets to black businesses, to achieve the highest BEE scores permitted. Currently, bidders are considering the use of black trust management companies or black entrepreneurs to acquire interests in incorporated JVs to satisfy the requirements of the BB-BEE Act. Black trust management companies are those that are 50% owned and controlled trust managers. To comply with the Act is the minimum requirement to enter

into the South African energy market. EPCs and investors should plan a suitable JV structure as soon as possible and to understand the relevant legislations so as to identify the risks to investment.

REIPPPP

In round 4 of the bidding, the average price per unit for photovoltaic and wind is ZAR 786 (approximately CNY320) and ZAR 619 (approximately CNY 250) respectively. This is a 29% and 25% from round 3. In comparing round 3 and round 4, the general reduction rate is between 30% to 40%. In Round 5, developers may only utilise the incorporated JV model for bidding purposes. From round 1 to round 4, the local black ownership requirement is 20%. We estimate that this is set to rise. As such, the use of the “flow through principle” via black trust management companies or private equity are the new trends. Even so, based on our interactions with the Department of Energy, they have insisted that part of the ownership must still be held by black natural persons and not through trusts or trust management companies.

Construction and procurement

Although the main contracting form utilized in South Africa is the EPC model, we sensed that developers are moving towards an EPCM model in order to control the overall cost to construction. At the same time, although the EPCM is concluded between the contractors and project owners on the construction liabilities, contract management and on-site liabilities - and despite the fact that guarantees are different to EPC models – Banks are extra cautious toward the finance feasibility report. Whether EPCM models become the mainstream approach is yet to be confirmed. Contractors should weigh the benefits of both models to improve competitiveness in the market and to improve management efficiency. Another thing to note is that we estimate that in round 5 of REIPPPP, the Independent Power Producer Procurement Office will also scrutinize the onshore and offshore content more carefully to ensure the protection of local procurement and local shareholders.

Beyond 2030

South Africa is currently a leading emitter of greenhouse gasses and must reduce its reliance on fossil fuels. South Africa has a limited natural gas reserve but its neighbor Mozambique has an abundance and there is already a pipeline connecting the two countries. In order to stabilize the supply of electricity in coastal cities, we anticipate an increase in gas generation units in ports. As to nuclear, the Department of Energy issued an RFI in this regard. We are of the view that the government will lean in favour of a modular and small scaled solution such as the Barakah in the UAE. Lastly, on the generation of power in the Southern Africa region, the Southern Africa Power Producers (SAPP) had been formed a while ago. In recent years, the grid connections between the countries have experienced problems relating to stability and compatibility. If it is decided that the power supply will be unified, South Africa will have to lead the planning and ultimately may be responsible for the ownership and management of the local grid. This presents a potential conflict between sovereignties. We are hoping for changes to the trade of energy in these counties. In the

long term, a move towards liberalization will become the trend in establishing a competitive energy trading market. The precondition is that the governments must have the political will power and determination for reform.

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