

THE RENEWABLE
ENERGY LAW
REVIEW

Editor
Karen B Wong

THE LAWREVIEWS

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REVIEW

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PREFACE

I am incredibly honoured to be the editor of the first edition of *The Renewable Energy Law Review*. Little did I know, working as a young associate in the ‘early days’ of renewable energy projects, that, fast-forward to 30 years later, the industry would be as large and as active as it is today across the globe. As a US-based partner at Milbank practising in the energy industry, I see different political environments, tax and other incentives in place in our 50 states and, having worked on multiple international projects on four different continents, I know that the regimes across the world are equally unique. This compendium has been formulated to provide you with a good overview of the legal framework and current status and challenges in structuring, financing and investing in renewable energy projects in the selected jurisdictions.

Whether you are someone already active in this sector or merely interested in learning more about the policies, legal structures and state of play in the renewable energy industry globally, I hope that this guide will aid you in your efforts as a participant in an industry that is increasing new sources of energy projects with fewer carbon emissions. As a young, naive and idealistic student applying to law school, I had a genuine desire to acquire the necessary skills and tools of a profession that would empower me to change the world. Frankly, I never imagined that I would have a legal career – to date spanning over three decades – that would offer me the opportunity to do just that in my capacity as an attorney facilitating transactions that literally help to keep our skies bluer and our air cleaner globally.

Karen B Wong

Milbank Tweed Hadley & McCloy LLP

Los Angeles

July 2018

SOUTH AFRICA

Lido Fontana and Sharon Wing¹

I INTRODUCTION

The fundamental driver for renewable energy projects in South Africa remains the Renewable Energy Independent Power Production Procurement Programme (REIPPPP) of the Department of Energy (DoE). Prior to the formal launch of REIPPPP in August 2011, the local renewable energy market was fairly inconsequential. A lot has changed since then, with REIPPPP being heralded globally as a shining example of how to successfully implement renewable energy auction programmes. The success achieved by REIPPPP has, however, not been without its challenges. Eskom Holdings SOC Limited (Eskom), the state-owned national utility and sole offtaker of electricity from projects under REIPPPP, has refused to sign any further power purchase agreements (PPAs) with independent power producers. Eskom's position has not been unexpected, with its historical monopoly on generation in South Africa now being gradually challenged by independent power producers that are able to deliver generating assets largely on time and on budget – key features that have been somewhat lacking in Eskom's skill set for some time, leading to above-inflation increased costs of electricity to the end users (while the tariff prices under REIPPPP continue to drop dramatically in each procurement round).

Eskom's open hostility to REIPPPP had a dramatically negative effect on the renewable energy market in South Africa, forcing the programme to an unwelcome halt for more than two years. Positive winds of change appeared to be blowing through during the course of 2017, however, with promises from government and Eskom that the much delayed Round 4 (as well as the final remaining Round 3.5 concentrated solar power (CSP) project) would be signed. In the end, the government and Eskom did not deliver on these promises during 2017. While this was a disappointment to the industry, a rather important political event did take place in December 2017, with a new African National Congress leader emerging in the form of Cyril Ramaphosa. Many believe Ramaphosa will play a key role in helping to unblock the issues with Eskom and the DoE's energy procurement programmes (including REIPPPP) to ensure that the country's burgeoning renewables market continues; and the local market is confident that 2018 will be an extremely positive year for renewables in South Africa.

There is a small but growing rooftop solar market in South Africa. The regulatory regime in South Africa does not currently allow for excess energy to be sold back into the grid, as is the case in certain parts of the United States. A change in the regulatory regime allowing for this would most likely stimulate the rooftop solar market and allow it to grow far more quickly than is currently the case. In addition, there are currently no significant

¹ Lido Fontana is of counsel and Sharon Wing is an associate at Covington & Burling (Pty) Ltd.

tax incentives or other government-led programmes that mirror those in the United States or the EU that have fostered the growth of renewables to such an extent in those markets. Large-scale retailers are now installing large rooftop solar facilities to reduce their reliance on Eskom as a supplier and what is perceived as ever increasing above-inflation tariff costs. Furthermore, reflecting international market trends, a number of international corporate entities are looking at renewable off-grid solutions. We expect this off-grid market to continue to grow, which presents a challenge for Eskom as its customer base continues to shrink.

II THE YEAR IN REVIEW

The year 2017 brought with it significant uncertainty in respect of transformation in the South African energy sector in relation to renewable energy. In February 2017, then President Jacob Zuma announced in his state-of-the nation address that Eskom would sign all outstanding power purchase agreements from Rounds 3.5 and 4 within the coming months. However, as a result of Eskom's continuous delaying tactics, 27 contracts totalling US\$4.7 billion and covering 2.3GW of renewable energy projects were only signed in the first quarter of 2018 because of an interdict brought by the National Union of Metalworkers of South Africa together with Transform SA.

There has been further uncertainty regarding the 20 small-scale projects (with capacity of between 1MW and 5MW and an aggregate capacity of 100MW) awarded through the bidding process under the Small Projects Independent Power Producers Procurement Programme. It is uncertain when these projects would be able to begin operations, as only 10 of the 20 have licences, while the remaining 10 are under evaluation. It is to be noted that the South African government has decided that independent power producers (IPPs) owning generators that do not exceed 1MW are to be exempt from the obligation to apply for and hold a licence (discussed below).

Although coal-fired generation still dominates the energy sector (with a net output of 35.6GW, representing 85 per cent of the South Africa's total capacity), by the end of 2017, a total of 3.2GW of renewable energy projects had been constructed and connected to the grid. This has brought total investments in renewable energy under REIPPPP to approximately 195 billion rand.² Further, South Africa was ranked 10th among G20 countries for renewable energy investment conditions by Allianz Climate and Energy Monitor.

III THE POLICY AND REGULATORY FRAMEWORK

i The policy background

Aside from a fairly recent amendment to the Income Tax Act, addressed below, there are very limited government-led regulatory and tax incentives for renewables. As already noted, the current regulatory regime in South Africa does not allow for excess electricity from renewable sources such as residential or rooftop solar to be sold back to the grid, and a reform to allow for this would stimulate and promote faster growth in the rooftop solar market. The situation is compounded by the absence of significant tax incentives or other government-led programmes to foster development of the renewables market. Nor are there

² <https://www.greencape.co.za/assets/Uploads/GreenCape-Renewable-Energy-MIR-2017-electronic-FINAL-v1.pdf>.

any tariff top-up arrangements like those seen in renewable energy programmes elsewhere in Africa, such as the successfully implemented GET FiT programme in Uganda. Although feed-in tariffs were initially proposed in South Africa, these were superseded by the auction process now known as REIPPP, which has proved hugely successful, with each further round being heavily oversubscribed.

As from 1 January 2016, Section 12B of the Income Tax Act (South Africa) No. 58 of 1962 (the Income Tax Act) changed the three-year accelerated depreciation allowance on renewable energy (50 per cent to 30 per cent to 20 per cent) to an even quicker depreciation allowance of one year (100 per cent). This accelerated depreciation allowance came about from a proposal in the 2015 draft Taxation Laws Amendment Bill that the definition of solar energy be amended to distinguish between solar photovoltaic (PV) energy of more than 1MW, solar PV energy of less than 1MW and concentrated solar energy. The amended Section 12B provision now provides for an accelerated capital allowance of 100 per cent in the first year, in respect of solar PV energy of less than 1MW.

The reason for the change is to accelerate and incentivise the development of smaller solar PV energy projects, as these have a low impact on water and the environment. This is also intended to help address the energy shortages facing South Africa in a more environmentally friendly way.

Section 12B of the amended Income Tax Act provides for a capital allowance for movable assets used in the production of renewable energy. More specifically, it allows for a deduction equal to 100 per cent in respect of any plant or machinery brought into use in a year of assessment for the first time and used in a process of manufacture or any other process of a similar nature. Notably, the allowance is only available if the asset is brought into use for the first time by the taxpayer. In other words, the allowance is not limited to new or unused assets. The wording merely prevents the taxpayer from claiming the Section 12B allowance twice on the same asset.

With this incentive, companies can deduct the value of their new solar power system as a depreciation expense from its profits.

While there has been a fairly large allocation for CSP technology under REIPPP, it is widely anticipated that the DoE will not continue with the procurement of this technology, given its much higher costs when compared with photovoltaics and wind. The challenge of intermittency is likely to be solved by the ever increasing introduction of battery solutions; it is unclear, however, on what scale this can be financed in the local marketplace.

ii The regulatory framework

In South Africa, the regulation of electricity from renewable sources falls under the jurisdiction of the National Energy Regulator (NERSA), one of three energy regulators in South Africa established under the National Energy Regulator Act 2004 (NRA), which regulates electricity, piped gas and petroleum pipeline industries. Eskom's tariffs are regulated by NERSA under the Electricity Regulation Act 2006 (the Electricity Regulation Act). These tariffs are based on Eskom's costs plus a reasonable rate of return.

The NRA, together with other key legislation regulating the relevant industries (in the case of electricity, the Electricity Regulation Act) establishes the framework for renewable energy regulation in South Africa. That legislation, together with associated regulations, notices, rules and guidelines, grants expansive regulatory power to the regulators, including the powers to issue, amend and revoke licences, as well as to approve tariffs.

Under the Electricity Regulation Act, a licence is required for each operation (i.e., for electricity generation, transmission and distribution facilities, and in respect of the import, export and trading of electricity – collectively, the Licensed Activities), but it provides exemptions for licences in respect of (1) any generation plant constructed and operated for demonstration purposes; (2) any generation plant constructed and operated for own use; (3) any non-grid-connected electricity supply other than for commercial use; and (4) any other activity relating to the Licensed Activities for which NERSA has determined that a licence is no longer required. In relation to the latter exemption, NERSA may require that persons undertaking the activity concerned nevertheless register it with NERSA.

A person obliged to hold a licence in terms of the Electricity Regulation Act must apply to NERSA for the licence in the form, and applying the procedure, prescribed. The application must be accompanied by the prescribed licence fee. The information required for such an application includes, among other things:

- a* a description of the applicant, including any vertical and horizontal relationships with other persons engaged in the operation of the relevant Licensed Activity;
- b* the administrative, financial and technical abilities of the applicant;
- c* a description of the proposed generation, transmission or distribution facility to be constructed or operated;
- d* a detailed specification of the services that will be rendered under the licence;
- e* a general description of the type of customer to be served;
- f* the proposed tariff and price policies; and
- g* evidence of compliance with the Integrated Resource Plan (IRP).³

The process entails publication of notices of the application in appropriate newspapers or other media and the applicant responding to objections to the application being granted, and it culminates in NERSA making a decision on the application within the prescribed period.

Transfer of control and the assignment of a licence issued in respect of Licensed Activities, including generation licences issued to IPPs, are restricted by conditions imposed on the licensee by NERSA.⁴ Accordingly, each licence must be reviewed on a case-by-case basis to determine what specific approvals are required for its transfer. However, the Electricity Regulation Act generally provides that a licensee may not cede or transfer its powers or duties under a licence to any other person without the prior consent of NERSA. The transfer of control and the assignment of licences issued to IPPs are further regulated by the implementation agreement between the South African DoE and the IPP; that agreement provides for, *inter alia*, government support for the development and financing of relevant IPP projects.

The initial IRP sets out the South African government's strategy for the establishment of new generation and transmission capacity for the country for the period 2010 to 2030. It calls for the doubling of the country's electricity capacity from its 2010 level of 238,272GWh, using a diverse mixture of energy sources, mainly coal, gas, nuclear and renewables, and including large-scale hydro to be imported from other countries in the southern African region. The initial IRP further details how this demand should be met in terms of generating capacity, type, timing and cost. The initial IRP also serves as an input to other government

3 Section 10(2)(a)–(h) of the Electricity Regulation Act 2006.

4 Section 15(1)(k) of the Electricity Regulation Act 2006.

planning functions, *inter alia*, economic development, funding, environmental and social policy formulation. It is also a process by which the requirement for further investment in electricity generation capacity for South Africa is determined.

At the time that the IRP was initially promulgated, the South African government advised that the IRP should be viewed as a 'living plan' that would be revised by the DoE every two years to ensure its relevance with regard to (among other things) technological and environmental developments in the global arena. An update to the IRP was provided for public comment in November 2013; however, this document was subsequently gazetted and remains of no binding relevance. On 2 November 2016, the Minister of Energy released drafts of an updated Integrated Energy Plan (IEP) and an IRP on 22 November 2016. The IEP serves as the government's master plan for the entire energy system, with its focus on the broader objective of reducing the country's energy footprint overall. The IEP regulates energy industries and promotes electric power investment, greater employer benefits and a more favourable environmental impact. The IRP on the other hand, being subordinate to the IEP, focuses specifically on electricity.

The updated IRP has received attention because the South African government, and Eskom, have promoted the importance of nuclear power within the overall electricity provision forecasts to 2050. The Minister of Energy extended public consultation to 31 March 2017. This allowed the South African government to make the necessary adjustments and promulgate the updated IRP in 2017, once it had been approved by Cabinet. During the consultation process, major issues were raised, particularly in relation to the base case. Some critics believe that the cost assumptions for solar PV and wind were too high and that if proper costs were reflected there would be no need to construct a nuclear plant up to 2050. On 22 August 2017, South Africa's Minister of Energy reported to the Portfolio Committee on Energy that the Minister anticipates that the upcoming IRP update and the draft IEP will both be finalised before the end of 2018.

The original IRP has only been updated recently, with NERSA holding public hearings as part of a consultation process designed to finalise new rules for small-scale solar PV generators to facilitate the supply of electricity from their households into the grid. The regulator has released a consultation paper titled 'Small-Scale Embedded Generation: Regulator Rules' to pave the way for public consultations with the aim of NERSA publishing the new regulatory framework by the end of May 2018. NERSA has published for comment proposed market rules for individuals and organisations who typically generate electricity from their own solar installations. This publication follows a notice published by the DoE in November 2017 that provided for exemption of small-scale embedded generators from the obligation to obtain a licence from NERSA to generate electricity. The rules for registration of small-scale embedded generation published by NERSA provide that every form of home electricity generation – including solar PV panels and backup generators – will have to be registered with the government. Given the current absence of a legal framework for grid-tied rooftop solar, this change is important because it introduces a set regulatory framework that will provide rules for small-scale embedded PV generation.⁵

The draft rules for registration of small-scale embedded generation leave no room for exceptions in the sense that any form of power generator of any size will have to formally be registered. These rules will apply to both off-grid systems, those with no connection to the

5 <http://polity.org.za/article/nersa-moves-to-finalise-rules-for-connecting-small-scale-solar-to-the-grid-2015-03-06>.

national electricity system, and systems connected to the grid. The significance of this paper, should it be accepted, is that small-scale embedded PV generators will pave the way for the replacement of the current red-tape licensing regime with a registration process that will reduce the regulatory burden on businesses and residential areas seeking to install grid-tied rooftop solar. NERSA further proposes the following considerations: that the current tariff structure be re-evaluated, from fixed network costs to connection and metering costs in the case of import and export credit tariffs, to ensure a balance of revenue for the generator, the distributor and other consumers.

IV RENEWABLE ENERGY PROJECT DEVELOPMENT

i Project finance transaction structures

A large percentage of the project financing activity for renewable energy projects has occurred within the framework of REIPPP and the Small Projects Independent Power Producers Procurement Programme. While the project finance structure that has been adopted to date follows international norms, there are a number of unique features imposed on sponsors under REIPPP, including localisation requirements that cover the development of specific categories of people, enterprises and communities or economic sectors. The following broad categories are covered:

- a* job creation;
- b* local content;
- c* ownership;
- d* management control;
- e* preferential procurement; and
- f* enterprise development and socio-economic development.

In terms of documentation, these follow international norms, with financing documentation largely following Loan Market Association precedents. Security packages typically include the following:

- a* borrower guarantee and share pledge;
- b* borrower cessions of its rights, title and interests in respect of aspects such as the project documentation, insurance proceeds, claims, licences, permits and authorisations under the transaction;
- c* general notarial bond, which is a registered security over all the movable assets of the borrower;
- d* special notarial bond, which is a registered security over specified movable assets of the borrower; and
- e* mortgage bond, which is a registered security over the borrower's land rights.

Construction, operation and maintenance agreements also largely follow international norms with engineering, procurement and construction contracts and operation and maintenance (O&M) contracts closely following what one would expect to see in established markets. Internationally accepted standard construction contracts such as a FIDIC Silver Book are common (amended though to tailor for market norms and certain testing and performance complexities relative to each renewable energy technology).

To date, the vast majority of debt has been provided by the large five domestic commercial lenders (Rand Merchant Bank, ABSA, Nedbank, Standard Bank and Investec)

with some participation from development finance institutions and pension funds (DBSA, PIC, IDC, etc). International institutions such as the International Finance Corporation and the Organization of the Petroleum Exporting Countries have also been involved with financing a number of large renewable projects.

Aside from a large number of Enel projects (the Italian national utility) in Round 3 of REIPPP, almost all projects have been financed on a limited or non-recourse basis.

While debt tenors vary, they are typically around 15 to 17 years (from commercial operation date) and spreads on the Johannesburg Interbank Agreed Rate are between 310 to 400 points (risk premium 250, liquidity 120 and statutory costs 30 points).

ii Distributed and residential renewable energy

Eskom, in its position as the national utility, is also the primary licensed distributor of electricity in South Africa. As was mentioned above, the current regime does not allow excess electricity to be sold back to the grid from renewable sources as it would be in jurisdictions such as the United States or the EU, and a change in the regulatory regime would stimulate the rooftop solar market and allow it to grow far more quickly. There is also no regulated framework for use-of-system charges for embedded generators (connected to the distribution network). NERSA is, however, in the process of developing a framework for generators.

Generators that wish to wheel energy to third parties face a number of challenges related to the use-of-system charges.

iii Non-project finance development

The appetite in the market for on-balance sheet, corporate, full equity finance is extremely small. Almost all developers and sponsors of renewable projects in south Africa adopt a project finance structure.

V RENEWABLE ENERGY MANUFACTURING

The implementation of REIPPPP resulted in a significant portion of the technical equipment being imported from Europe and China. However, the increased local demand has stimulated the desirability and growth of component manufacturing for the renewable energy sector in South Africa. More recently, there has been an increase in the number of wind turbine and solar panel manufacturing plants built in South Africa, and several of these manufacturers have taken full advantage of the benefits offered to entities operating within the specifically demarcated South African Special Economic Zones (SEZs). These specifically demarcated SEZs have been set up to encourage trade and investment that create employment opportunities in South Africa and ultimately benefit the South African economy, and there are SEZs that have positioned themselves for investment in renewable energy power generation and manufacturing plants, such as the East London Industrial Development Zone.

There is a small number of solar and wind turbine equipment manufacturers currently taking advantage of the favourable Special Economic Zone laws. The Coega Industrial Development Zone, which was formed in 1999 and is located 20 kilometres north of Port Elizabeth in the Eastern Cape province of South Africa, has attracted three manufacturers of solar and wind turbine equipment, namely DCD Wind Towers, Electrawinds and Powerway. There are concerns that when these components are exported from these Special Economic Zones into South Africa, the customs and VAT levied on the components will be based on

the value of the components, including South African raw materials and labour costs. This could result in a higher cost for South African customers as compared with components manufactured wholly offshore and imported directly into South Africa.

The Coega Industrial Development Zone is currently positioning itself to become the solar and wind turbine equipment hub for the Eastern Cape, as there are several renewable energy projects being proposed in the Eastern Cape. The East London Industrial Development Zone is also positioning itself to manufacture and supply electricity from renewable energy sources in the Eastern Cape Industrial Development Zones. This Industrial Development Zone has advertised that it has suitable land for electricity generation from both wind and solar facilities, with established relations with the top 100 users and the local authority for connection of the power plant to the grid and supply of electricity to the nearby Buffalo City metropolitan municipality.

VI CONCLUSIONS AND OUTLOOK

The future looks positive for renewable energy on account of the expectation that South Africa's new president will be promoting renewable energy to restore investors' confidence.

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