South African Renewables: From Investment Uncertainty to an Established Asset Class

Nearly a decade after uncertainty over the future of South Africa's renewable-energy programme threatened investment, the market looks very different. But some of the lessons from that period remain highly relevant.

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In 2017, Engineering News interviewed me about the consequences of uncertainty surrounding South Africa's renewable-energy programme.

At the time, Eskom's refusal to sign power purchase agreements with a number of independent power producers had created a standoff that threatened to interrupt what had become one of South Africa's most significant sources of infrastructure investment.

My concern then was not simply about the projects being delayed. Infrastructure investment has a much wider economic impact. Once a credible procurement programme loses momentum, the consequences extend through developers, lenders, investors, contractors, suppliers and the broader investment environment.

Nearly a decade later, it is interesting to revisit that argument - not simply to ask whether those concerns were justified, but to consider how profoundly the South African renewable-energy market has changed since then.

FROM THE ARCHIVE 2017

Engineering News - renewable-energy investment

This paper revisits themes raised in the 2017 Engineering News article "Industry leaders warn of loss in investments in renewables sector", in which Lionel Kruger commented on investment uncertainty surrounding South Africa's renewable-energy programme.

The market survived - and evolved

The most important observation is that South African renewable energy did not remain trapped in the uncertainty of 2017.

The REIPPPP survived, further procurement rounds followed and renewable generation became an increasingly established component of South Africa's electricity sector.

At the same time, the market broadened beyond government procurement.

Private power purchase agreements, corporate offtake structures and electricity trading have created additional routes to market. Renewable-energy investment is no longer dependent solely upon a single government procurement programme.

That is an important structural change.

A market that was once largely defined by successive REIPPPP bid windows is increasingly an ecosystem of public procurement, private generation, corporate demand and new trading models.

From proving the concept to delivering at scale

The questions have therefore changed.

A decade ago, a central concern was whether the renewable-energy investment programme itself would continue.

Today there is considerably less need to demonstrate that utility-scale renewable energy can attract institutional capital in South Africa. Developers, lenders and investors have accumulated substantial experience of financing and delivering projects.

Instead, many of the challenges now concern execution at scale.

Grid capacity and connection availability have become critical constraints. Projects are larger. Procurement and financing structures can be more complex. Development periods can extend considerably, and delays between preferred-bidder appointment and financial close can materially alter the assumptions on which a bid was originally based.

This changes the nature of the financial risks that projects need to manage.

Delay is itself a financial risk

One lesson from 2017 remains particularly relevant: uncertainty has a cost.

For an infrastructure project, delay is not simply an inconvenience in the development timetable.

Interest rates move. Exchange rates move. Equipment prices change. Hedge markets move. Credit approvals expire or need to be refreshed. Contractor pricing changes. Financing assumptions that were valid when a bid was submitted may look very different by financial close.

This matters particularly where projects contain substantial imported equipment.

A project may ultimately earn revenues in rand while significant portions of its construction cost are denominated in dollars, euros, renminbi or other currencies. Lenders will generally require construction-period FX exposure to be substantially or fully hedged because an adverse currency movement can otherwise create a funding shortfall.

The longer the period between bid, award and financial close, the more difficult that exposure can become to manage.

Bankability is more than raising capital

South Africa has demonstrated an impressive ability to attract capital to renewable-energy projects.

But attracting capital and achieving a bankable transaction are not quite the same thing.

A project also has to manage the financial risks between development, financial close, construction and operation.

That includes FX risk on imported equipment, interest-rate exposure on project debt, the consequences of delayed financial close, hedge breakage risk, refinancing risk and the interaction between financing and procurement schedules.

These issues can sometimes be treated as matters to be addressed once the principal commercial terms of the project have been agreed.

In my experience, that is too late.

Financial risk management works best when it is incorporated into transaction design rather than treated as a final execution exercise.

The financing market is changing too

There is another significant difference between 2017 and today.

The financial-market infrastructure supporting South African projects is itself changing.

The transition from JIBAR to ZARONIA means that new projects and existing financings increasingly need to consider how interest-rate risk is defined, priced and hedged in an overnight-rate environment.

For a long-dated infrastructure asset, this is more than a technical change to a benchmark.

Loan conventions, hedge conventions, compounding methodologies, credit adjustment spreads and the relationship between the underlying debt and derivative need to remain aligned.

At the same time, refinancing has become an increasingly important part of the project lifecycle as operational assets seek to take advantage of different funding structures or market conditions.

The financial risk strategy therefore does not end at financial close or even at commercial operation.

A more mature market brings different risks

The development of South African renewable energy over the past decade is, in many respects, a success story.

But maturity does not eliminate risk. It changes it.

In an emerging market, the question may be whether investment can be attracted at all.

In a mature infrastructure market, the questions become more granular: whether grid access can be secured, whether projects can reach financial close on their original assumptions, whether financial and procurement risks have been appropriately allocated, whether hedges remain aligned with changing construction schedules, and whether the financing structure remains efficient over the life of the asset.

Those may appear less dramatic than the institutional uncertainty confronting the industry in 2017.

Financially, they can be just as consequential.

Nearly a decade later

Looking back at the Engineering News article, the striking change is that renewable energy in South Africa is no longer an experiment whose future needs to be established.

It has become an asset class.

That is a considerable achievement.

The challenge for the next phase is therefore different from the one facing the industry in 2017. South Africa does not simply need to attract investment into renewable energy. It needs to ensure that viable projects can move efficiently from development through financial close and construction into operation - while managing the financial risks that arise along the way.

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The question has moved from whether capital will come to South African renewable energy to whether the market can consistently convert that capital into successfully financed and delivered projects.

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