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Investing for a
world of change

Powering change

The loadshedding crisis has sparked a new sense of urgency to reform Eskom and shift to renewables. This presents compelling infrastructure investment opportunities and could herald a new chapter for the economy.

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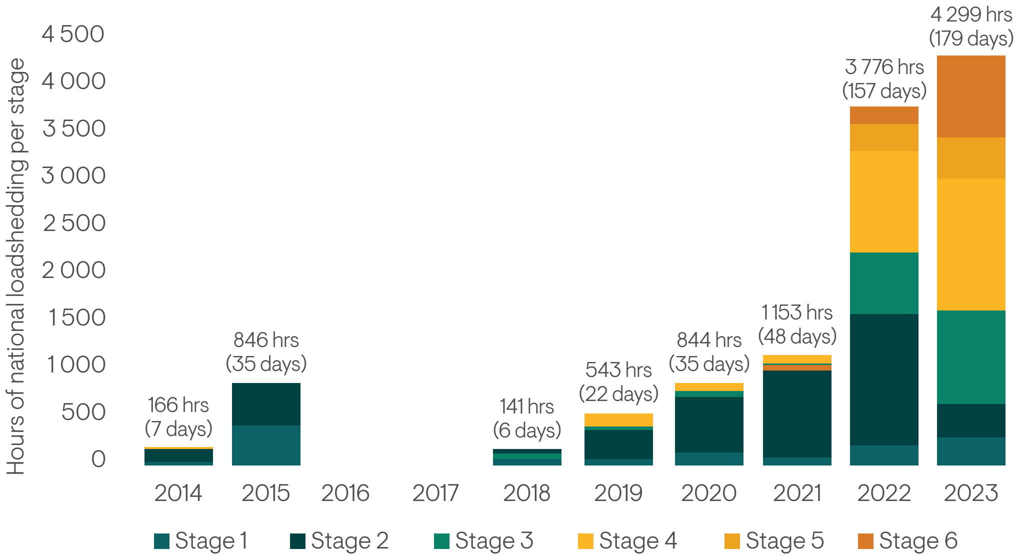
The fast view

- Unprecedented loadshedding has weighed heavily on SA's economy, denting GDP growth and causing inflation to remain persistently high.
- But it has also forced the energy sector to the top of the political agenda, giving impetus to reform.
- The potential positive implications are significant – both by drawing a line under the damaging growth and inflation impact of loadshedding and by spurring the shift to renewable energy.
- Reforms have already created a significant pipeline of renewable energy projects. The associated need for private finance should result in a raft of new infrastructure investment opportunities, which can be valuable additions to investors' portfolios.
- For this to be a true turning point for the country, grid infrastructure expansion and improvement are vital, and both the Presidency and Eskom's leadership team must maintain the positive momentum seen of late.

Loadshedding takes an increasingly heavy toll

South Africa has been laden with electricity power cuts for more than a decade, yet the intensity of these power cuts increased dramatically in 2022 and 2023, as shown in Figure 1. The economic impact has been severe.

Figure 1: Loadshedding reaches crisis point



Source: EskomSePush, August 2023.

In the wake of the intensified power cuts early this year, the South African Reserve Bank (SARB) slashed its GDP forecasts, estimating that loadshedding would shave a full 2 percentage points off this year's annual growth rate. Loadshedding has also been damaging to the country's inflation dynamics. Soft commodity price inflation eased early this year, yet food price inflation – while on a declining path – has remained stickier than it should have been. This is a direct result of the added cost of diesel for generators used in food production and storage.

A renewed impetus for reform

Sometimes it takes a crisis to effect positive change, and that certainly seems to be the reality in South Africa today: the substantial economic headwinds that Eskom's woes have inflicted on the economy have spurred a new sense of urgency around much-needed reforms.

Through the National Energy Crisis Committee (NECOM) and Operation Vulindlela (OV), the Presidency has begun to implement reforms in the energy sector. Currently, OV's focus is on the following five key reforms:

1. Fix Eskom and improve the availability of existing supply.
2. Enable and accelerate private investment in generation capacity.
3. Accelerate the procurement of new capacity from renewables, gas, and battery storage.
4. Incentivise businesses and households to invest in rooftop solar.
5. Fundamentally transform the electricity sector to achieve long-term energy security.

Fixing Eskom

In an attempt to "fix Eskom", the minister of finance announced the long-awaited Eskom debt relief bill in the February budget. This is an important step in providing Eskom with the financial bandwidth to effect meaningful change. The debt relief package – amounting to R254 billion over three financial years - is structured in the form of shareholder loans that convert to equity on a quarterly basis upon meeting certain conditions[1]. These conditions are important as they will ensure that after the 3-year period, Eskom has not increased its overall borrowings to end up right back where it started and that Eskom prioritises expansion and strengthening of the grid. To this effect, NECOM and Eskom have identified 25 projects that will add 12GW grid capacity in the next 5 years. The implementation of these projects is critical for the development of the electricity market in South Africa and could finally draw a line under the crippling loadshedding that has beset the nation.

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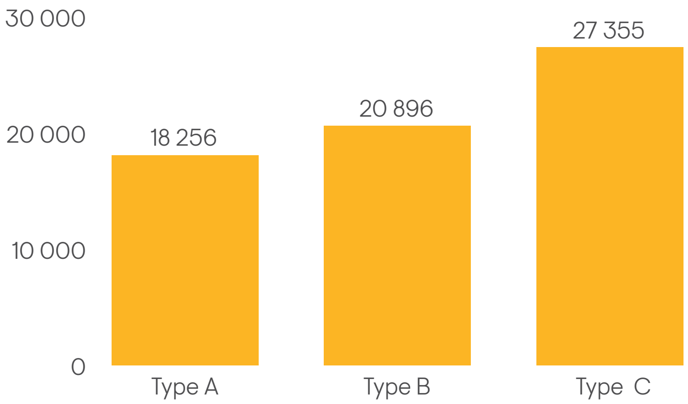
1. First, Eskom's capital expenditure is to be restricted to transmission and distribution. The only capital expenditure that may be undertaken for generation relates to minimum emissions standards, flue-gas desulfurisation for the Medupi power station and required maintenance. No other greenfield generation projects will be allowed during the debt relief period. Second, no new borrowing will be allowed from 1 April 2023 until the end of the debt relief period, unless written permission is granted by the Minister of Finance.

Ramping up private-sector involvement

Another key development that took place last year was the reduction and subsequent removal of the cap for setting up private power generation systems without licensing. Since then, the number of projects being developed by the private sector – particularly among mining and industrial companies – has risen sharply, with an emphasis on solar and wind. The government has also provided incentives to boost private sector investment in energy, with the National Treasury introducing a raft of renewable energy tax incentives for households and businesses.

This has already yielded a significant investment pipeline in renewable energy projects. In its survey of the renewable-energy development pipeline, Eskom highlighted a significant number of projects in various stages of development: early (Type C); underdevelopment (Type B); and advanced (Type A) - in which environmental approvals are in place, feasibility work is completed and a purchasing-power agreement is at least close to being signed.

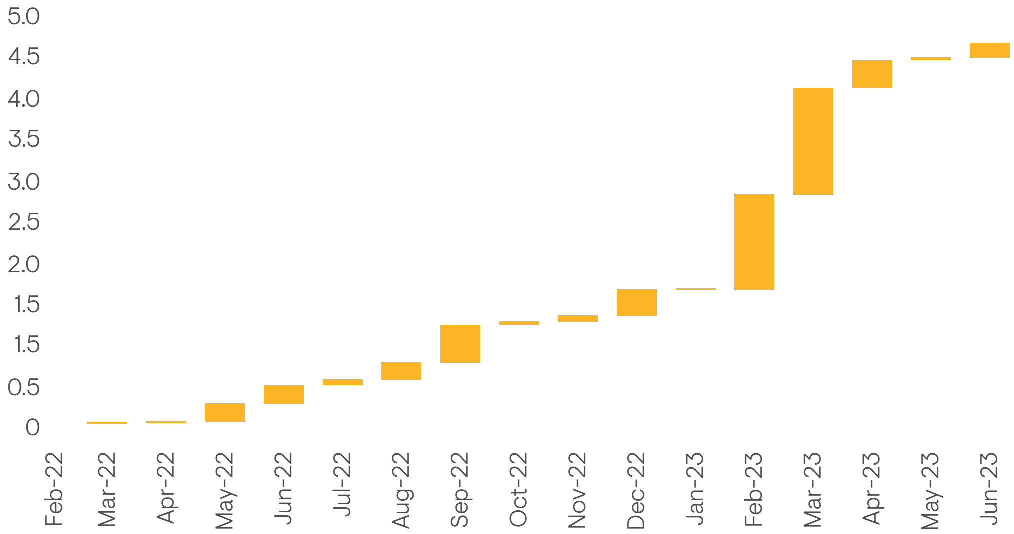
Figure 2: Number of projects by stage of development



Source: Eskom, SAPVIA, SAWEA, June 2023.

Of the almost 18GW of advanced projects (Type A) in the pipeline, NERSA has registered around 4.7GW of projects – these are the closest to financial close and should start being operational within 18 – 24 months. Furthermore, as the vast majority of these are small (below 50MW), many of these should come online relatively quickly.

Figure 3: Significant momentum unleashed by regulation change: NERSA registered projects



Source: NERSA, August 2023.

Enhancing the grid

Alongside this vital new power capacity, important upgrades are needed to expand and strengthen the country's transmission grid, the cost of which is forecast to exceed R200 billion over the next 10 years. In a recent first step towards this, the Energy Regulator has granted a 25-year transmission facilities license (which is one of three licenses, the others relating to trading and import/export) to the National Transmission Company South Africa (NTC). The NTC will operate as a separate entity to Eskom (following unbundling). Under the proposed Energy Regulation Amendment Bill as the system operator, a transparent, non-discriminatory trading platform for market participants will be created, allowing willing buyers and willing sellers to trade with each other. We believe this will encourage more power stations to be built and could prove pivotal for the country's struggling energy infrastructure.

Opportunities for institutional investors on the horizon

Vast sums of capital are involved both in the renewable energy projects outlined above and for the necessary expansion of the transmission grid. While banks will remain an important source of finance, institutional funding is also required given the sheer size of the demand in funding.

Fortunately for investors, the opportunities this will provide offer significant potential benefits. Infrastructure debt investments inherently have a long-term horizon, but the rewards for patience are easy to underestimate.

Our experience from 20 years of investing in infrastructure credit is that the following are typical characteristics:

- Attractive absolute cash-beating returns. Innate inflation linkage of assets and debt instruments offer real returns ahead of inflation.
- Predictable cashflows of underlying investments reduces risk; good performance on a relative basis through the economic cycle.
- Not subject to capital market volatility and low correlation coefficients (0.1)[2] to global equities and global bonds promotes portfolio diversification.
- Long-term nature of project infrastructure debt assets aligns with the goals of long-term investors as retirement funds seeking liability-matching assets.

A potential new chapter but risks remain

The rapid positive shift taking place in South Africa's energy sector brings great promise. However, we think it will still take a while before loadshedding is a thing of the past. It is possible to reduce loadshedding to an average of stage 3 from the middle of next year. The coal-powered stations will continue to contribute a significant portion of our energy needs. Therefore, getting Kusile Units and Medupi Unit 4 returning to service in the short term is crucial. Furthermore, for the full potential of the recent impetus for change to be realised, the following must hold:

- Urgent action is needed to improve the country's grid infrastructure – expansion and improvement of South Africa's transmission grid must go hand-in-hand with the creation of new generation capacity.
- The Presidency and Eskom's leadership team must maintain the positive momentum they have shown in recent months. Various engagements with both give us cause for optimism.

Conclusion

Over recent years, loadshedding has plagued the South African economy on many fronts. But it has also spurred a real sense of urgency at the Presidency and at Eskom. This is already giving rise to important reforms, aimed at putting Eskom on a sustainable path and incentivising the shift to renewable energy. Provided this momentum is maintained and important investment in improving grid infrastructure takes place in tandem and with an equivalent sense of urgency, this could herald an entirely new chapter for the country.

2. JP Morgan. Guide to Alternatives, correlation coefficient calculated between 2008 and 2020.

Important information

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