ESG windfall with expanded renewable energy tax incentive

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The introduction of an augmented and accelerated capital expenditure deduction for the cost of constructing renewable energy infrastructure in South Africa is a boon for companies that have not yet reached their Environmental, Social and Governance (ESG) goals. It provides the opportunity to undertake reportable ESG initiatives and simultaneously enjoy a reduction in tax costs. Fully leveraging this opportunity will require a comprehensive understanding of the mechanics of amended incentives and the dynamics of ESG reporting.

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In the 2023 Budget Speech, the South African Minister of Finance, as part of the package of measures to increase the generation of electricity in South Africa, indicated the intention to amend the existing renewable energy capital allowances to remove generation thresholds and accelerate the period over which the costs incurred can be set off against a company's taxable income.

Renewable energy capital allowance

The Minister of Finance has announced that the proposed renewable energy capital allowance will not be subject to any generation thresholds and, importantly, the full cost, plus 25%, of new renewable energy assets will be deductible in the first year. This is a significant acceleration of the allowance from the current version, which is applicable for tax years ending on or before 28 February 2023.

The current renewable energy capital allowance is contained in section 12B of the Income Tax Act 58 of 1962. In its present form, the section provides for a deduction of the lesser of the actual and arm's length costs of acquiring and installing any machinery, plant, implement, utensil or article used in the types of generation projects listed in section 12B(1)(h). The following types of renewable energy generation projects may benefit from the allowance:

- Wind power

- Photovoltaic solar energy of more than 1 megawatt
- Photovoltaic solar energy not exceeding 1 megawatt
- Concentrated solar energy
- Hydropower to produce electricity of not more than 30 megawatts
- Biomass generation comprising organic waste, landfill gas or plant material.

This allowance currently requires renewable energy assets to be brought into use for the first time as part of the taxpayer’s trade, and to be owned by the taxpayer or purchased under a qualifying instalment credit agreement. The capital allowance for the costs of renewable energy assets is spread over three years on a 50%/30%/20% basis. However, an exception is made for photovoltaic solar energy not exceeding 1MW (megawatt), which is deductible fully in the first year of expenditure. Any foundation or supporting structure that is designed for the generation asset and built for the purpose of the generation project ought to be deemed to be part of the generation asset, subject to the allowance and claimable under section 12B.

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The tax amendment bills, to be introduced into parliament in the coming months, will set out the specific requirements for the expanded renewable energy capital allowance. The particular parameters of the amended allowance will determine the utility and accessibility of the incentive. It is therefore critical for businesses seeking to utilise the allowance to ensure that the technical and other requirements are fully incorporated into the implementation of any renewable energy project.

To maximise the commercial and reputational benefits of deploying renewable energy initiatives, the outcome of the expenditure must enhance the company's reportable ESG credentials according to its selected reporting framework.

ESG reporting

Embracing environmentally sustainable business practices has become an essential part of doing business. While the importance of sustainability is clear from a climate risk perspective, it has recently grown into a key commercial driver, with a simultaneous increasing focus on ESG reporting.

ESG reporting requires companies to disclose the efforts taken to conduct business in a way that is cognisant of environmental sustainability, social welfare, and transparent and appropriate corporate governance. Recent trends indicate that accurate and consistent ESG reporting is directly linked to a company's financial stability, especially considering the rise of sustainable, socially responsible investing and consumption.

International directives

Various jurisdictions are considering compulsory ESG reporting requirements, with some mandatory reporting obligations already in place across international markets. In the United Kingdom and Singapore, certain companies are obliged to report on specific ESG topics, such as the impact of their activities on the environment. The European Commission will implement the Corporate Sustainability Reporting Directive (CSRD) in 2023, with compulsory ESG reporting beginning as early as 2024-2025. The CSRD requires EU companies, as well as qualifying non-EU companies, to report on a wide range of ESG risks, and to make this information easily accessible to the public. Similarly, the United States Securities Exchange Commission (SEC) has also considered mandating ESG disclosures.

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In May 2022, the SEC published for public comment various changes to the existing regulatory framework, which will oblige public companies to include environmental risks, such as their independently verified greenhouse gas emissions, in their financial risk reporting. These changes would require investment fund advisers registered with the SEC to include the ESG risks and strategies of the funds they endorse in their prospectuses and brochures. This proposal ties in with the increase in demand for sustainable investment worldwide, and strengthens the importance of ESG reporting.

South Africa

While these international directives are important for South African companies conducting business in those jurisdictions, ESG is also developing into a key requirement for companies listed on the Johannesburg Stock Exchange (JSE) by virtue of the JSE Listings Requirements. Due to their obligations under the Listing Requirements and King IV, listed companies are required to incorporate ESG disclosures into their annual reports. The JSE further supports the incorporation of ESG through the Sustainability Disclosure Guidance and the Climate Disclosure Guidance, published in June 2022. These documents provide clarity for listed companies on best practices when making disclosures in line with their obligations under the Listing Requirements and King IV.

ESG reporting is still a relatively novel area of corporate governance and this fast growing field does not yet provide standardised guidance, given that there is no single source for authoritative reporting standards. This can make it difficult for companies to compare their reporting against different frameworks. Further, reporting is still voluntary in some jurisdictions.

It is important to note the difference between ESG frameworks and standards. An ESG framework provides broad principles that guide the reporting process. ESG standards contain specific outlines of the methodology, criteria and information required for a specific report. Where frameworks provide the final destination of a report, standards outline the route to get there.

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GRI standards

Given that ESG reporting is not yet standardised, companies are free to report in terms of the standards most suitable to their industry and activities. The Global Reporting Initiative (GRI) Sustainability Reporting Standards (GRI Standards) are one example of such ESG standards.

The GRI Standards provide comprehensive and easily comparable standards for businesses to report on their non-financial metrics. They are designed as a modular set, covering three interconnected types of reporting:

- The Universal Standards applying to all organisations, and which include reporting on human rights and environmental due diligence
- The Sector Standards which are industry-specific
- The Topic Standards, which deal with nuanced topics particular to a business.

A GRI report may cover all of the Standards collectively, or may only include information material to the needs of a specific company's stakeholders. It is important to note, however, that businesses looking to register a report with GRI will need to obtain third-party verification of the information contained in the report, as GRI carefully disclaims that they do not verify or pass judgement on the quality of disclosures. The GRI Standards make provision for reporting on renewable energy activities through the Environmental Topic Standards. In light of radical development of environmental sustainability interventions, these Standards are due to undergo a major review, to be finalised in 2024.

While ESG reporting may not yet be a regulated obligation, given the importance investors and other key stakeholders place in a company's ESG credentials, companies should take the necessary measures to report adequately. Comprehensive and accurate reporting requires expert guidance to help navigate this dynamic area of compliance.

Overall, ESG reporting metrics, like the Environmental Topic Standards, enable businesses in South Africa to capitalise on the potential for significant reputational and commercial benefits presented by the opportunity to install cost-effective renewable energy capacity. They can do so by leveraging the tax cost reduction available under the augmented renewable energy tax incentives announced in the South African Budget Speech. This opportunity requires the necessary expertise to ensure that renewable energy capital expenditure fits within the parameters of the tax incentive and that these initiatives are appropriately reported for ESG purposes.

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