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Self-Build, Self-Fund, Self-Deduct?
A Critical Look at Palabora for IPP Grid Connection Assets

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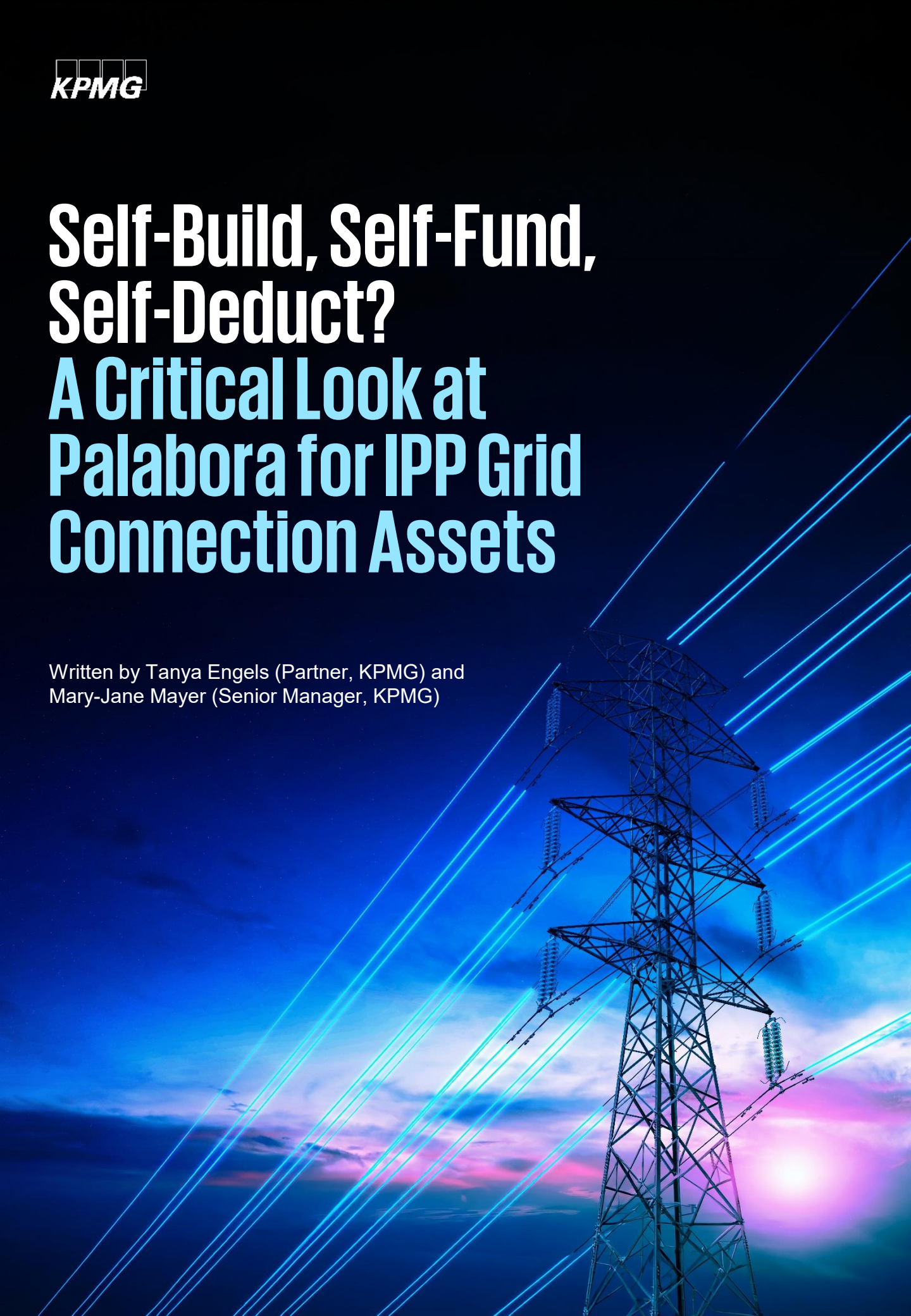

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For more than a decade, Independent Power Producers (**IPPs**) operating under South Africa's Renewable Energy Independent Power Producer Procurement Programme (**REIPPPP**) have debated whether they are entitled to a tax deduction in respect of the cost they incur to build the assets that connect their plants to the Eskom grid (colloquially referred to as "grid connection assets").

It is widely accepted that, in principle, Eskom is responsible for constructing and maintaining the grid connection assets. However, as the REIPPPP progressed, Eskom became severely capacity and resource constrained. In response, Eskom introduced a self-build policy in 2015. This policy allows an IPP to incur and manage the construction cost of the grid connection assets itself, rather than leaving it to Eskom.

Conversely, the IPP may request that Eskom build the connection works, but:

- Only if Eskom agrees to do so (and has the necessary capacity and resources); and
- In that case, the costs incurred by Eskom will be recovered from the IPP.

Prior to the Commercial Operations Date (**COD**), grid connection assets constructed by the IPP must be handed over to Eskom, who then owns them. Eskom does not compensate or reimburse the IPP for the construction costs.

A crucial point is that, whether the IPP leaves construction to Eskom (and reimburses Eskom) or constructs the assets itself under self-build, the IPP ultimately bears the cost.

Since Eskom owns the assets, the IPP has no legal ownership and cannot claim capital allowances in respect of these costs (section 12N of the Income Tax Act was amended in 2013 to deem ownership of certain assets constructed by IPPs in terms of the REIPPPP, to rest with the IPPs. However, it fails to achieve that objective, for legal interpretation reasons that the authors will not elaborate on in this article). This position appears to be broadly accepted in the industry. The IPP's remaining recourse is therefore to argue for a deduction under the general deduction formula (section 11(a)) in the Income Tax Act.

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The general deduction formula

The general deduction formula provides that, in determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from such person's income, expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature.

In the IPP context, it is generally accepted that the cost of grid connection assets meets the first requirements (i.e. actually incurred, in the production of income, and in the course of trade). The real question is whether these costs are "not of a capital nature".

The Income Tax Act does not define capital expenditure, so one must look to case law. The courts use various tests, but the pre-eminent one asks whether the expenditure is:

Part of the cost of performing the income-earning operations of the taxpayer (revenue);

or

Part of the cost of establishing or enhancing the income-producing structure of the taxpayer (capital).

If this enquiry is inconclusive, subsidiary tests such as whether the expenditure creates an enduring benefit are used. The creation of an enduring benefit generally points to a capital expense.

To address this question for grid connection assets, IPPs and their advisors have searched for past cases with similar facts where taxpayers successfully claimed a deduction under the general deduction formula. Various authorities have been invoked, but the most frequently quoted – and on the face of it, the most compelling – is the 1973 case of *Palabora Mining Company Limited v Secretary for Inland Revenue* (35 SATC 159), referred to here as **Palabora**.

The Palabora case

Palabora Mining Company Ltd (**Palabora Mining Co**) operated a copper mine. An essential factor in the mine's development was a reliable supply of water.

It was anticipated that future water requirements would be supplied by the Phalaborwa Water Board (**PWB**), whose main purpose was to store water in the Olifants River by constructing a barrage to provide an assured and sufficient water supply to the area. It was clear that the PWB would construct the barrage in due course.

Palabora Mining Co became concerned that the barrage might not be completed in time to impound the summer rainfall of the 1965/66 season. If the work were delayed, the water storage system would only be filled after the following season's rain, and copper production would be delayed by roughly eight months.

The PWB invited tenders for the barrage. Palabora Mining Co successfully tendered and was awarded contracts, including the barrage contract. The bulk of the work was to be carried out by subcontractors. Palabora Mining Co was to be compensated by the PWB for its services on a cost-plus basis.

To ensure completion as quickly as possible, Palabora Mining Co paid special incentives and inducements to the subcontractors. These inducement payments were over and above the cost of building the barrage (which Palabora Mining Co recovered from the PWB). The taxpayer knew that the inducement payments would result in a loss on these contracts, but considered the loss worthwhile to obtain earlier access to water and therefore earlier copper production.

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It is crucial to note that the disputed expenditure in Palabora was not the cost of constructing the barrage itself (which the PWB reimbursed). The dispute related to the additional inducement and incentive payments to subcontractors – the amount by which those inducements exceeded the reimbursed construction cost. Palabora Mining Co incurred this extra expenditure voluntarily to avoid a delay of eight months in production.

The court held that this disputed expenditure was not incurred to acquire a capital asset of enduring value. The barrage would have been built anyway by the PWB at no cost to Palabora Mining Co, and Palabora Mining Co obtained no proprietary rights or special privileges in the barrage or the water. The inducement payments served only to accelerate the commencement of copper production, thereby allowing profits to be earned earlier, in the relevant tax year.

The court was persuaded that the inducement and incentive payments did not create or enhance Palabora Mining Co's income-earning structure. They merely accelerated the use of a structure that was going to exist in any event. The benefit of the inducement payments was therefore short-lived (limited to the eight-month acceleration), and on that basis the expenditure was held to be revenue in nature and deductible under the general deduction formula.

Applying Palabora to IPP grid connection assets

It is not difficult to see why Palabora is often cited by IPPs under the REIPPPP. Like Palabora Mining Co, an IPP incurs expenditure on assets located on land over which it has no property rights, and does not own the assets once constructed.

However, a closer look at the facts reveals important distinctions. In the authors' view, these distinctions are significant enough to make Palabora a poor analogy for IPP grid connection costs.

The most important distinguishing factor is the nature of the expenditure under consideration.

- In Palabora, the disputed costs were inducement and incentive payments to accelerate (not fund) the construction of an asset (the barrage) that:
  - Was going to be built anyway by the PWB at no cost to Palabora Mining Co; and
  - In the authors' view, provided an enduring benefit over the mine's life (around 26 years).

Importantly, the actual construction costs of the barrage were not in dispute, because they were reimbursed. Rather, the question in front of the court was whether the additional inducement costs, which resulted in a loss on the project but produced a short-term timing benefit, were deductible.

- For IPPs, the situation is different. The IPP is seeking a deduction for the full cost of constructing the grid connection assets – the lines, substations, bays and related equipment that physically connect the plant to the Eskom grid – not just a marginal inducement or overrun. These assets provide a benefit for the entire term of the Power Purchase Agreement and associated agreements, typically around 20 years from COD.

Moreover:

- The IPP will ultimately bear these costs, whether it self-builds or reimburses Eskom.
- The grid connection assets are indispensable to the IPP's ability to earn income at all. Without them, the project cannot deliver electricity into the grid and cannot function commercially.

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In Palabora, the court's reasoning rested heavily on the fact that the taxpayer's extra expenditure was only to accelerate the arrival of a benefit that would have existed anyway, and that this acceleration benefit was short-term. In contrast, the IPP's grid connection costs represent the main construction cost of assets that form part of the project's income-earning structure and without which the project cannot exist.

On this basis, the authors submit that relying on Palabora to argue that the full cost of grid connection assets is revenue in nature, is problematic. The costs under consideration are not comparable in nature or purpose.

The "choice" argument – a weaker parallel

It could still be argued that at least a portion of the IPP's grid connection cost is analogous to the inducement payments in Palabora, in that the IPP "chooses" to self-build to accelerate completion and income. However, even this argument is fragile.

In Palabora:

- Palabora Mining Co could realistically have waited for the PWB to build the barrage.
- If Palabora Mining Co had not made the inducement payments, the barrage would still have been built within the next year at no cost to Palabora Mining Co, and the mine would still eventually operate.

In the IPP context, the "choice" may only exist in theory, but not in practical terms. While an IPP may request Eskom to construct the grid connection assets, several commercial realities intervene:

- Strict REIPPPP delivery timelines mean delays in grid connection can trigger severe penalties and risk the loss of generation licences or grid allocation.
- Project lenders typically require firm commitments on construction timelines and grid readiness before releasing funding.
- Eskom's capacity constraints mean that Eskom-build timelines often do not align with REIPPPP windows or financiers' requirements.

If an IPP formally insists that Eskom build its grid connection, Eskom must provide a quote and a timeline. In practice, however, the timeline will often breach REIPPPP deadlines, and the associated risk may cause equity investors and banks to walk away.

Given this, it is debatable whether an IPP can credibly argue that any portion of its grid connection cost was incurred voluntarily to accelerate income, in the sense contemplated in Palabora. For many projects, self-build is not an optional timing decision, it is effectively necessary and unavoidable if the project is to proceed and produce income at all.

In the authors' view, the more plausible characterisation is that the full cost of constructing the grid connection assets is part of establishing the IPP's income-earning structure and gives rise to an enduring benefit, rather than being analogous to Palabora's inducement payments.

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Conclusion

There is a clear distinction between:

- The inducement and incentive costs in Palabora, which were voluntarily incurred to obtain a short-term timing benefit, and
- The grid connection costs incurred by IPPs, which represent the full construction cost of essential assets that provide an enduring benefit and without which a REIPPPP project cannot exist commercially.

In Palabora, the court allowed a deduction on the basis that the disputed expenditure merely accelerated income from a structure that was already going to be created by someone else, at no cost to the taxpayer, and produced a short-lived benefit. In the IPP context, grid connection costs are fundamental to establishing the project's income-earning structure and securing access to the grid over the life of the PPA.

IPPs should therefore be cautious in relying on Palabora to support a conclusion that the costs incurred in building grid connection assets are revenue in nature and fully deductible under the general deduction formula. Even an argument that a portion of the costs should be treated as revenue, on the basis of a supposed "choice" to self-build rather than leave construction to Eskom, is unlikely to succeed unless the IPP can show that it had a commercially practical alternative, akin to Palabora's ability to wait for the PWB to build the barrage.

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