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FORESIGHT
Island Regions Edition - May 2014

Focus on Infrastructure

Trends that will impact island economies over the next five years

This newsletter focuses on global trends in infrastructure and how they will impact island jurisdictions. The hottest topic globally is also a hot topic for the island regions: the continuing challenges governments face in bringing projects to the market. There is an emerging consensus from the general public that more money needs to be spent on infrastructure, although people are still reluctant to dig into their pockets to pay for it through user fees or other taxes. However, the most important challenge for 2014 and beyond, is taking the critical next step and improving the flow of projects from a robust pipeline of development into procurement, construction and ultimately operations, when the benefits will be felt.

In this newsletter, four of KPMG's Global Infrastructure leaders (Nick Chism, James Stewart, Julian Vella and Stephen Beatty) reflect on their 2013 predictions and outline some additional trends that are expected to change the way infrastructure will be delivered over the next five years.

Investment leads to growth

The world believes that infrastructure is a path to economic growth. The World Bank has calculated that a 10 percent increase in infrastructure provision can result in a 1 percent increase in output.

For international businesses active in infrastructure, new markets continue to be the focus for growth outside of Europe and North America. Supported by domestic export-credit, regional development and other multilateral finance institutions, the race to compete is intensifying in Asia, Africa and Latin America as companies push boundaries of their traditional markets to develop projects and sell materials in faster developing jurisdictions. We've seen increasing outbound capital from investors in Japan, South Korea and China making a strong push into lucrative global markets, and we expect this to continue in 2014 and beyond.

One of our trends from 2013 that has not occurred yet is the emergence of new infrastructure models to better recognise long-term objectives and lifecycle value. While asset ownership is diversifying and outlined in our trends, we have yet to see many new funding mechanisms that effectively expand revenue sources for projects. New funding and finance models have been slow to develop. The institutional debt market has made less progress than anticipated. If deal flow increases as expected, capacity in the financial markets will come under significant pressure. This, coupled with the need to finance complex assets, will force new models to emerge.

Infrastructure is a global story

We hope that the insights in this newsletter provide a new perspective on key trends and opportunities facing the sector in 2014. To discuss these trends and their impacts in more detail, we encourage you to contact your local KPMG infrastructure team.

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Global Chair of Government and Infrastructure

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Chairman of Global Infrastructure

Julian Vella
Asia Pacific Head of Global Infrastructure

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Trends that carry over and are still relevant in 2014

At the 2013 KPMG Island Infrastructure Summit, James Stewart identified the trends that are changing the world of infrastructure, that are of particular relevance to island economies.

Trend 1 People will pay, but what can they afford?

More money needs to be spent on infrastructure, but there are only so many ways to pay for it. Tolls, taxes, rates, fares and fees are the most common. The affordability of infrastructure continues to be a major issue as governments strive to shift the cost burden to the end user and cost reduction continues to come more sharply into focus.

Difficult political decisions need to be made in 2014 as rising household energy prices and above-inflation tariff increases have heightened the public's awareness of infrastructure-related costs. Consumers in recovering economies are still feeling the pinch and struggling to keep up.

In their attempt to cope with increasing demand and get the funding balance right (i.e., how to pay for infrastructure), many governments concede that they cannot go it alone. This is where the private sector can lend support by proactively identifying potential solutions.

Communication is also important. Governments and the media still struggle with the difference between funding and financing*. Helping the general public to understand the nuance will move the discussion forward.

Globally more work needs to be done to accurately reflect the long-term benefit and value of developing infrastructure – particularly analysing all of the wider economic impacts and providing that critical link to economic growth. Robust data will give governments more confidence in political decision-making. This will improve accountability, the quality of the public debate on infrastructure and allow for greater long term thinking.

Case study

The Bahamas
Lynden Pindling International Airport

In April 2007, Nassau Airport Development Company (NAD), signed a 30-year lease with the government to manage and operate Lynden Pindling International Airport on a commercial basis. NAD, a Bahamian company owned by the Government of The Bahamas and managed by Vantage Airport Group, set out to build a world-class airport to align with the expanding tourism industry on the islands. This project was accomplished on time and on budget, transforming Nassau's airport for the more than three million passengers who pass through the airport annually. With the completion of the $410 million, three-phase redevelopment, the airport now has:

- Newly developed domestic and international departures terminals and domestic arrivals terminal;
- Increased in size by 24 percent and is capable of accommodating 50 per cent more passengers (over 5 million); and
- A total of 10 aircraft bridges and 30 aircraft ground loading positions increasing capacity and better passenger and airline handling.

* Financing versus funding - Infrastructure financing refers to raising the capital (debt and/or equity) necessary to pay for the project development and construction. Funding is the means by which the cost of the infrastructure project is covered over the operational life of the asset, e.g., fees, tolls, budget appropriation, etc.

Trend 2 Release the projects

There are plenty of projects in the pipeline around the world but many of the projects are stuck in the development and approval stages. Greenfield opportunities in particular have been difficult to progress as experts explore new ways of accelerating projects and getting them into procurement.

In 2013, KPMG interviewed global executives from 165 engineering and construction companies and 66 percent of respondents felt that national government's infrastructure plans were the single biggest driver of market growth. We have seen many more infrastructure plans appear with much more emphasis placed on prioritisation of projects within an overall investment programme.

Multilaterals and other public sector finance institutions have stepped in and increased their support. For example, the Asian Development Bank has completely changed its engagement model to focus more on assistance during the development stage of a project. In Latin America and Africa, development finance institutions have offered project development facilities to support feasibility studies and other early stage development.

Of the approximately $17 billion in infrastructure pipeline projects identified in the Island Infrastructure Pipeline Dossier (September 2013) over 60 percent were in the development stage.

Trend 3 Asset ownership is diversifying

Historically, governments have been the principal owners of infrastructure with very few exceptions. Over the past 20 years, privatisation programmes have transferred all or partial ownership to a range of privately held companies. With the emergence of direct pension investors and dedicated infrastructure funds, a new breed of strategic long-term financial investor and asset manager has emerged.

This trend is particularly noticeable in more mature private investment infrastructure markets like Australia, Canada and the UK, where cross-border investment from global institutions is on the rise. However, we expect the trend to spread to other markets as primary investors look to sell into secondary markets. Ownership is diversifying with unknown consequences as long-term buy and hold investors build market share alongside infrastructure funds, traditional owners and shorter-focused private equity investors. Government and regulators will be challenged to stay ahead of such a diverse set of owners.

The positive side of asset diversification is stronger competition and better asset management. The new owners want to be more active in their portfolio of investments and are hiring infrastructure management expertise to drive operational and capital efficiency. This should lead to better maintenance and utilisation as long-term investors seek to maximise the usable lifespan of a project.

With an increased awareness of specific project risks, this new breed of asset manager should have a better grasp on resilience planning. Unfortunately, 2013 brought further examples of natural and manmade disasters impacting the availability and performance of infrastructure. Protecting valuable assets from the impact of disasters remains critical for economic and political stability. This is an ongoing issue for owners and island governments alike.

Case study

Barbados Grantley Adams International Airport Inc

In Barbados, the Minister of Finance adopted a fiscal strategy that included the consideration of divestment of a portion of its wholly owned entities to the private sector.

The reform of the current ownership structure from wholly owned by the Government to majority owned, is expected to be a part of the Government's wider strategy to ultimately reduce the growing debt to gross domestic product ratio. Additionally, not only will capital be required to finance the future development of GAIA's infrastructure, but the divestment process will afford the potential to benefit from valuable industry experience provided by external parties in relation to the management of GAIA's operations.

Trend 4 Energy goes back to the future

Energy generation and distribution has traditionally been the domain of big power companies and monopolistic utilities. In the island region, new technologies are challenging traditional business models. This trend is developing owing to the very high cost of energy and the reliance on diesel powered generation.

Our global experience shows that traditional power generation and distribution and renewables are not an either or.

Gas fired power stations will co-exist alongside wind farms and solar projects. Smart grids will be rolled out as energy sources fragment and diversify. New types of distribution, companies and retailers will shake up the market in the region. Many island jurisdictions are faced with the need to retire diesel power plants. Governments across the island region are responding to the changing environment by creating the policy and regulatory frameworks necessary to achieve an optimal power generation mix. Shale gas has already caused dramatic disruptions in international energy markets, and will continue to alter new generation developments in North America. Islands are looking for ways to achieve the necessary scalability to take advantage of natural gas – currently a cheaper fuel source. Although climate change remains on the political agenda, investment decisions will continue to be driven by cost, deliverability of the projects, reliability, sustainability and socio-economic considerations.

Developing case studies

Curaçao Oil refinery

Refineria di Kòrsou is a 100 percent Government-controlled company that owns the refinery in Curaçao that is currently leased to the Venezuelan state oil company PDVSA. The refinery is one of the most important drivers of Curacao's economy in terms of contribution to GDP, employment and monetary reserves. In advance of the lease expiring in 2019, the Government is exploring options to modernise the refinery with the support of strategic partners.

The Government of Curaçao created a multi-disciplinary project team consisting of a modernisation team and a redevelopment team. The modernisation team will start with a Quick Scan and Strategic Orientation Study for the future of the refinery to prepare for negotiations. The Redevelopment team will create a Strategic Redevelopment Plan for the refinery site. The two teams include local and international experts in finance, energy, sustainability and strategy as well as, Government representatives, tax and legal advisors.

Trend 5 Transparency rises up the agenda

While debating the merits of potential projects, transparency is an important ally for building a stronger business case for infrastructure investment. Governments can improve transparency through legislation and regulation. Clear and balanced regulations will play an important role in attracting international infrastructure investors. The simple fact is that infrastructure investors and developers operate in a global economy where national programmes are compared with each other and competition for investment is fierce.

In the search for growth, global investors are entering new markets, and encountering new risks. What may seem like part of the fabric of doing business in one culture could be considered illegal in another. What should be black and white is often grey. It is not just about procurement; it includes the potential abuse of market power (monopoly), degradation of the environment and so on.

Managing this complexity is one of the many challenges facing governments, investors and their advisors in 2014. Several governments in the island regions have taken steps to improve transparency through legislation and the creation of PPP units to manage projects. Robust regulation supported by a structured process reduces barriers to developing a consensus on the need to invest, how to invest and attracting investment.

Case study

The Bahamas Energy Reform

The Government of the Commonwealth of The Bahamas ("Government") recognises that a reliable, cost effective, secure and environmentally responsible energy sector is fundamental for the people of The Bahamas and the future growth of The Bahamas. High energy costs are a burden to Bahamians and local businesses as well as a hindrance to economic growth. A liberalised energy market is considered to be a fundamental step towards lowering the cost of electricity in The Bahamas, as well as moving towards more environmentally responsible energy generation.

In order to achieve the liberalisation of the energy sector, the Government is looking into proposals from the private sector to reform the current energy market structure to enable both increased competition in the generation of power, as well as a more efficient and modernised transmission and distribution network. The Government is of the view that the intended reforms require the financial support, operational experience and innovation of the private sector.

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A Global Infrastructure Perspective

In the complex world of Infrastructure, hot topics of conversation and industry 'buzz' are constantly changing. Foresight: A Global Infrastructure Perspective is an article series featuring our take on some of the hot topics, trends and issues facing the industry and our clients.

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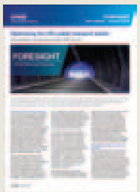

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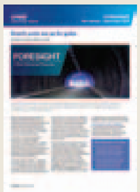

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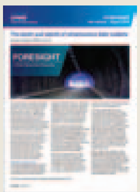

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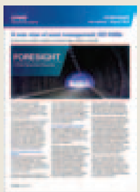
In this edition of Foresight, Darryl Murphy addresses a variety of project financing models for infrastructure assets and forecasts potential opportunities in the pipeline.



A new view of asset management: ISO 5500x
In this edition of Foresight, Daniel Pairon and Rodney Nelson discuss ways to better manage physical assets and deliver longer-term value by improving operational efficiency and reducing cost.

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