8 Emerging Trends for 2015

Global and regional trends that will impact island jurisdictions over the next 5 years

This newsletter focuses on infrastructure trends: both global trends that are impacting island jurisdictions and regional infrastructure market trends. Infrastructure is a story of evolution. Over the years, infrastructure has been a catalyst for social and economic development, and the diversification of island economies.

Island jurisdictions are leveraging infrastructure to allow societies, economies, companies and individuals the opportunity to perform and live to their full potential. At the same time, the way we approach infrastructure itself is also evolving. Some of the shifts in the sector are sudden and disruptive. Others evolve slowly, ebbing and flowing in and out of political consciousness as governments and businesses react to changing circumstances.

For a second year, KPMG has tracked the annual tides and trends driving the world's infrastructure markets with a particular focus on how these trends are manifesting themselves in island regions.

Welcome to our Island Edition on Emerging Trends in 2015.

A number of the trends we identified last year remain key issues today, although, many have themselves evolved. In 2014, we argued that projects were stuck in pipelines; this year we have noted significant moves by governments, multilaterals and development banks to 'unclog' the pipeline.

Other trends from last year continue to simmer. Affordability of infrastructure remains a key challenge as does the need for greater transparency. Worryingly, technical skills continue to be underdeveloped and the international demand for infrastructure professionals and capabilities will only continue to grow and will present a challenge for island nations.

Not surprisingly, we have seen a number of new trends rise up the agenda as societies struggle to balance necessity against opportunity in prioritising their infrastructure spend. Political uncertainty and regulatory reform are becoming key risk factors influencing global investment decisions. Development banks and multilaterals are recalibrating their targets to focus on leveraging private finance in order to improve the flow of capital towards developing projects. Of particular significance to island jurisdictions is the emerging prominence of Asian investment through export financing in the Caribbean region and development banks.

Once again, we hope that this year's insights provide a worthwhile perspective on key trends and opportunities facing island regions in 2015. To discuss these trends and their impacts in more detail, we encourage you to contact your local KPMG infrastructure team.

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Trend 1 Governments take action to unclog the pipeline

Infrastructure has never been higher profile globally. The G20 Summit, in Brisbane in November 2014, saw the formation of a Global Infrastructure Hub which – if armed with the right staff, scope and priorities – could help unlock trillions of dollars in private infrastructure spending. This may draw the attention of major infrastructure investors away from less-developed markets including the island regions.

In order to remain an attractive market for infrastructure developers, island jurisdictions may need to take a more interventionist approach, bundle projects to reach an attractive threshold, and improve capacity to develop robust business cases and procurement practices that can be marketed.

Taken on balance, the move towards greater government intervention by G20 countries is mixed news for island jurisdictions who are able to benefit from lessons learned and innovation on global projects, but will need to up their game to attract investment in an increasingly competitive environment.

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Trend 2 Political and regulatory risk rise up the agenda

The infrastructure community is no stranger to managing risk. But over the past year, many within the wider community – particularly investors and developers – have become increasingly concerned about the potential risks associated with political and regulatory uncertainty. The reality is that – compared to private equity – infrastructure provides relatively low returns but this corresponds with lower levels of risk. This is, after all, a large part of the attraction for institutional investors.

It is not just elections that are causing infrastructure providers and investors to sweat these days. So, too, is the uncertainty surrounding regulation. A balanced approach to protecting consumers and investors can support investor confidence and reduce uncertainty. For many islands, this presents a significant challenge owing to limited economies of scale resulting in monopoly providers. The unique nature of island jurisdictions often necessitates tailored regulation as regulatory models from larger jurisdictions are frequently less compatible with the reality of island markets. Investment in regulatory frameworks that effectively and transparently balance public policy with commercial interests will pay dividends both from the perspective of attracting infrastructure investment and meeting the needs of society.

For some island nations rating agency downgrades and revised downward outlooks have resulted in increased country risk. Consequently, the need to ensure business cases are sound is of greater importance to moving projects from the pipeline to development.

Islands are benefiting from having well planned national strategies that guide decision making and help to depoliticise national priorities. For instance, national tourism plans are a boost to planning and setting the agenda in hospitality-focused jurisdictions, as has been the case in Turks and Caicos, Bermuda and elsewhere.

> "Islands are benefiting from having well planned national strategies that guide decision making and help to depoliticise national priorities."

Trend 3 Market reforms: status quo is not fit for purpose

Over the past year, we have seen significant moves on the part of certain island governments to reform the market structure across a number of infrastructure sectors. This is, in large part, due to recognition that current market systems may not deliver the investment and efficiencies needed. Many infrastructure and regulatory leaders are starting to recognise that traditional price-cap regulation – while popular with consumers – may be insufficient to enable utilities and other regulated sectors to meet the future demand. It is also because the dynamics of infrastructure and utility markets are changing with the introduction of new generation sources and technology, gaining efficiencies from smart grids and metering, which often require changes to regulation.

Energy market reform in The Bahamas and Bermuda are two examples of government action to create dynamic regulatory frameworks which will underpin new investment in power generation and renewable energy.

Trend tracker: Market Reform

Regulators and politicians need to balance two key responsibilities as they consider new regulation and market reforms. The first is to provide certainty to investors that the regulatory regime will remain stable, consistent and supportive of ongoing investment. The second is to create mechanisms that balance the need to protect consumers with the need to ensure that investors receive sufficient returns to allow them to continue to invest in assets.

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Trend 4 The shifting role of multilaterals and development banks

With the renewed focus on enhancing the flow of long-term capital for infrastructure development – particularly into developing infrastructure markets – we have seen a significant shift in the operating models and performance targets of many of the world's multilateral and development banks.

In last year's **Emerging Trends Island Region report**, we noted moves by multilateral institutions and development banks to shift their engagement models and place more focus on assistance during the development stage of projects. In the past year, we have seen the trend shift further. Rather than measuring themselves purely on their quantum of lending, a number of institutions are increasingly moving towards targets related to the amount of private sector capital they are able to leverage.

This is a welcome development. We believe that development banks and mulitlaterals have a vital role to play in shaping the development of island infrastructure markets. Island governments can act as catalysts for private sector investment with financeable projects and robust procurement.

Evidence suggests that there continues to be an expansion in the market in terms of products and capacity. Over the coming year, expect to see the establishment of new development banks (most notably the formation of the US$100 billion Asian Infrastructure Investment Bank, led by China). We also expect to see Export Credit Agencies in the U.S. and Asia becoming more aggressive as they seek to support their domestic suppliers with international business.

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Trend tracker: Evolving U.S. Policy on Energy Exports

Recent changes announced in the United States' policy on energy exports to the Caribbean region have far reaching implications for governments interested in securing lower cost natural gas supplies and who are able to work with international financial institutions and private sector partners. The Government of Trinidad and Tobago will play a pivotal role in reconfiguring the energy matrix in the Caribbean. Whether the environment created by the shift in U.S. policy is sufficient to accelerate transition of island energy providers to Natural Gas is yet to be determined.

Trend 5 Asset recycling moves up the political agenda

Governments are keen on full or partial asset sales for financial reasons: partly because it means that future investment can be moved off the public books, but also because returns from asset sales can be ploughed back into developing new infrastructure (which, in turn can be privatised in a virtuous cycle of investment recycling).

Certainly, recent Initial Public Offerings (IPOs) for government assets have shown a clear departure from island jurisdictions owning 100% of infrastructure assets. Asset sales are also helping governments to improve the performance of underperforming assets with private partners bringing commercial experience and global networks to focus on asset performance

Governments are also taking a closer look at assets that are under-performing or superfluous to delivering essential public services. In the past few years, there has been an increase in transactions to sell all or a portion of government assets as a means of not only creating a fiscal injection of cash but also to benefit from the private sector's greater ability to deliver performance.

While we expect to see an increase in asset sales in the island regions, it is clear that deal flow will be impeded where government assets remain a politically-charged topic. Success will require politicians, regulators, and the private sector to work together to ensure that deals and regulation are structured appropriately to balance the needs of consumers and investors, while still gaining the support of voters.

Asset sales are also assisting certain island nations to improve their debt to GDP ratios. The decision of the Government of Barbados to divest 65% of the Barbados National Terminal Company Limited will certainly be watched closely by investors and island governments.

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Trend tracker: National Consensus on Priorities

How then should governments and infrastructure planners balance economic benefit against need given constrained financial resources? Ultimately, it will take a national consensus that brings together economic and social imperatives as well as more effective methodologies for evaluating these benefits. But planners will also need to remember that it's not a choice of one over the other, but rather well planned and executed combination that overlays long term objectives on top of the realities of immediate need.

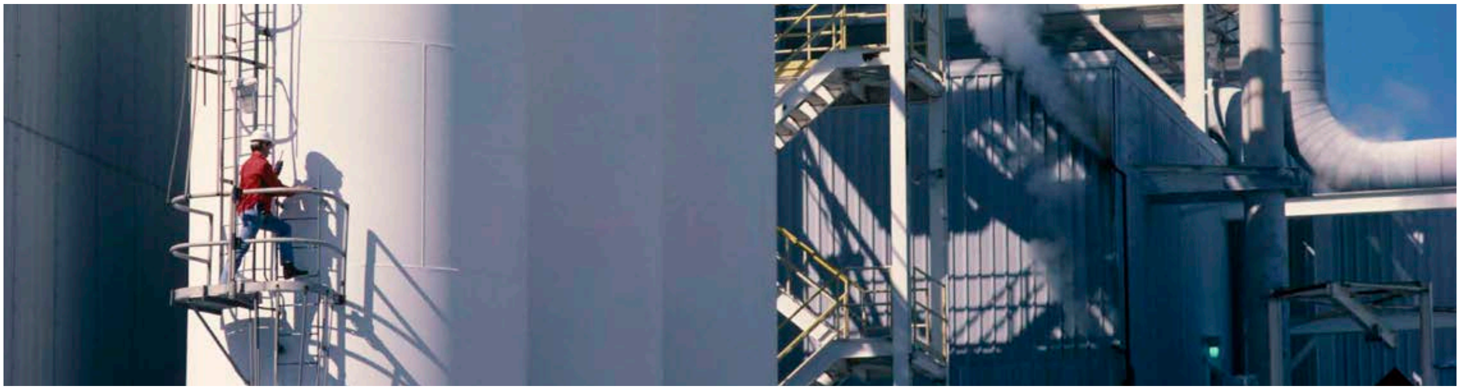
Trend 6 Striving for better asset performance

By now, it is widely recognised that private enterprises can perform better in terms of efficiency, cost and customer experience than their state-owned counterparts. As many public sector entities have learned, the key to island nations achieving the sought after results is in the robust planning, vetting and selection of private partners.

As governments aim to improve public services, many are starting to benchmark the performance of public utilities against best practice and explore alternative delivery and ownership structures. Not surprisingly, a growing number are looking to the private sector for help.

Many public utilities are undertaking a business transformation process – looking to evolve the way they operate and focus more on improved asset efficiency. This may involve introducing private operators and leveraging commercial models in order to improve performance and customer experience. One example is private sector management of the Bahamas' National Airport Development Company, which remains 100% owned by the Public Treasury.

Trend 7 Focus on life cycle maintenance



While the allure of new infrastructure attracts attention, many islands are faced with the need to invest more in maintaining and repairing existing infrastructure, including roads and other transportation infrastructure.

Replacement, which may be necessary and even critical in certain cases, is not always the best solution. Investment in improved systems of infrastructure management and greater investment in preventative maintenance can prolong the life of infrastructure assets and avoid the need for expensive replacement.

After many decades of cutting public works' budgets, particularly in the area of transportation assets, islands are re-thinking this short term approach in order to mitigate the often much higher cost of redevelopment and replacement.

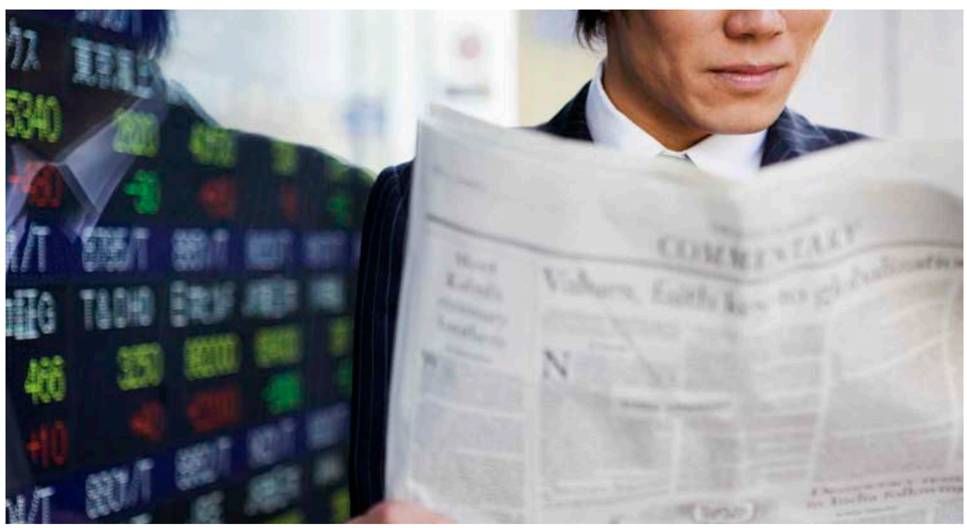
Certainly, one driver has been the short term opportunity to create employment by undertaking road maintenance.

However, the truly compelling longer term reason for taking a more holistic approach to asset management is reducing capital spend and the need for costly repairs.

Trend 8 The Emerging Prominence of Asia in the Caribbean

The last decade has seen the emergence of 'global developers' such as fast arriving Chinese firms seeking new opportunities outside their domestic market. Export financing in the Caribbean region has grown significantly as part of China's "Going Global" policy. While this trend is particularly evidenced in jurisdictions with strong diplomatic ties to China, investment by China's policy banks and State Owned Enterprises (SOEs) are expanding their interest to more island markets. Usually a condition of financing is the use of Chinese construction companies, labour and materials or a combination thereof. As a result, the economic stimulus that a major capital project can generate is muted.

Positively, public perception of Chinese infrastructure investment is evolving as island governments are adopting approaches, including leading procurement practices, to secure investment while improving the economic benefits to local businesses and citizens as well as minimising exposure to risks.



Trend tracker: Major interdependencies: long term capital

There is a growing pool of debt and equity available for investment into infrastructure. The challenge is in matching capital to worthy projects. The much anticipated entry into the market of Asian institutional investors (such as insurance companies, pension funds and sovereign wealth funds) promises to add even more capital to the mix particularly for island jurisdictions that have established ties with China and Taiwan.

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