

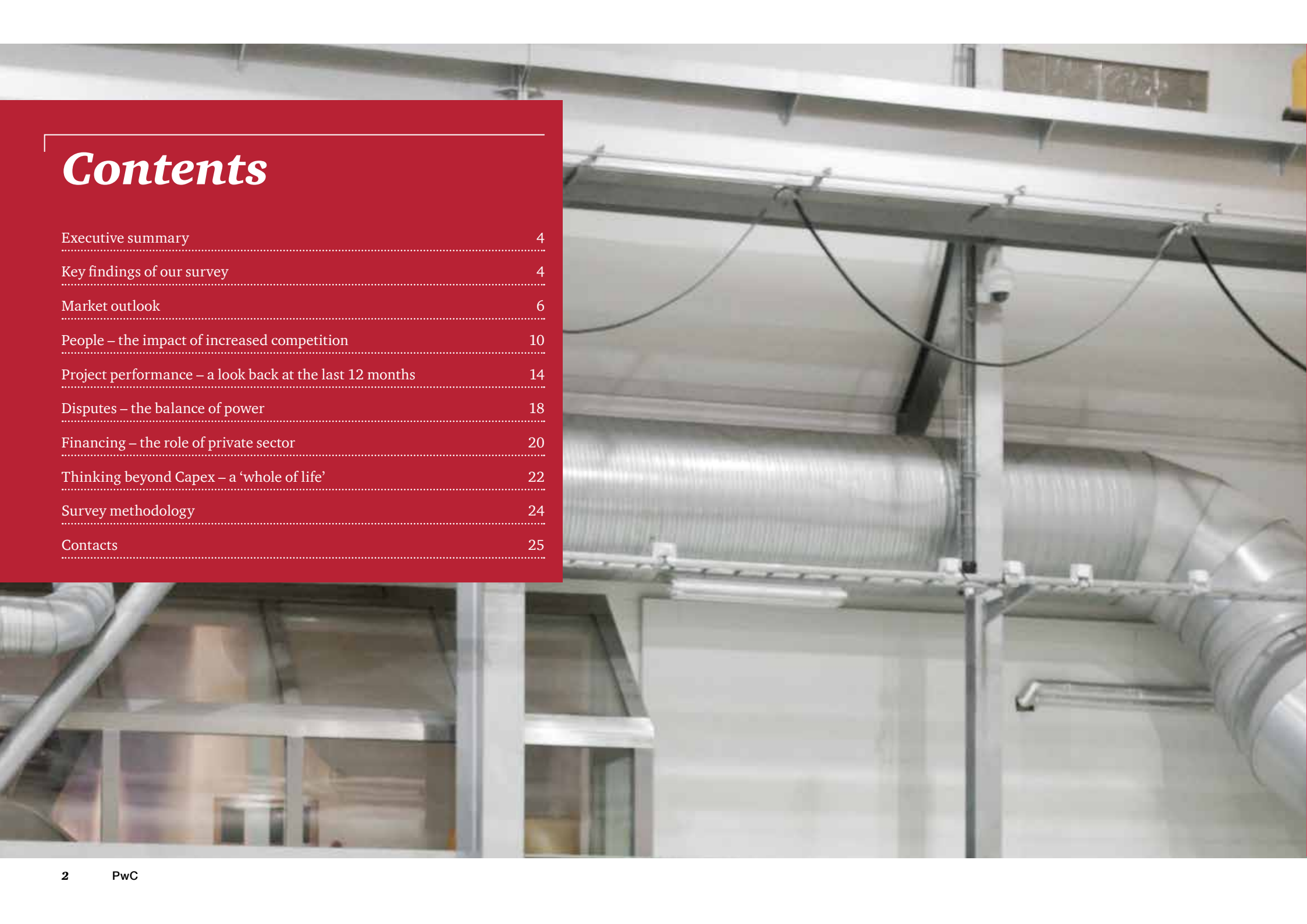
Building beyond ambition

*Middle East Capital Projects & Infrastructure Survey
June 2014*



Contents

Executive summary	4
Key findings of our survey	4
Market outlook	6
People – the impact of increased competition	10
Project performance – a look back at the last 12 months	14
Disputes – the balance of power	18
Financing – the role of private sector	20
Thinking beyond Capex – a ‘whole of life’	22
Survey methodology	24
Contacts	25



Welcome

Welcome to our latest Middle East Capital Projects and Infrastructure Survey. We asked 130 of our region's most prominent project owners, developers, contractors advisors, and financiers to tell us their views on their industry. What's their experience on the ground? How confident are they? Are they seeing more disputes? What are the delivery issues they face? Can they access funding?

Events of the past 12 months have continued to demonstrate a resurgence in optimism about the overall Middle East capital projects and infrastructure sector, and have also set a positive backdrop for momentum to continue into the coming year. However, our respondents say that this is only half the story – the results show that there is a 'capacity crunch' looming on the horizon, which needs to be urgently addressed if the region is to deliver on its ambitions.

We would like to thank all of those who participated in the survey and took their valuable time to share their views. We hope you find the results as interesting as we did.

Stephen Anderson

Middle East Leader, Capital Projects & Infrastructure

Executive summary

Strong economic growth and budget surpluses in much of the GCC provide the backbone for ambitious spending plans. Governments of the GCC are generally continuing to invest in economic diversification while at the same time spending to maintain or expand hydrocarbon and downstream petrochemical production.

The post Arab Spring turmoil continues to depress optimism in the rest of our region outside of the GCC, whilst providing a fresh incentive to invest in social housing, transport, education and healthcare by Governments to meet the needs of their citizens.

At the same time, the recovery in the banking sector (from the impact of the global financial crisis) along with several regional debt restructurings and the sheer scale of commitments, is making private sector finance a more attractive, and indeed necessary, option for funding infrastructure projects.

Key findings of our survey:



Spending increasing

75 percent expect an increase in spending in the coming 12 months. This is largely driven by mega events, including Dubai Expo 2020 and Qatar World Cup 2022, as well as increased spending on **social infrastructure** including housing, education and healthcare.



Fewer cancellations

There has been a significant reduction in the number of projects being scaled back or cancelled due to funding constraints, down **14%** from our last survey **18** months ago, with respondents expecting this **trend to continue** into the next year.



Investment focus

UAE, Qatar and Saudi Arabia are the top three countries for infrastructure investment.



Client decision-making

55 percent of respondents said that client decision making is the biggest challenge they face in relation to delivery of major projects.



Funding gap

Private finance is expected to play a greater role in funding projects, with **83** percent of respondents stressing the importance of the private sector in financing projects. **41** percent think that PPPs increase the likelihood of delivering capital projects on time, however, nearly **25** percent also complained that PPPs complicate the delivery of capital projects.



People – not enough to go round

Skills shortage and increased competition is creating a big problem. In short, it's becoming more and **more difficult to attract and retain enough of the right people** with the skills and experience at all levels required to deliver large, complex projects.

The result



More delivery delay

95 percent of respondents say their projects are delayed, with a staggering **45** percent delayed by more than 6 months. Likewise, **71** percent tell us that their projects are over budget.

More financial constraints and disputes

Whilst fewer projects are being

scaled back or cancelled due to funding issues, the number of projects being postponed is on the rise – **45** percent of respondents said projects had been deferred or delayed, up **30** percent from our last survey. **37** percent cited contractual disputes as a key external challenge to project delivery, second only to client decision making.

Reasons to be cheerful

Optimism is spread across all sectors, but those involved in mega events and social infrastructure are most optimistic about the prospects for the next 12 months. In Qatar the focus is mainly on mega event and transport related projects, while in Saudi Arabia and the UAE the focus is in general more evenly split across the sectors.

Challenges beyond the GCC

The outlook for capital projects and infrastructure beyond the GCC is more challenging. In countries like Iraq, Egypt, Jordan, Libya and Lebanon the market remains challenged by political instability, weak government finances, or a combination of the two. The proportion of respondents to the survey saying they would be targeting projects in Egypt fell substantially compared to our last survey, and it remains to be seen if the election of El Sisi as President, along with announcements to expand infrastructure programmes, can restore confidence.

The capacity crunch

Regardless of geography, our respondents identified that the capital project and infrastructure sector faces several significant challenges. Broadly speaking, these problems have been apparent in our region's infrastructure sector for several years, but the increase in activity is making them more acute. The survey findings could generally be described as market capacity failing to keep pace with demand, but this manifests itself in several different areas:



People

The transient nature of the region has always been a challenge, but the uptick of megaprojects both within the GCC and globally means competition for qualified, experienced people has intensified – 54 percent of owners, and 43 percent of contractors, consider the availability of skilled resources as a top challenge in the coming year. It's one of our biggest challenges to overcome – there are no quick fixes and ever-increasing compensation packages are adding to cost inflation.



A 'power-lite' client structure

The people issue isn't just confined to project delivery. On the client side, a lack of experience at a senior level to oversee large, complex projects and their contractors, also creates problems. When combined with relatively weak governance structures and a lack of delegation, it leads to delays in decision-making, last-minute variations, poorly defined scope or inadequate designs and a lack of oversight.



Contracts and disputes

The adversarial nature of most contracts in our region pits the interests of contractors and project owners against one another, and transfers most of the risk down the supply chain. This inevitably leads to conflict. However, increasing levels of activity means we are starting to see a 'flight to quality' – contractors can pick which clients they work with, and so the balance of power is tilting. As such contractors are increasing emboldened and more likely to enter into dispute than before. Moving to contracts that are more of a partnership, and reward contractors for delivery that is either ahead of schedule or under budget, would go a long way to resolve some of our region's delivery issues.



Funding gap

Private sector finance is expected to play an increasingly important role in the regional infrastructure sector. This is in part driven by the desire to gain access to more private sector expertise, but also because of the sheer scale of the developments planned around the region would create a major draw on the public purse. Private sector finance, however, will not be a panacea to constraints on government funding. Although the banking sector and capital markets are in a bullish mood, there are still expectations that rising demand will exceed the supply of capital.



The 'true' cost

Pressure on costs is driving focus away from capex alone and towards the cost of maintaining and operating assets after project completion – what we would call 'whole-of-life' cost. This is especially important when considering the role of the private sector in funding projects. Addressing these challenges will require project owners to take a broader view of their capital projects, taking into account the entire lifespan of a project, rather than just the initial development cost.

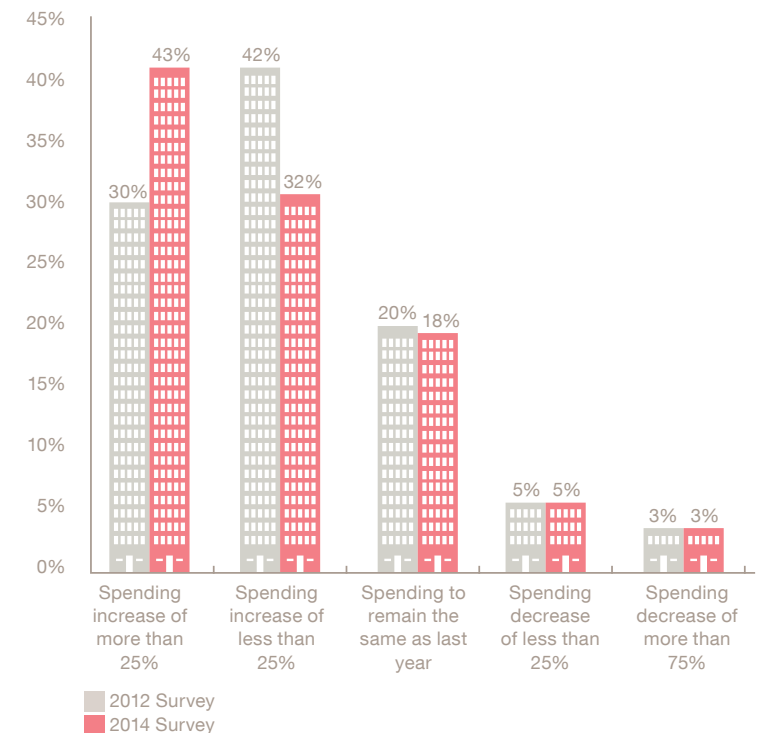
Outlook optimistic, but a capacity crunch looms large



More planned spend

A strong economic environment and political incentives to increase spending continue to provide a positive backdrop to regional infrastructure development plans. We are seeing this translate into a marginal increase of confidence in the industry compared to our previous survey in 2012 with 75 percent of our respondents expecting to spend more on projects than they did last year. The majority (over 40 percent) expect that increase to be greater than 25 percent.

Outlook for the next 12 months

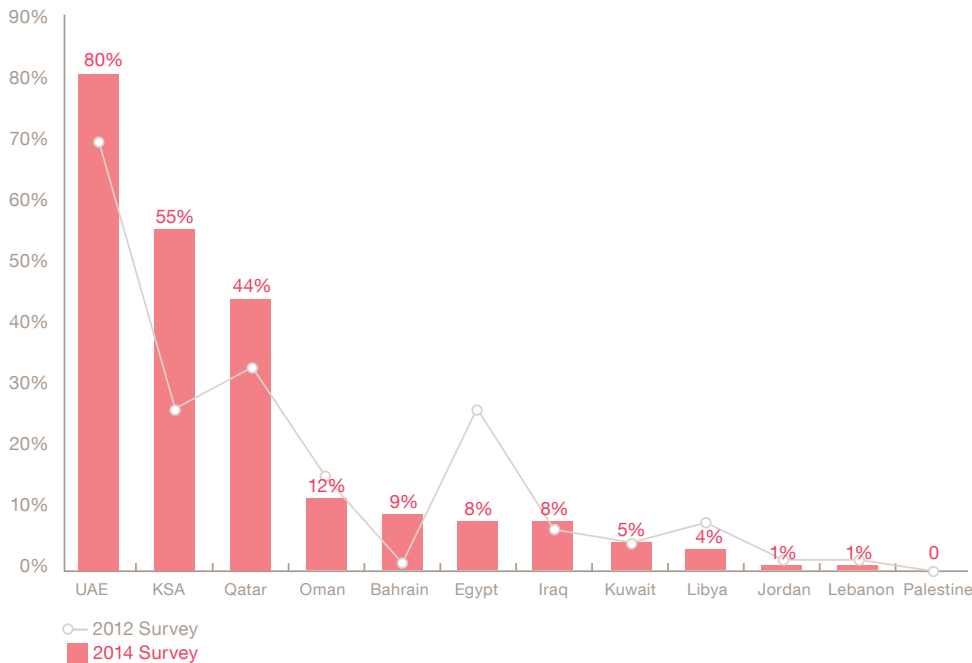


The expectation that project spending will continue to rise is being driven by the investments required around plans for mega events in the region, notably Dubai's World Expo in 2020 and Qatar's World Cup in 2022. This is combined with post Arab Spring social spending packages – particularly on social housing, healthcare and transport infrastructure – and continued investment in oilfields, petrochemicals and power production facilities.

Concentration of spend

Our findings confirmed the UAE is the most attractive country for major projects in the MENA region, followed by Saudi Arabia and Qatar. The top 3 is perhaps unsurprising given the combination of the sheer scale of investments planned in these countries, the creditworthiness of the governments behind them, and the working opportunities on offer from either a lifestyle or compensation point of view.

Target countries for investment in major projects and infrastructure in the next 12 months

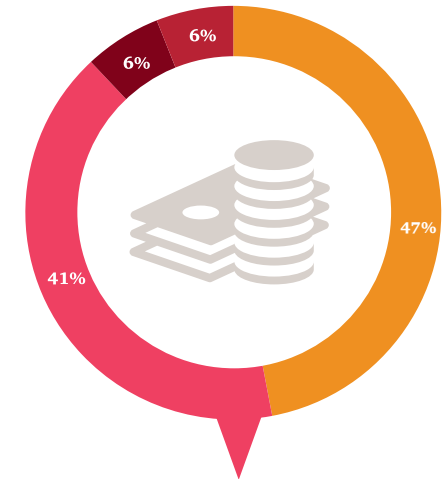


A capacity crunch looms large

The outlook is not entirely optimistic. Although spending on capital projects is rising fast, there are signs that the region's capacity to deliver them is unable to keep up with demand. There are two fundamental areas that will limit the ability to progress with project plans: people and financial resources.

The ability to find skilled staff – both in terms of quality and volume – was identified as a key challenge for both project owners and contractors. Difficulties securing funding are also expected to lead to project delays – our survey suggests that there simply isn't enough funding available to feed the increasing pipeline of activity across the region.

But these capacity concerns are emerging in other ways too. One indicator that capacity is unable to keep up with planned spending is inflation. 41 percent of our respondents involved in mega events expect construction costs to rise by between 15 and 50 percent. Only 6 percent think there will be no cost escalation.



Expected construction cost escalation as a result of up coming mega events

- Between 1% & 15%
- Between 15% & 50%
- Between 50% & 100%
- No escalation

Perspective on the ground

Iraq is a country with a significant lack of infrastructure in the energy sector. The country is net importer of refined products like diesel and still faces shortages in electricity supplies. Refineries, power plants and electricity grids are key investment priorities. It remains to be seen what impact current turmoil will have on these projects (at the time of writing).

Egypt now seems to have calmed down after the recent presidential elections and the old infrastructure investment programs in the transport, energy and water sector are on the table again. Heavy support programs from international donors like the World Bank, EC and UN support the roll-out out of these programmes.

In the Levant region, major infrastructure programmes in the energy sector (IPPs in Lebanon, LNG terminals in Jordan and power plants in the Palestinian Territories) are top priority projects for the public sector.

Bernhard Haider
Partner

Rising demand emboldens contractors

The rising demand is also starting to tilt the balance of power towards contractors. This follows several years in the wake of the global financial crisis when project owners had the upper hand in negotiations due to the slowdown in activity.

Although spending on capital projects is rising fast, there are signs that the region's capacity to deliver them is unable to keep up with demand.





People – increased competition and a skills shortage means there's not enough to go around



Availability of skilled resources at near-crisis point

While the Middle East may well have the ambition and political imperative to embark on the projects planned in the region, the key limiting factor and potential crisis point is around people.

The availability of skilled resources is a top external challenge for 54 percent of project owners and 43 percent of contractors that we surveyed.

Competing internationally for people

As more projects of greater complexity are planned or underway, competition for talent, both within the region and internationally, is expected to rise.

Factors beyond salary packages alone will be of increasing importance, and countries that offer good quality of life, access to prime schooling and healthcare will be the most attractive destinations to expatriate talent.

On a global scale activity levels have picked up too, and the region faces stiff competition from the likes of Japan, especially for specialists in areas such as nuclear power. 30 percent of respondents in the Energy, Utilities and Mining industry said competition from other countries outside of the MENA region was the biggest threat to them attracting and retaining talent.

Threats to attracting and retaining talent

42% **30%** **27%**



Competition with other countries in the MENA region



Competition with other countries outside the MENA region



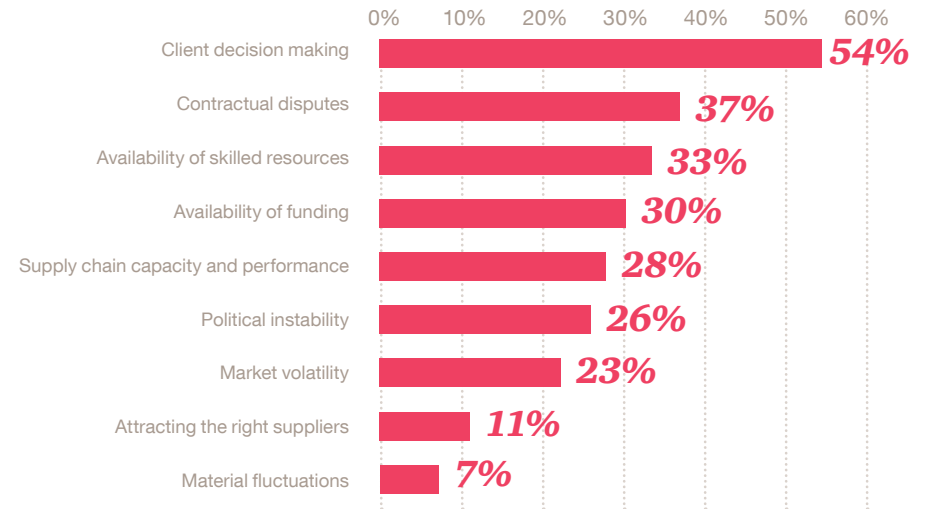
Competition with other companies or divisions within your group

'Power-lite' client structures

The talent vacuum presents a different set of challenges for project and programme owners, many of whom lack the mature, technically capable and well-staffed delivery functions that are essential prerequisites to successful project delivery of large and complex projects. The primary impact of this from a project perspective is slow decision making: 54 percent of those we surveyed said owner decision-making was the biggest delivery challenge they faced.

Organisations delivering complex and iconic projects need to rethink how they govern and oversee project delivery, building delivery units that are agile, empowered and able to make decisions effectively. Failure to do so risks these projects being mired in delays and disputes.

External challenges facing the delivery of major projects



The key limiting factor and potential crisis point is around people

Competition for talent, both within the region and internationally, is expected to rise

Keeping people

In a region that predominately relies on transient expatriate talent, being able to retain people is equally as important as attracting them in the first place. This is particularly important for technically complex and long term projects that require highly specialist skills, such as nuclear power plants. As an example, the top ranking factor in attracting and retaining talent in the energy, utilities and mining sectors was compensation and benefits, career progression was a clear second. Given the long-life span of many of these projects, being able to offer expatriates

opportunities to develop and progress in their roles should become an increasingly important part of retention strategies.

The top three countries where the availability of skilled resources is considered the biggest external challenge are the UAE, Qatar and Bahrain. Given that the UAE and Qatar are among the most active project markets in the region, this was expected, however, it is surprising that Saudi Arabia does not feature higher on that list as the Kingdom embarks on a thorough reform of its labour market.

Given the long-life span of many of these projects, being able to offer expatriates opportunities to develop and progress in their roles should become an increasingly important part of retention strategies

Perspective on the ground

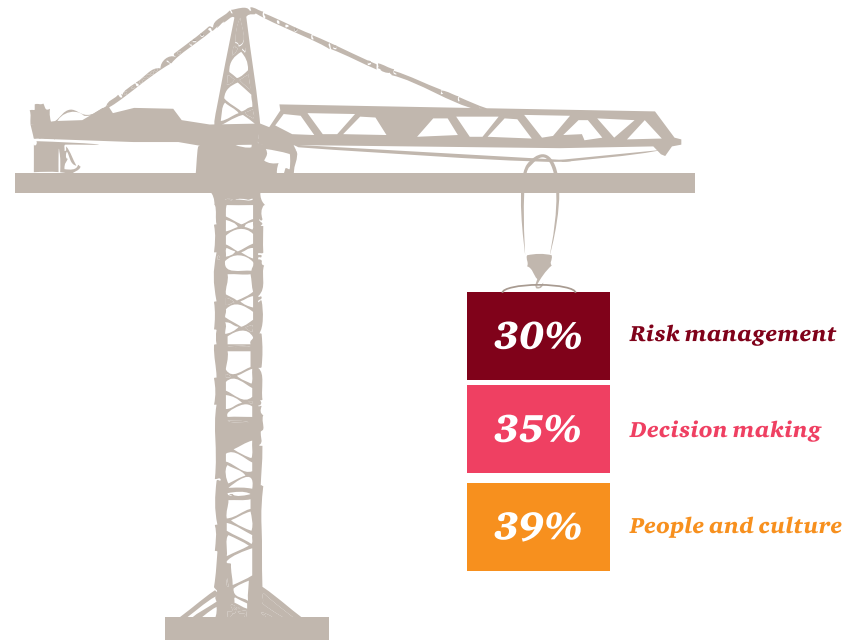
Saudi Arabia remains the largest projects and infrastructure market in the region with requirements driven by fundamental demand for utilities, transport, social infrastructure and real estate and the government's firm commitment to early investment in these areas.

The last couple of years have seen a huge commitment to new metro and bus projects led by the scheme in Riyadh, with new schemes still being confirmed. In the years to come we expect to see further focus on social infrastructure provision come to the forefront alongside the traditional infrastructure investment areas driven by population growth.

An interesting issue will be how the Kingdom balances the desire to nationalise its work force with ensuring sufficient capacity to build and run its projects.

Jonathan Barnes
Partner

Contractors' top internal challenges in relation to project delivery





Delivery performance – capacity crunch starts to bite

There are signs that capacity constraints are already starting to impact project delivery, with respondents reporting delays and cost overruns across the board.

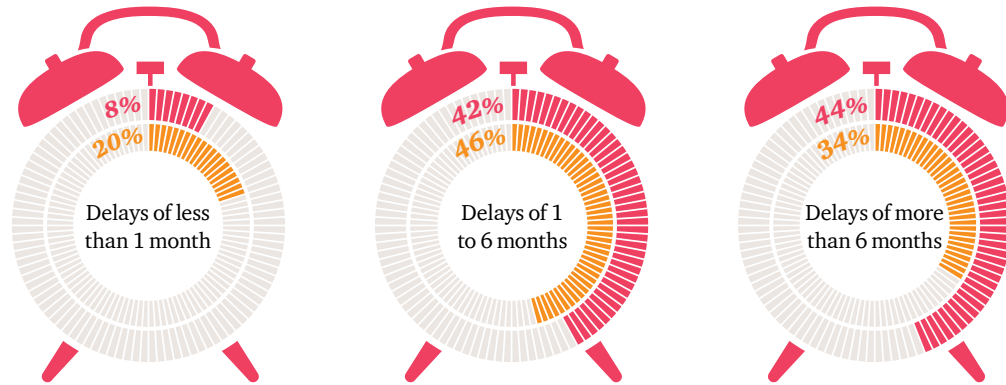


Delays and cost overruns are getting worse

Our respondents said that nearly all of their projects are delayed, and those delays are getting worse. In total 95 percent of projects suffered delay, up from 90 percent in our last survey. Respondents also said that 44 percent of projects were delayed by more than 6 months this year, compared to 34 percent in our last survey.

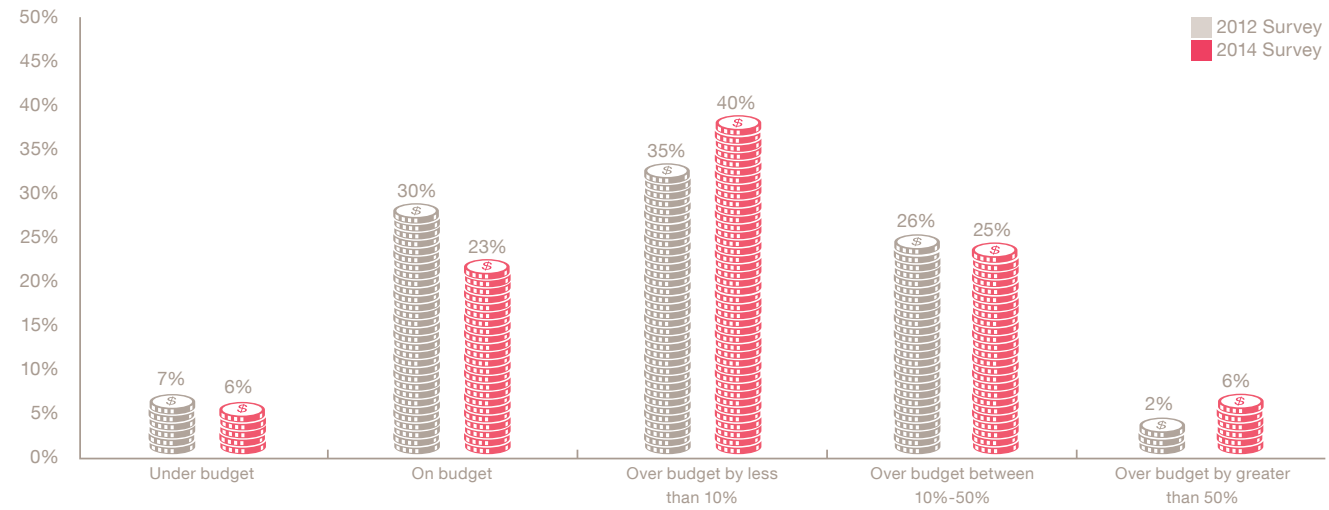
Projects are also over budget. Our respondents said that 71 percent of their projects were over budget this year, up from 63 percent in our last survey.

Average delays in the last 12 months



2012 Survey
2014 Survey

Average cost variances within the last 12 months



The blame game

Contractors and project owners each blame the other for performance issues. Contractors cited client-instructed scope changes as the main reason for delays, whereas owners cited poor performance of their contractors.

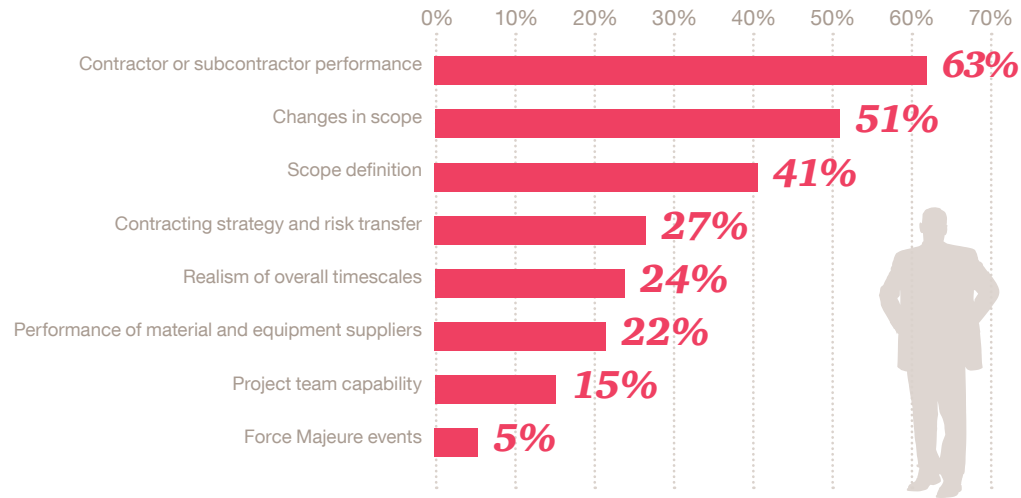
There is likely to be a degree of truth in both, however the root causes lie elsewhere:

Changes are frequent – the region’s infrastructure programmes are ambitious and complex. Projects start rapidly and there is immense pressure to break ground – consequently projects often start with immature or incomplete designs, which need to be updated as the details take shape.

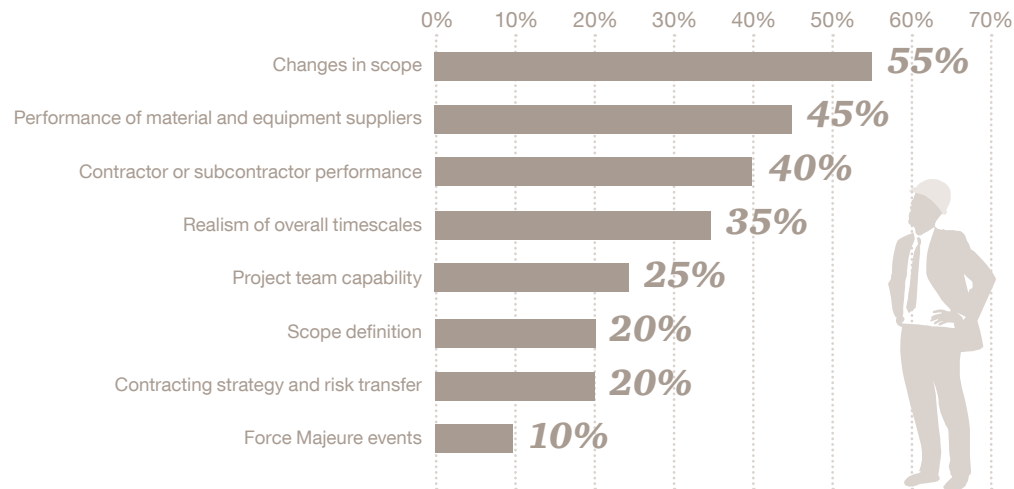
Decisions are slow – The organisations responsible for delivering major programmes are formed quickly and lack the capacity to administer change effectively. Governance structures centralise decision making and generally vest limited authority in project teams.

Risk is pushed down the supply chain – contracts generally transfer most of the risk to the contractor and contracts are adversarial in nature, so changes and issues tend to lead to protracted arguments between owner and contractor around culpability, impact and compensation.

Primary causes for delay – the owner’s view



Primary causes for delay – the contractor’s view



Addressing project performance is more important now than ever; with an increasing mega projects pipeline, building and transforming the institutions that will develop, deliver and operate these assets is of paramount importance.

Organisations delivering complex and iconic projects need to rethink how they govern and oversee project delivery, building delivery units that are agile, empowered and able to make decisions effectively. Failure to do so risks these projects being mired in delays and disputes.



Perspective on the ground

The ability of procuring organisations to deliver large scale investment programmes is improving across the region, but is impacted by some traditional procurement practices and an unwillingness to delegate authority to the right level.

Organisations here often believe that appointing a PMC or lead contractor will deliver them a programme. In reality, the client entity itself needs to have suitable resources and processes to manage the PMC to deliver the programme and manage client retained risks.

Chris Scudamore
Partner

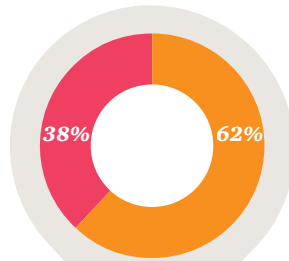
*No argument about it –
Disputes set to increase*



Poor performance in project delivery is leading to more contractual disputes between project owners and contractors. This trend is exacerbated by the increasingly complex, ambitious and higher risk projects planned or underway in the Middle East.

Our survey suggests there is an increasing willingness to engage in disputes: over 60 percent of respondents have been involved in disputes over the past 12 months, or expect to be involved in disputes over the next 12 months and contractual disputes were identified as the second biggest external challenge our respondents are facing.

- Not in dispute last year or not expecting to be in dispute next year
- In dispute last year or expecting to be in dispute next year



The balance of power is tilting

Any contractor operating in the Middle East will be well aware of the reputational risk that a dispute with a high profile or influential owner carries, and also that resolving disputes is a long and time consuming process. Despite this, the fact that disputes are becoming increasingly regular is a sign of how attitudes are shifting – contractors are increasingly willing to turn to their lawyers to resolve disagreements with owners.

Whilst contractors are becoming more assertive, the favoured option for settling disputes is direct negotiation, with around 80 percent citing it as their preference. Only around one in five would take disputes to external bodies or attempt to use arbitration mechanisms. Less than one in 10 would seek resolution through local courts, although as the legal framework matures this could start to change.

Perspective on the ground

Construction disputes in the Middle East continue to take time to resolve. Although old disputes are tailing off due to the previous lack of new projects started during the crisis, a new wave of disputes will emerge as execution of the mega projects pipeline ramps up.

James Hanson
Partner

The funding gap – who pays?



A role for private sector funding

Despite the wealth of many of our region's governments, our survey respondents expect private finance to play an increasingly important role in the regional infrastructure sector. This is in part driven by the desire to get access to private sector expertise and rigour, but also because of the sheer scale and public financial commitments of the developments planned around the region. In addition, some lower income countries want to spread the cost of new projects over a longer period of time and share the long term operational and financial risks with the private sector.

Whilst fewer than 10 percent of respondents thought public-private partnerships (PPPs) were not necessary in the region, the requirement for private sector funding is likely to increase.

A good time to raise funds

Four in five respondents expect some form of private finance to be involved in next year's projects, and 83 percent stressed the importance of private sector financing.

Now is a good time for projects to look at raising money from the private sector. Banks are recovering from the global financial crisis and liquidity is plentiful, driving down borrowing costs. During 2013 several large projects demonstrated this ability, with Saudi Aramco and Dow Chemical reaching financial close on a \$19.3bn funding package for the development of the Sadara Chemical Company. That deal was one of the largest project finance transactions in the world last year and attracted capital from major Western banks, export credit agencies, and the Islamic bond market.

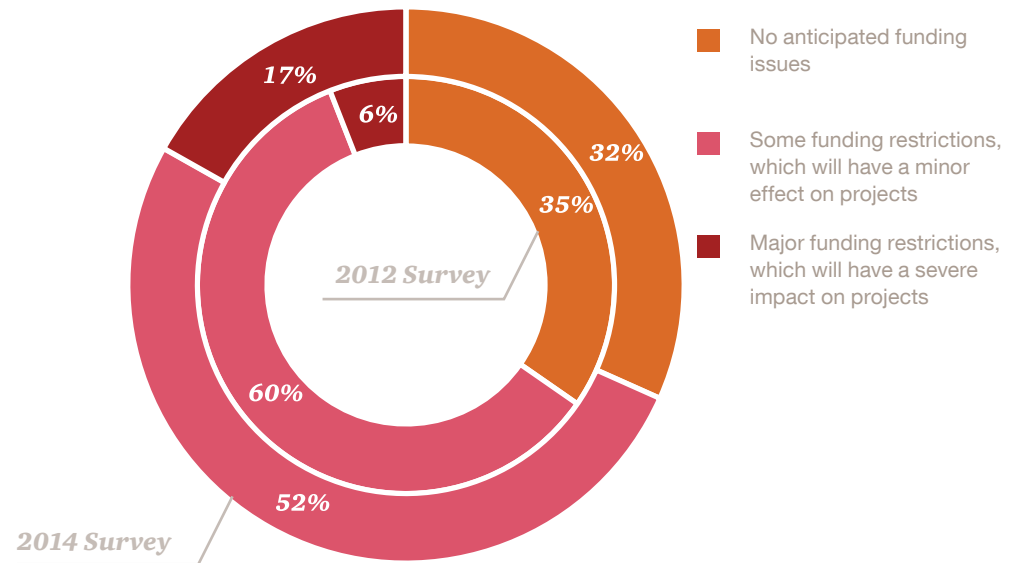
A positive influence on delivery

Rather than creating another layer of complexity, private sector finance can play a significant role in bringing in outside expertise, and help to incentivize projects to be delivered on time and on budget. In total 41 percent of respondents said they thought PPPs increase the likelihood of delivering a project on time and on budget.

But not a silver bullet

Private sector finance however will not be a panacea to constraints on government funding. Although the banking sector and capital markets are in a bullish mood, there are still expectations that rising demand will exceed the supply of capital. Over the last year 45 percent of respondents said funding constraints had resulted in projects being delayed or deferred. Around 65 percent of respondents said that restrictions on the availability of private finance would result in some delay on their projects over the next 12 months.

Availability of funding over the next 12 months

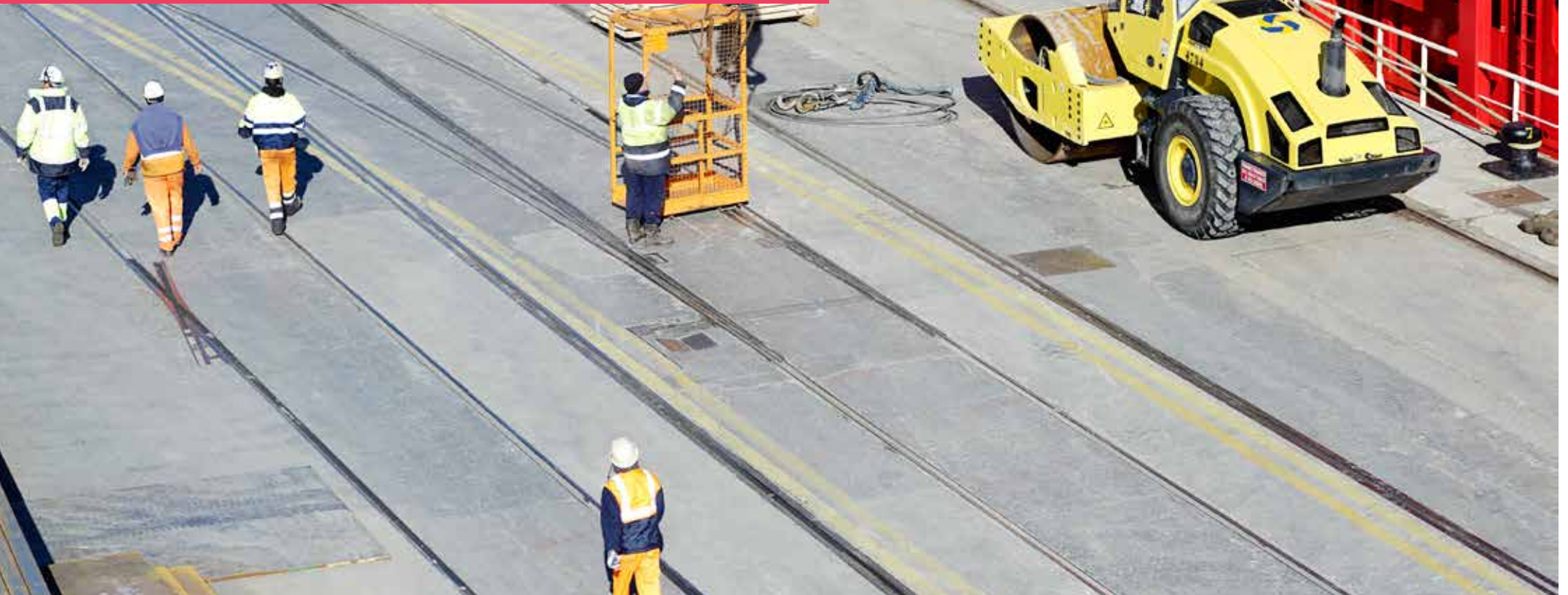


Perspective on the ground

While not all commercial lending banks have retreated from long term project financing in the Middle East, there is still a lingering liquidity crunch. This has led to the emergence of alternative financing sources ranging from infrastructure funds, Islamic debt, equity-driven products and, as Dubai is now demonstrating, bond financing with several successful placements in the US and EU markets – in short, “The Bond is back”.

Maarten Wolfs
Partner

*Thinking beyond the
Capex – a ‘whole of life’
view*



In order to overcome the challenges that the Middle East capital projects and infrastructure sector faces, Governments and Government agencies need to shift from the current typical mind-set of viewing infrastructure projects as one-off capital costs. Instead, more emphasis should be placed on long-term operations and maintenance costs and who will be responsible for them.

Production-sharing agreements

There are many successful examples of how government bodies in the region have used this approach to deliver projects on time and on budget. The energy and water industry in particular uses contract forms (Independent Power Plant and Independent Water Power Plant) to foster an approach where the state and private sector are incentivised to work together in a long term offtake arrangement. In the oil and gas sector production-sharing agreements put the onus for finding, developing and exploiting natural resources on the private sector, but also offer the promise of substantial financial reward to encourage delivery. Since its first use in Oman in 1994 the Independent Water and Power Plant (IWPP) has become an extremely successful model that has been replicated throughout the region. It has been responsible for bringing in billions of dollars of private investment and the involvement of some of the world's most experienced power companies.

Incentivising a 'whole of life' mindset

In traditional Engineering – Procurement – Construction tenders, the contractor is encouraged to do whatever necessary to submit the lowest bid. By tying the construction and operations together in a Public Private Partnerships (PPP) model, and passing the risk of cost overruns, delays or long-term operational costs to the private sector, bidders and developers are incentivised to consider the various costs incurred over the life of the asset. Failure to do so would eat into returns.

The challenge in non-utility sectors

The challenge we now face in the region, is how to extend this model into areas such as transportation, healthcare, education and housing. Often in these cases it will be more complicated to arrange a set of outputs that a hospital or school should meet, for example. Coupled with this, many regional governments are trying first to meet social and political objectives – for example the provision of housing, access to healthcare or the creation of jobs. In many cases it may not be possible to marry these objectives to a long-term commercial contract that will

be attractive to the private sector. Successful partnerships with the private sector also require Governments to completely overhaul the procurement process. They require a robust commitment from the state to an open and transparent tender process to attract internationally experienced operators.

Governments should carefully consider which form of contract they use to incentivise their contractor or a partner from the private sector, while being aware using a PPP contract will not always be appropriate.

Survey methodology

We surveyed over 130 industry insiders across the Middle East region from a range of sectors including transport, cities and urban development, social infrastructure, mega events, energy, utilities and mining. Our respondents included project owners, contractors, external advisors and financiers, all with a key role in delivering the region's mega projects.

We asked the respondents about the challenges they are facing delivering their major projects, their key priorities and their outlook for the year ahead.

We conducted the survey in April 2014

About Capital Projects & Infrastructure

Our team of infrastructure, real estate and capital projects experts, located in the Middle East, help project owners and stakeholders resolve complex issues across all stages of the project lifecycle.

We combine real industry expertise with deep subject matter knowledge and global knowledge with local presence.

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