POLICY BRIEF

What We Can Learn from Franchise Shipping Schemes in the Pacific

Government subsidies pay off in the long term as economic activity is stimulated and routes become commercially viable. Photo credit: ADB.

Make it easier and profitable for commercial operators to develop shipping routes to remote areas.

Introduction

Statement of issue

Most Pacific economies comprise small islands dispersed over large stretches of ocean. The distance between and among islands, and the limited land area and local capacity to host and maintain airports, point to shipping as the main means of moving people and goods, accessing essential services, and harnessing vital socioeconomic resources and opportunities. However, voyages to remote, outer islands involve travel through open waters, requiring large vessels that are expensive to operate. These operations are not commercially viable.

Remote island communities lack reliable maritime services and commonly pay high fees for ad hoc charter services. This limits access to social services and economic opportunities, which contributes to these communities' high rates of hardship and vulnerability, and exacerbates the impacts of disasters and climate change.

This policy brief examines the Asian Development Bank's (ADB) recent efforts to bring shipping services to remote areas in Papua New Guinea (PNG) and Solomon Islands through franchise shipping schemes. Although outcomes appear positive, the experiences of both countries provide important lessons for the design and implementation of similar arrangements in the future.

This was adapted from a policy brief published in the Pacific Economic Monitor.

Overview

Franchise shipping schemes allow private operators to provide subsidized shipping services along specified routes that service remote areas. Such schemes directly open travel to these areas, and shift the risk from operators to governments.

In PNG and Solomon Islands, these schemes have been implemented through performance-based contracts, which specify the following:

- vessel capacity and safety certification,
- areas and routes to be covered,
- locations and frequency of calls,
- mechanisms for monitoring (e.g., verifying calls, submitting voyage data, spot compliance audits), and
- tariff structures for passengers and cargo.

Bidders indicate the amount of subsidy they would require based on their operating costs and assumptions on average vessel load. Due to lack of data on these seldom-traveled routes, the contracts allow adjustments on subsidy payments early in the contract period as actual revenues and costs become known.

Although subsidies pose a fiscal burden on the government, payments under a franchise shipping scheme are expected to decrease over time as economic activity is stimulated and routes become commercially viable. The performance-based contracts also allow contractors to retain any earnings in excess of what is needed to break even (with subsidies), providing an incentive to keep operating costs low and maximize revenues by attracting more passengers.

Analysis

Papua New Guinea

In 2008, a community water transport project cofinanced by ADB and the OPEC Fund for International Development introduced the franchise shipping concept in PNG. The next year saw four contracts awarded (out of six routes put up for bid) that required a total of 5.2 million kina (about $1.9 million) in subsidies.

The initial tender faced a number of difficulties, including a lack of qualified operators and viable vessels to ply the routes; a contract time frame (3 years) too short for bidders to secure financing and recoup any investments; and reluctance of potential operators to contract with the government. By 2011, only two routes remained operational; two contracts had been terminated for nonperformance and retendering was unsuccessful.

However, the franchise shipping scheme saw improvements over time as the government became more experienced in implementation and contractors began to realize the benefits of participating in the scheme. By 2015, one route (the South Coast route in New Britain Province) no longer needed a subsidy and six other routes were operating under the scheme.

Despite the difficulties experienced during the tendering process, ADB analysis upon completion of the project showed that the franchise shipping approach provides a model for governments to efficaciously meet their community services obligations. Even during the subsidy phase, costs per traffic unit (i.e., passenger or unit of cargo) under the scheme were well below those for government-provided services (adjusted to 2010 prices) such as the government trawler fleet deployed in the 1980s and the Border Development Authority fleet (Table 1). Costs for the scheme were also less volatile. In addition, the subsidy requirement per traffic unit of this approach was only 21% of the cost of the government trawler fleet, and 13% of the cost for the Border Development Authority fleet.

Table 1: Cost per Passenger or Unit of Cargo in PNG
(2010 kina)

ROUTE	MINIMUM	MAXIMUM	RANGE
Successful FSS routes	145	254	109
Government trawler fleet	926	1,446	520
Border Development Authority Fleet	1,081	2,801	1,720

FSS = franchise shipping scheme, PNG = Papua New Guinea.
Source: ADB estimates.

Apart from the socioeconomic benefits to the serviced communities from affordable and regular maritime transport, government capacity to administer the scheme efficiently improved. This was evidenced by development of procedures to analyze potential routes, models to set rates and estimate subsidies, and templates for standard bidding documents and reports. Government staff were also trained to apply bidding and monitoring procedures.

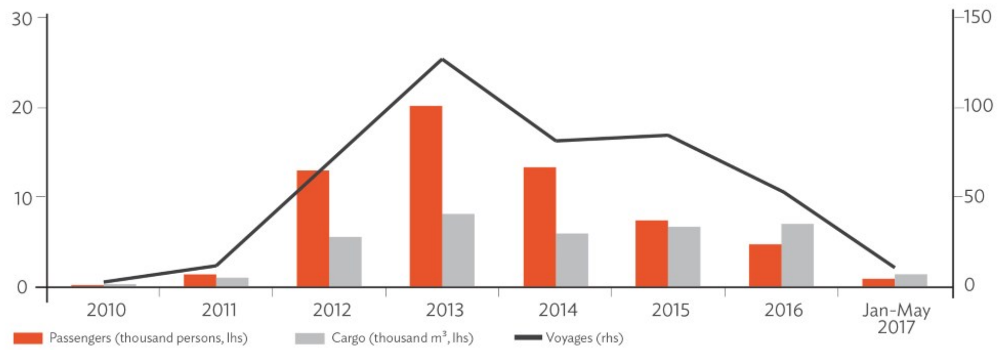
Solomon Islands

In 2010, a domestic maritime sector support project, funded by ADB and the European Union, commenced using franchise shipping schemes to service routes not covered by existing operators, to stimulate economic activity along those routes.

However, as in the case of PNG, there were difficulties in the initial tender because of operator nonperformance as well as delays in implementation due to absence of qualified bids. Further, the life of the contract was even shorter than those in PNG, only 2 years, due to government funding constraints. Five performance-based contracts were awarded but vessels were damaged or changed hands during the life of the contract, and by the end of the first year, four of the initial contracts had been terminated.

The terminated contracts were successfully retendered, and in 2013, all routes were operational and passenger traffic reached a high of 20,000 (Figure 1). This progress was derailed in 2014 as cyclone-related vessel damage resulted in the suspension of two routes and discontinuation of another. However, more routes were added and by 2015 seven routes were operational. Of these, three required lower subsidies. The direct income of voyages to the Temotu Outer Islands was observed to have increased, with the third voyage earning about double the income of the first two voyages. This was due to high inbound shipments of agricultural products back from the rural communities, suggesting growing confidence in the service and increased economic activity.

Figure 1: Passenger and Cargo Traffic under the Solomon Islands Franchise Shipping Scheme, 2010–2016



lhs = left-hand scale, m³ = cubic meter, rhs = right-hand scale.
Source: Government of Solomon Islands, Ministry of Infrastructure Development. 2017. *Domestic Maritime Support (Sector) Project Phase 2—Franchise Shipping Scheme Monthly Progress Report* (various months). Honiara.

Delays from contract termination and retendering significantly limited activity in franchise shipping in 2016, but as of May 2017, five routes were operational, and contracts had been awarded for the remaining three routes. The Solomon Islands government is hopeful that all routes will be operational this year.

Analysis of the 2010–2016 financial performance of Solomon Islands routes under the franchise shipping scheme showed that the profitability (based on income in excess of the subsidized breakeven point) of all the routes averaged 29.8% of total voyage costs.

Insights and Recommendations

Pacific experiences with franchise shipping schemes thus far show that subsidized services have been useful in providing maritime transport to outer islands. The evidence from PNG and Solomon Islands shows that well-structured schemes can provide an efficacious means of connecting remote outer islands to markets and social services; in some cases, the routes have even become profitable.

One key lesson is the need to strike a balance between development and commercial goals. Flexibility on the terms of the performance-based contracts helped address the lack of interest that met initial tenders. For instance, shipping routes were restructured to include some profitable ports of call, compared with initial routes focused exclusively on nonviable areas. This invited more bids in both PNG and Solomon Islands, and eased the burden of subsidy. Longer contract periods could also be considered, where possible, to improve contractors' access to credit and allow time to recoup investments. To work around the constraint of their 2-year time frame, new contracts in Solomon Islands will now feature a renewal option. Further, thorough analysis is needed to establish cost and revenue benchmarks. Tracking emerging data on franchise shipping routes and operations will be a valuable resource in informing estimates.

Experience in the Solomon Islands project emphasizes the importance of streamlining procedures: prequalification requirements were lowered to attract participants to the franchise shipping scheme, bid documents were simplified, pre-bid meetings were conducted to clarify the scope of services required, and operators were given more time to prepare their bids. The Solomon Islands government also purchased and leased equipment to operators to help them comply with contract-mandated maritime safety standards, and raised awareness among insurance brokers on maritime safety reforms to improve operators' access to insurance. Operators in PNG and Solomon Islands also benefited from having a financial system that enabled them to put up movable assets (e.g., vessels and the contracts themselves), through secured transactions frameworks, as collateral for loans.

Local capacity building for management, monitoring, and evaluation is important to ensure country ownership and sustainability of franchise shipping schemes. The gains realized under the scheme are partly due to government institutions in PNG and Solomon Islands developing experience in implementing the scheme. Enforcement of maritime administration and safety regulations is another major piece of the institutional framework surrounding the franchise shipping scheme, and both PNG and Solomon Islands continue to receive technical assistance to improve their capacity to exercise these vital functions.

In addition, coordination within the government—as well as with development partners and among the partners themselves—remains important as this would reduce resources used in redundant or competing efforts. For instance, grant-financed vessels that can be operated at lower cost have diverted traffic from franchise shipping routes. The reduced traffic, in turn, has raised subsidy requirements necessary for franchise shipping operators to maintain viability.

Finally, complementary investments would help sustain the franchise shipping scheme and promote demand in remote communities. This includes rehabilitation and reconstruction of water transport infrastructure (and construction of new structures, if needed). However, these investments must consider relevance to franchise shipping routes and needs of vessels operating in the area; the PNG project was adversely affected when government policy shifted from linking infrastructure investments to franchise shipping routes to instead constructing new facilities in other areas that were also incompatible with local vessels. Mitigating disaster risk, and providing for operations and maintenance of these facilities, is also crucial to ensuring that remote communities can stay connected via efficiently operating shipping services over the long term.

Resources

Asian Development. 2017. Pushing the Boat Out: Franchise Shipping Schemes in the Pacific. *Pacific Economic Monitor.* July. pp. 23-25.

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