CASE STUDIES IN PRIVATE SECTOR PARTICIPATION: FRANCHISE SHIPPING

Finance Manager Joy Isihanua of the Franjti Shipping Company Limited, at the Honiara Port, Solomon Islands.

Marine Transport Services in the Pacific

Marine transport services, such as cargo shipping and passenger movement, provide essential commercial linkages within and between Pacific island countries (PICs). These services are provided by state-owned enterprises and private companies, and in some cases with the support of a government subsidy. Subsidies are introduced when the cost of providing services on selected routes is higher than the tariffs collected from users.

Governments will typically introduce a subsidy to allow more frequent or more predictable services in a target area. The hope is that the introduction of the service will stimulate trade and increase demand for transport over time, gradually reducing the need for the subsidy.

Where and How Is the Private Sector Involved?

Private companies operate on a competitive basis to provide passenger and cargo transport services throughout the Pacific. They range from large shipping companies that provide international and domestic services, to single-vessel companies that provide charter or scheduled services on a limited number of routes. Subsidized shipping services are provided by private operators via performance-based contracts (PBCs) with the public sector.

A survey of water transport PBCs in eight PICs, which was conducted in 2015 and facilitated by the Pacific Region Infrastructure Facility, identified a total of five franchise shipping programs. While the scope of the survey was not comprehensive, the identified contracts provided useful insights that will help shape future programs. While the survey focused on shipping services, PICs have also contracted air services on similar terms.

The Pacific Private Sector Development Initiative is a regional technical assistance facility cofinanced by the Asian Development Bank, the Government of Australia, and the Government of New Zealand.

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This case study focuses on Papua New Guinea (PNG) and Solomon Islands, which ran the largest franchise shipping schemes identified in the survey.

Performance-Based Contracting Model

In the PBC model, contracts specify the routes, frequency of service, capacity of vessel, safety standards, and passenger fares or freight rates. Contractors bid on the routes, and indicate the level of subsidy that they require to provide the service.

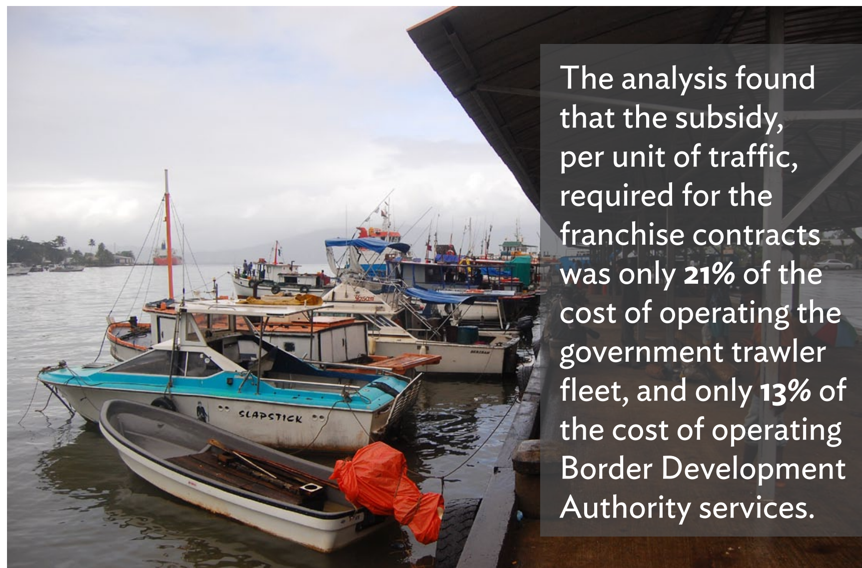
The subsidy is the difference between the cost of providing the service (as specified in each bid) and the revenue raised through passenger and/or freight charges. Revenue is self-reported by the contractors in their monthly reports, and these reports form the basis of the subsidy payments made. Spot audits of the voyages and vessels help ensure the operators' compliance with contract terms, as well as safety and quality standards.

While this contract structure allocates 100% of the demand risk to the government, the PBCs incentivize contractors to perform efficiently, as their operating costs for the service form the basis of their proposals. The contractors are also incentivized to attract as many passengers as possible on their routes, as any revenue above breakeven is theirs to keep.

Demand forecasting is difficult because most of the contracts are for routes that are new or did not previously have regularly scheduled services. Subsidy requirements are, therefore, based on assumed average vessel load factors. These load factors are typically set at low levels, gradually increasing over the life of the contract as commercial activity is attracted by the services.

CASE STUDY

Community Marine Transport Services in Papua New Guinea



In 2008, PNG first introduced franchise shipping routes as part of the Community Water Transport Project, which was funded by the Asian Development Bank (ADB). The project established a trust fund of $11 million to finance small water infrastructure and the delivery of transport services to poor and remote communities. A total of six routes were identified and tendered, four of which resulted in 3-year PBCs being awarded in 2009. The subsidy requirement for each contract was approximately K1.3 million. Two of the routes were unsuccessful in attracting bids, due to a lack of availability of vessels and operators willing to undertake the services.

By 2011, two of the four contracts were terminated for nonperformance, leaving only two operating routes. Subsequent tendering of one of these routes was unsuccessful, due to a lack of interest from the private sector. By 2015, however, the remaining route no longer required a subsidy. Five new routes had also been successfully tendered, so that a total of six were operating.

The difficulties faced in the initial tender process were the result of a number of factors: (i) lack of existing, viable vessels to provide services; (ii) short time frames for contracts (3 years), restricting the ability of private operators to secure financing for appropriate vessels; (iii) a shortage of qualified operators; (iv) a bid requirement for vessels to moor at jetties instead of also allowing ramps; and (v) a reluctance by some operators to contract with the Government of Papua New Guinea. Many of these factors could have been uncovered in the project preparatory process. It illustrates the importance of thorough market research and topographical analysis to structure bankable contracts.

Over time, however, the program has yielded improved outcomes for the communities it seeks to serve. Regular shipping services provide critical access to markets as well as to health, education, and other government services. Analysis carried out by ADB indicated that the cost per traffic unit of the franchise contract approach was far lower than that of government-provided services. The analysis compared the subsidy requirements of the franchises with those of the government trawler fleet of the 1980s and to services offered by PNG's Border Development Authority (with costs converted to 2010 price levels). The analysis found that the subsidy, per unit of traffic, required for the franchise contracts was only 21% of the cost of operating the government trawler fleet, and only 13% of the cost of operating Border Development Authority services.

In addition to the community benefits and improved administrative value for money resulting from the franchised routes, the government has also developed contracting and monitoring capacity and standard contract terms, which reduce the cost of administering the program and enhance its sustainability.

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CASE STUDY

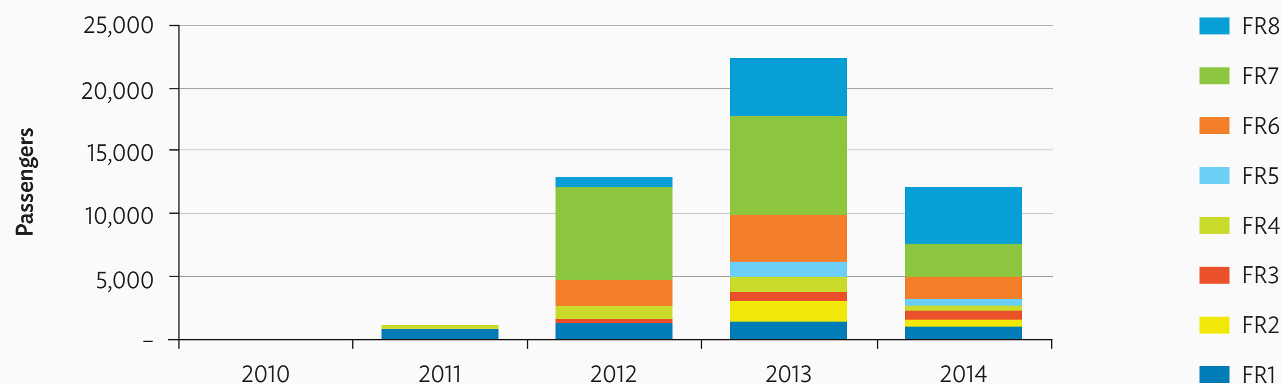
Solomon Islands Franchise Shipping Scheme

The Franchise Shipping Scheme started in Solomon Islands in 2010. By the end of 2014, it had conducted 271 voyages on eight separate routes, transporting 48,717 passengers and 26,463 cubic meters of cargo. These routes had not been previously covered by regular services, so the franchises were designed to stimulate economic activity. This resulted in increased passenger and cargo demand, eventually reducing the subsidy requirement. Most importantly, the regular services facilitated trade, allowing farmers and other small businesses owners to transport their goods to buyers on a regular basis. As was the case in PNG, the franchise shipping subsidy in Solomon Islands allowed the government to provide a service at less than half the cost of running its own shipping fleet.

Having sold its shipping fleet in 1996, the Government of Solomon Islands turned to the private sector via PBCs. Routes were competitively tendered, with bidders defining their operating costs for the required service quality and frequency. The government set the tariff based on market rates, and assumed all of the demand risk. Operators were paid a monthly subsidy to cover the difference between actual revenues collected and the costs specified in their contracts, with no cap on the subsidy.

As was the case in PNG, the tendering process was challenging, and some contracts were terminated well before their standard 2-year period. Factors such as operator nonperformance, accident or weather damage to vessels, and changes in the ownership of vessels at the middle of the contract period were the major causes. In some cases, tenders attracted no acceptable bids, or no bids at all, and the tendering process had to be repeated, delaying the operation of the services.

Franchise Shipping Scheme Passenger Volumes per Route, 2011–2014



FR = franchise route.
Source: Pacific Private Sector Development Initiative.

The first year of operation, 2010, was particularly difficult, and four of the five contracts were terminated in early 2011. This was due mainly to the inability of operators to secure the required insurance and to understand the payment terms of the contracts. Three of the four terminated contracts were successfully retendered in the latter half of 2011, and one in early 2012.

All routes were operating for at least part of 2012, and for virtually all of 2013. Traffic on the routes rapidly increased to a peak of 22,000 passengers in 2013 (figure) as services were added. This indicates that passenger volumes were constrained by supply rather than demand.

A typhoon in 2014 damaged two vessels that were not replaced, causing a suspension of services while the retender process was undertaken. A third route was discontinued when an operator from outside the province faced difficulty collecting revenue, and no operators submitted bids on the route when it was retendered.

These factors sharply reduced passenger volumes to 12,000 in 2014. By 2015, however, seven routes were operating and subsidy requirements had declined on three of these, reflecting increased demand and revenue collection.

An ADB assessment of the financial performance of the routes in 2010–2014 revealed that the total subsidies paid (SI$32 million) were generally higher than would be justified by normal commercial return considerations.

After subsidies were paid, the profitability of all routes, expressed as a percentage of total voyage costs, ranged from 6% to 58%, with an average of 36%. In comparing the estimated cost per voyage or bid cost, bid costs were higher than the actual recorded voyage costs for most routes, while bid revenue estimates were lower. As the subsidy formula was based on bid costs, not the actual costs, franchisees were incentivized to reduce costs wherever possible.

All seven contracts will be retendered in 2017. Drawing on the lessons of the previous tenders, the 2016 contracts are being revised to allow monthly rather than quarterly adjustment of the subsidy payments, to better align the subsidy to the actual revenue collected.

An extension of the initial contract period beyond 2 years will not be possible, due to government funding constraints, but an option for contractors to renew will be included.

Lessons from the Pacific Experience with Franchise Shipping

The experience with contracted shipping services in the Pacific has demonstrated the value of introducing scheduled shipping services at affordable rates, replacing infrequent and unpredictable services offered at higher rates by ad hoc charter services. In PNG, the experience also illustrates the value of investing in supporting infrastructure, such as small jetties and ramps.

In PNG and Solomon Islands, franchise shipping has positively impacted the ability of people to plan projects, open markets, confidently increase local production, and raise their standards of living, with better access to imported goods, materials, and services. Contracting the services to private operators, rather than running them through a state-owned enterprise or department, has been a cost-effective decision for the governments of both countries.

What Can Be Done to Extract More Value from Franchise Shipping Contracts?

Streamlining the contracting process is key for franchise shipping in the Pacific. This includes establishing benchmark costs and structuring contracts that are commercially attractive to bidders (e.g., by scope, geography, duration). The process must determine what, if any, supportive or complementary investments could be warranted to enhance market interest, leading to increased demand across the shipping services. All funding arrangements should also be in place before committing to contracts. As in all contractual arrangements, uncertainty and changes (especially late ones) increase risk and costs.

Contract monitoring could be enhanced by the greater use of technology to record passenger volumes, and by soliciting passenger feedback on the safety and quality of services offered.

The difficulty of operators to access finance can be addressed through longer contract periods, allowing operators more time to recoup the costs of purchasing vessels. Access to finance could also be expanded through collateral reform, allowing movable property (e.g., vessels and government contracts) to be used as security for loans. The former is dependent on the ability of the governments to commit to funding their shipping programs, but the use of grants or donor funds can assist with this, especially where the funding requirement decreases over time. Collateral reform is already in place in Solomon Islands, and has been used on one franchised route.

The introduction of new vessels, financed through government grants, has disrupted competition on a number of the franchise routes. These vessels, which do not carry depreciation costs, can be operated at lower costs than those that are procured commercially and used on the franchise shipping routes. In Solomon Islands, these vessels have reduced traffic on the franchise routes, driving up subsidy costs for the government. A more coherent government policy on grant expenditures could address this problem, restoring fair competition and value for money on the franchise routes.

[*] These case studies were prepared by the Pacific Private Sector Development Initiative, following input from the Pacific Region Infrastructure Facility and its Transport Sector Working Group.

Pacific Private Sector Development Initiative
Level 20, 45 Clarence Street
Sydney 2000 Australia
Tel: +61 2 8270 9444
E-mail: psdi@adb.org
www.adbpsdi.org
@ADB_Sydney_PSDI
www.facebook.com/adbpsdi

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