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Managing Fiscal Risks from National Airlines in Pacific Island Countries

by Vybhavi Balasundharam, Leni Hunter, Iulai Lavea, and Paul Seeds

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I N T E R N A T I O N A L M O N E T A R Y F U N D

IMF Working Paper

Asia and Pacific Department

Managing Fiscal Risks from National Airlines in Pacific Island Countries

Prepared by Vybhavi Balasundharam, Leni Hunter, Iulai Lavea and Paul Seeds

Authorized for distribution by Todd Schneider

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Abstract

Pacific island countries (PICs) rely on national airlines for connectivity, trade, and tourism. These airlines are being struck hard by COVID-19. Losses will weigh on public sector balance sheets and pose risks to economic recovery. With a backdrop of tight fiscal space and increasing government debt, losses in airlines are adding to fiscal risks in some PICs. This paper discusses tools to evaluate and manage the fiscal risks from national airlines in the Pacific. We present a snapshot of the current state of Public Financial Management (PFM) practices in PICs and detail the best practices. This exercise would illustrate the areas in which PICs have scope to improve their risk management with regard to national airlines. We then discuss the use of diagnostic tools and capacity development to enhance monitoring and risk management. Greater transparency and accountability in the airlines, combined with rigorous oversight, would be the first step towards improved financial management of national airlines.

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I. INTRODUCTION

Vulnerabilities of state-owned enterprises (SOEs) pose a substantial fiscal risk to governments. Of all the SOEs, national airlines have some of the highest stakes. The national airline provides essential connectivity for some of the most geographically isolated countries in the world, like the Pacific Islands Countries (PICs). However, these SOEs generally have a poor financial track record. This is largely due to their high fixed costs, particularly the capital requirements that result in excessive debt burden, and vulnerability to external shocks. Given the large risks, governments would need robust oversight to ensure that national airlines are well managed. COVID-19 has severely impacted the airline industry and presents an opportunity to overhaul the fiscal risk management and strengthen governance of national airlines.

There is a burgeoning literature that focuses on the policy issues related to SOEs. IMF (2016) discusses best practices to manage fiscal risks in general, but there is limited analysis regarding SOEs. A closely related recent work by Baum et al. (2020) focuses on fiscal risk management for SOEs in general, providing a novel “risk tool” to benchmark and mitigate risks. Another strand of work presents the options for supporting SOEs, particularly the airlines, during times of distress, like the COVID-19 crisis (IMF, 2020b; Abate et al., 2020). Other papers analyze the performance and governance of SOEs in selected groups of countries (Bower 2017; Richmond et al. 2019; Baum et al. 2019).

This paper presents an analysis of fiscal risks from national airlines in PICs, both prior to and during the COVID-19 pandemic. We then present a snapshot of the current Public Financial Management (PFM) practices in the PICs, benchmarking against the best practices. Many governments struggle to monitor and contain the risks from national airlines, reflecting the weak governance, lack of capacity of governments to oversee the companies and sparse availability of information that undermines the ability to assess all potential risks. This exercise would help to identify where there is scope for more action in PICs. Finally, the paper summarizes diagnostic tools and capacity development available to evaluate risks and the guiding principles for offering financial support to national airlines. It shows how even the use of a simple “SOE Health Check” could illustrate the vulnerabilities of airlines. Overall, improving governance and transparency of national airlines would be the first step to mitigating the risks from national airlines.¹

The rest of the paper is organized as follows. Section II presents the state of national airlines in PICs and its impact on budgets. Section III provides a snapshot of latest Public Financial Management (PFM) practices in PICs and an overview of best practices. Section IV discusses risk management, diagnostic tools, and potential capacity development. Section V concludes.

¹ Baum et al. (2019) show that SOE governance reforms can also generate significant performance gains.

II. STATE OF NATIONAL AIRLINES IN PICs

Airline connectivity is critical for the geographically remote and dispersed PICs. PICs rely on airline connectivity for tourism, education, employment opportunities, access to healthcare, and delivery of goods and services. This dependence has driven many PICs to have state-owned national airlines, which are typically the sole provider of domestic routes and a major provider of international routes, amounting to over 60 percent of the seat capacity in Fiji, Vanuatu and PNG, and 100 percent of the routes in Nauru (Chart 1). Box 1 provides a brief context on the political economy of the national airlines in PICs.

Financial losses and weak profitability have been a long-standing concern for several Pacific airlines—partly reflecting weak commercial viability due to remoteness, geographical dispersion, and thin traffic and freight levels (Chart 2). Several airlines have been through restructurings and remain vulnerable to external shocks. For example, Air Vanuatu was restructured in 2016, following damage from Tropical Cyclone Pam. Samoa Airways has faced financial difficulties since its inception in 2017, and the pandemic has pushed it into deeper financial distress. Fiji Airways, which services the country's large tourism industry, is the only airline to have made consistent profits over the past six years.

Relative to GDP, the investment required for national airlines in PICs is significant, and some airlines have large balance sheets (Chart 3). At around twenty percent and over ten percent respectively, Fiji and Nauru have the largest airlines in the region compared with GDP. Kiribati and RMI have also have relatively large balance sheets – and while Samoa Airways is smaller, the airline had a negative equity position in 2019. (For comparison, Qantas and Air New Zealand have assets of around 1-2 percent of GDP.)

Chart 1. Importance of national airlines in PICs

(Share of national airline in international routes and seat capacity, in percent)

Source: Pacific Regional Infrastructure Facility.

Chart 2. National Airlines' Profit and Loss

(In percent of GDP of year of financial reporting)

Sources: Financial statements, IMF WEO April 2021. Asterisk denotes media reports used for Vanuatu and PNG, in absence of recently published financial statements. Note: Reporting years in brackets. Excludes government subsidy/CSO payments.

Chart 3. National Airlines' Assets and Liabilities

(In percent of GDP of calendar year of latest available financial statement)

Sources: Airline financial statements, IMF WEO April 2021. Financial statement year end shown in brackets.

With international travel and tourism halted as a result of the COVID-19 pandemic, national airlines face mounting financial difficulties. Airlines have faced ongoing costs despite the collapse in revenue. Fiji Airways faced monthly costs of F\$38 million in early 2020 “comprising aircraft loans and leases of F\$20.2 million, employee costs, fixed payments for aircraft maintenance and other costs”.^{2 3} Payments associated with these costs were subsequently reported to have been reduced to F\$20 million per month, through loan and payment deferrals.⁴ Financial losses in national carriers are contributing to the negative spillovers of the pandemic on PICs.

The COVID-19 crisis has seen increased levels of government support to national airlines. Governments are directly exposed to airlines by virtue of state-ownership, and were providing financial support even before the pandemic, diverting resources from other development needs. Chart 4 shows government support during a window of 2018-2021. While Nauru Airlines received the most government support over this period, it has also demonstrated higher levels of transparency (Table 1). The government of Fiji has guaranteed loans of around 5 percent of GDP for the national airline, which have added to fiscal contingent liabilities. However, the chart does not include all relevant spending, as some was done directly on the government’s balance sheet. For example, in Kiribati the Cabinet approved the purchase of two Embraer E190-E2 jets in 2018, with A\$44m (15.7 percent of GDP) recorded in the 2019 recurrent budget for one of the planes. The chart may also omit other forms of support, for example implicit government guarantees over loans from development banks. For some countries, a significant part of the fiscal stimulus response to COVID-19 has been allocated to the national airlines (Chart 5). This additional support requires more oversight and strengthening of governance to mitigate future fiscal risks.

Airlines will struggle to improve financial performance, with weak demand expected even after the pandemic recedes. The recovery in tourism is subject to considerable risk and could well be protracted, with levels of travel unlikely to reach pre-COVID-19 levels prior to 2023. All carriers remain operational and are earning revenue from domestic,

² See Parliament of the Republic of Fiji, 2020.

³ Fiji Airways is also the only carrier with a foreign airline as a major shareholder (Annex 1).

⁴ <https://www.fijitimes.com/sayed-khaiyum-fiji-airways-has-reduced-recurring-monthly-costs/>

repatriation and cargo flights. However, attempts to cut costs have added to job losses, with potential scarring effects: Fiji Airways has laid off 51 percent of its workforce (758 people) and applied a 20 percent pay cut for remaining staff; and Solomon Airlines has laid off 20 percent of its workforce. Further cost cutting is proving difficult, due to expensive lease/purchase agreements that had been entered into pre-crisis. Airlines are likely to hold excess capacity well after the pandemic recedes, particularly as some had been in expansion mode prior to COVID-19. For example, Air Vanuatu has agreements to purchase four A220s starting in 2020, though official figures regarding the cost of the A220s and the current status of these agreements have not yet been made available.⁵

Some of the airlines are undergoing restructuring, offering an opportunity to overhaul governance and oversight. The government has taken control of Air Vanuatu, firing its board and appointing a new CEO. A commission of inquiry is also probing decisions made by the former board to purchase four Airbus A220s. Air Niugini, the national carrier of PNG, is currently undergoing a restructuring. Tonga launched its state-owned national carrier, Lulutai Airlines, after the privately-owned Real Tonga airlines shut down. These changes provide an opportunity to overhaul governance and management standards of the national airlines.

Box 1. Political Economy of National Airlines

Control over air connectivity: In small and remote island countries, governments may see the ownership of national airlines as providing a critical level of security for maintaining international connectivity. Privatizing the national airline could eliminate the control over the prices, and continuity and frequency of flight connections. This autonomy could be critical for tourism development and growth. For example, Air Vanuatu is the only provider of direct air connectivity between New Zealand and Vanuatu, accounting for 12 percent of the annual visitors. Similarly, 11 percent of annual visitors to Fiji are from the US, from where direct air connections are only offered by Fiji Airways. Concerns about loss of control over connectivity may limit enthusiasm for development of regional airline (Annex II), in addition to other factors.

National prestige: Alongside other factors, considerations of national prestige can play a role in continued public support for maintaining national airlines. For example, Samoa's national carrier was founded in 1959 as "Polynesian Airlines", providing domestic and international flights throughout the South Pacific. Since inception, it has been through multiple restructurings, and suspended international routes in the 2000s. In 2017, the government announced the closing of Virgin Samoa and launched a new national carrier "Samoa Airways", resuming international flights.

Provision of public goods: Many airline passenger routes are not economically viable due to low demand, reflecting remoteness, geographical spread, and small populations of PICs.⁶ In these cases, the government may step in to subsidize the provision of airline connectivity for its citizens to ensure access to critical services, goods and economic opportunities. In addition to direct subsidies, there may also be cross-subsidization of domestic routes through international fares. An example of a national airline with the primary purpose of provision of subsidized airline connectivity is Nauru Airlines. From 2020 onwards and unrelated to the COVID-19 crisis, the Government started paying Community Service Obligations (CSOs) to Nauru Airlines for providing services below market price to its population in need. In return, the airline should not operate with a loss.

⁵ The government has been negotiating with Airbus.

⁶ As discussed in Becker (2012).

Box 1. (continued).

Too Big to Fail: As noted above, national carriers can be large relative to GDP. They are also considered integral to the development of tourism sector, which contributes to over a third of employment in countries like Fiji and

Vanuatu. In addition, some national pension funds and development banks in PICs have lent to the national airline (adding to large tourism exposures in some cases). For example, as of December 2018, loans to Air Vanuatu amounted to 4.2 percent of Vanuatu National Provident Fund's total assets. The Fiji National Provident Fund (FNPF) has provided loan of F\$53.6 million to Fiji Airways during the COVID-19 crisis as it is a strategic investment for tourism, which accounts for around 16 percent of the Fund's investment portfolio. Hence, there may be a strong proclivity toward intervention especially during a crisis situation where there is a strong urge to protect jobs and reduce the risk of insolvency.

Limited transparency: Many airlines have not published financial statements in a timely manner (Table 1), a problem common to other state-owned enterprises in the region, likely reflecting capacity limitations. However, in a loss-making situation, there may be concerns that public release of financial data from the airline may erode public support for the airline, for example, if airline operations have added to fiscal contingent liabilities.

III. THE PFM PERSPECTIVE: STRENGTHENING GOVERNANCE, OVERSIGHT AND TRANSPARENCY

National airlines fall under the category of public nonfinancial corporations and their oversight is usually exercised as part of the state-owned enterprise (SOE) sector. However, added scrutiny and more frequent engagement may be required for the airlines depending on their size and respective risk profiles.⁷ Individual countries may have different arrangements for governing, monitoring and overseeing the SOE sector. This section looks at the current governance and institutional arrangements and interactions with the airlines throughout the PFM cycle in PICs and the relevant best practices.

A. Governance and Institutional Frameworks

Best practice: A strong legislative framework which clearly defines the ownership and management responsibilities, facilitates managerial autonomy whilst reinforcing accountability, and provides good governance through the application of sanctions for non-compliance. A published Ownership Policy supporting the legal framework which sets out clearly the rationale for ownership, dividend policy and governance arrangements, including board appointment, reporting, approvals, e.g. for borrowing, etc.

The governance arrangements are important for clearly defining the corporate responsibilities of the board of directors and the arrangements for their appointment. A strong governance framework gives SOEs autonomy, while ensuring their accountability to the general public. In some countries the governance arrangements for SOEs are defined in an overarching law

⁷ For example, engagement and oversight will need be reinforced where the entity, e.g. an airline, is in financial distress and there are likely to be financial implications for the budget.

specific to SOEs, whereas in other countries these arrangements may be brought out in the PFM Act. In addition, SOEs are often governed by company laws.⁸

Airlines, as with other SOEs, typically have dual lines of responsibility, reporting to: (i) the sector ministry on policy matters; and (ii) a central agency on financial matters—this may be a unit within the Ministry of Finance or a separate Ministry dedicated to the oversight of SOEs on financial matters. The functions of ownership and management need to be clearly distinguished. The management boards should be allowed to exercise their duties without undue influence from the sector ministry. The airline should be able to set its own plans, within the parameters of its established mandate, whereas the role of the sector ministry is to set the policy for the sector as a whole. Notwithstanding, the managerial autonomy of the airlines (and other SOEs), they are financially accountable to their owners, i.e. the government.

The legal framework, ideally supported by a published Ownership Policy, should set out the arrangements for appointing the board; establishing policy (including pricing); reporting requirements (financial and nonfinancial); dividend policy; approving medium and long-term investment plans; borrowing powers; and requirements on providing quasi-fiscal activities, for example the requirement of operating routes to remote location at below-market prices in order to connect citizens. Additionally, the framework should provide measures (or sanctions) to be taken in the event of non-compliance—such measures might include additional reporting requirements; additional controls imposed on the airlines; action against board members⁹; and withholding financial support from the budget.

Table 1 summarizes key aspects of airline governance arrangements in PICs, with columns relating to the following: (1) the law governing SOEs, including the national airline; (2) whether there is reporting on SOE operations including the airline in the budget; (3) publication of airline financial statements; (4) oversight arrangements. Looking at the governance regulations, we see that many PICs have enacted a SOE governance act that covers some or all the of the major provisions. However, Fiji and Vanuatu, countries with two of the largest airlines in the region, do not have regulations governing the national airlines. In addition, in terms of coverage, most of the governance laws do not require approval of capital expenditures and borrowing including lease agreements, both of which pose the largest risks to the airline and the government.

B. Airline Planning Process

Best practice: Airline plans approved by government including borrowing and investments plans, planned new leases and proposed guarantees.

Airlines are responsible for setting their own corporate plans which should include: strategic goals; operating and financial plans; investment plans; performance targets; planned

⁸ In the case of Fiji for example, SOEs are governed by the Public Enterprises Act 2019 and overseen by the Ministry of Public Enterprises. However, Fiji Air is not included in the schedule of enterprises covered by the Act.

⁹ Boards would also be held accountable against their performance contracts and/or service agreements.

expansion of routes and growth plans; expected financing for Community Service Obligations (CSOs)¹⁰; other required financing from the budget, etc. SOEs in many countries typically publish statements of corporate intent (SCI) which would encapsulate the corporate plans. For its part as owner, the government would approve the SCI and issue a letter of expectation, which might include requirements upon the airline to uphold strict safety standards; adopt conservative business case scenarios in predicting growth; seek government approval for borrowing and incurring liabilities, e.g. entering into new leases; and to advise on progress and deviations from business plans. Government (via the SOE oversight body and the sector ministry) should monitor progress against the plans and intervene where there is significant deviation from plan.

The annual plans should highlight expected funding support from the budget in terms of subsidies, remuneration of CSOs, capital injection and on-lending/guaranteed borrowing. The plans should be explicit regarding all liabilities and contingent liabilities. These include liabilities where the airline plans to borrow on the strength of its own balance sheet, and liabilities emanating from lease contracts, e.g. leasing a new airplane.

C. Transparency of Airline Support in the National Budget

Best practice: Clear and transparent publication of budgeted inflows and outflows, ideally via an annex to the budget, covering all SOEs. A strong budget challenge process requiring robust justification for support from the budget, e.g. via a cost benefit analysis. All CSOs should be remunerated transparently through the budget.

National airlines in the PICs rely heavily on government support. The extent to which that support is provided in the national budget is not as transparent as it should be. In many cases funding for national airlines is buried in the output structure of the Ministry of Finance budget. Having an annex in the budget document that summarizes the inflows and outflows of national airlines as well as an assessment of its financial position and associated risks provides a transparent format the public can easily understand.¹¹

At the company level, some carriers do not disclose all the financial and nonfinancial information that is required for monitoring their financial status. In many cases they are incomplete and/or inconsistent with internationally accepted accounting standards. They are also not published in a timely manner.

The pandemic has pushed Pacific carriers closer to the point of insolvency—which underscores the urgency for full transparency. In the COVID era, all this information is critical for the design of appropriate government support measures. National carriers should

¹⁰ It is important to quantify and publish CSOs along with other support provided in the budget. The Fiscal Transparency Code (FTC) 3.3.2 requires for an advanced practice that: *All direct and indirect support between the government and public corporations is disclosed and, based on a published ownership policy, a report on the overall financial performance of the public corporations sector, including estimates of any quasi-fiscal activities undertaken, is published on at least an annual basis.* Whilst PICs are a long way from an advanced practice, it is worth noting the elements involved and the areas requiring strengthening over time.

¹¹ Kenya provides a good example of such an annex to its budget highlighting all flows into/from the budget by the various SOEs.

disclose financial and nonfinancial information according to internationally recognized standards. They should report on their audited financial and operating results, business plans, debt levels and ability to service them, as well as nonfinancial information for example remuneration policies, related party transactions, governance structures, and governance policies.

Table 1. A Snapshot of PFM practices in PICs relating to national airlines

	SOE Governance Act	Transparent Budget Reporting	Audited Financial statements	Fiscal Risk Oversight Institution
Fiji	Public Enterprise Act 1996 - Includes Airlines: N - Coverage (elements): 0	Revenues: N Transfers: Partial ¹² CL: Y ¹³ Profitability: N	Last available for 2019 ¹⁴	Solicitor's General office
Kiribati	SOE Act passed in 2013 - Includes Airlines: Y - Coverage (elements): 6/7	Revenues: N Transfers: N CL: N Profitability: N	Last available for 2017	SOE Monitoring Unit within the MFED
RMI	SOE Act 2015 - Includes airlines: Y - Coverage (elements): 4/7	Revenues: N Transfers: Y CL: N Profitability: N	Last available for 2018	SOE monitoring unit within Ministry of Finance
Nauru	Public Enterprises Act in 2019 - Includes airlines: Y - Coverage (elements): 7/7	Revenues: Y Transfers: Y CL: N Profitability: Y	Last available for 2020	Public Enterprise Monitoring Unit in the Dept of Finance
PNG¹⁵	Independent Public Business Corporation of Papua New Guinea (Kumul Consolidated Holdings) (Amendment) Act 2015. - Includes airlines: Y - Coverage (elements): 2/7	Revenues: Partial Transfers: N CL: N Profitability: Y, reported with 1-year lag	Recent audited financial statements are not yet available	Minister for Public Enterprises and State Investments, and National Executive Council
Samoa	Public Bodies Act in 2001 - Includes airlines: Y - Coverage (elements): 4/7	Revenues: Y Transfers: Y CL: Y Profitability: Y	Last available for 2019	Ministry for Public Enterprise
Solomon Islands	SOE Act passed in 2007 SOE ownership policy endorsed in 2018 - Includes Airlines: Y - Coverage (elements): 4/7	Revenues: Y Transfers: Y ¹⁶ CL: N Profitability: N	Last available for 2018	No separate institution
Vanuatu	No legislation found, as the Government Business Enterprises Act 2018 bill has not been passed	Revenues: N Transfers: Y CL: N Profitability: N	Last available for 2014	Government Business Enterprise Monitoring and Evaluations Unit, within the Ministry of Finance and Treasury

Source: National budgets and legislations. SOE Governance Act coverage elements relate to provisions covering board appointment; approval of plans and budgets; remuneration; approval for dividend policy; approval of borrowing; approval for capital expenditure; reporting obligations (See Annex IV for details). Transparent budget reporting indicates budget reporting of: revenue flows from the national airline; transfers from government to the national airline; contingent liabilities (CL); and budget reporting of the airline's profitability.

¹² Economic and fiscal update supplement to the budget (para 4.20): Partial Reference to subsidy to Fiji Airways to develop attractive packages for promoting the tourist sector but unclear in the budget tables.

¹³ Not included in the summary table of contingent liabilities but narrative embedded in the economic and fiscal update supplement to the budget (para 5.26).

¹⁴ Physical copies can be obtained from the Companies Office, but are not currently available online.

¹⁵ PNG is working on SOE reform with assistance from the Asian Development Bank, which will include strengthening of the legislative and policy framework. See Asian Development Bank 2020, and International Monetary Fund 2019.

¹⁶ The COVID-19 stimulus booklet published by the Ministry of Finance had details of revenues and transfers to SOEs as part of the stimulus package, although the supplementary appropriation bill does not present details.

As budget resources are scarce, the need for emergency funding to national airlines must demonstrate it is the best use of limited government resources. There are many other competing priorities and it may imply less resources for other critical areas such as health care. A cost-benefit analysis (CBA) is needed considering the many demands and limited fiscal space.¹⁷ The analysis should include a review of the rationale for maintaining the national airline. Potential costs should encompass immediate budgetary resources and possible future costs for example risk from government guarantees. At the outset, budget support should embed clear phasing-out mechanisms and limits or caps on the size of government risk exposure for certain interventions.

Any dedicated financing to bail out national carriers must entail an assessment of the risk exposure of the airline on the government as the owner. All the information required to conduct a complete risk assessment must be provided by the airline. The assessment should also be integrated into the budget process with the financial rate of return for maintaining the airline published as part of that work.

Overall, from Table 1, many PICs are reporting budget allocations to the national airlines. However, reporting of revenues, contingent liabilities and profitability of all SOEs, and specifically the national airline, should be improved.

D. Budget Execution Considerations

Best practice: Airlines provide early notification of any significant anticipated deviations from plan, especially where there may be implications for the budget. Timing of required funds from the budget made known to government at the start of the financial year and any revised timing advised as soon as this becomes known.

Airlines may contribute towards the budget in the form of dividends and tax-take as well as making calls upon the budget in the form of subsidies, capital injections and borrowing. These flows should be incorporated into the airline's annual plans as well as the annual budget (as discussed above). During annual operations, it is vital for the airlines to keep government fully informed of the amount and timing of the expected flows. For example, if there are profit warnings due to a significant drop off in business, this will result in reduced (or no) dividends and tax-takes—it is vital that this information is relayed early, so that government can plan accordingly. Similarly, if the airline requires the release of budget funds to be expedited or requires additional funds under a supplementary appropriation, this should be relayed at the earliest opportunity so that the ministry of finance or appropriate agency is able to plan and prioritize these transfers in the context of other cash demands on the budget. Governments usually explicitly state their priorities in making cash available for payments. These priorities are based on the potential consequences of not making those payments—

¹⁷ Governments should use this CBA in deciding upon the appropriate levels of support to be provided, which could include various options including potential partnering arrangements with other airlines—the underlying risks as well as the costs would need to be factored in. For countries dependent on tourism, the CBA might also consider a holistic overview of the tourism sector. The government's policy on publication (of CBAs and other data) should aim to balance the needs of transparency against the sensitivity of that data, vis-à-vis commercial competitiveness and reputational risk.

typically payroll expenses and debt servicing ranking high in these priorities. With airlines the consequences can be high of not meeting payments for debt servicing, fuel, maintenance, landing and other airport fees. This would be detrimental to corporate reputation as well as operations—in extreme instances planes can be impounded.¹⁸ A well-defined process should be in place for airlines (and other SOEs) to access budget funds when needed, which includes the airline’s obligation to keep government informed of the timing of these requirements. It is vital to avoid situations where government only becomes aware of a major problem when there is risk of an imminent default on a major payment.

E. Reporting and Monitoring

Best practice: Promote a culture of compliance, holding airline boards accountable for good governance and performance of their mandate and responsibilities, including reporting and the provision of financial and nonfinancial data. Increasing the frequency of oversight where an airline is in a position of extreme financial distress.

The main focus of financial reporting is often on the annual financial statements, which have the advantage of being prepared in accordance with International Financial Reporting Standards (IFRS) and being subjected to independent audit for the provision of an audit opinion as to the quality of the statements. This provides reassurance to readers on the integrity of the data and the consistency of its presentation. The annual reports represent a good data source for undertaking corporate “health checks” using various financial ratios, specifically looking at the trends over time, assessing whether the ratios are improving or worsening over time. More detailed data may be required for undertaking more complex stress test, which might look at the impact of different scenarios, such as changes in oil prices, exchange rates, significant drop in passenger loads, etc. (see below).

As useful as the annual financial statement data is, it suffers from issues of timeliness and frequency. The published data is often not available until several months after the year-end at best (see Table 1).¹⁹ Furthermore, in a volatile industry such as the airline industry and in a fast-changing environment such as during the recent COVID crisis, an annual perspective is far too long for effective monitoring. In-year reporting is important for filling this void in data but few low-income developing countries (LIDCs) undertake such practices. Quarterly reporting of SOE performance would strengthen oversight and provide early warning of issues arising such as profits turning to losses, a deteriorating balance sheet²⁰, unexpected need for cash injections, etc.²¹

¹⁸ As happened to Air Nauru in 2005.

¹⁹ In some countries where compliance is low audited annual financial statements may not be published at all or only a few more than a year. For example, Air Vanuatu has not produced audited annual financial statements since 2015. Some governments require annual financial statements to be subjected to parliamentary scrutiny before publication, which also adds to the delays in public disclosure. By comparison, Kenya publishes unaudited consolidated statements of its SOE sector with key information (revenue, expense, borrowing, etc.) by individual SOE.

²⁰ This would look at solvency and liquidity. Assets would need to be assessed and revalued periodically for any significant impairment of assets.

²¹ The detailed in-year reporting of SOEs would be for government’s internal use rather than published, although a summary of flows to/from SOEs should be included in the published budget execution reports.

When an SOE such as an airline is in deep financial distress, even quarterly frequency of reporting may be inadequate. It may be necessary to report monthly or even weekly, where there is a significant probability of a risk materializing. Significantly material events impacting the operating and financial performance of the airline should be notified immediately. Contingent liabilities should also be closely monitored with assessments made on the probability of their materializing.

In addition to backward looking data, based on updated information, for example major shocks emanating from the COVID-19 pandemic, it may be prudent to revise projections and annual plans. These should be shared with the MoF and approval sought for their formal adoption.

Good governance is highly dependent on compliance by the airline. The SOE oversight entity plays a crucial role in monitoring compliance on issues such as timely publishing of audited annual financial statements; in-year reporting; nonfinancial performance reporting; securing government approval of annual plans; adherence to policy (including remuneration and dividend policy); obtaining approval (where required) on borrowing and other incurrence of significant liabilities; convening and documenting board meetings. As highlighted in Section *a* above, the legal framework should provide for the imposition of sanctions in the event of non-compliance.

IV. RISK MANAGEMENT, DIAGNOSTIC TOOLS, AND POTENTIAL CAPACITY DEVELOPMENT

Best practice: Use of risk assessment tools; the health check and stress test tools. Incorporation of airline risks into the consolidated fiscal risk register, which identifies the risks, quantifies them and presents the strategies for managing and mitigating the risks.

The IMF has many tools at its disposal that can help countries diagnose the risks from the national airlines:

- Conducting an SOE Health Check, to assess financial strength of individual SOEs like the national airline and the sector as a whole. A simplified version of this tool is available as well (example below).
- Assessment of guarantees to estimate the extent of fiscal exposure.
- Applying an SOE stress test to determine the effects of different macroeconomic assumptions and scenarios.
- Compiling the Public Sector Balance Sheet (PSBS) to take stock of the size of the SOE sector and its impact on the overall finances of the public sector.
- Conducting either a full Fiscal Transparency Evaluation (FTE) to assess transparency practices, identify gaps, and develop an action plan to address these, or Fiscal Risk Assessment.
- The Fund's debt sustainability frameworks (the MAC DSA and LIC-DSF) can be used to monitor the fiscal risks from National Airlines. Where these fiscal risks are substantial and data availability is adequate, it may be appropriate to expand the coverage in DSAs to capture airline debts. Alternatively, both debt sustainability frameworks include

contingent liability stress tests which can be used to assess the potential implications of these risks for public debt and financing needs.

The IMF can also provide CD to help countries enhance monitoring, control and risk mitigation in relation to the national airline. Such CD could help with:

- Strengthening oversight arrangements and fiscal risk management capacity in MoFs.
- Enhanced budget documentation and budget preparation to ensure adequate control (e.g., fiscal risk statements, dedicated budget documentation on SOEs, periodic fiscal reports compliant with international standards).
- Updating the legal framework on SOEs.

Given the data constraints in PICs, the Simplified SOE Health Check Tool can provide a diagnostic check, as has been done in Table 2 below, using the latest available year's financial statements. The results are subject to the caveat that in some cases financial statements may be outdated or unavailable (Air Vanuatu). In addition, because it is only based on data from the latest available year, it does not capture trends such as improving performance or deteriorating conditions. It is also sensitive to accounting methods. For example, Nauru Airlines was at moderate risk in 2019 when government was not providing CSOs. In 2020, only after including the CSOs as part of total revenue, Nauru Airlines is at low risk.

Results show overall high risk for Samoa Airlines and Air Kiribati, and generally low risk for Solomon Airlines and Nauru Airlines. Liquidity indicators show that all national airlines would be at high risk of being unable to meet short-term obligations. Some results appear overly sanguine. For example, low risk on the solvency indicators reflects low debt levels, but low debt levels may in turn reflect low debt servicing capacity. Similarly, the simplified tool does not seem appropriate for evaluating the government relationship, as it does not capture actual or implicit government guarantees, or assistance other than grants. Moreover, some airlines have not had tax payable, in part due to financial losses (for example, Air Kiribati Ltd). Profitability indicators are mixed, with low or moderate risk ratings for Solomon Airways and Nauru Airlines reflecting efforts to improve financial performance in these airlines prior to COVID-19.

A. Examples of Support Measures and Considerations for Use²²

National airlines across the world are facing significant financial distress due to the impact of the pandemic, and airlines in PICs are no exception. Given the financial constraints, government support should only be considered after remedial measures have proven insufficient. Remedial measures could involve the airline borrowing independently, selling non-core assets, postponing investments, lay-offs, temporarily reducing or delaying dividends or royalty payments to the government. Support should be accompanied by measures to contain costs (such as wages, leasing costs) and a strategy to improve efficiency.

²² See IMF (2020b) for a detailed discussion.

For situations of ongoing support, governments should consider interventions such as revising policy mandates, for example by allowing the company to gradually raise prices closer to cost, close loss-making routes, reduce frequency, to contain fiscal costs and risks. If the airline has ongoing losses (e.g. Samoa airlines) and there are private airlines in operation

Table 2. Simplified SOE Health Check Tool

<i>For Latest available year</i>	Marshall Airlines	Fiji Airways	Solomon Airlines	Samoa Airways	Nauru Air	Air Kiribati
Liquidity indicators						
Current ratio	High Risk	Very High Risk	Very High Risk	Very High Risk	High Risk	Very High Risk
Quick ratio	Very Low Risk	Low Risk	Very High Risk	High Risk	Low Risk	Low Risk
Creditor turnover days	Very Low Risk	Moderate Risk	Very Low Risk	Low Risk	Very Low Risk	Moderate Risk
Debtor turnover days	Low Risk	Very High Risk	Low Risk	Moderate Risk	Very Low Risk	Very High Risk
Solvency indicators						
Debt to equity	Very High Risk	Very Low Risk	Very Low Risk	Very High Risk	Very Low Risk	Low Risk
Debt to assets	Low Risk	Very Low Risk	Very Low Risk	Moderate Risk	Very Low Risk	Low Risk
Interest coverage	Very High Risk	Moderate Risk	Very Low Risk	Very High Risk	Very Low Risk	Very High Risk
Profitability indicators						
Net profit margin (%)	Low Risk	Moderate Risk	Low Risk	Very High Risk	Moderate Risk	Very High Risk
ROA (%)	Low Risk	Moderate Risk	Very Low Risk	Very High Risk	Moderate Risk	Very High Risk
ROE (%)	Very Low Risk	Low Risk	Very Low Risk	Very Low Risk	Moderate Risk	Very High Risk
Financial performance						
Operating costs to revenue	Moderate Risk	Very Low Risk	Moderate Risk	High Risk	Very Low Risk	Very Low Risk
Cost recovery	Very High Risk	High Risk	Moderate Risk	Very High Risk	Very High Risk	Very High Risk
Government relationship						
Grants to revenue ratio (%)	Very Low Risk	Very Low Risk	Very Low Risk	Very Low Risk	Very Low Risk	Very Low Risk
Taxes payable to current liabilities	Very Low Risk	Very Low Risk	Very Low Risk	Very Low Risk	Very Low Risk	Very Low Risk
Overall risk rating	Moderate Risk	Moderate Risk	Low Risk	High Risk	Low Risk	High Risk

governments should assess if it is worth saving the national airline. For systemically important airlines, any support should be accompanied by a substantial reform package. This could involve support from development partners such as the Pacific Regional Infrastructure Facility (PRIF), World Bank, and private investors.

Emergency financing may be appropriate for an airline facing a temporary crisis but which is otherwise profitable (e.g. Fiji airlines, Solomon airlines, Air Vanuatu). Emergency support can help preserve the airlines services and value and may be critical for airlines that have binding leases, maintenance costs for its infrastructure including certification and compliance to standards.

Figure 1 below provides a suggested approach for analyzing government support, starting from consideration of the rationale for provision of government support. Different types of support are also discussed below.

Figure 1. Analysis of government support

- *Budgetary measures* include additional spending such as capital grants and targeted transfers; or tax measures (cuts, relief, or deferrals), provided through standard budget channels. Their full cost will be reflected in the fiscal balance and government debt, unless these can be met by offsetting measures (e.g., expenditure reprioritization). CSOs may be useful where an airline is dependent on regular transfers from the budget to cover costs associated with policy mandates (e.g. Nauru Airlines, Air Marshall Islands). This could involve subsidies directed, or capital injections.
- *Strengthen the airline's balance sheet*: For financial distress situations caused by shocks such as the COVID-19 pandemic, equity injections may be preferred to regular subsidies. Government would recover these cash outlays through future dividends. Alternately, debt-for-equity swaps may be an option if the debt service burden for the national airline is its main source of financial pressure. However, the government's debt and debt service will immediately increase.

- *Facilitate airline borrowing – government guarantees:* Guarantees put the least pressure on current government finances and cash resources, but should be temporary and limited (powers to issue guarantees should be explicit under the Public Financial Management Act). Both Fiji and Vanuatu have provided large government guarantees.
- *Facilitate airline borrowing – on lending:* Government could borrow directly in the market and on lend to the national airline. In this case, the government carries all the risks, but it may imply a lower cost of borrowing for the airlines compared to government guarantees.
- *Public banks and national provident funds,* if financially sound, can be used to provide support to national airlines with limited or no market access. If these operations result in losses to the public banks, the government would need to re-capitalize the bank or take lower dividends. While there is no initial (upfront) fiscal cost, these measures may affect fiscal deficits down the road.
- *Bring in private investors:* Strategic investors can potentially inject capital and add to the expertise for more efficient management of the company. However, this might not be a possibility during a global crisis like the COVID-19 pandemic when all the airlines are struggling. In addition, PICs might not be attractive for private investors as most routes are not financially viable, and there is always the threat of fire sales. See Annex III for some experiences in African Small States.

V. SUMMARY AND CONCLUSIONS

This paper has taken a snapshot of the financial situation in the airlines, based on available data. We find that fiscal risks in national airlines merit special attention in the Fund's surveillance work with PICs, given the size of airline liabilities and government support, particularly in the aftermath of COVID-19. Many PICs have governance legislation and oversight arrangements, and efforts are underway to improve SOE governance frameworks, but further implementation is needed. Deeper analysis would be needed for a more detailed assessment of the implementation of governance arrangements.

Discussion of national airlines is multifaceted and may require consideration of political economy concerns. However, further information and transparency can help to improve fiscal risk management.

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Annex I. Pacific Island Airlines – Country Experiences

Air Kiribati Ltd. According to financial statements, Air Kiribati was unprofitable from 2014 to 2017. The 2018 Article IV Staff Report also noted that Air Kiribati was not profitable and had been receiving government subsidies. The government purchased a Dash 8 aircraft in 2017 (costing roughly 3 percent of GDP), and in 2018 the Cabinet approved the purchase of two Embraer E190-E2 jets for delivery in 2019 and 2020. The 2018 AIV Staff Report noted that operating losses may grow: the new routes involve an established competitor (Fiji Airways), and the E190-E2 model is a high--value aircraft that may have low utilization in the proposed routes. An official figure for the final cost of aircraft is not currently available. However, the 2021 recurrent budget showed expenditure for Embraer Aircraft of A\$44m in 2019 (page 87) and the 2021 development budget showed development partner grant assistance of A\$60m for Embraer Aircraft (page 29).

Fiji Airways. Fiji Airways cancelled all passenger flights from April 2020. The airline has reduced monthly costs to F\$20 million per month, up to August 2021. A large share of fixed costs is lease payments, including on two A350s, which Fiji Airways took delivery of in November 2019. The airline laid off 51 percent of its workforce (758 people), and applied a 20 percent pay cut for remaining staff. As noted in its 2019 financial statement, steps to secure financing have included new loans, deferred loan and lease payments, and the release of cash security held by lenders to secure standby letter of credit facilities. Fiji's government provided a government guarantee to the value of F\$455m (4 percent of 2019 GDP), comprising domestic borrowing (F\$191.1m) and offshore borrowings (US\$117.1m). Fiji Airways is 51 percent owned by the Fiji government, with Qantas Airways (a competitor on the Sydney-Nadi route) holding 46.3 percent. The next biggest shareholder is Air New Zealand with nearly 2 percent. The governments of Kiribati, Tonga, Samoa and Nauru hold less than 1 percent in all.

Nauru Airlines. Nauru Airlines was allocated A\$5.1m emergency government support in the FY2020-21 budget, in response to the pandemic. Of that amount, the Government announced A\$2.5m would be used to support staff, with a redundancy package for staff based in Brisbane.¹ The October 2020 Supplementary Budget included a loan from Exim Bank of Taiwan US\$25m (about 20 percent of GDP), to replace aging aircraft. Unrelated to COVID, government started paying Community Service Obligations (CSOs) to NAC for providing services below market price to population in need. In return for the CSO, the NAC should not operate with a loss.

Samoa Airways. The airline was established in 2017 and the most recent financial statement is for 2019, for Polynesian Limited trading as Samoa Airways. According to the 2019 financial statements, the airline was not profitable in 2019 or 2018, and is in a negative equity position with negative net assets. Samoa Airways has a SAT\$30m loan from the Unit Trust of Samoa, which carries a government guarantee. The airline ended its wet lease and a new and less expensive dry lease was taken up with a replacement plane, which arrived in August. Samoa Airways received \$1m tala in government support in the budget and will also

¹ <http://www.naurugov.nr/government-information-office/gio-notices/friday,-8-may-2020.aspx>

receive a total \$12m as compensation for land taken over by the government (to be paid in installments).²

Solomon Islands. Prior to the pandemic the airline had been upgrading its fleet and received a new A320 in March 2020. Financial performance had improved in recent years, with reported profits in 2017 and 2018, following losses in 2014-16. Air travel had been increasing due to a slowly developing tourism market and the opening of an international airport at Munda. The pandemic has led to a reported loss of 60 percent of income. In response the airline has laid off 20 percent of its workforce and like other airlines is competing for charter flight business. Further cost cutting has proven difficult due to lease/purchase agreements that had been entered into pre-crisis. The airline has received SI\$15 million concessional loan and SI\$5 million grant as part of the COVID-19 stimulus package and further concessional lending has also been announced.³

Air Vanuatu. The Vanuatu government is providing significant support to Air Vanuatu. This has included a VT2 billion loan in 2019 (2019 Supplementary Budget), a government guarantee to Air Vanuatu for an amount of VT592 m in 2020, and VT 200m cash injection in 2020 to cover costs associated with the new planes.^{4 5} A Commission of Inquiry is underway to investigate issues afflicting the airline. Apart from a recently appointed CEO, the Council of Ministers decided to terminate the remainder of the Board in March 2021.⁶

² <https://www.samoaoobserver.ws/category/samoa/63464>

³ <https://www.flysolomons.com/about-us/news/general/solomon-airlines-new-chairman-media-briefing-27-april-2021>

⁴ https://dailypost.vu/news/extra-vt200m-for-airbus-purchase-agreement/article_33f115e8-0f36-11eb-ad61-4fcbe4a1fa0c.html

⁵ https://dailypost.vu/news/vt592m-financial-guarantee-for-air-vanuatu/article_ccdd95d4-2920-11eb-9d01-03d2fbfdea35.html

⁶ https://dailypost.vu/news/air-vanuatus-board-of-directors-terminated/article_3a855d42-8515-11eb-ab74-8be6d2fdd4de.html

Annex II. Scope for a regional airline: History in the PICs and example from the Caribbean

Caribbean region is an archipelago of islands heavily reliant on tourism. While they are not as geographically isolated as the PICs in terms of distance from the major markets, they face similar challenges with regards to smallness and capacity constraints. Regional service delivery, or pooling, has been advocated as a means of addressing these challenges.

A number of pooling initiatives in the Pacific have failed due to perceived inequity. An example is the Air Pacific in the 1970s – 1980s that served seven Pacific Island government shareholders. However, the regional airline experiment failed due to country rivalry and inability to secure consensus on operational and other issues. Fiji was left as the majority shareholder in the airline as other PICs bailed out. Air Pacific was able to survive and later prosper with good management and a commercial focus, renamed Fiji Airways in 2012 – a joint venture between the Fiji Government and Qantas.

Caribbean islands have established a regional airline for inter-island travels. Leeward Islands Air Transport (LIAT) has been owned by seven Caribbean governments, with three being the major shareholders: Barbados, Antigua & Barbuda and St. Vincent and the Grenadines along with Dominica (94.7%); other Caribbean governments, private shareholders and employees (5.3%) from 1974. However, countries with national airlines like Trinidad and Tobago (the sole shareholder of Caribbean Airlines) have chosen not to take part in the initiative. Due to sustained competition from several regional and international carriers, LIAT has had limited profitability and been heavily subsidized by the shareholder governments. As a result of the COVID-19 crisis, it is currently under administration for restructuring.

Annex III: Lessons from Airlines in the African Small Island States

Small island states in Africa are similar to PICs in many ways: small, geographically disbursed and isolated, and dependent on tourism. These small states are reliant on the air transport sector and face common connectivity issues. Examples in Africa include Mauritius, Seychelles and Cabo Verde, all with their own national carriers. Like the experiences in PICs, the airlines in these African small island states struggle financially, often requiring governments to divert capital from other important developmental priorities to recapitalize the airline.

Strengthening governance and oversight: State-owned Air Seychelles has struggled despite substantial government support. After the restructuring in 2011-12 when Etihad Airways acquired 40 percent of the company from the government of Seychelles, the airline turned profitable for a few years. However, rapidly increasing competition from Europe meant a return to significant loss in 2017-18. Air Seychelles subsequently embarked on a comprehensive operational restructuring, reducing its workforce and terminating loss-making international routes, with financial support from its shareholders including debt write off from Etihad, and annual guarantees and grants from the government. It is also concentrating on developing operations in the region, increasing frequency in the profit-making routes. The financial performance improved significantly until the collapse of tourism activities triggered by the COVID-19 pandemic. To cope with the COVID-19 crisis, the government made additional transfers to the national airline, amounting to 0.5 percent of GDP in 2020 (IMF 2020a).

To identify and contain the fiscal risks, the Public Enterprise Monitoring Commission (PEMC) is undertaking a governance and operational audit of the airline and increasing its financial oversight. This has been delayed due to the COVID-19 crisis. Over the medium-term, the government is working on strengthening the governance of non-financial SOEs through legislation to enhance the enforcement power of the PEMC, preparing a dividend policy and improving financial oversight.

Lesson I: The experience in Seychelles highlights the fiscal cost of efforts to assist the national airline. Air Seychelles has been restructured twice in the past decade but remains vulnerable to external shocks. Maintaining some fiscal space and improving oversight are essential to managing these recurring risks.

Privatizing the national airline: To subside the fiscal risks generated by loss-making Transportes Aéreos de Cabo Verde (TACV), the government partially privatized the national airline company in March 2019, selling 51 percent of the shares to a subsidiary of Icelandair and creating a new company, Cabo Verde Airline. 10 percent of the remaining shares were sold to workers of the former national airlines and emigrants. The other 39 percent of shares were to have been sold on the stock exchange but will now stay in state ownership. This privatization is expected to boost growth prospects in the tourism sector as new routes are being added. The new shareholder aims to use Cabo Verde's location in the South Atlantic as a hub for intercontinental air traffic, linking Africa, Europe, North and South America.

To prepare TACV for privatization and ensure smooth transition, a one-year management contract was signed with Icelandair for international routes in October 2017. In August 2017, all domestic routes were transferred to a new private airline company, Binter Cabo Verde, with 30 percent stake retained by the government. Government transfers to TACV increased in 2017 to prepare for the restructuring and preparation for its privatization.

Lesson II: Privatizing a national airline will require substantial preparation and resources. Cabo Verde airlines has multiple shareholders and has taken over two years to privatize, until the COVID-19 crisis halted progress. Despite being a minority stakeholder, the government had had to intervene and provide assistance during this unprecedented crisis. The onus of a national airline will remain with the government as long as it remains a stakeholder.

Restructuring the national airline amidst the COVID-19 crisis: Air Mauritius was struggling even before the COVID-19 crisis, making significant losses in recent years. In January 2020, management had set up a Transformation Steering Committee to address the financial difficulties of the business model. The airline was placed in voluntary administration on 22 April 2020, after the COVID-19 related disruptions made it impossible for the airline to meet its financial obligations for the foreseeable future. This move will provide the company some time to continue discussions for restructuring with its creditors. Air Mauritius has monthly fixed costs of over US\$ 20m, which includes the salaries of around 3,000 employees and the leasing costs of Airbus A350-900 and A330-900neo. While the airline has managed to save US\$ 50m in fixed costs between April and October 2020, two brand new A350s that had been leased to South African Airways in 2019 have been returned in August 2020.

Despite poor performance and frequent turnover in top management, the board has remained intact. Most key strategic decisions are approved by the board, which is believed to be too closely tied to politics.

Lesson III: Decisions affecting fixed costs, such as the purchase or lease of new aircraft, require increased scrutiny. The board should include qualified apolitical members to approve plans and business models. Best practices for board term limits should be adopted to ensure organizational discipline and mitigate conflict of interests.

Annex IV: PIC coverage in SOE Governance Act

	Fiji	Kiribati	RMI	Nauru	PNG	Samoa	Solomon Islands	Vanuatu
Appointing the board	-	Y	Y	Y	Y	Y	Y	-
Approval of board remuneration	-	N	Y	Y	Y	Y	N	-
Approval of plans and budget	-	Y	Y	Y	N	Y	Y	-
Approval of dividends	-	Y	N	Y	N	N	Y	-
Approval of borrowing including lease agreements	-	Y	N	Y	N	N	N	-
Approval of capital expenditure	-	Y	N	Y	N	N	N	-
Reporting requirements	-	Y	Y	Y	N	Y	Y	-
Total	N/A¹	6	4	7	2	4	4	N/A¹

¹ Fiji Airways is not covered by the SOE Governance Act and Vanuatu does not have a SOE Act.

Note: "Y" indicates existence of relevant provision in the respective SOE Governance Act while "N" indicates no such provision in the Act.