DOCUMENT RESUME

04303 - [B3394614]

The Panama Canal Treaty. November 30, 1977. 16 pp.

Testimony before the House Committee on Merchant Marine and Fisheries: Panama Canal Subcommittee; by Elmer B. Staats, Comptroller General.

Contact: Office of the Comptroller General.
Budget Function: International Affairs (150).
Organization Concerned: Canal Zone Government; Panama Canal Co.
Congressional Relevance: House Committee on Merchant Marine and Fisheries: Panama Canal Subcommittee.
Authority: Government Corporation Control Act (31 U.S.C. 841 et seq.). Budget and Accounting Act of 1921.

Unresolved issues relating to the implementation of the Panama Canal Treaty include: the form of U.S. Government organization that the proposed Panama Canal Commission would take; provision for external audits; transfer of property to Panama, recovery of U.S. investment in the Canal, depreciation policy, and future capital outlays; treatment of interest currently paid to the Treasury on the interest bearing investment of the United States; treaty payments to the Republic of Panama; resolution of Panama's debt for past services; increased benefit payments to employees for repatriations, early retirements, and relocations; and the impact of the treaty on toll rates. A fundamental economic aspect of the treaty that needs to be addressed by the Congress is the question of whether the investment of the United States should be recovered over the life of the treaty. This decision will have a profound effect on the financial operations of the new organization, the toll rates, and the taxpayer. It is doubtful that toll rates could be successfully raised to recover both the new payments to Panama and increased depreciation charges designed to recover the past U.S. investment in the Canal. Panama's debt for past services, which is not mentioned in the treaty, should be resolved either through a lump sum payment to the United States or as a credit against U.S. treaty payments to Panama. (SC)

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UNITED STATES GENERAL ACCOUNTING OFFICE
Washington, D. C. 20548

FOR RELEASE ON DELIVERY
Expected at 10:00 AM
November 30, 1977

STATEMENT OF

ELMER B. STAATS

COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE

SUBCOMMITTEE ON PANAMA CANAL

COMMITTEE ON MERCHANT MARINE AND FISHERIES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

THE PANAMA CANAL TREATY

Mr. Chairman and Members of the Subcommittee:

We welcome this opportunity to discuss our observations on the proposed Panama Canal Treaty and its financial and operational implications for the Canal.

The General Accounting Office, as you know, is responsible for auditing the financial operations of the Panama Canal Company and the Canal Zone Government. We are currently auditing their accounts and financial statements for fiscal year 1976, the transition quarter, and fiscal year 1977.

We have had a long involvement with these entities, dating back to the establishment of the Panama Canal Company in 1951 as a corporation subject to the requirements of the Government

Corporation Control Act. Because of our statutory auditing responsibility and long relationship with the Canal Company and Government we have followed the treaty negotiations with great interest. Now that the treaties have been signed and specific future functions and activities of the proposed Panama Canal Commission have been outlined, we plan, as part of our current audit, to analyze the problems involved in the implementation of the treaties.

Governor Parfitt has established a Treaty Planning Committee to guide and coordinate planning for treaty implementation and under the direction of the group, a number of studies are now underway to determine the specific organizational, personnel, and financial impact of the treaty provisions. We have asked for and Governor Parfitt has agreed to provide these studies as they are completed. Until we receive and have an opportunity to analyze the studies we are unable to make any definitive statements on the financial viability of the proposed Panama Canal Commission. Nevertheless, based on our auditing experience and understanding of the treaty, we can highlight some of the issues to be resolved in implementing the Panama Canal Treaty.

In our testimony today we will not attempt to address the impact of the treaty on the U.S. military forces in Panama or the $345 million economic and military assistance package over the next 10 years which has been arranged outside of the treaty.

The unresolved implementation issues include

--the form of U.S. Government organization that the proposed Panama Canal Commission would take;

--provision for external audits;

--transfer of property to Panama, recovery of U.S. investment in the Canal, depreciation policy and future capital outlays;

--treatment of interest currently paid to the Treasury on the interest bearing investment of the U.S.;

--treaty payments to the Republic of Panama;

--resolution of Panama's debt for past services;

--increased benefit payments to employees for repatriations, early retirements and relocations; and the

--impact of the treaty on toll rates.

Form of U.S. Government Organization

The treaty is silent as to what form of organization the proposed Commission would take--government corporation or independent agency.

The Panama Canal Company is a wholly-owned U.S. Government corporation managed by a board of directors appointed by the Secretary of the Army. The Canal Zone Government is an independent U.S. Government agency. The budgeting and accounting functions of the Company are subject to the Government Corporation Control Act (31 U.S.C. 841 *et seq*) and the Government is subject to the Budget and Accounting Act of 1921, as amended.

Under the provisions of the Panama Canal Treaty the Canal Company and the Government would cease to exist. Article III, paragraph 3 of the treaty provides for the establishment of a

> "* * * United States Government agency called the Panama Canal Commission, which shall be constituted by and in conformity with the laws of the United States of America."

The Commission would be supervised by a Board composed of five U.S. citizens and four Panamanian nationals. Through December 31, 1989, the Administrator of the Board would be a U.S. citizen and the Deputy Administrator a Panamanian citizen. These roles would reverse on January 1, 1990 and continue until the termination of the treaty at noon, Panamanian time, December 31, 1999.

The implementing legislation has not yet been presented to the Congress but we understand that the Administration prefers to stick as closely as possible to the current corporate form. In September, the Secretary of the Army recommended to the Senate Foreign Relations Committee that the future Canal Organization continue to be operated under the provisions of the Government Corporation Control Act. We believe that this would be appropriate since it would preserve the businesslike accounting and budgeting principles which have successfully served the Canal organization for over 25 years.

The distinguishing budgeting, accounting, and auditing features of a government corporation are

--business-type budgets and maintenance of accounting records in accordance with commercial corporate accounting principles and standards and

--audit by the General Accounting Office with a mandatory report to Congress.

Information required for the business-type budget includes a statement of financial condition, statement of income and expense, analysis of surplus or deficit and statement of source and application of funds.

Our audit of government corporations is on a reimbursable basis and is performed in accordance with the principles and procedures applicable to commercial corporate financial transactions. Unless specifically authorized by law, government corporations cannot engage private accounting firms for audits.

<u>Provision for External Audits</u>

A related issue to the type of U.S. Government entity the proposed Commission would take concerns the subject of external audits. The treaty documents do not discuss this issue. Nevertheless, we presume that, unless specifically precluded by law, the General Accounting Office will continue to be responsible for auditing the accounts and operations of the Canal organization. It is not clear what role, if any, my counterpart, the Comptroller General of the

Republic of Panama, would have under the proposed treaty. However, we believe that it would be appropriate to explore ways of cooperating with the Comptroller General of Panama concerning the audit.

<u>Transfer of Property, U.S. Investment and Depreciation</u>

I would like now to discuss some of the financial implications of the treaty provisions which would cause major changes in the valuation of U.S. assets, capital-generating depreciation costs, other costs, and revenues.

A fundamental economic aspect of the treaty that needs to be addressed by the Congress is the policy question of whether the investment of the United States should be recovered over the life of the treaty. This decision will have a profound effect on the financial operations of the new organization, the toll rates, and the taxpayer.

At the time of our last audit for the fiscal year ended June 30, 1975, the United States had an unrecovered investment in the Panama Canal enterprise of $736 [illegible]. According to unaudited figures, this amount increa[illegible]o $752 million by the end of fiscal 1977. I should note that these amounts do not include investment in military facilities in the Canal Zone. Under the provisions of the Panama Canal Treaty, the United States will turn over to Panama all its real property, including non-removable improvements thereon in accordance with a specified timetable, with the final transfer upon expiration of the proposed treaty.

There is currently no systematic method for repaying the invested capital of the Canal Company. The Company repays the invested capital through dividends only when the Board of Directors determines that funds exceeding working capital and capital improvements requirements are available. Since its incorporation, the Company has repaid $40 million in dividends; the last such payment was in 1969. The invested capital of the Canal Zone Government, however, is being systematically repaid. The cost of operations and capital programs are initially financed by appropriations. The Government charges individuals and other government agencies for services and these revenues are paid into the Treasury. In addition, the difference between these revenues and expenses <u>including depreciation</u>, or the net cost of operations, are paid into the Treasury by the Company. Therefore, the entire costs, including the capital investments, are being recovered.

We have been concerned for some years about the repayment of the U.S. investment in the Canal Company. This concern led us to recommend for many years that certain previously undepreciated assets such as titles, treaty rights and excavations be depreciated and that consideration be given to using the amounts recovered through inclusion of the depreciation of these assets in the toll rate structure for minimal repayments of the U.S. investment. Depreciation on these assets began on July 1, 1973, but the Company's capital requirements have precluded paying any dividends to the Treasury since.

The United States could recover its investment by increasing depreciation charges sufficiently above the amounts needed for capital expenditures and raise toll rates to recover this additional depreciation. This would permit repayment of dividends to the Treasury during the lifetime of the treaty. This could be accomplished by adjusting annual depreciation charges to coincide with the provisions of the treaty relating to the transfer of assets. To recover the existing U.S. investment over the next 22 years would require additional depreciation charges of over $25 million each year in excess of the new capital investment requirements. While theoretically possible, these actions may not be economically sound because of the impact on toll rates and possible adverse effect on traffic and revenues. For the proposed Commission to be financially self-sufficient, toll rates would have to be raised to cover these increased depreciation costs. The potential for increasing toll rates and the sensitivity of Canal traffic to toll increases in now under study by a private consulting firm, International Research Associates, engaged by the Canal Company. The results of this study are not expected until January 1978. However, based on previous toll studies, it is doubtful that toll rates could be successfully raised to recover both the new payments to Panama and increased depreciation charges designed to recover the past U.S. investment in the Canal.

In addition to recovering past U.S. investment in the Canal, we are also concerned about the impact of the treaty on future capital outlays. Article XIII of the treaty requires that upon treaty termination the United States turn over the Canal "in operating condition and free of liens and debts." This transfer would involve "all real property and non-removable improvements" used by the United States during the treaty and the "equipment related to the management, operation, and maintenance of the Canal." It is obvious that the United States would have to continue to make some new capital investments during the lifetime of the treaty to meet its treaty obligations and to continue operating the Canal in an efficient manner. It is equally obvious that, if the treaty is ratified, new capital budgets should receive close scrutiny by the Administration and Congress to assure that only essential capital investments are made.

Interest Payments to the U.S. Treasury

Although the Panama Canal Company is not required to systematically repay the U.S. investment in the Company, it is required to pay interest to the Treasury on the interest bearing U.S. investment which was about $319 million as of June 30, 1976.

According to Company figures, interest payments due in fiscal year 1976 and the transition quarter were calculated at $16.7 million and $4.4 million, totalling $21.1 million. Interest payments amounted to only $11.8 million; the difference represents the net operating loss of the Company which must be paid from future revenues. Total interest payments to the Treasury since the establishment of the Company through September 30, 1976, have been about $272 million.

Although the legislative package for treaty implementation has not yet been presented, we understand that the Administration proposes to relieve the Commission of the statutory obligation to pay interest to the Treasury. This proposal would improve the cash position of the new Commission and relieve some of the upward pressure of costs on toll rates, but it would also reduce Treasury receipts and impact on the overall U.S. budget. It will be necessary for the Congress to evaluate this trade-off when considering implementing legislation.

Treaty Payments to the Republic of Panama

Article XIII of the treaty requires the United States to pay $40-$60 million annually to the Republic of Panama for the use of the Canal as follows.

--30 cents per Panama Canal net ton for each tollpaying vessel transiting the Canal each year. This rate is indexed to the U.S. wholesale price index for total manufactured goods and would be adjusted biennially, beginning 5 years from the entry into force of the treaty. The current estimated value of this payment is $40 million annually;

--a fixed annuity of $10 million each year; and

--an annual amount of up to $10 million per year if Canal operating revenues exceed expenditures. If revenues do not produce this surplus in any year, the unpaid balance would be paid from future operating surpluses in a manner to be mutually agreed.

These payments would replace the $2.3 million annuity currently paid to Panama under the 1955 treaty. The Panama Canal Company pays about $500 thousand of this annuity and the remaining $1.8 million is paid through appropriations to the Department of State.

The 30 cents per ton and fixed annuity payments under the proposed treaty appear clear cut. However, a question has been raised whether the additional annual payment to be paid if operating revenues exceed expenditures constitutes a fixed liability of the proposed Commission. If it does, then at termination of the treaty it could require a lump sum payment of Panama of up to $220 million if no payments were made during the lifetime of the treaty. On the other hand, if it is a fixed liability then the Commission could include it as an annual expense in its budget and set toll rates designed to recover this additional expense. We await the implementing legislative package before forming an opinion on this issue.

Article III, Section 5 of the treaty stipulates another payment to Panama which has raised questions. According to this provision, the Commission would pay the Republic of Panama $10 million a year for the costs involved in providing the following public services in the Canal operating and housing areas: police, fire protection, street maintenance, lighting and cleaning, traffic management and garbage collection. The treaty is not clear as to whether payments for the first 3 years are a flat $10 million a year or require a determination of the actual costs incurred by the Republic of Panama. After 3 years the treaty appears to relate payments to costs.

> "The costs involved in furnishing said services shall be reexamined to determine whether adjustment of the annual payment should be made because of inflation and other relevant factors affecting the cost of such services."

The treaty documents are silent about how these costs are to be calculated. The treaty also does not contain specific provisions concerning the quality of services to be provided. The implementing agreement for Article III of the treaty, however, does provide for the establishment of a United States-Panamanian Coordinating Committee for consultation and coordination on matters concerning the housing areas. This committee could possibly serve as a forum for resolution of any problems concerning the quality of public services to be provided by Panama.

Panama's Debt for Past Services

As of September 30, 1977, the Republic of Panama owed the Canal organization over $8.4 million for past services. Approximately $4.8 million of this total was for the operation of Palo Seco hospital, a facility for the treatment of Hansen's disease. The treaty documents provide that the United States continue to provide certain utility services such as power, water and services in the Canal area and that the Commission would be reimbursed for its cost in providing such services. There is no mention in the treaty of Panama's debt for past services. This is an issue which should be resolved either through a lump sum payment to the United States or as a credit against U.S. treaty payments to Panama.

Benefit Payments to Canal Employees

The proposed treaty would have far reaching effects on the employees of the Canal organization, and would require significant additional costs for repatriations, relocations, and early retirements. In September, Governor Parfitt testified before the Senate Foreign Relations Committee that on the effective date of the treaty the workforce would be reduced by between 5,000 and 6,000 employees, of which between 2,100 and 2,400 would be transferred to the Department of Defense. An additional reduction of 500 employees would occur by about 30 months later with the phaseout of remaining governmental activities and further reductions would be made throughout the remaining life of the treaty as more Panamanian citizens are employed.

Earlier this month Governor Parfitt expressed his concern to me about the morale and fair treatment of the Canal labor force. He is concerned both with maintaining an adequate level of services and benefits for all employees, and providing equitable benefits for those employees who lose their jobs through a reduction-in-force. One of the proposed benefits is an early optional retirement program for present employees. Another proposal is priority job placement program with other U.S. Government agencies. In addition to new programs the Canal organization has existing obligations to its employees for repatriations and accrued leave.

The details and costs of a reduction-in-force have not yet been presented. When they are available we can better judge whether the proposed Commission will be able to bear the added expenses or whether appropriations will be necessary.

Impact of Treaty on Toll Rates

Under existing legislation (2. C. Z. C. sections 62 and 412) the Company is expected to (1) recover all costs of operating and maintaining its facilities, including depreciation; (2) pay interest to the U.S. Treasury on the U.S. Government's net direct investment in the Company; and (3) reimburse the U.S. Treasury for (a) annuity payments to the Republic of

Panama under the convention of 1903, as later modified and (b) the net costs of operating the Canal Zone Government, including depreciation on fixed assets. Tolls are set to recover these costs, not to maximize revenue by charging what the traffic will bear. The proposed treaty is silent on the subject of toll-setting policy, but we presume that the present principle of recovering only costs will continue.

We have not seen the financial picture of a Canal organization restructured to the treaty provisions but indications are that an increase in toll rates will be required. It has been estimated that current toll rates would have to be raised between 25 percent and 40 percent to generate sufficient revenues for the estimated $50 to $60 million in annual payments to the Republic of Panama as required by the treaty. More precise estimates will require analysis of the financial data which the Canal Company is developing. As I have indicated, there are a number of financial issues which must be resolved before we know what costs the proposed Commission must cover through tolls. Before toll rates are set, it is also necessary to know the revenue-generating potential. As I mentioned before, International Research Associates, is now preparing traffic projections, sensitivity analyses of the impact of various rate increases and estimates of maximum obtainable revenues. We plan to take a close look at this toll study and the Company's financial data. At this time, however, we cannot make an ihformed statement on the level of future toll rates.

Mr. Chairman, this completes my statement. We would be pleased to respond to any questions you or members of the Subcommittee may have.