

GAO

Report of Congressional Committees

November 1991

PANAMA CANAL
COMMISSION

Assessment of
Proposal for
Organizational and
Management Change



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United States
General Accounting Office
Washington, D.C. 20548

**National Security and
International Affairs Division**

B-255351

November 5, 1993

The Honorable Sam Nunn
Chairman
The Honorable Strom Thurmond
Ranking Minority Member
Committee on Armed Services
United States Senate

The Honorable Ronald V. Dellums
Chairman
The Honorable Floyd D. Spence
Ranking Minority Member
Committee on Armed Services
House of Representatives

The Honorable Gerry E. Studds
Chairman
The Honorable Jack Fields
Ranking Minority Member
Committee on Merchant Marine and Fisheries
House of Representatives

The Panama Canal Commission (PCC) authorization act for fiscal year 1993 (P.L. 102-484, Title XXXV) requires that we and the executive branch study and report on structural changes to PCC, which, if made before transferring the Panama Canal to the Republic of Panama, would facilitate and encourage the operation of the Canal now and after the transfer of the Canal in 1999. To assist in developing its report, the executive branch, through PCC, retained Arthur Andersen & Co., to perform the study and Weil, Gotshal & Manges to advise the PCC Board of Directors regarding the legal and other issues addressed in the study.

As agreed with your offices, we limited the scope of our review to evaluating the recommendations and the scope and methodology of Arthur Andersen's study and the recommendations of the PCC Board of Directors.

Background

The Panama Canal Treaty of 1977 requires the United States to transfer the Panama Canal to the Republic of Panama on December 31, 1999, in good running order, free of debt, and with a skilled work force capable of operating and maintaining the Canal. The mission of the PCC—the U.S.

agency that currently operates the Canal—is to (1) sustain the Canal's business viability, (2) provide an efficient and professional facility and work force for the benefit of world trade, (3) meet competitive challenges and customer needs, and (4) support the transition of the Canal to Panama.

Legislation implementing the Panama Canal Treaty, the Panama Canal Act of 1979 (P.L. 96-70), established the PCC as an executive branch agency supervised by a Board of Directors comprised of five U.S. and four Panamanian nationals. The legislation specifies that one of the Board members shall be the Secretary of Defense or his designee. The PCC Board members are appointed by the President of the United States and serve at his pleasure. Board members can be replaced, with or without cause, at any time.¹

Arthur Andersen and the PCC Board of Directors recommended structural changes in governance and financial management that they believe will strengthen PCC's ability to meet its mission. These recommendations include designating the PCC as a government corporation, eliminating the power of any member to direct the votes of other members, providing for international advisers to the PCC Board, changing certain audit requirements, and eliminating certain regulatory requirements.

Results in Brief

We agree with the thrust of most of Arthur Andersen's and the PCC Board of Directors' recommendations. We believe that most of the recommendations are consistent with U.S. foreign policy objectives of (1) encouraging the Panamanian government to adopt an apolitical strategy for managing the Canal and (2) achieving a smooth transition of the Canal to Panamanian control at the end of 1999 in accordance with the Panama Canal Treaty of 1977. We agree that the recommended change to a government corporation with a fully empowered board of directors is warranted, that the Presidents of the United States and Panama should each appoint a nonvoting international adviser to the Board, and that a dissolution fund should be implemented as soon as reliable cost estimates are available. We also support the recommendation eliminating our annual financial audits in favor of having the PCC hire an independent external auditor to perform them.

¹According to the Panama Canal Treaty, the four Panamanian Board members are to be proposed for appointment to the Board by the Republic of Panama and may be removed at Panama's request.

However, we disagree with the recommendations to relieve the PCC Inspector General of its statutory requirements and be converted into an internal auditing function accountable only to PCC management and the Board of Directors. We believe the Inspector General function concept should not be altered and all audit reports should continue to be made available to the Congress. We also have concerns about eliminating U.S. regulatory requirements concerning personnel, procurement, travel and ethics without knowing specifically what management controls, if any, would replace those eliminated.

We believe that the scope and methodology used by Arthur Andersen in their study of the PCC is reasonable and the information presented in their study is representative of the data gathered. Arthur Andersen interviewed officials of various U.S. executive branch agencies, congressional staff members, members of the PCC Board of Directors, senior management officials of PCC, Canal users' representatives, Panamanian government officials, and individuals who have played key roles in the evolution of the PCC and its form of governance. Arthur Andersen also reviewed studies, reports, and documents bearing upon these issues. It examined the governance and financial arrangements of several other organizations, both domestic and international, which offered points of comparison to the PCC. It held detailed discussions on findings and issues leading to their recommendations with the management and the Board of the PCC. While we disagreed with Arthur Andersen on some recommendations, this does not imply a concern with either their scope or methodology. Rather, using similar facts we arrived at different conclusions.

Our detailed views on Arthur Andersen's and the PCC Board of Directors' recommendations are contained in appendix I. We have also included the executive summary from the Arthur Andersen study as appendix II and the Board of Directors' recommendations as appendix III.

Scope and Methodology

In addition to reviewing the Arthur Andersen's and the Board's reports, we met with and obtained relevant documents from officials of the PCC, the Departments of State and Defense, the Agency for International Development, U.S. Embassy in Panama, Panamanian officials, Arthur Andersen, and the PCC Board members. We participated in a seminar at the University of Miami on Canal Transition issues. We visited and observed operations of the Panama Canal.

We conducted this review from January to September 1993 in accordance with generally accepted government auditing standards. We did not obtain written agency comments. However, we discussed our draft report with Arthur Andersen representatives and PCC officials.

We are sending copies of this report to the Secretaries of Defense, State, Commerce, and Transportation; members of the Board of Directors and the Administrator of PCC; and interested congressional committees. We will also make copies available to others upon request.

This report was prepared under the direction of Harold J. Johnson, Director, International Affairs Issues, National Security and International Affairs Division; and Robert W. Gramling, Director, Corporate Financial Audits, Accounting and Information Management Division, who can be reached at (202) 512-4128 and (202) 512-9406, respectively. Other major contributors to this report were Lawrence L. Suda and Oliver G. Harter.



Frank C. Conahan
Assistant Comptroller General

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Abbreviations

PCC Panama Canal Commission

Our Comments on Arthur Andersen's and the PCC Board of Directors' Recommendations

Governance and Organizational Structure

The Panama Canal Act of 1979 (P.L. 96-70), legislation implementing Panama Canal Treaty, established the Panama Canal Commission (PCC) in 1979 as an appropriated fund¹ agency in the U.S. executive branch. The President of the United States exercises authority over the PCC through the Secretary of Defense or his designee. The PCC is supervised by a nine member Board of Directors; five are U.S. nationals appointed by the President of the United States, with the advice and consent of the Senate, and four are Panamanian nationals proposed by the Republic of Panama for appointment by the President of the United States.

Arthur Andersen and the PCC Board recommended that the PCC be designated as a government corporation. They further recommended that the stockholder of this corporation should be the President of the United States or an officer of the executive branch designated by the President, so as to focus executive branch involvement in the Canal's affairs to issues of broad policy and general significance.

We agree with the recommendation to designate the PCC as a government corporation. We testified in support of continuing a corporate structure for the PCC at the time the treaty implementation legislation was being debated in 1979.² At that time, the Panama Canal was a revenue producing business, expected to be self-sustaining, and one that required considerable operating flexibility. We also testified that even though the PCC could operate as an executive agency, the administrative burden and loss of management flexibility would not be compensated for by improvement in congressional oversight. We believe the argument remains valid.

The recommendation that the President or an official of the executive branch designated by the President be the stockholder is based on the fact that U.S. oversight interests in the Canal during the next several years will likely transcend those of any single agency. For example, the Departments of State, Commerce, Transportation, and Defense will probably all take an interest in PCC affairs. Accordingly, the stockholder would act as the direct representative of the executive branch and not as the representative of any particular agency. However, this arrangement would not interfere with or preclude congressional oversight. For example, the Congress has created a number of separate legal entities, referred to as government corporations, such as the Federal Deposit Insurance Corporation or the Resolution Trust

¹Changed to a revolving fund in 1988.

²Statement of Elmer B. Staats, Comptroller General, before the Subcommittee on Panama Canal of the House Committee on Merchant Marine and Fisheries, February 26, 1979.

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Corporation, or government sponsored enterprises, such as the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association that have many of the attributes of and function as private corporations or are entirely private. However, the Congress continues to oversee the entities' mission and operations and to enact legislation affecting them.

Directed Vote

Under current law, the Defense Department's representative on the Board has the power to direct other U.S. members on how to vote. Arthur Andersen and the Board recommended eliminating this power. Their rationale was that the President could protect U.S. interests against the hypothetical misjudgments of a Board member he has appointed by merely using his power to remove and replace Board members. The Arthur Andersen study found no example of a directed board vote in any other entity of the U.S. government and concluded that its application to the PCC was designed to ensure U.S. solidarity on a binational board.

We agree that the directed vote authority can be eliminated. We recognize that this directed vote authority may have been a useful mechanism for assuring solidarity of U.S. positions on matters that come before the binational Board. However, as the PCC transitions to a new entity under Panamanian Control, we believe that removing this control mechanism is consistent with the U.S. objectives of encouraging Panama to adopt an apolitical management strategy and achieving a smooth transition of the Canal to Panamanian control at the end of 1999.

**Executive Branch
Representation, Board
Membership
Qualifications, Election of
Board Chairman, and
International Advisers**

The PCC Board is comprised of five U.S. and four Panamanian members. The U.S. Defense Department representative has invariably been named chairman because of the extraordinary ability to direct the votes of the other U.S. members. The remaining U.S. members come from various economic sectors—organized labor, port organizations, shipping organizations, and one from the business sector.

Arthur Andersen and the Board recommended that the President name one full-time executive branch official to the Board and that the remaining U.S. members of the Board should be nominated by the President and confirmed by the Senate. These individuals should not be full-time U.S. government officials and should be chosen for the independent and distinguished perspective they can bring to the Panama Canal's affairs. Members should not be required to represent any specified interest group

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or economic sector. The Board should continue to elect its own chairman from among the members. The President of the United States and the President of Panama should each name one individual who is neither a U.S. or Panamanian national to serve on the Board as a nonvoting, international adviser to the Board. The international advisers would not serve as representatives of any particular customer interest or nation. They would be chosen for the independent and distinguished international perspective they can bring to the Panama Canal's affairs.

The preceding recommendations are reasonable and typical of corporate boards, and we agree with these recommendations. The recommendation does not preclude a Department of Defense representative from being included for consideration on the Board. Further, the recommendation provides that the other four U.S. members can come from any economic sector. We would encourage the selection of Board members who have broad experience in matters related to the Canal.

Arthur Andersen also commented on the desirability of multiyear staggered terms of office for the PCC Board members. They pointed out, however, that only 6 years remain before the Canal is transferred to Panama, at which time, no U.S. officials will serve on the Board. The imposition of staggered terms at this point would seem to have little practical significance.

We agree that staggered terms of office for the Board members are desired, but we also recognize the limited opportunity to implement such a proposal in the remaining transition period. Several alternatives may warrant consideration. They include

- replacing some but not all of the current U.S. members, thereby in essence establishing staggered terms;
- inviting Panama to stagger the terms of its members to introduce the concept; or
- appointing Panamanian individuals to "shadow" current U.S. Board members, thus better preparing them for taking a position on the Board after 1999.

**Increased Board
Involvement**

Arthur Andersen and the Board recommended that the Board take steps to strengthen its policy-making role through a revised committee structure and through provisions for more frequent and substantive involvement in policy issues facing the PCC. They also recommended establishing an

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effective audit committee comprised of Board members with broad business experience.

We believe the recommendations to increase and strengthen the Board's involvement in policy issues are consistent with good business practices. We also agree that establishing an audit committee composed of board members with broad business experience would help ensure an impartial review of management's conduct of the entity's business. In general, audit committees are intended to play a very important role in an entity's corporate governance. Their responsibilities should include monitoring the entity's internal controls, overseeing the activities of the auditors, and reviewing financial statements and important accounting policies.

Audits of the PCC

We are required by the Panama Canal Act of 1979 to conduct an annual audit of the PCC. Further, the Inspector General Act requires the PCC Office of Inspector General to report directly to the Congress on its audits and investigations, as well as the Chairman of the Board.

Arthur Andersen and the Board recommended that the Board be authorized to hire independent external auditors answerable only to the Board and its proposed audit committee, to render opinions on both the financial statements and internal controls of the PCC. They also recommended that we, while retaining authority to conduct whatever special audits and investigations are deemed appropriate, should be relieved of our responsibility to conduct an annual financial audit. In addition, Arthur Andersen recommended that we should be required to conduct two special reviews of the PCC—one at the midpoint between enactment of any reforms and the actual transition and one as of the date of the transition. Arthur Andersen stated that the PCC operates on commercial principles and supports itself entirely from its own business revenues. They also stated, however, that while the U.S. government requires a regular accounting of the PCC's business, the rigorous budgetary oversight currently exercised is unnecessary.

We agree with the recommendation that the Board hire an independent external auditor and the selection of the auditor should be made by the Board's audit committee. We believe the proposed reviews by our office at the midpoint and at the time of the transition are appropriate. We also believe that having the PCC's external auditor report not only on the fair presentation of financial statements but also on the internal controls of the PCC is very important as an early warning of any financial problems that

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may arise because of internal control weaknesses. In that respect, it may be appropriate to have PCC management annually assess and report on the effectiveness of internal controls and have the external auditor review and report on management's assertions as part of the annual audit of the PCC's financial statements. The Federal Deposit Insurance Corporation Improvement Act of 1991 (P.L. 102-242) requires similar reporting by large federally-insured banks and thrifts. Also, the Federal Managers' Financial Integrity Act of 1982 (P.L. 97-255) requires government agencies to annually review their internal controls.

Arthur Andersen and the Board also recommended relieving the Office of Inspector General, currently reporting directly to the Congress and the Chairman of the Board, of the requirements of the Inspector General Act. They further recommended that the Office of Inspector General be established as an internal audit function accountable to the PCC management and to the PCC Board.

We do not agree with the recommendation to relieve the Inspector General of the requirements of the Inspector General Act or to alter the assurances and oversight intended to be provided by the Inspector General. We believe that the Board's proposed audit committee should play a key role in ensuring that the functions of the Inspector General are continued and that its reports should continue to be made available to the Congress.

**Financial
Management Issues**

In the area of financial management, the PCC is expected to (1) provide financial resources necessary to maintain and improve its physical plant and facilities, (2) recover all costs of operating and maintaining the Canal through tolls and other revenues, (3) ensure operational continuity when the transition occurs, and (4) provide operating personnel with the financial information necessary to maintain commercial viability and provide professional customer service.

Arthur Andersen and the Board have made a number of recommendations concerning financial management. They involve, among other things, changing government regulations, the toll rate setting process, dissolution fund, liquidation of liabilities, management incentives, and compensation of Board members.

**Government Agency
Regulations**

Arthur Andersen and the Board indicated that federal regulations regarding the PCC's business practices preclude the PCC from working

effectively with Panama to develop procedures that Panama can adopt for continuity after 1999.

Accordingly, Arthur Andersen and the Board recommended that if the PCC is made into a government corporation, it should be relieved from obligations to comply with U.S. government regulations regarding budgets, procurement, personnel, travel and, where irrelevant and inappropriate, ethics. They believe the PCC should develop practices and procedures in these areas that reflect efficient commercial standards of practice and that serve the needs of the transitional period. However, the Board of Directors recommended that a legislative package to accomplish this purpose be deferred until a full study is conducted under the direction of an empowered Board of the procedures it would propose to adopt.

The goals proposed by Arthur Andersen are worthwhile in concept, but the U.S. regulatory system does provide standards and procedures in these areas. We agree with the Board that action on this matter should be deferred until the Board completes a full study of the procedures the PCC would propose to adopt in place of U.S. regulations. We could review the merit of proposed regulations in aiding the Congress in its oversight of the PCC.

Toll-Rate Setting Process

Public Law 96-70, implementing the Panama Canal Treaty, established the process whereby changes in toll rates may occur. The process is similar to utility rate making in that it provides for public hearings and opportunities for users to comment. A rate increase, however, becomes effective only upon approval by the President of the United States. Arthur Andersen concluded that given the objective of Board empowerment and the commercial mission of the PCC, the requirement of presidential approval seems an unnecessary intrusion into an essentially commercial question.

Arthur Andersen and the Board recommended eliminating the requirement that the President approve any toll-rate increase and giving the Board the authority to change toll rates.

Arthur Andersen's and the Board's recommendations makes no substantive change in the process because the President's role in the rate making is pro forma at present. Since the process requires the PCC to cost justify toll increases and subject them to challenge by users, we can accept the recommendations.

Dissolution Fund

Public Law 96-70 expressed the sense of the Congress that the additional costs resulting from the implementation of the Panama Canal Treaty of 1977 should be kept to an absolute minimal level. The PCC accrues reserve funds to cover liabilities associated with all operating matters, such as ship accident claims, employees' retirement and vacation costs, and employees' post-retirement medical costs. However, after the transition, various administrative matters will need to be addressed. For example, it is likely that a skeleton group of U.S. employees will need to be retained for a few years in either Washington, D.C., or Panama. The PCC has not yet established an accrual for these likely dissolution costs, but is currently attempting to develop a reasonable estimate of such costs.

Arthur Andersen and the Board recommended that a dissolution fund, currently under study by the PCC, be implemented.

We believe that a dissolution fund for administrative costs should be implemented as soon as a reliable estimate of costs is available. We believe that the appropriate congressional committees will need to determine the reasonableness of the fund estimates developed by the PCC. In addition, the PCC study should address how any remaining dissolution funds will be used after the administrative actions are completed.

Liquidation of Liabilities

Arthur Andersen and the Board recommended that the PCC be required to certify annually to the Congress that the entity is on course to liquidate all its liabilities on December 31, 1999.

Since the U.S. government will serve as guarantor of the PCC's financial liabilities until December 31, 1999, we believe such an annual certification accompanying the financial statements would provide additional assurances that the PCC will be in a position to meet its financial liabilities on December 31, 1999. The certification could take the form of an annual statement of obligations and funds available that would accompany the PCC's financial statements and be reported on by the PCC's external auditor as part of the annual audit. In addition, we could include an assessment of the PCC's ability to meet all of its liabilities in the midpoint review previously discussed.

Management Incentives

Arthur Andersen recommended that the PCC Board of Directors develop an internal system of management incentives for increased efficiency, specifically through management bonus plans and an expanded capital

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reserve fund. The Board of Directors did not make a similar recommendation.

Arthur Andersen stated that various organizations, including government organizations, employ various financial incentives to accomplish their objectives. Since a profit incentive is not available to the PCC, Arthur Andersen suggested two alternatives that might encourage efficiency: management bonuses and an enhanced capital fund. Arthur Anderson suggested that a management bonus system based on improved cost performance could be an effective way to reduce embedded structural costs. They also suggested the use of a flexible capital fund in which the fund would be supplemented in years that financial performance was better than expected. Under the current arrangements, any excess profits are to be turned over to Panama under the terms of the treaty.

We support the concept of pay for performance bonuses but believe the implementation of such a concept warrants detailed attention. The ways in which the PCC will determine who gets what amount of money for what reasons needs to be developed and articulated well in advance of any cash disbursements. The Board may wish to explore an incentive system similar to the Senior Executive Service or merit pay currently in use in some U.S. agencies. Even though Arthur Andersen recommended a flexible capital fund, its own study recognized this approach could be interpreted as an infringement upon Panama's treaty rights.

**Compensation of Board
Members**

According to Arthur Andersen, Board members currently receive compensation of about \$300 daily for attending meetings (plus travel expenses), a level which "represents a financial loss for each day of meeting attendance, and scarcely qualifies as compensation." Arthur Andersen stated that the practice in private U.S. corporations is to provide significant levels of compensation to encourage Board members to take their responsibilities seriously. Arthur Andersen recommended that compensation should be provided to Board members at a level comparable to that provided Board members of private-sector U.S. corporations of similar size. The Board did not make a similar recommendation.

We believe that Board members should receive some compensation for attendance at Board meetings as well as travel expenses. However, there is an aspect of public service that accompanies serving on the PCC Board, and compensation levels comparable to those provided by private U.S.

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corporations may not be appropriate. A more appropriate guide would be to make compensation similar to that of other government corporations. It was also noted in the Arthur Andersen study that several Panamanians interviewed during the study said that providing significant increases in the level of compensation to Board members would be regarded by Panamanians as an instance of inappropriate personal enrichment.

Executive Summary of Arthur Andersen's Study on the Panama Canal Commission

PANAMA CANAL COMMISSION

ASSESSMENT OF GOVERNANCE AND FINANCIAL MANAGEMENT STRUCTURE

SEPTEMBER 1993

**ARTHUR
ANDERSEN**

ARTHUR ANDERSEN & Co. SC

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ARTHUR
ANDERSEN

ARTHUR ANDERSEN & CO. SC

Arthur Andersen & Co.

33 West Monroe Street
Chicago IL 60603-3385

September 17, 1993

Honorable Gilberto Guardia F.
Administrator
Panama Canal Commission
Balboa, Republic of Panama

Dear Mr. Guardia:

We are pleased to submit to the Panama Canal Commission our report assessing the governance and financial management structure of the Panama Canal Commission and proposing recommendations for modifications to that structure. The Commission engaged us to prepare this report in order to assist the Commission in responding to Section 3522(a) of the Panama Canal Commission Authorization Act for Fiscal Year 1993. That legislation mandates a study to determine what changes, if any, to the Commission between now and 1999 would "facilitate and encourage the operation of the Canal through an autonomous entity under the Government of Panama after the transfer of the Canal on December 31, 1999, pursuant to the Panama Canal Treaty of 1977 and related agreements."

As you know, we have been assisted greatly by the willingness of Commission management and Commission Board members to make major commitments of time and effort to this study, both through individual interviews and through extended collective deliberations. We appreciate as well the assistance and counsel provided throughout this study by Commission personnel.

We are most grateful for this opportunity to assist the Commission and hope that you will call on us if you have any questions regarding our findings or recommendations.

Very truly yours,

Arthur Andersen & Co.

ARTHUR ANDERSEN & CO.

EXECUTIVE SUMMARY

This report, prepared pursuant to Section 3522 of the Panama Canal Commission Authorization Act for FY 1993, sets forth analyses and recommendations of Arthur Andersen & Co. submitted to the Panama Canal Commission regarding the structure of governance and financial management under which the Panama Canal Commission operates.

This issue arises in the context of new challenges which will face the Commission over the six years that remain before the Panama Canal is turned over to Panamanian control. The binational Commission established by the 1977 Treaties is widely acknowledged as having done an extraordinary job, often under trying circumstances, in managing the Canal and beginning to lay a groundwork for the 1999 transition. However, the next six years will call for attributes of organizational flexibility and dynamism which the Commission's current structure of governance and financial management may be unable to provide. Moreover, the Republic of Panama has begun to develop a plan for establishing an autonomous, business-oriented Canal organization after 1999. To the extent that the Panama Canal Commission's governance structure during the remaining years of U.S. oversight can be adapted to serve those same objectives, the chances for a smooth and successful transition will be increased.

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Because the governance and financial management structure of any organization should be shaped by that organization's broad purposes, this report considers these structural issues through three basic questions:

- What is the mission of the Panama Canal Commission and what are the primary challenges it faces?
- How effective is the current structure of governance and financial management in serving that mission and meeting those challenges?
- What changes in the structure of governance and financial management would strengthen the Commission's abilities to accomplish its purposes?

To answer these questions extensive interviews were conducted with government officials of the U.S. and Panama, with Commission management and Board members, and with a variety of users and informed observers of the Commission. In addition, benchmark reviews were performed of selected comparable organizations in the U.S. and other countries to assess the success of other governance and financial management structures in the performance of comparable missions.

The essential recommendations we make are that the Panama Canal Commission be converted to a government corporation owned by the United States Government, and that the Board of Directors of that corporation be clearly empowered to manage the affairs of that corporation. Certain other fiscal and management aids to this end are also recommended. In this way, an engaged Board of Directors would contribute more effectively to a seamless transition of ownership of that corporation to the Republic of Panama in 1999.

Chapter One: Background and Context

The current structure of Commission governance and financial management is the product of a historical evolution that has taken place in three phases since the United States undertook to construct the Panama Canal in 1903. In the first phase, 1903-1951, the Canal and the government of the Canal Zone were operated under an appropriated fund agency of the United States Government called The Panama Canal. Other commercial activities were the responsibility of a government-owned corporation called the Panama Railroad Company. In 1951 a more rigorous system of accounting was introduced and the Canal operation was grouped with other commercial activities into a government corporation called the Panama Canal Company. Governmental functions remained in an appropriated fund agency called the Canal Zone Government. This structural recognition of the Canal itself as a fundamentally commercial enterprise persisted until 1979, when legislation

implementing the 1977 Panama Canal Treaties established the Panama Canal Commission as an appropriated fund federal agency once again.

The Commission today serves a market that is vulnerable to the development of alternative transportation routes and to broad shifts in the sourcing of cargo in world trade. Nonetheless, on the assumption that the Commission's service and reputation remain strong, and its tolls policy continues to be nondiscriminatory and restrained, the Canal is likely to see continued modest traffic growth into the foreseeable future. Today the Commission's commercial challenges are (1) to project a reassuring and credible market presence, (2) to maintain or improve current levels of operating efficiency and reliability, (3) to control costs so as to preserve options with respect to tolls policy, and (4) to be clear about its commercial objectives and to ensure that its tolls policy reflects those objectives.

Beyond these commercial challenges, the Commission faces significant challenges arising from the transition of the Canal six years from now to Panamanian control. A large number of issues need to be addressed by the Republic of Panama during this period, having to do with the ultimate role of the Canal in the economy and society of Panama, the structure of Canal governance under Panama, the legislative framework that will apply to the Canal, and myriad operating policies and practices. Panama is beginning now to address these issues in a way that will ensure a successful transition, but it

must have the active cooperation and involvement of the Commission and the United States Government.

Chapter Two: Governance and Organizational Issues

The mission of the Panama Canal Commission comprises four elements: to sustain the Canal's business viability, to provide an efficient and professional facility and workforce for the benefit of world trade, to meet competitive challenges and customer needs, and to support the transition of the Canal to Panama through sound example and through detailed contribution to transition planning and implementation.

The Commission's governance structure described in the Treaties is very general. The significant specifics were established in the U.S. legislation which implemented those Treaties, Public Law 96-70. The general effect of that law was to tighten the control of the U.S. Government over Commission affairs, principally by means of establishing the Commission as an appropriated fund agency of the U.S. Government (modified in 1988 to be a revolving-fund agency) under the direction of the Secretary of Defense, and by giving the Secretary's representative on the Board the power to direct the votes of the U.S. members.

In several respects the linkage between the Commission's mission and the governance structure provided to the Commission in Public Law 96-70 is defective. The problems emerge in three areas.

- The basic form of organization. The current form subordinates the Commission to the chain of command of the Executive Branch, and subjects the Commission to the full range of governmental oversight provisions and federal agency rules. It thereby precludes the flexibility the Commission requires to deal effectively with the complexities of its binational and transitional status and the changing world economy, and it offers a structure of governance which the Republic of Panama is unlikely to wish to continue after 1999.
- The structure and role of the Board of Directors. The Commission's mission makes it highly desirable that the Commission have the benefit of guidance from a fully empowered Board. The ability of the Secretary of Defense's representative on the Board to direct the votes of the U.S. members is a denial of Board empowerment. The consequent subordination of the Board to the Secretary's representative undermines the Board's authority and accountability. The appointment of Board members from various specified economic interest groups, the lack of formal international representation on

the Board, and the negligible level of compensation provided to Board members further undermine the Board's potential effectiveness.

- Various specific devices of U.S. Government control. The application of Executive Branch regulations in areas of procurement, personnel, and wages and salaries impede the evolution of practices and procedures which could be adopted by the post-1999 Canal organization. The assignment of auditing responsibilities to the GAO and to an internal Inspector General, neither of whom is responsible directly to the Board, is inconsistent with the authority and accountability a fully engaged and empowered Board should have.

The foregoing structural limitations inhibit the authority of the Board of Directors to oversee the affairs of a significant enterprise which is responsible for meeting its costs, without subsidy, while maintaining a viable international shipping route.

The following changes in structure are recommended to strengthen the linkage between Commission governance and Commission mission:

- The Commission should be designated a government corporation.

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- The stockholder of this corporation should be the President of the United States, or an officer of the Executive Branch designated by him, rather than any existing U.S. Government agency, so as to help limit the occasions of Executive Branch involvement in Commission affairs to issues of broad policy and general significance.

- The power of any member of the Board to direct the votes of any other members should be eliminated. The ultimate need the President may have to protect U.S. interests against the hypothetical misjudgments of a Board he has himself appointed is adequately protected by the President's power to remove and replace those members.

- The President should be invited to name one full-time official of an Executive Branch department to the Board. All other U.S. members of the Board should be appointed by the President, with confirmation by the Senate, to serve at the pleasure of the President. They should not hold any full-time position with the U.S. Government and should be chosen for the independent and distinguished commercial perspective they provide. Members should not be required to represent any specified interest group or economic sector.

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Executive Summary of Arthur Andersen's
Study on the Panama Canal Commission

- The Board should continue to have the power it currently possesses of electing its own Chairman from among its members.
- The President of the United States and the President of Panama should each name one individual who is a national of neither the U.S. nor Panama to serve on the Board as a non-voting "International Adviser to the Board." In all respects except voting such International Advisers would be full and equal participants with Board members in all Board matters. Such International Advisers should be disinterested with regard to Canal matters and should not serve as representatives of any particular user group or nation. They should be chosen on no basis other than their international stature and general commitment to the advancement of world trade.
- Compensation should be provided to Board members at a level comparable to that provided Board members of private-sector U.S. corporations of similar size.
- The Board on its own initiative should take steps to strengthen its policy-making role through a revised committee structure and through provisions for more frequent and substantive involvement in the issues of

policy facing the Commission. These steps should include the establishment of an effective, independent audit committee comprising members with broad business experience.

- The Board should be authorized to hire independent external auditors answerable to the Board. The independent auditors should be required to render opinions on both the financial statements and the internal controls of the Commission. The General Accounting Office, while retaining authority to conduct whatever audits and investigations it deems appropriate, should be relieved of its current responsibility to conduct an annual audit. However, to assure the U.S. Congress that the Commission is continuing to perform its mission effectively and efficiently, the GAO should be required to conduct two special reviews of the Commission, one at the mid-point between enactment of any reforms and the actual transition, and one as of the date of the transition. The office of the Inspector General should be revised. The important functions performed by that office should be continued, but rather than reporting directly to Congress and the Chairman, effectively bypassing management and the Board, this office should be relieved of the regulations of the Inspector General Act and

established as an internal auditing function responsible to Commission management and to the Commission Board.

- The Commission should be permitted to develop commercially accepted practices and procedures regarding budgeting, procurement, personnel, and ethics which reflect the needs of the transitional period and which can be adopted by the post-1999 Canal organization. Routine Congressional oversight should be eliminated except for the filing of annual reports on the Commission's performance with regard to its commercial and transitional objectives.

In this manner, during the next six years, the Board of Directors will have the requisite authority to oversee the affairs of a corporate organization which can operate efficiently to meet its mission and the needs of international shippers. It can develop management performance objectives, develop incentives for managers to meet those objectives, interact with management in developing long-term strategic plans, and otherwise act as modern corporate governance requires a Board of Directors to act. With this authority, it will be far easier in 1999 for the United States Government to convey to the Republic of Panama ownership of a going concern under a proper form of governance, which need only be carried on if Panama wishes. A properly constituted Board during the next six years will take cognizance of developments in the Republic of Panama and endeavor,

through an interactive process, to adjust itself and the organization to the foreseen needs of the Republic of Panama while still preserving the interests of the United States. It will at the same time demonstrate to Panama the positive aspects of the governance mechanisms recommended here.

Chapter Three: Financial Management Issues

The mission of financial management at the Panama Canal Commission is (1) to provide financial resources necessary to maintain and improve the physical plant of the Commission, (2) to recover all costs of operating and maintaining the Panama Canal through tolls and other revenues, (3) to assure that when the transition occurs the Commission has sufficient cash on hand to settle all liabilities then existing and to ensure operational continuity, and (4) to optimize the allocation of resources by empowering operating personnel with the financial information necessary to support the Commission's efforts to maintain commercial viability and provide professional customer service. To date, the Commission has been notably successful in accomplishing these objectives.

The principal elements in the current structure of the Commission's financial management are the designation of the Commission as a revolving-fund agency in the U.S. Government, the requirement that the Commission break even annually, the requirement that the first \$10 million of profit in each year be paid to Panama, the

requirement of substantial annuity and tonnage payments to Panama each year, the requirement of annual interest payments to the U.S. Government, and the requirement in setting toll rates of Presidential approval for any rate increases.

In light of the Commission's strong financial performance, none of these structural constraints can be characterized as a severe impediment to fulfilling the commercial aspects of its financial management mission. The financial management regulations of the U.S. Government which attach to the Commission's status as an Executive Branch agency, however, are inappropriate to the financial management of a commercial organization subject to market economic forces. More importantly, they are a serious handicap to the Commission's need to evolve a set of financial management practices and procedures that will facilitate the transition and that could be adopted by the post-1999 Canal organization.

Although the annual break-even requirement poses a challenging and inflexible benchmark for the Commission, and although this benchmark is made more challenging by the annual interest-payment requirement, the Treaties -- most notably in the requirement to pay all profits to the Republic of Panama -- and the circumstances of the Commission provide little room today for practical modification of these requirements.

From the United States Government's perspective, the most serious financial risk is that the United States is the financial guarantor of the Panama Canal Commission. Accordingly, the United States Government should be assured by the Commission regularly that the Commission will have the necessary cash resources on hand on December 31, 1999, to liquidate all liabilities.

The tolls-setting process is appropriate for the most part. The requirement of Presidential approval for toll-rate increases, however, is inconsistent with the financial and governance empowerment that the Commission needs over the next six years.

The absence of a profit motive is a handicap in efforts to improve cost control and management efficiency.

The dissolution fund currently under review by Commission management pursuant to Section 3521 of the Panama Canal Commission Authorization Act for FY 1993 is a necessary measure to ensure that the administrative costs of winding down the Commission's operations are adequately provided for.

Accordingly, it is recommended that:

- The Commission should be exempted substantially from those government financial regulations which interfere with the flexibility of the Commission in developing

efficient commercial standards of practice in such areas as the budgetary process.

- The requirement that the President approve toll rate increases should be eliminated.
- The dissolution fund currently under study by the Commission should be implemented.
- The Commission should be required to certify annually that the entity is on course to liquidate all its liabilities as of December 31, 1999.
- The Commission Board should take measures to develop an internal system of management incentives for increased efficiency through management bonus plans and an expanded capital reserve fund.

Panama Canal Commission Board of Directors' Recommendations



OFFICE OF
THE SECRETARY

Board of Directors *Panama Canal Commission*

September 17, 1993

The Honorable Leon E. Panetta
Director
Office of Management and Budget
252 Old Executive Office Building
Washington, DC 20503

Dear Mr. Panetta:

Enclosed are the recommendations of the Panama Canal Commission as required by Section 3522, Public Law 102-484. The enclosed letter from the Board of Directors, Panama Canal Commission, explains the background of the study and its recommendations. This letter is only to explain the manner in which the Board has transmitted this package to you, in light of the recent departure of Mr. John Shannon as Chairman of the Board.

Eight of the nine members of the Board have signed the forwarding letter. Unfortunately, because Board members are located in Panama, Great Britain, Mexico, Texas, Florida, New York and Washington, DC it was necessary, in order to be timely, to obtain some signatures by facsimile. I certify by this letter that eight of the nine members of the Board have endorsed the document, as represented by the signatures appearing on the enclosed letter.

You will note that there is no signature above the block marked "Chairman", the ninth member of the Board. As noted above, Mr. John Shannon is no longer Chairman or the Secretary of Defense's representative on the Board. Thus, the Board is presently without a Chairman. It is significant to report, however, that at the last meeting of the Board on August 10 here in Washington, then Chairman Shannon agreed with all the recommendations contained in the enclosure to the letter signed by the Board.

Michael Rhode, Jr.
Michael Rhode, Jr.
Secretary

Enclosure

"The Panama Canal—Serving World Shipping for Over 75 Years"

Appendix III
Panama Canal Commission Board of
Directors' Recommendations



Board of Directors
Panama Canal Commission

The Honorable Leon E. Panetta
Director, Office of Management & Budget
252 Old Executive Office Building
Washington, D.C. 20503

Dear Sir:

We are pleased to transmit to you herewith the recommendations of the Panama Canal Commission with respect to the future governance and financial management structure of the Canal as contemplated by Section 3522 of the Panama Canal Commission Authorization Act for Fiscal Year 1993. The Board of Directors and management of the Commission have prepared the attached recommendations to the President to assist the President in making recommendations to Congress for changes to the Commission as called for by that Act. It is recognized that, in accordance with the Act, the recommendations to Congress are to be coordinated with representatives of the Secretaries of State, Defense, Treasury, Commerce and Transportation, as well as the Panama Canal Commission.

To assist in developing its recommendations, the Commission retained the international accounting and consulting firm of Arthur Andersen & Co. to conduct a study of the Canal's governance and financial management and also retained the international law firm of Weil, Gotshal & Manges to advise the Board and management regarding the issues addressed in the study. Enclosed herewith is a report, prepared by Arthur Andersen & Co., which summarizes that firm's study, which included obtaining the views of representatives of significant public and private U.S., Panamanian and international interests that are concerned with the Canal and its future. The report provided a great deal of the background for the Board's deliberations leading to the Commission's recommendations. The Commission, however, has not accepted certain of the recommendations of Arthur Andersen & Co. contained in its report. Also enclosed herewith is a draft of the legislation necessary to implement the Commission's recommendations, which has been endorsed by the Commission, along with a section-by-section analysis providing an explanation of the effect of each provision. These documents, taken together, are intended to provide a comprehensive framework for the interagency review process and for the report by the President to the Congress.

The matters that have been addressed by the Commission are vital to the effective future operation of the Canal and the achievement of a smooth transition of the Canal's operations to Panamanian control at the end of 1999 in accordance with the Panama Canal Treaty of 1977 and related agreements. We urge the incorporation of the enclosed recommendations in the report to be submitted by the President to Congress in accordance with the Act and the prompt adoption

"The Panama Canal—Serving World Shipping for Over 75 Years"

Appendix III
Panama Canal Commission Board of
Directors' Recommendations


of the legislation necessary to implement the recommendations. We look forward to working with you in this endeavor.

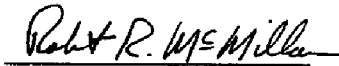
Sincerely,


THE BOARD OF DIRECTORS OF THE PANAMA CANAL COMMISSION:

CHAIRMAN


CECILIA A. ALEGRE


WILLIAM E. CARL

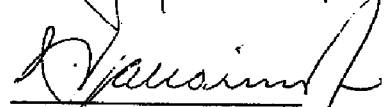

ROBERT R. MCMILLAN


WALTER J. SHEA


LUIS A. ANDERSON


JOHN F. DANILOVICH


ALFREDO N. RAMIREZ


JOAQUIN J. VALLARINO, JR.

RECOMMENDATIONS OF THE PANAMA CANAL COMMISSION

As contemplated by Section 3522 of the Panama Canal Commission Authorization Act for Fiscal Year 1993, the Panama Canal Commission makes the following recommendations for changes in the governance and financial management of the Panama Canal during the period until the transfer of the Canal pursuant to the Panama Canal Treaty of 1977. The recommended changes are intended to "facilitate and encourage the operation of the Canal through an autonomous entity under the Government of Panama after transfer of the Canal on December 31, 1999" pursuant to that Treaty.

- **Form of Organization.** In order better to carry out the Panama Canal Treaty of 1977, the Commission should be designated a government corporation, the stockholder of which will be the President, or such officer of the Executive Branch as he designates, so as to focus the occasions of Executive Branch involvement in the Canal's affairs to issues of broad policy and general significance.
- **Directed Vote.** The power of any member of the Board to direct the votes of any other member should be eliminated. Any ultimate need the President may have to protect U.S. interests against the hypothetical misjudgments of a Board he has himself appointed is adequately protected by the President's power to remove and replace Board members.
- **Executive Branch Representation.** The President should name one full-time official of an Executive Branch department to the Board, to serve at the President's pleasure.
- **Board Membership Qualifications.** The remaining U.S. members of the Board should be nominated by the President, and confirmed by the Senate, to serve at the pleasure of the President. These individuals should not hold any full-time position with the U.S. Government and should be chosen for the independent and distinguished perspective they can bring to the Panama Canal's affairs. Members should not be required to be selected from any specified interest group or economic sector.
- **Election of Chairman.** The Board should continue to have the power it currently possesses of electing its own Chairman. The Chairman should be chosen from among the members.
- **International Advisors.** The President of the United States and the President of Panama should each name one individual who is a national of neither the U.S. nor Panama to serve on the Board as an "International Adviser to the Board." In all respects except voting such International Advisers would be full and equal participants with Board members in all Board matters. They would not serve as representatives of any particular customer interest or nation.

**Appendix III
Panama Canal Commission Board of
Directors' Recommendations**

They would be chosen for the independent and distinguished international perspective they can bring to the Panama Canal's affairs.

- **Increased Board Involvement.** The Board on its own initiative should take steps to strengthen its policy-making role through a revised committee structure, including establishment of an audit committee, and through provisions for more frequent and substantive involvement in the issues of policy facing the Commission.
- **Audits.** The Board should be authorized to hire independent external auditors, answerable to the Board and its audit committee, to render opinions on both the financial statements and internal controls of the Commission. The General Accounting Office, while retaining authority to conduct whatever special audits and investigations it deems appropriate during and at the conclusion of the transition period, should be relieved of its current responsibility to conduct an annual audit. The office of the Inspector General, currently reporting directly to Congress and the Chairman of the Board, should be revised. The function that office currently performs should continue, but the office should be relieved of the regulations of the Inspector General Act and established as an internal inspector general function responsible to Commission management and to the Commission Board.
- **Government Agency Regulations.** The Commission should be relieved legislatively from obligations to comply with U.S. Government regulations regarding budgets, procurement, personnel, travel and, where irrelevant and inappropriate, ethics. The Commission should undertake to develop practices and procedures in these areas which reflect efficient commercial standards of practice and which serve the needs of the transitional period. The Commission believes that a legislative package to accomplish this purpose should be deferred until a full study is conducted under the direction of an empowered Board of the procedures it would propose to adopt.
- **Toll-rate Process.** The requirement that the President approve toll-rate increases should be eliminated and the Board should be given final authority to change toll rates.
- **Dissolution Fund.** The dissolution fund currently under study by the Commission should be implemented.
- **Liquidation of Liabilities.** The Commission should be required to certify annually that the Canal organization is on course to liquidate all its liabilities on December 31, 1999.

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