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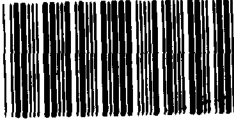
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Statement of

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Comptroller General of the United States

before the

Subcommittee on Panama Canal

HSE02906

of the

House Committee on Merchant Marine and Fisheries

on

Legislation to Implement the Panama Canal Treaty

Mr. Chairman and Members of the Subcommittee:

We appreciate this opportunity to discuss the recently introduced legislation for implementation of the Panama Canal Treaty. A little over a year ago when we testified before the Senate Armed Services Committee, we stated that the treaty-implementing legislation would be the key determinant of the financial viability of the Panama Canal Commission. This is still our view and we, therefore, are gratified that most of our previously expressed concerns have been addressed either in the Senate resolution of ratification or the proposed legislation.

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Today, we would like to

--discuss the fundamental organizational, accounting and financial issues;

--compare how these issues are dealt with in H.R. 111 and the Administration's bill, H.R. 1716; and

--offer suggestions for legislative consideration.

WHAT FORM OF ORGANIZATION IS BEST SUITED FOR THE NEW COMMISSION?

As you know, the Panama Canal Company is a government corporation which operates under the provisions of the Government Corporation Control Act. The Administration's bill H.R. 1716 would continue this form of organization for the new Panama Canal Commission. H.R. 111, on the other hand, would organize the Commission as an executive government agency. In our previous testimony, including testimony before this Subcommittee, we recommended that the new Commission be operated as a government corporation. We continue to hold this view. Even though the Commission could operate as an executive agency, the administrative burden and loss of management flexibility involved in a change from a government corporation would not be compensated for by improvement in congressional oversight. Before discussing the specifics which underlie this conclusion, I would like to briefly review the rationale for the 1950 legislation which completed the separation of the

business-type and government activities of the Canal organization by creating the present Panama Canal Company and Canal Zone Government.

In 1950 testimony before this Subcommittee, the Bureau of the Budget, now the OMB, took the position that the financial controls generally applicable to government-type programs, such as civil government, health and sanitation were not appropriate for programs which were essentially business operations. BOB noted that the operation of the Canal was a business which produced revenue, was expected to be self-sustaining, and required considerable operating flexibility. The Bureau of the Budget concluded that the business-type budgeting, accounting and auditing provisions of the Government Corporation Control Act were more appropriate for the business of operating the Canal than were the provisions of the Budget and Accounting Act of 1921 under which the Canal organization was then operating. The GAO concurred in this conclusion because we had found that the accounting system was inadequate for determining and presenting revenues, costs and expenses and net profits or losses. The Bureau of the Budget's conclusion was also in line with the Hoover Commission recommendation that

> "*** straight-line business activities be incorporated so as to secure greater flexibility in management and simpler accounting, budgeting and auditing methods."

We believe that the successful operation of the Panama Canal Company since the 1950 legislative changes has demonstrated the appropriateness of the corporate form of organization.

What changes would H.R. 111 require? Section 234 of the bill would require the Panama Canal Commission to establish and maintain its accounts pursuant to the Accounting and Auditing Act of 1950, the basic legislation governing accounting for executive agencies of the government. Under this change, the Commission would have to develop an accounting system which would conform to the principles, standards and related requirements prescribed by the Comptroller General for executive agencies. This accounting system would include a series of accounts not now maintained by the Panama Canal Company such as appropriation, allotment, and obligation accounts. In addition to requiring the establishment of a new series of accounts designed for executive agencies of the government, H.R. 111 would require the new Commission to continue to maintain the business-type accounting system required of government corporations. The result would be a hybrid accounting system creating additional administrative burden for the Commission.

GAO Audits Would Continue

Both H.R. 111 and H.R. 1716 provide that the General Accounting Office shall audit the Panama Canal Commission.

The Administration's bill, H.R. 1716 would allow for commercial type audits under the Government Corporation Control Act. H.R. 111, however, requires a two-pronged audit. Section 236(a) of the bill requires a GAO audit pursuant to the Accounting and Auditing Act of 1950, while Section 236(b) requires that our report be in the form of a audit report for a government corporation. In fact, the language of this subsection is virtually identical to Section 106 of the Government Corporation Control Act which specifies what should be included in audit reports for government corporations. In essence, these sections would require GAO to audit the Commission in accordance with standards established for government agencies and for government corporations. From an audit and reporting standpoint, this requirement would increase the complexity and degree of GAO's involvement.

Before leaving the subject of audits, we would like to note several other differences between our current audits of the Panama Canal Company and the provisions of H.R. 111. First, the Company is now required to reimburse GAO for our audits; H.R. 111 does not provide for reimbursement. Second, H.R. 111 would require annual audits with a report to the Congress no later than 6 months after the end of the fiscal year. Under a 1975 amendment to the Government Corporation Control Act, GAO is required to audit each corporation at least once in every 3 years. At the

present time, we are conducting the majority of the examinations required by the Act on a biennial basis which has proved to be satisfactory. Our last audit of the Panama Canal Company covered the fiscal periods 1977, transition quarter, and 1976. Because of the financial significance of the Treaty, we are following up this audit with an audit of fiscal 1978. After the first few years under the new organization, however, biennial audits may again be satisfactory.

Would a Change in Organization Improve Congressional Oversight?

Since the creation of the Panama Canal Company the Corporation's activities have been under the same form of congressional oversight as the approximately 100 government corporations now in existence. The Company's budget is reviewed annually by the Office of Management and Budget and the cognizant authorization and appropriation committees of Congress. No funds have been appropriated for the Company; instead, the Company is authorized to use funds and the $40 million borrowing authority available to it. The Company's budget, however, is subject to the imposition of limitations on spending. For instance, the fiscal 1979 budget limits general and administrative expenses to $31.3 million and the purchase of passenger motor vehicles to 48. The current procedures afford the Company managerial

flexibility to adjust the level of operations and expenditures on the basis of business experience. To date, the Company has been self-sustaining and has not used its borrowing authority.

H.R. 111 would require existing funds and future revenues to be deposited in the general fund of the Treasury. Expenses would be met by annual approrpriations. In addition, the Commission would be authorized to draw on a $10 million emergency fund to be established in the Treasury to defray emergency expenses and to insure continuous operation of the Canal. In essence, congressional oversight and control would revert to the system which existed prior to the creation of the Company.

We think that these changes are unnecessary and that there is adequate congressional oversight and control under the existing system for reviewing the Company's activities. There is now ample opportunity for congressional modifications and limitations to the Company's annual budget. We are wary of a reversion to the old system which unduly restricted managerial flexibility and which failed to emphasize management responsibility for self-sustaining, business-like operations. Under the changes proposed in H.R. 111, there could be an erosion of management responsibility and a temptation to subsidize operation of the Canal through appropriations.

For these reasons, we would prefer to see the Panama Canal Commission organized as a government corporation subject to the existing system of congressional oversight and control.

SHOULD THE UNITED STATES FOREGO INTEREST PAYMENTS AND RECOVERY OF ITS INVESTMENT?

As we have previously testified, the questions of whether the United States continues to receive interest payments and also attempts to recover its investment are policy questions which should be decided by implementing legislation. These decisions will have significant financial implications for the new Commission, future toll rates and U.S. consumers and taxpayers.

From inception, interest has been charged on the U.S. investment in the Panama Canal enterprise. When the present organization was established in July 1951, interest charges were continued for the Panama Canal Company but not for the investment in the Canal Zone Government. As of September 30, 1978, the U.S. investment in the equity of the Panama Canal enterprise was $589.8 million. Of this amount only $318.9 million was considered to be interest-bearing. The remainder, which has been legislatively determined to be non-interest bearing, consists of reinvested earnings ($187.3 million), investment in the Canal Zone Government ($65.4 million) and the Thatcher Ferry Bridge ($18.1 million).

The applicable rate of interest is determined by the Secretary of the Treasury and under present practice it is the computed average coupon rate on outstanding bonds as of July 31 of each year. For fiscal 1978, the rate was 6.071 percent and interest payments were $19.3 million. Since interest payments are an operating cost for the Panama Canal Company, toll rates have been set to recover this cost.

Under Senate Reservation 6 to the Panama Canal Treaty, the Panama Canal Commission would continue to pay interest, at a rate determined by the Secretary of the Treasury, unless new legislation provides otherwise. By eliminating the requirement to pay interest, the Administration's bill, H.R. 1716, would reduce the Commission's operating costs and relieve some of the pressure to increase toll rates. But it also would reduce Treasury receipts and, thereby, increase the burden on U.S. taxpayers. H.R. 111, on the other hand, would retain interest payments to the Treasury at the expense of higher Canal operating costs and toll rates. Higher toll rates, however, have an impact on U.S. citizens as producers and consumers by adding to the cost of goods shipped through the Canal.

Concerning recovery of the U.S. investment, the existing practices differ between the Panama Canal Company and Canal Zone Government. The Company repays invested capital only through dividends declared by the Board of Directors.

The Company has repaid $40 million in dividends since its incorporation. The capital invested in the Canal Zone Government, however, is being systematically repaid. Its operating cost and capital programs are initially financed by appropriations. The government charges users for services and pays the revenues into the Treasury. The difference between these revenues and expenses including depreciation, which is the net cost of the government, is then paid into the Treasury by the Company. Therefore, the entire costs of the government, including the capital investment, are being recovered.

Section 412(b) of H.R. 111 includes amortization of the U.S. investment as a cost to be included in the toll base in addition to depreciation. This cost representing accelerated depreciation of assets, however, is excluded from the calculation of the annual $10 million contingent surplus payment to Panama called for in Article XIII, 4(c) of the treaty. Therefore, if the Commission's revenues met all costs including the accelerated depreciation of assets, Panama would be assured of receiving the $10 million contingent surplus payment. The United States would retain annual amounts above $10 million and, thereby, recoup only a portion of its investment. Obviously, if the intent of H.R. 111 is to recover the U.S. investment then the accelerated depreciation charges should be included both in the toll base and as an element of cost for the calculation of the contingent surplus payment.

The Administration's bill, H.R. 1716 would continue the existing practice of not requiring the recovery of the U.S. investment in Canal except through dividends. Under the treaty, however, dividends could be paid only after the $10 million contingent surplus payment to Panama.

It is not clear from our analysis of the studies prepared by the Company or the executive branch that toll rates can be raised high enough to cover both interest payments and complete recoupment of the U.S. investment. There is a practical limit to toll rate increases beyond which total earned revenues would fall as traffic would be diverted to alternative shipping methods and new trading patterns would emerge. Last year, Governor Parfitt expressed concern about the long-range ability to raise toll rates to cover projected costs. His concern was based on anticipated cost inflation and foreseeable drop in North Slope oil traffic because of alternative pipeline development. Because of the uncertainty about the Canal's long-range revenue potential, we think it may be difficult to recover the U.S. investment through accelerated depreciation charges which would significantly increase toll rates closer to the point of diminishing returns. On the other hand, the Canal has historically generated adequate revenues to pay interest on the U.S. investment.

Existing legislation requires the Panama Canal Company to make annual interest payments to the Treasury to the extent earned. If not earned in any given year, interest payments shall be made from subsequent earnings unless the Congress otherwise directs. We believe that these provisions should be incorporated in the treaty-implementing legislation and that interest payments should be specifically considered an operating expense in the calculation of the $10 million contingent payment to Panama. The implementing legislation should also address the possibility of any unpaid interest liability upon termination of the treaty.

Based on the current value of the interest-bearing investment, and the applicable rate of interest for fiscal year 1978, interest payments over the life of the treaty would amount to about $400 million. This is only a rough projection. The actual annual amounts and cumulative total would depend on the value of the interest-bearing investment after property transfers to other U.S. Government agencies and to Panama and on the applicable rates of interest which are determined each year.

WHAT TREATY RELATED COSTS HAVE BEEN IDENTIFIED?

Costs associated with the Panama Canal Treaty have been the subject of considerable discussion in testimony before your Committee and other Committees of the Congress. We would like to highlight some of the costs, excluding the additional treaty-specified payments to Panama of about $60 million each year

(that will result in increased toll payments by users), which we believe are directly or indirectly related to the Treaty and will be borne by U.S. Government agencies unless otherwise legislated. Some of these costs have been estimated for the life of the treaty while other costs are stated on an annual basis because they could vary widely each year. Therefore, it is not, possible to accurately estimate the total cost. At a minimum, however, the cost would be about $399 million. If the Commission is not required to pay interest on the U.S. investment, there would be additional costs of about $20 million each year, or approximately $400 million over the treaty lifetime.

The estimated costs would include

--Early optional retirement payments estimated at $270 million.

--Severance pay liability estimated at $3.5 million for employees losing their jobs.

--Defense relocation and other costs were originally estimated at $43 million. The current estimate for the first 5 years is $88 million. This estimate includes treaty-related construction to be completed by October 1, 1979, estimated at $10.9 million.

--Discharging the existing accrued annual leave and repatriation liability for employees scheduled for transfer to DOD is estimated at

$6.3 million for leave and $3.7 million for repatriation. DOD would have to request appropriations for payment of these liabilities if no funds are transferred. We recommend that the implementing legislation specifically require the Commission to transfer the necessary funds either to DOD or to the Treasury. If this authority is not provided for by legislation, then the Commission would be relieved of this liability, thereby, increasing the Commission's income.

--Loss on retail store inventories estimated at $2 million.

--Disinterment and reinterment of remains of United States citizens estimated at $1.7 million.

--General and administrative expense associated with a reduction in force and related activities estimated at $1.8 million.

--Cost for health services by DOD estimated at $32 million direct funding less recoveries of $10 million, net cost $22 million.

--State Department personnel costs associated with Embassy consular activities for visas and passports estimated for fiscal year 1980 at $184,100.

Other identified costs for which estimates are not available are:

--Additional educational costs for dependents of the estimated 2,600 employees transferring to the Department of Defense.

--Adjustment of compensation for the loss of exchange and commissary benefits after 5 years by U.S. citizen employees of the Panama Canal Commission.

Concerning retirement costs, we would like to add that both H.R. 111 and H.R. 1716 would establish a special early retirement program for employees who leave government service, either voluntarily or involuntarily, and provide higher than normal retirement benefits for those who stay. We have been asked by the House Post Office and Civil Service Committee's Subcommittee on Compensation and Employee Benefits to analyze each of the provisions that would add to the retirement system's liability with particular attention on their justification and cost.

Our analysis is in process. The Office of Personnel Management's initial rough estimate of the added retirement outlays is $9 million a year for 30 years which is an unfunded liability of $270 million. The Office is now preparing a more precise estimate which we will be evaluating.

HOW SHOULD THE COMMISSION'S ASSETS BE VALUED?

Both H.R. 1716 and H.R. 111 provide for the depreciation of assets, but neither bill states the basis to be used for the valuation of the assets assumed by the Commission. Annual depreciation charges would be an expense to be recovered through tolls and also would be included in the calculation of the contingent payment to Panama. To avoid any misunderstanding by all parties concerned, we believe that the implementing legislation should establish the basis for valuation of assets.

By way of background, when the present Panama Canal Company was established in 1951, the Company's charter prescribed the criteria for valuation of the transferred property. The original cost of $634.7 million was adjusted for defense costs, interest during original construction, suspended construction projects, accrued depreciation and an economic valuation allowance, making the net transfer value $402.1 million. The transfer value was approved by the Bureau of Budget and accomplished in three stages, February 1, 1950, July 1, 1950, and July 1, 1951, or about 1-1/2 years. The valuation and inventory process which cost about $750,000 required the creation of a special staff of engineers and accountants.

The assets to be transferred to Panama and U.S. Government agencies at varying times, as well as those to be assumed by the Panama Canal Commission, are now stated at net book value which is cost less depreciation and allowances. We recognize that other bases of valuation, such as current and replacement costs, can be applied to these assets. The revaluation of assets, however, would involve the substitution of another basis and identification of the assets that would continue to be used in operations and those to be disposed of or retired. This would be accomplished through a detailed inventory which we have advocated in prior testimony. We understand that the Company is presently in the process of inventorying only those assets to be transferred to Panama. Although we have not fully analyzed the alternative methods of valuing the assets to be transferred to the Commission we believe that until some operating experience has been gained, for the transition period at least, the most expedient and preferred method would be to make the transfer at book value when the Treaty goes into force on October 1, 1979.

In closing, we would like to comment on three other matters--amortization of the "use-rights," the Panama Canal Emergency Fund and the administration of payments between the United States and Panama--which may require some revisions to the implementing legislation.

Amortization of "Use-Rights"

Both H.R. 111 and H.R. 1716 provide for the amortization of the U.S. rights to use certain assets. Ownership of these assets, principally housing, will be transferred to the Republic of Panama on October 1, 1979, but the United States will continue to use them as the need exists. It is not possible to establish an exact value for the right to use a particular house because the United States may relinquish its use-right at any time during the treaty. Therefore, the Company's proposed policy is to establish the use-right value at the net book value of the assets at September 30, 1979, and amortize the asset at the same annual dollar value as they were depreciated under the Panama Canal Company. Since these amortization charges will be considered operating costs of the Commission, they should be included in the toll base. We note that there is a possible oversight in H.R. 111 in that amortization charges for use-rights are specifically mentioned in Section 234 as an expense but Section 412(b) of the bill fails to include it as a cost to be recovered through tolls.

Panama Canal Emergency Fund

The Panama Canal Company has the authority to borrow up to $40 million from the Treasury for any purpose. H.R. 1716 would continue the borrowing authority for the Commission. H.R. 111, however, would replace this authority with an

Emergency Fund on which the Commission could draw. There may be some confusion about the amount of the proposed Emergency Fund. Section 233 of the bill stipulates that the fund would be $10 million but the section-by-section analysis mentions a $40 million fund which would be consistent with the existing borrowing authority.

Administration of Payments Between the United States and Panama

The treaty stipulates certain annual amounts which the United States shall pay to Panama but does not specify whether payments may be made semi-annually, quarterly or more frequently. The treaty also provides for reimbursement of each party for services rendered. For example, the United States shall reimburse Panama for railway shipments and Panama shall pay for utility services which the United States continues to provide. The treaty, however, does not provide detailed guidance on the administration of these payments.

We think that the treaty implementing legislation should address the question of frequency of payments because of the cash flow implications for the United States. Neither H.R. 111 or H.R. 1716 specifically cover this question.

Section 251 of H.R. 111 does provide that Panama's payments to the Commission may be offset against amounts due the Republic of Panama by the United States. From a financial standpoint, an offset of payments appears to be an equitable arrangement.

We also suggest that consideration be given to incorporating Senate Understanding 1 to the treaty in the implementing legislation. This understanding provides a mechanism for establishing the quality of public services to be provided by Panama. The understanding also provides that the United States would pay $10 million for each of the first 3 years. Based on an examination of the actual costs to Panama for providing the services, payments for each of the following 3 years would be adjusted by one-third of any excess or deficit. The procedure would continue through the life of the treaty.

Mr. Chairman and Members of the Committee, this completes our prepared statement. We will be pleased to answer any questions you or members of the Committee may have.