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## **Panama Canal Authority**

Special Purpose Audit Report  
on the Costs of Investments in Progress and Operating Expenses  
in the Panama Canal Expansion Program

September 30, 2009

Deloitte - Panama

**Panama Canal Authority**

**Special Purpose Audit Report  
September 30, 2009**

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Teléfono: (507) 303-4100  
Facsimile : (507) 269-2386  
infopanama@deloitte.com  
www.deloitte.com/pa

### SPECIAL PURPOSE AUDIT REPORT

Sirs  
Board of Directors  
Panama Canal Authority

We have audited the accompanying statement of costs of investments in progress as at September 30, 2009 and the statement of operating expenses for the year then ended in the Panama Canal Expansion Program. These statements are the responsibility of the management of the Panama Canal Authority. Our responsibility is to express an opinion on the statements based on our audit.

We conducted our audit in accordance with International Standard on Auditing (ISA) 800 for Special Purpose Audit Engagements. This Standard requires that we plan and perform the audit to obtain reasonable assurance about whether the statements are free from material misstatement.

Our audit included examining, on a test basis, evidence supporting the amounts and disclosures in the statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statements of costs of investments in progress and the statement of operating expenses. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

In our opinion, the statements present fairly, in all material respects, the statement of the costs of investments in progress as at September 30, 2009 and statement of operating expenses for the year then ended in the Panama Canal Expansion Program in accordance with International Financial Reporting Standards.

Deloitte (Signed)

February 12, 2010  
Panama, Republic of Panama

# Panama Canal Authority

## Statement of Costs of Investments in Progress Canal Expansion Program September 30, 2009 (In thousands of balboas)

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	Notes	2009	2008
Program Management		48,779	27,161
Commission fees and other financing costs		14,930	-
Construction of the new locks		29,828	10,168
Construction of the Pacific access channel		88,785	39,969
Navigational channel improvements		179,843	37,489
Water supply improvements		<u>234</u>	<u>-</u>
	4,6	<u>362,399</u>	<u>114,787</u>

The accompanying notes are an integral part of this special purpose audit report.

# Panama Canal Authority

## Statement of Operating Expenses Canal Expansion Program For the year ended September 30, 2009 (In thousands of balboas)

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	Notes	2009	2008
Contracted services and fees		307	110
Materials and supplies		766	184
Transportation and allowances		74	32
Internal support		726	156
Other expenses		<u>98</u>	<u>42</u>
	5, 6	<u><u>1,971</u></u>	<u><u>524</u></u>

The accompanying notes are an integral part of this special purpose audit report.

# **Panama Canal Authority**

## **Notes to the Special Purpose Audit Report For the year ended September 30, 2009 (In thousands of balboas)**

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### **1. General Information**

The Panama Canal Authority (PCA) is an autonomous agency of the Government of Panama, established in accordance with Article 316 of the Political Constitution of the Republic of Panama. PCA is responsible for the administration, operation, conservation, maintenance, modernization, and other related activities of the Panama Canal (the Canal), that are necessary to ensure the safe, uninterrupted, efficient and profitable operation of the Canal in accordance with the constitutional and legal regulations in effect. The PCA has its own patrimony and the right to manage it. The PCA was organized on June 11, 1997 under Law No. 19 (Organic Law).

PCA, in coordination with government entities designated by law, is also responsible for the management, maintenance, use and conservation of the water resources of the Canal watershed, including lakes and their tributary streams.

With the expiration of the 1977 Torrijos-Carter Treaty at noon on December 31, 1999, the Panama Canal reverted to the Republic of Panama free of debts and liens, becoming an inalienable patrimony of the Republic of Panama, open to the peaceful and uninterrupted passage of vessels of all nations, and its use is subject to the requirements and conditions established by the Political Constitution of Panama, the Organic Law of PCA, and its management.

The main PCA offices are located at the Administration Building #101, Balboa, Republic of Panama.

On February 12, 2010, the Panama Canal Authority's Management approved and authorized the issuance of this special purpose audit report, for the period ended September 30, 2009.

# Panama Canal Authority

## Notes to the Special Purpose Audit Report For the year ended September 30, 2009 (In thousands of balboas)

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### 2. General information of the project

#### 2.1 *Approval and estimated cost*

The nation of Panama approved the Canal Expansion program through the referendum held on October 22, 2006. The Program has an estimated cost of B/.5,250,000, detailed as follows:

<b>Description</b>	<b>Estimated amount</b>
Construction of the new locks	2,730,000
Water saving basins	620,000
Construction of channels	820,000
Improvements to navigational channels	290,000
Water supply improvements	260,000
Inflation during the construction period	<u>530,000</u>
Total	<u><u>5,250,000</u></u>

The objectives of the Canal expansion are: (1) to achieve long-term sustainability and growth for the Canal's contributions to Panamanian society, through the payments PCA makes to the National Treasury; (2) to maintain the Canal's competitiveness as well as the value added by Panama's maritime route to the national economy; (3) to increase the Canal's capacity to capture the growing tonnage demand with the appropriate levels of service for each market segment; and, (4) to make the Canal more productive, safe and efficient.

The schedule of the Program is divided in two main phases: the preconstruction phase and the construction phase.

The preconstruction phase includes the development of designs, models, specifications and contracts, pre-classification of possible contractors, and finally, contractor selection. This first phase has a duration of two to three years with respect to the component of the locks.

The construction phase includes the simultaneous construction of both lock facilities with their water recycling basins, dry excavation of the new Pacific access channel, and dredging of both the new lock access channels and Gatun Lake navigational channels, as well as the entrances from both seas.

# Panama Canal Authority

## Notes to the Special Purpose Audit Report For the year ended September 30, 2009 (In thousands of balboas)

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### *2.2 Estimated construction period*

The execution of the Panama Canal Expansion Program began in fiscal year 2007 and is expected to take up to a maximum of 8 years. Operations are estimated to begin in 2014.

## **3. Significant accounting policies**

### *3.1 Statement of compliance*

This report, related to the accounts of costs of investments in progress and operating expenses in the Panama Canal Expansion Program, has been prepared in accordance with International Financial Reporting Standards.

### *3.2 Costs of investments in progress*

Accumulated costs of investments in progress include all direct charges for materials, labor, studies, equipment, professional fees and indirect costs associated with the expansion works. After finishing these works, the construction value will become part of the property, plant and equipment and its depreciation will begin.

### *3.3 Operating expenses*

Expenditures that are not capitalized primarily include service contracts and purchase of materials that do not meet capitalization criteria, and therefore, these are not included as "Costs of Investments in Progress". These also include the purchase of equipment whose unit cost is equal to or less than B/.5. All these items are recorded as expenses in the period they are incurred.

### *3.4 Internal support*

Internal support in the Canal Expansion Program includes: salaries and employment benefits, materials, supplies and use of equipment. The internal support directly related to investment projects in the Canal Expansion Program is capitalized. Internal support charged to operating expenses represents indirect costs that are not directly attributable to the construction of the facility. These expenses include internal resources dedicated mainly to cleaning, moving and maintenance tasks of buildings and equipment.

# Panama Canal Authority

## Notes to the Special Purpose Audit Report For the year ended September 30, 2009 (In thousands of balboas)

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### 3.5 *Monetary unit*

The PCA maintains its accounting records in balboas (B/.) and the Special Purpose Audit Report is stated in this currency. The balboa, monetary unit of the Republic of Panama, is at par and has free exchange with the U.S. dollar. The Republic of Panama does not issue paper money and in its place utilizes the U.S. dollar as legal currency.

### 4. **Costs of investments in progress**

At September 30, 2009, the accumulated costs of investments in progress of the Panama Canal Expansion Program amounted to B/.362,399 (2008: B/.114,787). These costs are included in the audited financial statements of the PCA at September 30, 2009 in Property, Plant and Equipment - Constructions in Progress for B/.514,388 (2008: B/.273,635).

The annual activity of costs of investments in progress is detailed as follows:

	<b>September 30, 2009</b>		
	<b><u>Beginning Balance</u></b>	<b><u>Increase</u></b>	<b><u>Ending Balance</u></b>
<b>Costs of investments in progress</b>			
Program management	27,161	21,618	48,779
Commission fee and other financing cost	-	14,930	14,930
Construction of the new locks	10,168	19,660	29,828
Construction of the Pacific access channel	39,969	48,816	88,785
Navigational channel improvements	37,489	142,354	179,843
Water supply improvements	-	234	234
	<u>114,787</u>	<u>247,612</u>	<u>362,399</u>

# Panama Canal Authority

## Notes to the Special Purpose Audit Report For the year ended September 30, 2009 (In thousands of balboas)

	<u>September 30, 2008</u>		
	<u>Beginning Balance</u>	<u>Increase</u>	<u>Ending Balance</u>
<b>Costs of investments in progress</b>			
Program management	5,420	21,741	27,161
Construction of the new locks	3,638	6,530	10,168
Construction of the Pacific access channel	1,708	38,261	39,969
Navigational channel improvements	2,110	35,379	37,489
Water supply improvements	-	-	-
	<u>12,876</u>	<u>101,911</u>	<u>114,787</u>

### 5. Operating expenses

Operating expenses of the Panama Canal Expansion Program amounting to B/1,971 (2008: B/.524) as summarized in the statement of operating expenses are included in the income statement of the PCA's audited financial statements.

### 6. Total Costs and Expenses of the Panama Canal Expansion Program

Total costs and expenses of the Panama Canal Expansion Program at September 30, 2009 are summarized as follows:

	<b>2009</b>	<b>2008</b>
Capitalized costs	362,399	114,787
Expenses:		
2007	821	821
2008	524	524
2009	<u>1,971</u>	<u>-</u>
	<u>365,715</u>	<u>116,132</u>

# Panama Canal Authority

## Notes to the Special Purpose Audit Report For the year ended September 30, 2009 (In thousands of balboas)

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### 7. Risks management

Article 44 of the Financial Management Regulation, in accordance with Article 190 of the Regulation on PCA Purchasing and Contracts, establishes that PCA is authorized to enter into hedge contracts with specialized institutions in an effort to mitigate the risks associated with fluctuations of:

- prices of commodities acquired by the PCA or its contractors for the purpose of the functioning, maintenance, operation, modernization and the expansion of the Canal,
- interests rates on loans or other credit obligations assumed by the PCA, and
- the exchange rates of foreign currencies in relation to the ones of legal tender in the Republic of Panama when the PCA has incurred obligations in foreign currencies.

The specialized institutions which provide these services must have a risk qualification at the time of entering into contracts in accordance with the established Policies Applicable to the Contracting of Risk Mitigation Services through Hedge Financial Instruments.

#### *7.1 Price adjustment clauses in contracts related to the Canal Expansion and Modernization Program*

As mentioned in Note 8, the PCA has different commitments related to the Canal Expansion and Modernization Program. These commitments include price adjustment clauses related to the main commodities that will be used during construction such as: reinforced steel, cement, structural steel, and light diesel. The clauses use, price indexes of the commodities' fair value, a fixed reference price for each material, the quantities or maximum volume, and target dates for price adjustment performance as adjustment reference factors.

# Panama Canal Authority

## Notes to the Special Purpose Audit Report For the year ended September 30, 2009 (In thousands of balboas)

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The maximum volumes to which the PCA is exposed during the execution of this project are the following:

Raw material	Agreed volume (thousands)	Reference fixed price (in balboas)	Fair value reference index
Reinforced steel	279.0 metric tons	B/.575 per metric ton	<i>Reinforcing Bar - Platts Steel Market Daily</i>
Structural steel	67.2 metric tons	B/.1,000 per metric ton	<i>"Plate - Platts Steel Market Daily"</i>
Cement	1,278.6 short tons	B/.100 per short ton	<i>"Portland and Other Cements, Commodity Code 13220161" by US Bureau of Labor Statistics.</i>
Light diesel (Third Set of Locks contract)	60,000 gallons	B/.1.40 per gallon	<i>US Gulf Coast Diesel No.2 Oil by Platts Latin American Wire</i>
Light diesel (Pacific Access Channel excavation contracts)	2,054 gallons	B/.1.7580 per gallon	<i>Import Parity Price for light diesel as described by Panamanian Energy Secretary</i>

Throughout the life of the project, the PCA shall determine the fair value of the commodities to be used during the periods established in its proposal, for the purpose of determining the variations with the referenced agreed price. This price difference shall be multiplied by the agreed volumes to obtain the amount which the PCA must pay or charge the contractor during periodic payments for work progress. In addition, the contract for the construction of the locks allows for the covering of a portion of the incremental cost associated exclusively with local labor, as it was conceived to cover solely the cost overrun of Panamanian labor.

### ***7.2 Sensitivity to the risk associated with price adjustment clauses of the Canal Expansion and Modernization Program contracts***

To analyze the effect of a possible variation in the price of light diesel on the cost of the Canal Expansion and Modernization Program, an analysis was performed assuming an upward variation that takes the price of diesel to a value of B/.2.30 per gallon during fiscal year 2010. Using an estimated total consumption of 4.7 million gallons during that period, and keeping all other variables constant, this variation impacts the fuel expense item in approximately B/.3.100.

# Panama Canal Authority

## Notes to the Special Purpose Audit Report For the year ended September 30, 2009 (In thousands of balboas)

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For fiscal year 2010, no consumption of cement, reinforced steel, or structural steel has been forecasted.

### 8. Commitments

Commitments as a result of construction contracts in progress and undelivered purchase orders amounted to approximately B/.3,435,000 (2008: B/.230,000). Canal Expansion Program contracts awarded during the fiscal year totaled B/.3,360,426 (2008: B/.229,280).

On July 15, 2009, the PCA awarded the design-build contract for the Canal Expansion Program's major component, the third set of locks, to Grupo Unidos por el Canal (GUPC), for B/.3,221,631. GUPC is composed of the corporations Sacyr Vallehermoso S.A. (Leader) (Spain), Impregilo S.p.A. (Italy), Jan de Nul n.v (Belgium) and Constructora Urbana, S.A. (Panama).

On August 11, 2009, the consortium submitted to PCA the B/.400,000 performance bond as well as the B/.50,000 payment bond, consequently, PCA issued the order to proceed. GUPC initiated works on August 25, 2009 and must deliver the project within 1,883 days.

In January 2010, the PCA made will make a B/.300,000 advance and mobilization payment to GUPC after the contractor complied with all requirements established in the conditions of the contract.

#### *Financing of the Costs of the Canal Expansion Program*

The estimated B/.5,250,000 cost of the program will be financed 40% by loans and the remaining 60% by retained earnings.

Article 319 of the Political Constitution of the Republic of Panama and the Organic Law, whereby the Panama Canal Authority is organized, establish that the Board of Directors is entitled to authorize, upon duly reasoned and supported proposal by the Administrator, the acquisition of loans and other credit obligations to make investments upon prior approval by the President's Cabinet and within the terms provided by this Law and the Political Constitution of the Republic.

# Panama Canal Authority

## Notes to the Special Purpose Audit Report For the year ended September 30, 2009 (In thousands of balboas)

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On October 10, 2008, the Board of Directors agreed to request the approval of the President's Cabinet to contract up to B/.2,300,000 in loans and other credit obligations to cover the financial needs of the Expansion Program of the third set of locks. The President's Cabinet, by means of Cabinet Decree No. 178 of October 13, 2008, approved the request and, in turn, on October 14, 2008, the Board of Directors authorized the Administration to proceed with the loan contracts in accordance with the terms and with the following multilateral and bilateral agencies:

### Terms:

- Financing was provided without guarantees or recourse from the Panamanian Government.
- Financing is not subject to the binding commitment of obtaining goods or services from any particular source.
- Lenders shall not intervene in the operation or management of the Canal.
- Financing will not have an effect on payments to the National Treasury, pursuant to Law No. 28 of 2006.
- Each loan's maturity will not be less than twenty years, with a ten years grace period and ten years amortization of capital.
- The margin of each bank charged on the Libor floating rate at 6 months is agreed on the Finance Contract for each lender agency, with the exception of the European Investment Bank (EIB). On each disbursement, EIB offers PCA the option of a fixed or floating rate which includes their margin.

The following multilateral and bilateral agencies are committed to granting loans to the PCA, as detailed below:

- The European Investment Bank (EIB), for B/.500,000.
- The Japan Bank for International Cooperation (JBIC), for B/.800,000.
- The Inter-American Development Bank (IDB), for B/.400,000.
- The International Finance Corporation (IFC), for B/.300,000.
- Andean Development Corporation (ADC), for B/.300,000.

These resources will be available until December 9, 2014. At the date of this report, these loans have not been disbursed.

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