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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, 2010

Panama Canal Authority

Special Purpose Audit Report
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Translation of a report originally issued in Spanish

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, 2010 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, 2010 and statement of operating expenses for the year then ended in the Panama Canal Expansion Program in accordance with International Financial Reporting Standards.

Deloitte.

November 26, 2010
Panama, Republic of Panama

Panama Canal Authority

Statement of Costs of Investments in Progress
Canal Expansion Program
September 30, 2010
(In thousands of balboas)

	Notes	2010	2009
Program Management		72,788	48,779
Commission fees and other financing costs	7	26,924	14,930
Construction of the new locks		179,836	29,828
Construction of the Pacific access channel		148,470	88,785
Navigational channel improvements		305,981	179,843
Water supply improvements		598	234
	4, 6	734,597	362,399

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, 2010
(In thousands of balboas)

	Notes	2010	2009
Contracted services and fees		464	307
Materials and supplies		442	766
Transportation and allowances		85	74
Internal support		44	726
Non-capitalized equipment		163	75
Other expenses		73	23
	5, 6	1,271	1,971

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

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.

(In thousands of balboas)

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:

Description	**Estimated amount**
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	530,000
Total	5,250,000

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.

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.

As of September 30, 2010, the Expansion Program presented an execution advance corresponding to a 15.5% as compared to the planned 17.6%.

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 (IFRS).

3.2 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 of 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.

3.3 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.

3.4 Borrowing cost

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the cost of those assets, until such time as the assets are substantially ready for their intended use or sale. Other borrowing costs are recognized as expenses when incurred.

3.5 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.

3.6 Operating expenses

Expenditures that are not capitalized primarily include service contracts and purchase of materials that do not meet capitalization criteria, of which unit cost is equal to or less than B/. 10.

(In thousands of balboas)

4. Costs of investments in progress

At September 30, 2010, the accumulated costs of investments in progress of the Panama Canal Expansion Program amounted to B/.734,597 (2009: B/.362,399). These costs are included in the audited financial statements of the PCA at September 30, 2010 in Property, Plant and Equipment - Constructions in Progress for B/.931,608 (2009: B/.514,388).

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

	September 30, 2010		
Costs of investments in progress	**Beginning Balance**	**Increase**	**Ending Balance**
Program management	48,779	24,009	72,788
Commission fee and other financing costs	14,930	11,994	26,924
Construction of the new locks	29,828	150,008	179,836
Construction of the Pacific access channel	88,785	59,685	148,470
Navigational channel improvements	179,843	126,138	305,981
Water supply improvements	234	364	598
	362,399	372,198	734,597

	September 30, 2009		
Costs of investments in progress	**Beginning Balance**	**Increase**	**Ending Balance**
Program management	26,008	22,771	48,779
Commission fee and other financing costs	-	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
	113,634	248,765	362,399

(In thousands of balboas)

5. Operating expenses

Operating expenses of the Panama Canal Expansion Program amounting to B/.1,271 (2009: B/.1,971) 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, 2010 are summarized as follows:

	2010	2009
Capitalized costs	734,597	362,399
		-
Expenses:		
2007	821	821
2008	524	524
2009	1,971	1,971
2010	1,271	-
Total capitalized costs and expenses	739,184	365,715

7. Commission fees and other financing costs

The commission fees and other financing costs are detailed as follows:

	2010	2009
Interest on loans	4,554	-
Commitment fees	4,267	3,688
Other expenses	3,173	11,242
Total interest expense for financial liabilities at amortized cost	11,994	14,930
Less: amount included in the cost of capitalized	(11,994)	(14,930)
loans	-	-

The accumulated commission fees and other financing costs totaled B/.26,924 as of September 30, 2010, B/.11,994 in fiscal year 2010 (2009: B/.14,930).

8. Financial instruments

8.1 Capital Risk Management

The PCA manages its capital to ensure that it will be able to continue as an ongoing concern, while it maximizes the return through the optimization of its liability and equity balances.

The PCA's capital structure consists of net debt (loans as detailed in note 9), compensated by cash and cash equivalent balances, and equity of the enterprise (consisting of contributed capital, reserves, other equity accounts, and unappropriated retained earnings).

The PCA has operated with its own resources, however, on December 9, 2008, the PCA subscribed a common term agreement with multilateral and bilateral agencies, which committed to grant loans with the purpose of partially financing the Canal's Expansion Program (see note 9).

8.2 Interest rate risk management

The PCA is exposed to interest rate risk because it borrows funds at both fixed and floating interest rates. The risk is managed by the PCA through the use of interest rate swap contracts. Hedging activities are evaluated regularly to align with interest rates and the defined risk appetite, ensuring that the most cost-effective hedging strategies are applied.

8.2.1 Interest rate swap contracts

During fiscal year 2010, the PCA established interest rate swap contracts, without collateral from PCA, to fix the floating interest rate of the B/.800,000 loan. Of the B/.800,000, B/.200,000 were requested in fiscal year 2010, and the rest (B/.600,000) are scheduled to be received during fiscal year 2011; B/.300,000 on November 15, 2010, and B/.300,000 on May 15, 2011. Biannual amortizations of B/.40,000 should start on May 15, 2019 until maturity. According to interest rate swap contracts, the PCA agrees to swap the difference between the fixed and floating interest rate amounts calculated on the agreed notional principal amounts. Such contracts allow the PCA to mitigate the risk of interest rate changes on the cash flow of the hedged debt agreed at a floating interest rate. The fair value of interest rate swaps at the end of the reporting period is determined by discounting future cash flows using the curves at the end of the period in question and the inherent credit risk in the contract, which is detailed later as follows.

(In thousands of balboas)

The following table details the notional principal amounts and the remaining terms of the outstanding interest rate swap contracts at the end of the reporting period.

Cash flow hedges
(Effective date: May 15, 2010. Maturity: Nov 15, 2028)

Contracts with floating interest rates and outstanding fixed payment rates	Average contracted fixed interest rate		Notional principal value		Fair value	
	2010	2009	2010	2009	2010	2009
	%	%				
5 years or more	4.67	-	800,000	-	(147,636)	-

The interest rate swaps are paid biannually. The floating rate on the interest rate swaps is at 6-month Libor. The PCA will pay the difference between the floating and the fixed interest rate on a net basis.

All interest rate swap contracts exchanging floating rate interest amounts for fixed rate interest amounts are designated as as cash flow hedges in order to reduce the PCA's cash flow exposure resulting from floating interest rates on borrowings.

8.2.2 Interest rate sensitivity analysis

The following sensitivity analyses have been determined based on the exposure to interest rates for financial instruments at the end of the reporting period.

As of September 30, 2010, for each increase/decrease in basis points in the Libor rate curve through the remaining maturity of the contract, the unrealized loss on the interest rate swap contract would decrease/increase by B/. 1,029. This amount was calculated based on the DV01 indicator generated by Bloomberg’s valuation tool used in the valuation of interest rate swap contracts.

As of September 30, 2010, in a worst case scenario, the PCA expects the Libor rate through the remaining life of the contract to increase by 50 basis points during fiscal 2011, which would represent an increase a decrease of B/.51,441 in the PCA´s equity.

8.3 Price risk on adjustment clauses in contracts related to the Canal Expansion and Modernization Program

As mentioned in Note 10, the PCA has different commitments related to the Canal Expansion and Modernization Program. These commitments include adjustment clauses pertaining to the main commodities that will be used during construction, such as: reinforced steel, cement, structural steel, and light diesel. The clauses use, as adjustment references, price indexes of the commodities’ fair value, a fixed reference price for each material, the quantities or maximum volume, and the target dates for adjustment calculations.

(In thousands of balboas)

The maximum quantities to which the PCA is exposed to are as follows:

Commodity	Agreed volume (thousands)	Fixed reference price	Fair value reference index
Reinforced steel	279.0 metric tons	$575 per metric ton	"Reinforcing Bar - Platts Steel Market Daily"
Structural steel	67.2 metric tons	$1,000 per metric ton	"Plate - Platts Steel Market Daily"
Cement	1,278.6 short tons	$100 per short ton	"Portland and Other Cements, Commodity Code 13220161" from the US Bureau of Labor Statistics
Light Diesel (Third Set of Locks contract)	60,000 gallons	$1.40 per gallon	US Gulf Coast Diesel No.2 Oil from Platts Latin American Wire
Light Diesel (Pacific access channel excavation contract)	2,054 gallons	$1.7580 per gallon	Diesel's Import Parity Price of the Secretariat of Electric Energy

During 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 difference with the referenced fixed price. This price difference shall be multiplied by the agreed volumes to obtain the amount over that 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 covering the portion of the incremental cost associated exclusively with local labor, as it was conceived to cover solely the cost of Panamanian labor.

8.3.1 ***Sensitivity to price risk on adjustment clauses in contracts related to the Canal Expansion and Modernization Program.***

Article No. 44 of the Financial Regulations, in accordance with Article No. 190 of the Purchasing and Contracts Regulations, establishes that the PCA could hedge contracts with specialized institutions, in an effort to mitigate the risks associated with price fluctuations of the commodities acquired by the PCA or its contractors, in regards to the functioning, maintenance, operations, modernization, and expansion of the Canal.

Light Diesel

On April 22, 2010, the PCA conducted a hedge transaction for 36.5 million gallons of light diesel, to cover the risk of variability of future cash flows attributable to the variability in the diesel price index from April 26, 2010 to July 25, 2012 (first two years of the project). The instrument was set at a swap price of B/.2.4396/gal.

The variation of prices in light diesel will not affect the PCA's profit and loss nor its equity as it is capitalized as part of the Canal expansion program.

(In thousands of balboas)

Reinforced steel, structural steel, and cement

For these commodities, according to current market conditions, a financial instrument that allows the mitigation of the risk of future cash flows due to price variability, has not been obtained from the various hedge service providers. For fiscal year 2010, there were no amounts in these categories. The quantities specified in the locks contract for fiscal year 2011, and the estimated amounts for each one of them are shown in the table below:

Commodity	Unit	Quantity	Total
Reinforced steel	Metric Ton	47,077	5,623
Structural steel	Metric Ton	67,200	(1,788)
Cement	Short Ton	-	-

As of September 30, 2010, the reinforced steel price (moving average as stipulated in the contract) was B/.642.64 /metric ton. With an established consumption of 47,077 metric tons for fiscal year 2011, assuming an upward variation trend that increases the reinforced steel price to B/.742.64 / metric ton, the category for this commodity in the construction contract would show an increase of approximately B/.4,700, which the PCA would have to pay, as long as the price stays above the reference price agreed upon in the locks contract.

As of September 30, 2010, the structural steel price (moving average as stipulated in the contract) was B/.866.40/metric ton.

The variation of prices in these commodities will not affect the PCA profit and loss nor its equity as it is capitalized as part of the Canal expansion program.

8.4 Liquidity risk management

The PCA manages the liquidity risk by maintaining savings accounts, proper borrowing facilities, continuously monitoring the forecasted and actual cash flows, and reconciling the maturity profiles for the financial assets and liabilities. Note 8.4.2 specifies the details about credit facilities that the PCA has at its disposition to further reduce the liquidity risk.

(In thousands of balboas)

8.4.1 Interest and liquidity risk tables

The following tables detail the remaining contractual maturity of the PCA financial liabilities with their agreed reimbursement periods. The tables have been designed based on undiscounted cash flows of financial liabilities based on the date in which the PCA shall make the payments.

	Weighted average effective interest rate (%)	1 month or less	1-3 months	1 - 5 years	More than 5 years	Total
September 30, 2010						
Instruments at floating interest rates	1.13688	-	-	-	200,000	200,000
Instruments at fixed interest rates	5.196	-	-	-	100,000	100,000
		-	-	-	300,000	300,000

The PCA has access to financing facilities, as described in note 8.4.2, of which US$2,000 million were not utilized at the end of the 2010 period. The PCA expects to comply with its other obligations with the cash flows from the operations and from the maturity of financial assets.

The following table details the PCA's liquidity analysis for its financial instruments. The table has been designed based on contractual net cash flows that are paid on a net basis. Cash flows are based on the contractual maturities of financial instruments.

	1 year or less	1 - 5 years	More than 5 years
September 30, 2010			
Interest rate swap	-	-	(147,637)
Locks diesel swap	-	(3,235)	-
	-	(3,235)	(147,637)

All subscribed contracts with the different counterparties have a clause that prevents the PCA from having to cover with collaterals any unrealized loss resulting from the periodic valuations of these financial instruments.

(In thousands of balboas)

8.4.2 Financing facilities

	2010	2009
Loans with amounts available up to 2014 that could be extended by mutual agreement		
Amount used		
JBIC Credit Facility	200,000	-
EIB Credit Facility	100,000	-
Amount not used		
JBIC Credit Facility	600,000	800,000
EIB Credit Facility	400,000	500,000
IADB Credit Facility	400,000	400,000
IFC Credit Facility	300,000	300,000
CAF Credit Facility	300,000	300,000
	2,300,000	2,300,000

9. Borrowing

Borrowing received for the Canal Expansion Investment Program, with its amortized cost at September 30, 2010, are detailed as follows:

	2010	2009
Japan Bank for International Cooperation (JBIC)	200,000	-
European Investment Bank (EIB)	100,000	-
Balance at the end of the year	300,000	-

Financing from JBIC was subscribed at a variable rate (6-month Libor plus margin), with equal biannual payments to principal starting on May 15, 2019, and ending in November 2028. Financing from EIB was subscribed at a fixed rate with equal biannual payments starting on May 15, 2019, and ending in November 2028.

10. Commitments

Commitments as a result of incomplete construction contracts and undelivered purchase orders amounted to approximately B/.3,647,000 (2009: B/.3,435,000). Canal Expansion Program contracts awarded during the fiscal year totaled B/.406,997 (2009: B/.3,360,426). The total amount of costs incurred in the Canal Expansion Program for the fiscal year totaled B/.373,470 (2009: B/.249,583).

Contracts awarded during fiscal year 2010, include: Pacific Access Channel, Project No. PAC-4 to ICA-FCC-MECO for B/.269,861; north entrance dredging of the Pacific access channel for the new third set of locks complex on the Pacific side to JAN DE NUL N V for B/.54,551; and widening and deepening of the northern reaches of the Gatun Lake channel to Dredging International NV for B/.39,984.

The fiscal year 2010 balance includes 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.

11. Reclassifications

Some figures on the report of costs of investments in progress for the year ended September 30, 2009 have been reclassified for comparative purposes.

12. Approval of special purpose audit report

The special purpose audit report for the period ended as of September 30, 2010, was approved by the Board of Directors and authorized for issuance on November 25, 2010.

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