

Vote for FRETILIN!

2007 Parliamentary Elections

"Defending Timor-Leste's independence"

Briefing paper for international journalists

20 June 2007

Timor-Leste Petroleum Fund: Eradicating the Myths

1 Background on Timor-Leste's Petroleum Fund

The Petroleum Fund of Timor-Leste devised by the Government of Dr. Mari Alkatiri came into existence by the enactment of the Petroleum Fund Law Number 9/2005 promulgated in August 2005. The intention of the law is to have all payments of whatsoever form related to petroleum activities to be paid into the specially established Petroleum Fund. The Petroleum Fund will contribute to the wise management of the petroleum resources for the benefit of both current and future generations. The Petroleum Fund is a tool that contributes to sound fiscal policy, where appropriate consideration and weight is given to the long-term interests of Timor-Leste's citizens.

One of its express aims is to maintain national spending from development separated from oil and gas income, thus avoiding what has been called "Dutch Disease". It is not a substitute for sound fiscal management, but can help build public awareness and support for wise and long-term management of petroleum wealth, for the benefit of both current and future generations.

The challenge for Timor-Leste as with all other oil rich developing countries is to avoid the "oil curse" or "resource curse". The experiences from these other developing oil producing countries give reason for the Timorese people to have serious concerns about a future with oil and gas receipts flowing in as it has in recent years, without the capacity of the national economy to absorb it into productive sectors. That would result in large amounts of public spending and consumption without any developed productive sector to replace the petroleum wealth.

In other words, the Petroleum Fund is at the heart of the FRETILIN government's plans for the sustainable development of the nation's economy.

2 Management of the Petroleum Fund

The Petroleum Fund is coherently integrated into the State Budget and gives a clear and reliable representation of the development of public finances as Timor-Leste develops. The Petroleum Fund is prudently managed and operated with the highest standards of transparency and accountability to the national parliament and the people of Timor-Leste.

The Government of Timor-Leste, represented by the Minister of Planning and Finance, is responsible for the overall management and investment strategy of the Petroleum Fund.

Article 11.3 of the Petroleum Fund law gives the responsibility to the Banking and Payments Authority (BPA) to undertake the operational management of the Fund under an agreement with the Minister. The BPA is an independent government agency established by law and is the forerunner to what will become Timor-Leste's Central Bank. It already performs many of the functions of a central bank.

A Management Agreement between the BPA and the Ministry of Planning and Finance was signed in 2005.

To execute its responsibility, the BPA established the Petroleum Fund Management Department in August 2005. The Department is headed by an Executive Director accountable to the General Manager, and comprises an Investment Division with responsibility for investment management, and a Risk Management Division responsible for performance measurement and to monitor and manage risk. Other divisions of the BPA provide support for the Fund's operations, including Accounting, Settlements, Information Technology and Internal Audit.

The BPA commenced Petroleum Fund operations in September 2005 after the Government transferred an opening balance of \$205 million. The mandate given to the BPA in the Management Agreement includes a requirement to passively manage the Fund close to a defined benchmark.

Details of the mandate and benchmark are in the Management Agreement and the Quarterly Reports. The portfolio is managed 100% internally within the BPA.

The BPA also provides the secretariat for the Investment Advisory Board, which is established in the Petroleum Fund law to provide the Minister with advice on the Fund's investment strategy.

To ensure transparency, the BPA submits Quarterly Reports on the performance of the Petroleum Fund to the Minister of Planning and Finance, with the reports being published within 40 days of the end of each quarter. The first report was published (Report No. 1) on 30 September 2005 and the latest report (Report No. 7) was published on 31 March 2007.

The publications of the reports are aimed at ensuring transparency, and all previous reports are available on the BPA's web site: www.bancocentral.tl The Petroleum Fund's Annual Report, which contains a more complete description of the Fund's activities and its audited financial statements, is published by the Ministry of Planning and Finance. These documents are all publicly available and published periodically.

3 Petroleum Fund Investment Advisory Board

The Investment Advisory Board (IAB) is established under the requirement of Article 16 of the Law No 9/2005 on the Petroleum Fund to provide strategic investment advice concerning the investments of the Petroleum Fund to the Minister of Planning and Finance. The responsibilities of the IAB are:

- developing for the Minister performance benchmarks of desired returns from, and appropriate risks of, the investments of the Petroleum Fund;
- advising the Minister on the investment instructions that the Minister shall provide to the Investment Managers of the Petroleum Fund appointed pursuant to Article 12;
- advising the Minister on the performance of the external Investment Managers and making recommendations to the Minister on the appointment or removal of external Investment Managers; and
- advising the Minister on the need for changes in the overall investment strategy or management of the Petroleum Fund, including the making of recommendations as to such changes.

The secretariat of the IAB is located at the BPA.

The Chairman of the Board is elected by its members to serve a one-year term and may be re-elected. The first Chairman was Mr. Abraão de Vasconselos, General Manager of the BPA. He was re-elected for a second term in the Board meeting held in 19 January 2007.

The Petroleum Fund Law establishes the Board which is made up of the following persons:

- The Director of Treasury
- The Head of the Central Bank
- Two persons appointed by the Minister who have significant experience in investment management
- One other person appointed by the Minister

4 Petroleum Fund Consultative Council

The Petroleum Fund law establishes the Consultative Council as an independent oversight body; independent of both government and parliament.

This role of this independent Consultative Council to:

- advise Parliament on the operations of the Petroleum Fund
- act as a "watchdog" and contribute to informed public debate and sound management of petroleum wealth (it is mandated by law to consult widely, arrange consultation meetings)

The members are appointed by the different constitutional bodies; i.e. they are separately appointed by President, Parliament, Government and civil society. There are also positions in the Council for former

Presidents of the Republic, Speakers of Parliament, Prime Ministers, Ministers of Finance and Heads of the Central Bank (subject to minimum term in office).

In keeping with Timor-Leste's commitment to the Extractive Industries Transparency Initiative, to which Timor-Leste has been committed since its inception, reports are to be made public.

5 Transparency Measures

A fundamental principle of accountability, transparency and availability of accessible information is enshrined in the legislation.

The highest degree of transparency of operations is mandated. Comprehensive and accessible reporting by Parliament, Minister, Central Bank, Investment Advisory Board, External auditor and the Consultative Council are mandated with respect to:

- the management of the Petroleum Fund
- whether spending of petroleum revenues is consistent with long-term considerations
- whether there is a discrepancy between Petroleum Fund receipts and payments made by companies as Petroleum Fund receipts (a core element of the Extractive Industries Transparency Initiative)

The law also requires that an internationally recognized accounting firm be appointed to perform regular independent external audits.

This Auditor will undertake regular audit work to bolster confidence that money going to, from or remaining in Petroleum Fund is not misappropriated.

The Auditor will also:

- Certify calculations of estimated sustainable income
- Prepare report on payments made as PF receipts

6 Spending Money from the Petroleum Fund

The spending of Petroleum Fund savings is fully integrated into the Timor-Leste state budget development and expenditure process. The Petroleum Fund can only be spent through the annual budget of the state which is submitted annually by the government and approved by parliament. All proposed appropriations are strictly through a law approved by the parliament.

Transfers from Petroleum Fund can only be made to a single State Budget account.

However, the law establishes a sustainable wealth rule, which is an amount calculated in accordance with a formula set out in the law which takes account of future reserves on price estimates based on the very conservative NYMEX index. So the law permits future receipts to be spent, but in a prudent fashion.

Parliament sets a ceiling on total transfers from the Petroleum Fund, which is determined by financing needs of the State Budget (excluding petroleum revenues) and a formula established in the law. Higher public spending means less money will be left in the Petroleum Fund and for that reason the Fund and its management and withdrawals from it are fully integrated to the State Budget. The Petroleum Fund is also the savings instrument of the government. The Government has separately (not part of Petroleum Fund) adopted a savings policy, which gives a target for the size of Budget financing need (and thus transfers from Petroleum Fund).

Contrary to misinformation by many ill informed politicians and candidates, the Fund has been drawn on to supplement two successful Timor-Leste national budgets since it was established in July 2005. That year USD\$60 million was drawn out from the Fund pursuant to legislative approval granted by the National Parliament for the 2005-2006 national budget. In 2006, USD\$279 million was drawn on for the 2006-2007 national budget under parliamentary legislative approval.

The Fund has made a huge difference to the annual national budget as seen from below:

2002-2003 national budget USD\$ 80.7 million

2003-2004 national budget USD\$ 74.6 million

2004-2005 national budgetUSD\$ 87.4 million

2005-2006 national budget
USD\$143.0 million (budget received PF injection)

2006-2007 national budget
USD\$328.6 million (budget received PF injection)

In accordance with the Petroleum Fund Law rules, annually an audit is undertaken and an amount determined as the sustainable wealth is calculated as the maximum that should be expended in order to retain sustainability in the Fund.

Though National Parliament can exceed this amount, it can only be done after a report setting out all the ramifications for the sustainability of the Fund is first examined.

7 Current Balance of the Petroleum Fund

The Banking & Payments Authority (BPA) has released the seventh Quarterly Report of the Petroleum Fund of Timor-Leste showing that the Capital of the fund as of 31 March 2007 was \$1,217.98 million compared with \$1,011.76 million at the end of December 2006.

The report shows that the gross cash inflows during the quarter were US\$310.14 million. This consisted of the taxpayers contribution to the Fund of US\$ 126.40 million and royalties contribution from the Timor Sea Designated Authority of US\$ 183.74 million. (The TSDA is the entity mandated under the Timor Sea Treaty signed between Australia and Timor-Leste to jointly operate the Joint Petroleum Development Area of the Timor Sea. It collects the royalty payments and distributes them 90% to Timor-Leste and 10% to Australia as mandated under the treaty.)

The fund accrued interest was \$10.47 million during the quarter, while the change in market value was \$5.96 million. The absolute return on the Fund for the quarter was positive 1.42%, equivalent to an annual return of 5.82%. The portfolio return for the quarter was 1 basis point lower than the benchmark return within the mandate.

During the quarter, an amount of US\$120 million has been transferred to the General State Budget on 21 March 2007 as requested by the Ministry of Planning and Finance. An amount of US\$ 367.80 thousands management fee has been deducted from the fund during the quarter.

The Petroleum Fund law specifies that the BPA, as the future central bank of Timor-Leste, is the agent responsible for the operational management of the Fund. The Ministry of Planning and Finance is responsible for setting the overall investment strategy for the Fund. The mandate given to the BPA is to manage the fund closely to the Merrill Lynch 0-5 years US Government Bond Index. The BPA has managed the portfolio close to the benchmark over the first seventh quarters. The difference in return between the portfolio and the benchmark since the inception of the fund is zero basis points.

Highlights of the VII Quarterly Report, which covers the period from 1 January to 31 March 2007, include:

- An opening Balance of \$1,011.76 million.
- The gross receipts during the quarter were \$310.14 million which consist of taxpayer's receipt of \$126.40 million and the TSDA receipts of \$183.74 million whereof the cash outflows was USD 120.37 million consist of the transfer to the General State Budget of US\$120 million and the Management fee of US\$367 thousands. The net cash inflow was US\$ 189.77 million.
- Absolute return number was 1.42% for the quarter, or \$16.44million.
- A closing balance was \$1,217.98 million.

The quarterly report, as well as the Petroleum Fund law and Management Agreement, are available from the Banking & Payment Authority's website: www.bancocentral.tl

For more information, please contact:

Jose Teixeira on (+670) 728 7080 www.timortruth.com, www.fretilin-rdtl.blogspot.com