



Timor-Leste Petroleum Fund Draft Act

*Petroleum Fund Steering Group
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*Public Consultation
February 2005*

Background

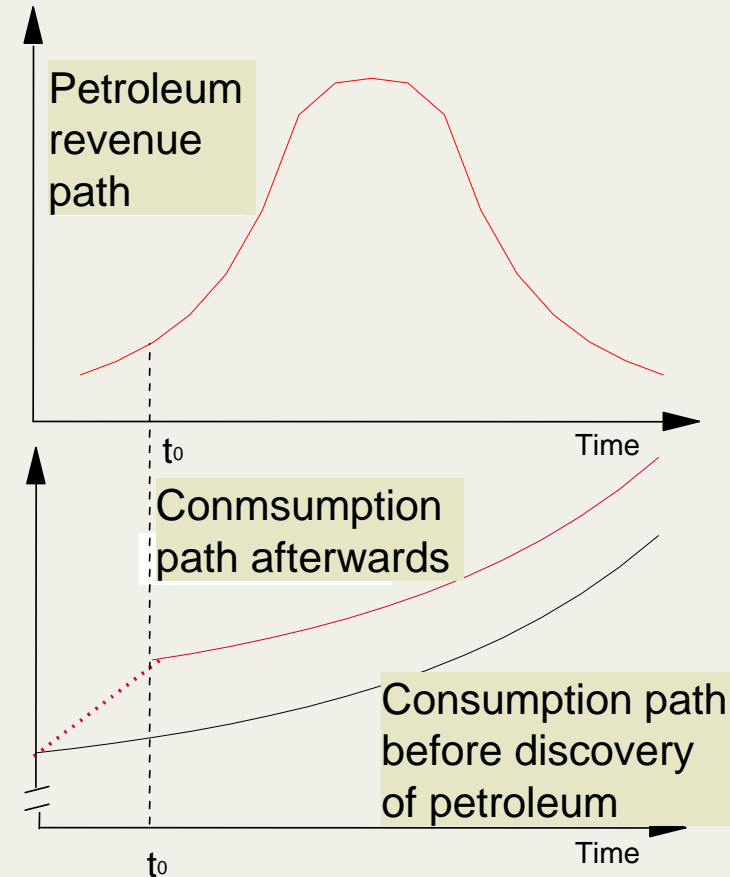
- A public consultation **discussion paper on key policy issues** on the Petroleum Fund released in Oct-04 (www.mopf.gov.tp)
- **Broad public consultation** during Oct-Dec. Briefings to Parliament, the President and the Courts. Meetings held in all districts. PM presentation in Dili broadcast on TV and radio
- **Feedback** from the public consultation: overall support to the key principles outlined in the discussion paper

Way forward

- **Draft Act on the Petroleum Fund now ready for public consultation**
- **Tentative schedule:**
 - *Consultation meeting* in mid-February in Dili
 - *Deadline submissions* around 1 March
 - *Council of Ministers* submits Act to Parliament in March/April
 - *Act approved by Parliament and promulgated by President* before approval of 2005-06 Budget, so that Fund operational 1 July 2005

Management of petroleum wealth

- Spending must be separated from current oil & gas income
- A Petroleum Fund can support fiscal management if it has:
 - Wide political and public support
 - Clear rules
 - Stores genuine savings



Key idea

- *A Petroleum Fund is no substitute for sound fiscal management*
- *But a well-designed fund can help build public awareness and support for a wise and long-term management of the petroleum wealth*

Petroleum Fund – purpose and challenge

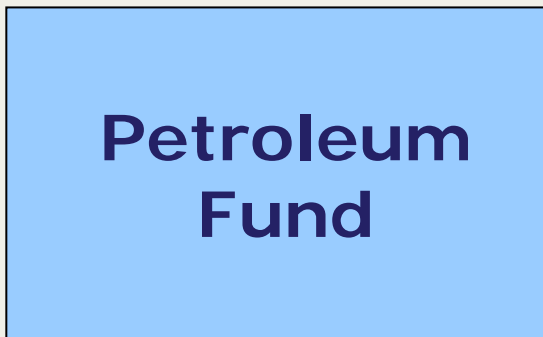
- **Purpose:** An instrument to manage the petroleum wealth wisely for benefit of both current and future generations
 - build understanding for the need to save a substantial share of petroleum revenues to smooth public spending
 - build public confidence and support for strategy of managing the petroleum wealth
- **Challenge:** Experiences from other petroleum producing countries give reason for serious concern. Petroleum will be a curse instead of a blessing if not well managed

Petroleum Fund – key principles

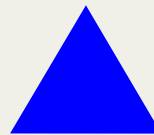
- Builds on the Constitution (article 139)
- Strengthens key public sector institutions (Parliament, MoPF, Central Bank) instead of building new ones
- Tool that contributes to sound budget policy – which is key to avoiding the “resource curse” (Fund integrated with the Budget, Fund shows Government saving)
- Prudently managed – in early years invested securely in low-risk financial assets abroad
- Highest standard of transparency and accountability

How the Petroleum Fund works

Petroleum revenues +
Return on investments

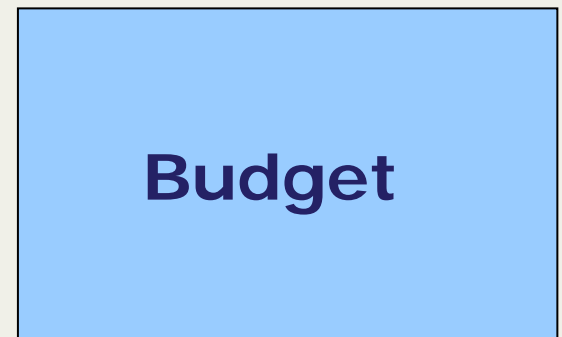


Transfer to
finance budget
deficit (ex
petroleum)



Gov't savings policy
(spend estimated sustainable
income of petroleum wealth)

Domestic revenues



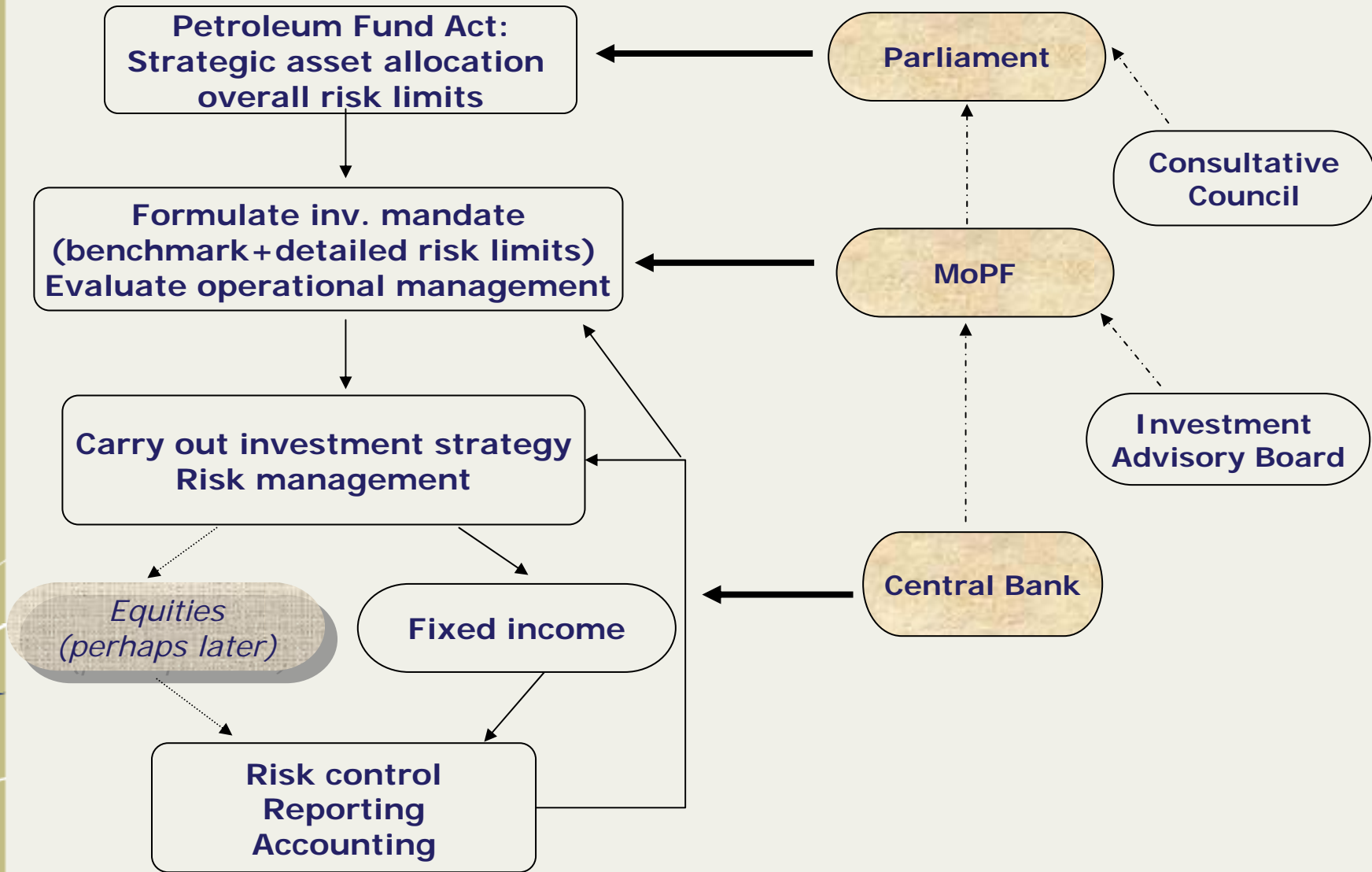
Expenditures

- consumption
- investment
(infrastructure,
human capital)

Investment alternatives

	Physical	Financial
Domestic	Important in T-L Done through Budget	Make economy more cyclical, less stable Risk of bad governance
Foreign	Illiquid investments Less transparent	Liquid and efficient markets. Spread risks. Protect domestic economy

Management of the Petroleum Fund



Feedback from the public consultations

- Comments from consultation meetings held throughout Timor-Leste during Oct-Dec 2004 and through five written submissions (available on www.mopf.gov.tp)
- Overall support to establish PF along the lines proposed in the discussion paper
- Focus on the need for strong provisions on transparency and accountability
- Some also emphasise the relationship between the Petroleum Fund and fiscal policy (rules vs flexibility, suggest fiscal policy rule in PF Act - referring to Sao Tome)
- Comments in consultation meetings focus on need to spend money in budget wisely to build the country – investing in infrastructure and human capital
- Scepticism in meetings as to why invest PF money abroad eased when arguments were presented

Structure of the Petroleum Fund Act

- Articles 1-5: General provisions
- Articles 5-7: Establishment of PF. Receipts and transfers
- Articles 8-11: Management and investment of PF
- Articles 12-14: Supervision of PF
- Articles 15-17: PF Consultative Council
- Articles 18-20: Transparency
- Article 21: Penalties
- Articles 22-25: Transitional and final provisions
- Schedule 1: Calculating estimated sustainable income

Inflow into the PF (Articles 5, 6)

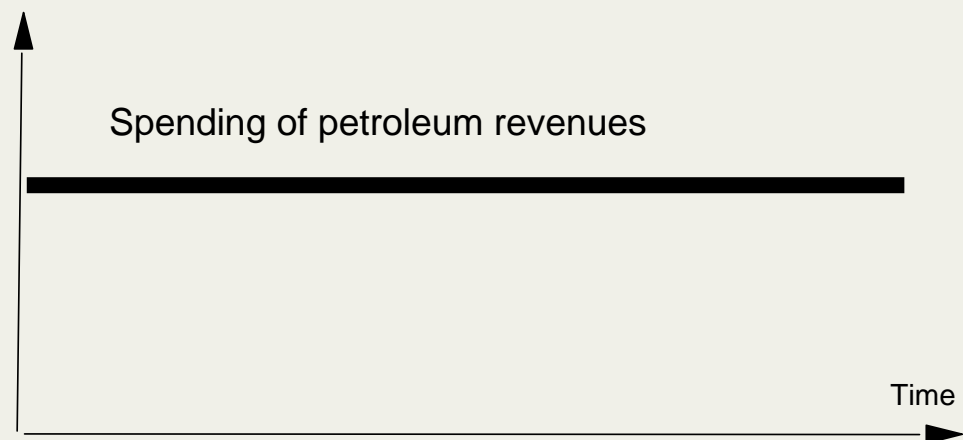
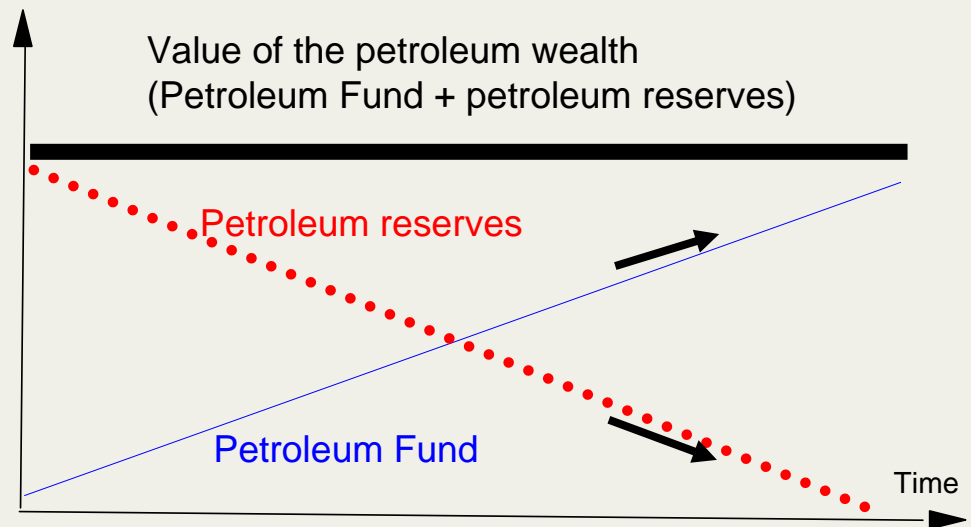
- All receipts to be deposited in an earmarked account
- PF receipts: All petroleum revenues + return on Fund's investments (net of management expenses)
- Opening balance 1 July 2005: Accumulated FTP + extra amount due to large petroleum revenues this year

Outflow from the PF (Article 7)

- Transfer from PF can only be made to a single State Budget account
- Parliament sets a ceiling on total transfers from PF
- Height of ceiling determined by financing need of State Budget (excluding petroleum revenues)
 - Higher public spending means less money left in PF. Therefore, Fund fully integrated in State Budget. Fund reflects government financial savings
- PF is the savings instrument. Government has separately (not part of PF) adopted savings policy, which gives a target for the size of Budget financing need (and thus transfers from PF)

The Government's savings policy: *Keep constant real value of petroleum wealth*

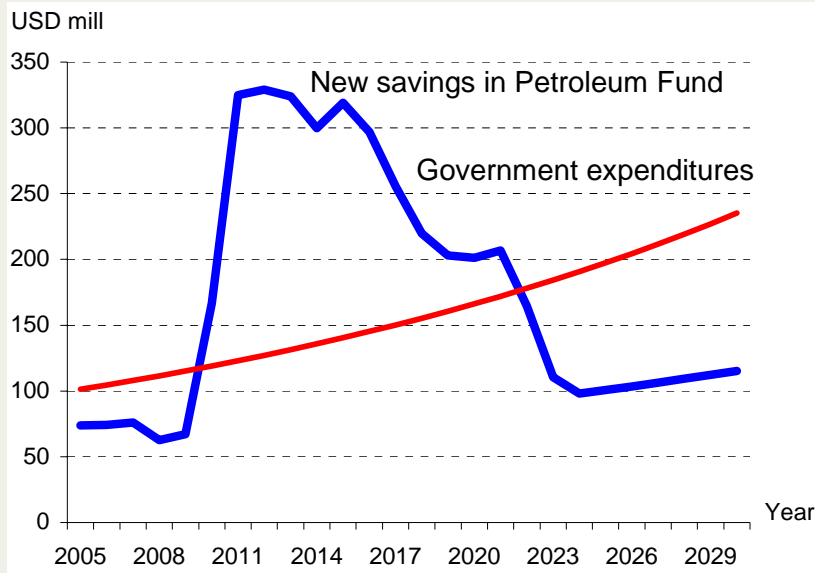
- This means **spending the "estimated sustainable income"** of petroleum wealth. Equal amount can be withdrawn forever
- This means room for a significant increase in spending, but must be gradual and not wasted
- Spending was \$75m last year, while sustainable spending is \$100m (domestic revenue \$30m, estimated sustainable income from petroleum \$70m, but expect revisions)



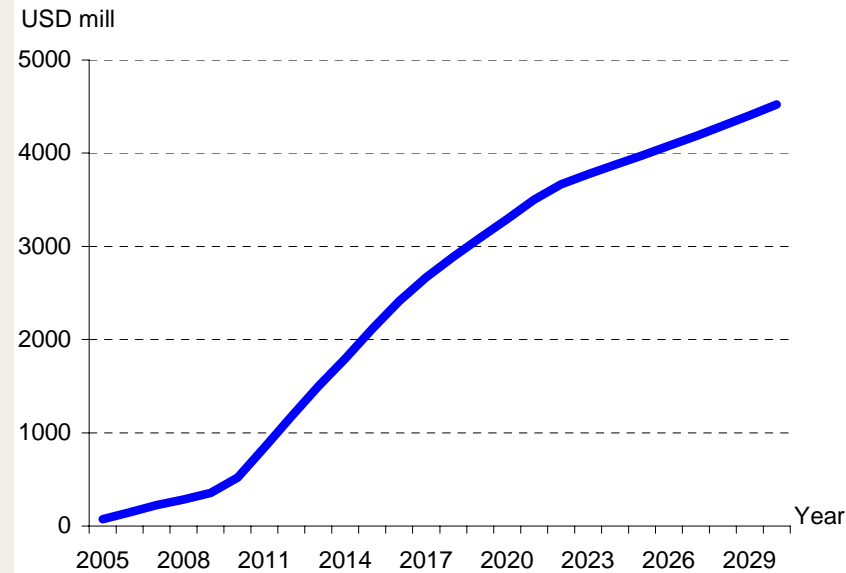
Note: These charts are intended only as a general illustration

Current estimates from savings policy (in nominal terms)

Government spending and financial savings



Accumulated savings in the Petroleum Fund



The management of the PF (Articles 8, 9)

- The Government has overall responsibility
 - Minister of Planning and Finance will be advised by an Investment Advisory Board
- Operational management is delegated to the Central Bank
 - investment management will from start be outsourced (to the US central bank)
- Secure investments in low risk financial assets abroad.
 - USD denominated debt instruments with low credit risk
 - minimum credit rating Aa3 by Moody's or AA- by S&P
- The investment strategy is to be reviewed within 5 years
 - larger Fund and improved institutional capacity may suggest a different asset allocation (for example include equities/shares)

Credit Rating – an illustration

RATING SCALE	DEFAULT PROB P.A.	DEFINITIONS
Aaa/AAA	0.01%	INVESTMENT GRADE Best quality Strong ability for timely payments Somewhat more exposed for negative changes Adequate ability to meet payments. Some elements of protection.
Aa1/AA+	0.02%	
Aa2/AA	0.02%	
Aa3/AA-	0.03%	
A1/A+	0.05%	
A2/A	0.06%	
A3/A-	0.08%	
Baa1/BBB+	0.14%	
Baa2/BBB	0.18%	
Baa3/BBB-	0.23%	
Ba1/BB+	0.80%	SPECULATIVE GRADE/ HIGH YIELD Speculative risk. Future not well secured. Timely payments at the moment, but very exposed to any negative changes Default a likely option Default has taken place
Ba2/BB	1.06%	
Ba3/BB-	1.33%	
B1/B+	3.71%	
B2/B	4.94%	
B3/B-	6.18%	
Caa3/CCC+		
Caa2/CCC	19.14%	
Caa3/CCC- ...		
D, SD		

The Investment Advisory Board (Articles 10, 14)

- Expert body to advise the Minister. Shall offer advice on everything related to the management of the PF before Minister makes decision
- Members: Director of Treasury, Head of Central Bank, two experts in investment management, one other person
- Advice will be made public

Independent, external auditor (Art 1, 7, 14, 20, 23)

- Internationally recognized accounting firm will perform duties as independent, external auditor
- Auditor will undertake regular audit work to bolster confidence that money going to, from or remaining in PF is not misappropriated
- Auditor will also:
 - Certify calculations of estimated sustainable income
 - Prepare report on payments made as PF receipts

Consultative Council (Articles 15, 16, 17)

- Independent Consultative Council to
 - advise Parliament on the operations of the PF
 - act as a “watchdog” and contribute to informed public debate and sound management of petroleum wealth (shall consult widely, arrange consultation meetings)
- Members: Appointed by President, Parliament, Government and civil society. Also seats for former Presidents, Speakers of Parliament, Prime Ministers, Ministers of finance and Heads of the Central Bank (subject to minimum term in office)
- Reports will be made public

Transparency (Articles 7, 10, 14, 17, 18, 20)

- A fundamental principle of accountability, transparency and availability of accessible information
- A high degree of transparency of operations. Comprehensive and accessible reporting by Parliament, Minister, Central Bank, Investment Advisory Board, External auditor, Consultative Council
 - on management of the PF
 - on whether spending of petroleum revenues is consistent with long-term considerations
 - on whether there is a discrepancy between PF receipts and payments made by companies as PF receipts (a core element of the *Extractive Industries Transparency Initiative*)

Summary of Petroleum Fund Act

- **Purpose:** An instrument to manage the petroleum wealth wisely, to help build an understanding for the need to save a substantial share of the petroleum revenues
- **The Fund's income:** All petroleum revenues + investment returns
- **The Fund's expenditures:** Transfer to State Budget the amount necessary to finance the deficit (excluding petroleum revenues). This means Fund fully integrated in gov't budget
- **Management of the Fund:** The Fund is to be invested securely in low risk financial assets abroad. Gov't has overall responsibility, MoPF advised by Investment Advisory Board, while operational management delegated to the Central Bank
- **Transparency:** There will be a high degree of transparency of operations, including comprehensive and accessible reporting. An independent *Consultative Council* advising Parliament and acting as a watchdog

Appendix: How to calculate the estimated sustainable income of the petroleum wealth

- *Estimated sustainable income (ESI) is the maximum amount that can be taken from the Petroleum Fund (PF) each year forever*
- *ESI depends on the size of the **petroleum wealth (PW)** and the **real interest rate (r)** we earn on the investments*

$$ESI = r * PW$$

- *PW is the sum of the **Petroleum Fund (PF)** and the **present value of future Petroleum Fund receipts (PV)***

To calculate the present value of future PF receipts, we use a discount rate (interest rate, i) to convert future receipts to today's value. This is because 100 in revenues in 10 years is worth less to us than 100 today

$$PV = \sum_{t=1}^n \frac{R_t}{(1+i)^t}$$

- *(Remember: ESI will change when oil prices change)*

Example of calculation of estimated sustainable income of petroleum wealth

- ***ESI = 3% * PW = 3% * (PF+PV)***
= 3% * \$2 343m = \$ 70m
- *PF = \$14m (balance of 'Petroleum Fund' 1 July 2004)*
- *PV = \$2 329m (present value future PF receipts)*

$$PV = \sum_{t=1}^n \frac{R_t}{(1+i)^t}$$

$$PV = \frac{129}{(1+0.055)^1} + \frac{142}{(1+0.055)^2} + \frac{142}{(1+0.055)^3} + \dots + \frac{16}{(1+0.055)^{19}}$$

$$PV = 123 + 128 + 121 + \dots + 6 = 2\,329$$

Note: The numbers are taken from the Discussion Paper released in Oct-04