

Petroleum Fund of Timor-Leste — Operational Management Agreement

This Agreement is made on [date] between the Minister for Planning and Finance (“Minister”) representing the government and the Banking & Payments Authority (“Central Bank”), hereinto referred to as the “Parties”, pursuant to Articles 11.3 and 12.4 of Law No. []/2005 on the Petroleum Fund (“Law”).

Whereas the Minister will exercise the key functions and competencies of the Government, which has been assigned overall responsibility for the management of the Petroleum Fund (“Fund”) and the Banking and Payments Authority has been assigned the responsibility of the operational management of the Fund;

Whereas the requirement established by law that the Minister shall enter into an agreement with the Central Bank for the operational management of the Fund;

It is therefore agreed between the parties

1. The Central Bank shall undertake the operational management of the Fund and shall be accountable for its operational management of the Fund to the Minister.
2. The Government shall be responsible for the overall management of the Fund, which shall include the following functions to be exercised by the Minister:
 - a. To establish the overall policies and guidelines for the investment of the capital of the Fund, and to issue such instructions to the Central Bank as may be required to allow the Central Bank to implement the operational management of the Fund;
 - b. No less than fifteen (15) days prior to the commencement of each calendar quarter, to provide a forecast of the monthly cash requirements of government for that quarter, including the projected timings and amounts to be transferred from the Fund;
 - c. To provide the regulatory framework for the management of the Fund, and to consult with the Central Bank concerning proposed changes to this framework;
 - d. To provide documentation as necessary to clarify the tax position of capital from the Fund that has been invested abroad;
 - e. To ensure that requests by the Central Bank for guidance on ad hoc policy decisions to enable it to

implement the operational management of the Fund are responded to clearly and in a timely manner;

f. To consult with the Central Bank concerning information to be released to the public;

g. To appoint the independent auditors of the Fund and to arrange for their remuneration from the State budget.

3. The Central Bank shall be responsible for the operational management of the Fund, which shall include the following functions:

a. The investment of the capital of the Fund in financial instruments as set out in this Agreement, including exercising all the rights and complying with all obligations associated with the ownership of the Fund's assets;

b. Receiving and accounting for the investment income and other revenues of the Fund;

c. Without prejudice to the responsibilities of the proper authorities for administering tax and royalty payments, maintaining a register of all payments made as Petroleum Fund receipts;

d. Maintaining the books of account for the Fund on behalf of the Director of Treasury;

e. Appointing and dismissing banking correspondents, dealers, brokers, custodians and other financial intermediaries necessary for the proper management of the Fund;

f. Acquiring and maintaining the information necessary to construct benchmark indices and construct notional portfolios for policy development and reporting purposes;

g. Evaluating the performance of external fund managers;

h. Supplying information to the Minister and the Director of Treasury necessary for the drafting of reports and statements relevant to the management of the Fund, including all reports relating to the management of the Fund required by law, with all such information being available to the recipients at least ten working days prior to any legislated publication date unless otherwise agreed between the parties;

i. Meeting all the operational expenses relating to the management of the Fund, which shall be compensated for from the annual management fee;

- j. Implementing systems, procedures, risk management practices, and development of human resources to minimise the risk of operational loss to the Fund;
 - k. Advising the Minister of all significant events affecting the value of the Fund and other matters considered to be urgent or of importance relating to the management of the Fund;
 - l. Providing the members of the public with such information concerning the Fund as may be determined by the Minister;
 - m. Assisting the Minister in the preparation of the Annual Report of the Fund;
4. The Central Bank shall maintain the Secretariat of the Investment Advisory Board (“the Board”), which shall include the following functions:
- a. Preparation of notices of meeting to the members of the Board;
 - b. Preparation, in consultation with the Minister, of reports, financial accounts, recommendations, background papers and other information to be submitted to meetings of the members of the Board;
 - c. Preparation, in consultation with the Minister, of technical advice and recommendations to the Board, including special reports on the operations of the Fund as may be requested by the Board;
 - d. Arrangement of facilities to hold the meetings of the Board;
 - e. Preparation and distribution of minutes of meetings of the Board;
 - f. Administering the meeting expenses of the Board, including remuneration of the members, the cost of which unless otherwise agreed shall be met from the State budget.
5. The Minister and the Central Bank shall jointly undertake the following functions with respect to the Consultative Council (“the Council”):
- a. Preparation of such technical advice and reports as may be requested by the Council in the course performing its duties;
 - b. Preparation of such commentaries on the operations and performance of the Fund as may be requested from

time to time by the Council.

6. The Central Bank shall implement the operational management of the Fund through the adoption of the following principles:
 - a. The assets of the Fund shall be maintained in the name of the Central Bank, but shall at all times be segregated from the assets of the Central Bank in such a manner as shall allow the beneficial ownership of the assets and the income associated with those assets to be clearly determined at any time;
 - b. The books and records of the Fund shall be maintained separately from the books and records of the Central Bank to the maximum extent practicable;
 - c. The Central Bank shall make the books and records relating to the operational management of the Fund available at any time on request to the Minister, staff authorised by the Minister, and the auditors of the Fund.
 - d. The Central Bank shall ensure that all staff associated with the management of the Fund shall be bound by a code of ethics and rules to avoid conflicts of interest.
7. The Central Bank shall be permitted to invest only in the qualifying instruments described in Article 15.1 of the Law.
8. The Minister shall determine the mandate set out in Annex 1 to this Agreement, and the Central Bank accepts the mandate and shall undertake it to the best of its ability.
9. The performance of the Fund shall be measured periodically against the benchmark set out in Annex 1, and will be the subject of periodic reports.
10. The Minister shall give the Central Bank at least four week's notice before implementing any change to the mandate or benchmark as set out in Annex 1, and the Central Bank shall advise the Minister as to the anticipated length of time it will take to effect the new requirements.
11. The remuneration of the Central Bank shall be subject to Annex 2 to this Agreement, and shall be payable in monthly instalments from the assets of the Fund.
12. The earmarked receipts account of the Fund required by Article 5.2 of the Law shall be account number 021080973 held by the Central Bank at the Federal Reserve Bank of New York, with further details as set out

in Annex 3 to this Agreement.

13. The single state budget account referred to in Article 7.1 of the Law shall be account 2-3711 held by the Ministry of Planning and Finance at the Central Bank.
14. The Central Bank shall undertake the appointment of external portfolio managers, under the following conditions:
 - e. The Central Bank shall undertake the procurement process in a fair and transparent manner according to its internal procedures;
 - f. The Central Bank shall make a written recommendation of the appointment to the Board, including but not limited to information about the services to be provided, the proposed level of fees, the proposed benchmark, the levels of insurance cover maintained against negligent losses, and such information concerning the procurement process as is necessary to inform the Board that the process was undertaken in accordance with the law;
 - g. The Minister shall issue a written decision to the Central Bank concerning the recommendation to appoint the proposed portfolio manager;
 - h. The Central Bank shall enter into a contract with the portfolio manager in its own name.
15. Should the Central Bank wish to terminate the contract of an external portfolio manager, the Central Bank shall consult with the Minister as follows:
 - a. The Central Bank shall provide a written recommendation to the Minister concerning the termination of the portfolio manager's contract, and send a copy to the President of the Board;
 - b. The Minister may, within five working days of receiving the recommendation, seek the advice of the Board concerning the proposed termination of the portfolio management contract;
 - c. The Minister shall confirm in writing the decision within 30 working days of receiving the Central Bank's recommendation, failing which the Central Bank's recommendation shall be deemed to be approved.
16. The Central Bank shall not be liable for losses arising from the operations of the Fund unless such losses arise from the negligence of the Central Bank or its employees.

17. The Minister shall provide with at least five working days' notice written payment instructions to transfer amounts from the Fund to the government's account referred in Article 13, that shall include the following information:

- a. The amount or amounts to be transferred;
- b. The date or dates on which the transfer(s) are to take place;
- c. The parliamentary appropriation under which the transfer is authorised;
- d. A statement that the provisions of Articles 8 to 10 of the Law have been complied with, including such supporting documentary evidence as may be relevant;
- e. The signature of the Minister;
- f. The signature of the Director of Treasury.

18. All formal communications between the Minister and the Central Bank required under this agreement shall be in writing, and the communications shall be delivered as follows:

- a. To the Minister: Minister for Planning and Finance,
Building 5
Palácio do Governo,
Dili
- b. To the Central Bank: The General Manager
Banking & Payments Authority of Timor-Leste
Avenida Bispo Medeiros
Dili

Either party may at its discretion provide copies of formal communications to the Board.

19. This agreement may be amended by the parties at any time, provided that such amendments shall not be effective except in writing and signed by both parties. The Minister shall at the Central Bank's request delay the publication of amendments to this agreement concerning changes in portfolio allocations, benchmarks or other aspects that may affect the value of the Fund until the Central Bank has substantially completed the

related market operations.

20. The Minister may propose changes to this Agreement on the basis of advice received from the Board after this body is established.

This agreement shall enter into force on 2005

Signed on ## 2005.

The Minister for Planning and Finance,

Maria Madalena Brites Boavida

The General Manager, Banking & Payments Authority,

Abraão Fernandes de Vasconcelos

Annex 1: Qualifying Instruments and Benchmarks

1. QUALIFYING INSTRUMENTS

The assets of the Fund shall be invested in the classes of instruments as described below. The indices indicated with each asset class shall be used to measure the performance of the Fund.

Debt instruments issued by the United States and other qualifying sovereign governments:

Index: Merrill Lynch 0-5 year government bond index

Short-term liquidity instruments maintained by the Fund limited to budgeted monthly appropriations from the Fund to the state budget account described in Article 13 based on cash projections supplied to the Central Bank by the Minister shall be excluded from the Fund for the purpose of benchmark comparison, but the Central Bank shall otherwise be accountable for the return on these instruments.

2. MANDATE

1. The nature of the mandate established by the Minister shall be to passively manage the Fund close to the benchmark, so that in normal circumstances the objective shall be to achieve a return within 25 basis points¹ of the benchmark.
2. The difference in the modified duration² between the portfolio and the benchmark shall be less than 0.2 year.

To enable the orderly acquisition of suitable investments, the parameters in this Annex 1 shall apply only from thirty (30) days after the date of entering into force of this Management Agreement.

¹ 100 basis points is the same as 1 percentage point.

² By “modified duration” is meant a measure of the percentage decline (increase) in the market value of the Petroleum Fund due to a 100 basis point increase (decline) in the level of interest rates.

Annex 2: Remuneration of the Central Bank

1. The remuneration of the Central Bank shall be calculated on the basis of the costs incurred with the management of the Fund.
2. The upper limit for the remuneration thus calculated, for the 2005/06 fiscal year, shall be two hundred and seventy thousand United States dollars (USD \$270,000).
3. The remuneration may be drawn in monthly instalments from the assets of the Fund.
4. In addition to recovering costs limited to the value of remuneration set forth in paragraph 2 of this Annex, the Central Bank shall receive remuneration for the portion of the fee to external investment managers that is due to excess returns received.

Annex 3: Settlement Instructions for Earmarked Receipts Account

The following instruction is applicable for transfers in United States dollars to the Petroleum Fund of Timor-Leste:

Bank: The Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045

SWIFT Code: FRNYUS33

Account Name: Banking and Payments Authority of East Timor - Petroleum Fund Account

Account Number/ABA: 021080973

Details:

1. Name of taxpayer
2. Taxpayer Identification Number
3. Details/reference of payment