



## IV CONSTITUTIONAL GOVERNMENT

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**Legislation Proposal no.**

of .....

### **First Alteration to Petroleum Fund Law no. 9/2005 of 20 June**

The Petroleum Fund was established in 2005 to contribute to the efficient and effective management of the petroleum resources and to sound fiscal policy. Law no. 9/2005 of 20 June regulates the operational management and the investment policy of the Petroleum Fund, including the collection and management of petroleum receipts, transfers into the State Budget and provisions concerning the Government's accountability and supervision responsibility.

The Petroleum Fund Law states that the range of financial instruments shall be reviewed by the Government and approved by Parliament after the first five years of the Petroleum Fund's existence, taking into consideration the size of the Petroleum Fund and the level of institutional capacity.

The present Law seeks to change the provisions concerning investment rules and principles, providing greater flexibility in terms of diversifying the portfolio and enhancing the future return of investments, with clearly defined risk limits. Additionally, the present diploma clarifies what requirements must be met by Government should it be necessary to make a withdrawal that exceeds the Estimated Sustainable Income, provides flexibility regarding the entity responsible for Operational Management in the future and changes the rules for the appointment of members and the composition of the Investment Advisory Board.

One of the key documents consulted in the course of reviewing the present Law was the International Working Group's "Sovereign Wealth Funds: Generally Accepted Principles and Practices", otherwise known as the Santiago Principles. The Santiago Principles is an international cooperative effort to identify best practices for Sovereign Wealth Funds particularly in the area of governance and policy. The Government reviewed the Petroleum Fund Law based on these principles to ensure that Timor-Leste continues to be an example of the best international practice in terms of Fund management.

## Article 1

### Alteration to Law no. 9/2005 of 20 June

Articles 2, 9, 11, 12, 14, 15, 17 and 24 of Law no. 9/2005 of 20 June will now read as follows:

## “Article 2

### Definitions

1. In this Act, unless the context requires otherwise:
  - a) “Exchange of Notes” means
    - i. Exchange of Notes Constituting an Agreement between the Government of Australia and the United Nations Transitional Administration in East Timor, of 10 February 2000; or
    - ii. Exchange of Notes Constituting an Agreement between the Government of Timor-Leste and the Government of Australia, of 20 May 2002.
  - b) **“Financial Year” means the twelve (12) month period from 1<sup>st</sup> January to 31<sup>st</sup> December**
  - c) “Independent Auditor” means an internationally recognised accounting firm appointed for the purpose of auditing the Government accounts as set out in the Timor-Leste law until the hierarchy of the administrative, tax and audit courts is established, or thereafter an internationally recognised accounting firm appointed pursuant to Article 34.
  - d) “Petroleum Authorisation” means:
    - i. An access authorisation, a petroleum contract, a prospecting authorisation or a seepage use authorisation, or any agreement made in respect of such an authorisation or contract, granted or entered into under the Petroleum Act; or
    - ii. An authorisation or production sharing contract, or any agreement made in respect of such an authorisation or contract, granted or entered into under the Code;
  - e) “Central Bank” means the authority to be established under Section 143 of the Constitution of the Republic or, until such authority is established, the Banking and Payments Authority;

- f) “Code” means the Petroleum Mining Code and the Interim Petroleum Mining Code agreed and adopted by Timor-Leste and Australia under Article 7 of the Treaty, as amended, varied, modified or replaced from time to time, and regulations made and directions given under it;
- g) “Petroleum Fund” means the Petroleum Fund for Timor-Leste established under Article 5.
- h) **“Investment Manager” means the Operational Manager or any other person designated as external financial manager under Article 12;**
- i) **“Operational Manager” means the Central Bank or any other public entity established by the National Parliament to manage and operate the Petroleum Fund;**
- j) “Petroleum Act” means the 2005 Petroleum Act, as amended, varied, modified or replaced from time to time, and regulations made and directions given under it;
- k) “Minister” means the Minister in charge of finances;
- l) “Petroleum Operations” means authorised activities under a Petroleum Authorisation;
- m) “State Budget” means the State Budget referred to under Section 145 of the Constitution of the Republic;
- n) “Payer” means any entity on whom there is an obligation to make a payment into the Petroleum Fund;
- o) “Parliament” means the National Parliament of Timor-Leste;
- p) “Petroleum” has the same meaning given to it in the Petroleum Act;
- q) **“Investment Policy” means a public statement on the risk profile and the allocation of the Fund’s assets, investment criteria and universe, principles associated with investment, investment options and other issues related with the general investment policy;**
- r) “Petroleum Fund Receipts” has the meaning given to it in Article 6;
- s) “Tax Revenue” means any tax, fee or duty imposed under Timor-Leste law;
- t) “Estimated Sustainable Income” for a Financial Year means the amount determined in accordance with the formula set out in Schedule I;
- u) “Timor-Leste” means the Democratic Republic of Timor-Leste; and

- v) "Treaty" means the Timor Sea Treaty between the Government of Timor-Leste and the Government of Australia signed on 20th May 2002, as amended, varied, modified or replaced from time to time.
2. **All other terms in the present Act that are defined in the Timor-Leste law on budget and financial management have the same meaning given to it in that law.**

## Article 9

### **Transfers Exceeding the Estimated Sustainable Income**

No transfer exceeding the Estimated Sustainable Income shall be made from the Petroleum Fund in a Financial Year unless the Government has first provided Parliament with:

- (a) The reports indicated in paragraphs (a) and (b) above;
- (b) A report estimating the amount by which the Estimated Sustainable Income for the following Financial Years will be reduced as a result of transferring from the Petroleum Fund an amount exceeding the Estimated Sustainable Income of the Financial Year in which the transfer is made;
- (c) A report from the Independent Auditor certifying the estimated reductions in the Estimated Sustainable Income indicated in Article 9 (a) and (b);
- (d) Justification as to the reasons why it is in the long term interest of Timor-Leste to transfer an amount exceeding the Estimated Sustainable Income.**

## Article 11

### **Management of the Petroleum Fund**

1. The Government is responsible for the overall management of the Petroleum Fund.
2. **The Minister shall not make any decisions in relation to the investment policy or management of the Petroleum Fund without first seeking the advice of the Investment Advisory Board in accordance with Article 16.**
3. **The Minister shall enter into an agreement with the Operational Manager, which shall be accountable to the Government, for the operational management of the Petroleum Fund.**
4. The Petroleum Fund shall be managed prudently in accordance with the principle of good governance for the benefit of current and future generations.

## Article 12

### External Investment Managers

1. The **Operational Manager** may propose to the Minister, either of its own motion or at the request of the Minister, the appointment of one or more external Investment Managers to be responsible for managing the investment of amounts in the Petroleum Fund.
2. **The Operational Manager may select and appoint one or more external investment managers under Article 12.1 only if the Minister is satisfied that:**
  - (a) The external Investment Manager is a legal person with sufficient equity capital and adequate guarantees and insurances against operational risks;
  - (b) The external Investment Manager has a sound record of operational and financial performance; and
  - (c) The references and reputation of the external Investment Manager in the field of fund management are of the highest standard.
3. The **Operational Manager** shall be responsible for the tendering procedures required for any appointment made pursuant to Article 12.1, as well as for the contracting of any other professional services under the operational management agreement referred to in Article 11.3, and shall in doing so comply with the substantive provisions of Timor-Leste law.
4. The procedures for terminating a contract with an external Investment Manager shall be laid down in the operational management agreement referred to in Article 11.3.
5. The duty of the Investment Manager is to maximise the return on the Petroleum Fund investments having regard to appropriate risk as indicated by the investments permitted under Articles 14 and 15, any subsidiary legislation under this Act, any instructions by the Minister and the operational management agreement referred to in Article 11.3.

## Article 14

### Investment Policy

1. **The Minister shall establish the investment policy for the Petroleum Fund that shall apply the principles of diversification with the objective of maximising the risk-adjusted financial returns of the Petroleum Fund after taking into account the purposes for which the Fund is established, the constraints under which it operates, and Timor-Leste's ability to bear risk.**

2. The investment policy must provide sufficient liquidity in the portfolio to ensure that funding is available whenever required for transfers to the State Budget or for rebalancing investments within the policy exposure.
3. The Minister and the Operational Manager shall develop and maintain policies, systems and procedures to ensure that the risks associated with the implementation of the investment strategy are identified, monitored and managed.
4. The management of the Petroleum Fund shall be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which investments are made.
5. The Minister shall present a summary of the proposed investment policy of the Petroleum Fund to the parliament in the Annual Report of the Petroleum Fund each year and prior to decisions on major asset allocation changes. The Annual Report shall also include a statement setting out how the provisions of Articles 14 and 15 have been applied during the year.

#### Article 15

##### Investment Rules

1. In order to qualify as an eligible investment under this Article an investment must be issued or situated abroad in an internationally recognised jurisdiction.
2. Not less than 50 per cent of the amounts in the Petroleum Fund shall be invested in eligible investments in the form of deposits or debt instruments that bear interest or a fixed amount equivalent to interest, provided that:
  - (a) The debt instruments are determined to be of investment grade, or
  - (b) The deposits are held with financial institutions with a rating corresponding to investment grade.
3. Not more than 50 per cent of the amounts in the Petroleum Fund shall be invested in eligible investments in the form of listed equities, provided that:
  - (a) The equities are traded in a regulated financial market, and
  - (b) No holding shall exceed five per cent of the issued capital of the issuing company.
4. No more than 5% per cent of the amounts in the Petroleum Fund may be invested in other eligible investments provided that:

- (a) The Minister has included the asset class to which the eligible investments belong in the proposed asset allocation presented to Parliament in accordance with Article 14.5, and
  - (b) The policies and criteria for selecting, managing and valuing individual financial instruments within the asset class have been approved by the Minister and published.
5. The exposure of the Petroleum Fund:
  - (a) To any one company or issuer, except for a sovereign state, in the form of eligible investments, shall not exceed three per cent of the total value of the Petroleum Fund;
  - (b) To any one asset class shall, on a net basis, be positive.
6. Notwithstanding the provisions of subarticles 20.1 and 20.2, charges arising in the course of market transaction management or participation in security lending programs that are of a short-term nature and consistent with prudent asset management principles shall not be regarded as encumbrances in the course of investing amounts in the Petroleum Fund by the Investment Manager.
7. Subject to article 20.1 and article 20.2, costs related with the management of the stock market or participation in safe short term loan programs, done in accordance with the principles of prudent asset management, shall not be considered as charges or burdens within the scope of the Investment of the Petroleum Fund amounts by the Investment Manager.
8. A derivative instrument shall qualify as an eligible investment only if:
  - (a) It is used for the purpose of reducing the risk to the Fund from the underlying instrument or instruments or to facilitate the efficient implementation of asset exposure; and
  - (b) The risk from the derivative instrument is not larger than that which could be had by direct exposure to the underlying assets in accordance with this law; and
  - (c) The Minister has established conditions with respect to the operational use of the derivative instrument.
9. The Minister shall determine the period within which Investment Managers shall dispose of instruments if they cease to be eligible investments because of a change in the rating of the financial instruments or the issuer of the instruments.

## Article 17

### Organization of the Investment Advisory Board

1. **There shall be 5 or more members of the Investment Advisory Board to be appointed by the Prime Minister, on the advice of the Minister, at least 3 of who shall possess significant experience in investment management. The Director of Treasury and a representative of the Operational Manager shall be entitled to participate in meetings of the Investment Advisory Board, without the right to vote.**
2. **The Operational Manager shall provide the secretariat for the Investment Advisory Board and any support required by the board to carry out its functions.**
3. The Minister shall provide, in accordance with Timor-Leste law:
  - (a) A person to sit on the secretariat of the Investment Advisory Board; and
  - (b) Appropriate remuneration for the members of the Investment Advisory Board appointed under paragraph 17.1.
4. **The members of the Investment Advisory Board shall on the occasion of their appointment and as appropriate when providing advice to the Minister signify in writing an affirmation that their appointment or advice does not present a conflict with any of their other interests. The Minister may request members of the Board, as necessary, to submit a declaration concerning their assets to avoid any conflict of interest.**

## Article 24

### Information contained in the annual report

1. The Annual Report for the Petroleum Fund shall be prepared in a manner that makes it readily adaptable for public information, and shall contain in particular the following information for the Financial Year for which the Report is prepared:
  - (a) Audited financial statements certified by the Independent Auditor, comprising:
    - i. An income and expenditure statement;
    - ii. A balance sheet, including a note listing the qualifying instruments of the Petroleum Fund, valued at market value;
    - iii. Details of all appropriations and transfers from the Petroleum Fund; and
    - iv. Notes to the financial statements, as appropriate;



- (b) A report signed by the Minister describing the activities of the Petroleum Fund in the year, including all advice provided by the Investment Advisory Board, any reports prepared by the Independent Auditor under Article 35 and drawing attention to particular issues or matters that may be of concern or interest to Parliament;
  - (c) **A report on the investment policy under Article 14.6;**
  - (d) A statement by the Director of Treasury drawing attention to any accounting issues or practices arising from the Report that may materially affect the interpretation of amounts or activities shown within it;
  - (e) The income derived from the investment of Petroleum Fund assets during the Financial Year compared with the income of the previous three Financial Years;
  - (f) A comparison of the nominal income on the investment of Petroleum Fund assets with the real return after adjusting for inflation;
  - (g) A comparison of the income derived from the investment of Petroleum Fund assets with the benchmark performance indices provided to the Minister pursuant to Article 16.1;
  - (h) A comparison of the Estimated Sustainable Income for the Financial year with the sum of transfers from the Petroleum Fund for the year;
  - (i) In the event of Government borrowings, the liabilities shall be reflected in the presentation of the Petroleum Fund accounts so as to provide a true demonstration of the expected future development of the Government's net financial assets and rate of savings; and
  - (j) A list of persons holding positions relevant for the operation and performance of the Petroleum Fund, including:
    - i. The Minister;
    - ii. The Director of Treasury;
    - iii. The members of the Investment Advisory Board;
    - iv. The external Investment Managers;
    - v. The Head of the **Operational Manager**; and
    - vi. The members of the Petroleum Fund Consultative Council.
2. The sources of the information described in Article 24.1, whatever their form, and including all reports and statements, shall be annexed to the Annual Report in unedited form.”

**Article 2**

**Financial year and Operational Manager**

1. The designation of financial year is adopted to refer to the budget period, replacing the designation of fiscal year.
2. The reference to Central Bank in articles 5, 6, 7, 11, 12, 13, 14, 16, 17, 24, 26, 31 and 32 is replaced with Operational Manager.

**Article 3**

**Republication**

Petroleum Fund Law no. 9/2005 of 20 June, altered by the present diploma, is republished as an attachment and is considered to be integrant part of the present act.

**Article 4**

**Entry into force**

The present diploma enters into force on the day after its publication.

Approved by the Council of Ministers on ..... 2010.

**The Prime Minister**

**Kay Rala Xanana Gusmão**

## SCHEDULE I

### CALCULATING ESTIMATED SUSTAINABLE INCOME FOR A FINANCIAL YEAR

I. Estimated Sustainable Income for a Financial year is the maximum amount that can be appropriated from the Petroleum Fund in that financial year and leave sufficient resources in the Petroleum Fund for an amount of the equal real value to be appropriated in all later financial years as determined in accordance with the formula in paragraphs II and III below.

II. Estimated Sustainable Income for a financial year is calculated according to the following formula:

$$r \times \text{petroleum wealth}$$

where:

**r** is the estimated real rate of return on Petroleum Fund investments in the future and, for the purposes of these calculations, shall be 3.0%.

III. In this Schedule, "Petroleum wealth" is calculated according to the following formula:

$$V + \text{present value } (R_0, R_1, \dots, R_n) = V + \sum_{t=0}^n \frac{R_t}{(1+i)^{t+0.5}}$$

Where:

**V** is the estimated value of the Petroleum Fund at the end of the prior financial year

**R0 R1, etc.** are the published budget projections for expected annual Petroleum Fund receipts minus investment returns for that financial year (R0) and future Financial years (R1, etc.)

**i** is the long term estimated nominal yield for the current investment portfolio, according to the terms of the mandate.

**n** is the number of years until no further Petroleum Fund receipts are projected to be received.

**Petroleum Wealth** is to be calculated from the start of the financial year, assuming that receipts are received in the middle of the year.

IV. All assumptions upon which the calculations made pursuant to paragraphs II and III above are based shall be clearly identified and explained, and any changes made in these assumptions in subsequent calculations shall be clearly pointed out.

- V. All assumptions made shall be prudent, reflect international best practice and be based upon internationally recognized standards.
- VI. The amount determined in accordance with the formula in paragraphs II and III above shall be certified by the Independent Auditor.

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