

Timor-Leste

Comments on Draft Petroleum Fund Law

World Bank, February 2005

The following provides comments from the World Bank Group (the “Bank”) on Timor-Leste’s draft Petroleum Fund Act, February 2005.

Timor-Leste is well endowed with oil and gas reserves which are currently projected to be exhausted within about one or two generations. The World Bank welcomes the draft Petroleum Fund Act and the commitment it represents to rigorous and transparent management of petroleum revenues. The Government is taking a model approach which includes a strong commitment to transparency. In addition to the accounts published by the Treasury, information will be available from the reports to Parliament of the BPA, the East Timor Revenue Service, the Independent Auditor, and the annual reports of the Designated Authority and the Petroleum Fund.

The draft contains very many positive features, incorporating, or indeed introducing international best practice. These include:

- Comprehensive coverage of petroleum revenues
- Transfer of all revenues to the Petroleum Fund
- Prohibition of borrowing against the Fund
- Professional management
- Clear oversight and review
- Professional, independent audit
- Serious commitment to transparency

At the same time, the consultation process established by the GTL provides an opportunity to suggest areas for clarification, improvement or more careful consideration. These include:

- References to the public release of reports and audits
- References to confidentiality
- Remedies available in the case of poor performance in fund management, or in the case of irregularities revealed by the audit process
- References to the appointment of auditors
- Determination of petroleum wealth

In finalizing the legislation and implementation arrangements, it may be useful to take into account the following points:

Article 2. Definitions

It may be useful to consider defining the word “timely,” which occurs in a number of critical Articles. As an alternative, actual deadlines might be established in the Articles concerned.

Article 4. Inconsistencies

One issue that may come up under this heading is the confidentiality of payments made under petroleum contracts. See comments below on clarifying confidentiality provisions.

Article 6. Petroleum Fund Receipts

Article 6.1(d)

This Article seems to refer mainly to income attributable to a national oil company’s possible direct equity participation in operations. However, though the Bank does not recommend the establishment of a national oil company, it is possible to imagine a situation in which such a company were established. In this case the requirement that *all* its revenue (i.e., not simply its fiscal obligations and a reasonable dividend) be transferred to the Fund could seriously inhibit its ability to operate in a commercial manner, e.g., in meeting the cash call demands of its joint venture on a timely basis.

Article 6.2

This does not mention the transfer of investment earnings on First Tranche Petroleum revenue, though these would also be transferred to the Fund.

Article 7. Transfers

This Article is well-drafted, creating an appropriate tension between Parliamentary discretion (Article 7.2) and savings guidelines (Articles 7.3 and 7.4).

It would be desirable, in this Article or elsewhere, to give explicit consideration to: (a) the determination of merited revisions to sustainable income (how? by whom?); and (b) the treatment of windfalls in excess of estimated sustainable income (how to balance the desirability of increasing budget allocations to the sustainable level, on the one hand, and realistic considerations of the Government’s capacity to implement any additional allocations on the other hand).

Article 7.3(c)

The auditor is required to “certify” estimated sustainable income, but while an auditor may be willing to verify calculations, he or she will not normally have the skills or expertise to challenge

the assumptions and methodologies behind the calculation. This is a specialist field of activity best assigned to consultant with appropriate actuarial skills, and an equally important understanding of petroleum sector operations and petroleum markets.

Article 7.4

While this Article states that transfers from the Fund to the budget shall not exceed the estimated sustainable income in a given fiscal year without justification by Government to Parliament, it does offer the possibility of higher transfers without setting an overall ceiling on the amount over the sustainable budget that may be transferred. In the interest of safeguarding the country's petroleum wealth from the possibility of imprudent fiscal policies in the future, the Government may wish to consider placing a limit on the amount by which exceptional transfers could exceed the estimated sustainable income.

Article 8. Management of the Petroleum Fund

The provisions in this Article are well-drafted, but a few queries/suggestions follow:

Article 8.4

In addition to the appointment of investment managers, the services of a global custodian may also be helpful (particularly where multiple investment managers are employed). The functions of a global custodian would be (in summary) to:

- Integrate management reporting for all funds managers
- Independently assess performance of fund managers
- Prepare, record and account for all Petroleum Fund transactions
- Ensure both fund managers comply with the operating guidelines

The accounting for investments is a specialized function which requires access to current market data in order to calculate accurate valuations on a day to day basis. There is also a need for attribution analysis in order to determine reasons for variance from benchmarks. The Government may therefore wish to consider providing for the possibility of the appointment of a global custodian through the Petroleum Fund Act. Alternatively, it would at least be desirable to harmonize tasks between the Central Bank (Article 8) and the Investment Advisory Board (Article 10).

Article 8.8

The provision of quarterly reports is clearly desirable. The reference to their publication "in such form and manner as may be adapted for public information" is, however ambiguous. The concern to avoid overly obscure and difficult reporting language is understandable. At the same time, it raises the possibility of excessive simplification or removal of key information on the part of the Central Bank. A simple solution would be to make the full reports available for reference at the same time as the more accessible versions are widely disseminated. In addition, some reference should be made to remedies envisaged if the management of the fund(s) is deemed unsatisfactory.

The reference to prevention of “disclosure of confidential information” could also be clarified. It would be important for the Act to prevent an overly restrictive interpretation of commercial confidentiality. An attempt should be made to define, as narrowly as possible, what is meant by “confidential information”, and the responsible authority in this regard should be identified.

Article 9. Investment Rules

Article 9.2

Norway, Alberta and Alaska, admittedly against a more sophisticated institutional background, all widened their coverage of securities. Is it unclear whether such an absolute restriction to fixed interest instruments is necessary. A small percentage allocation, under professional management, could provide important experience with using equity markets.

Article 9.6

This Article calls for a review of qualifying instruments for investment in five years’ time, but there is no mention of how the result of the review will be acted on. It should be clear that any change in the investments would only be permitted through an amendment to the Petroleum Fund Act.

Article 10. Investment Advisory Board

Article 10.1 (a)

How does this Article on the establishment of benchmarks relate to the fixed benchmark of 3% in Schedule 1?

Articles 10.2, 10.3, and 10.4

Article 10.2 refers to advice “in a timely manner” and Article 10.3 to “insufficient time”. Please see comments above under Definitions. Article 10.4 limits the opportunity for abuse of “timely”, but it may still be preferable to set actual time limits in the Act.

Article 10.6 (c)

In addition to expertise in investment management, one or more of the two (or three, see *Article 10.6 (d)*) additional appointees should have a good understanding of the upstream oil sector and of oil sector markets. This will be important if advice is to be given on the merits of estimated sustainable income calculations and implied availability of funds for investment. See comment above on Article 7.3 (c) and below on Schedule I.

Articles 10.7 and 10.8

The source of funding for servicing the Investment Advisory Board is not made clear. Would this be funded from the budget or from investment earnings? The Board should have the capability to contract out specialist work (such as assistance in the five year review referenced in Article 9.6). This may be important to mention specifically in the Act. If the budget for the board is not subject to Parliamentary scrutiny, there is a danger that it will become a vehicle for excess.

Article 10.10

Comments above on “confidential information” again apply.... Who decides, on what basis, etc.?

Article 12. Petroleum Fund Accounts and Records

Article 12.1

In practice it will be essential to ensure that the Director of Treasury has the resources to engage qualified consultant support to perform the accounting function.

Article 13. Audit

This is a key function. How it is to be performed may require some clarification. Article 13 refers to Government bodies. Next, Article 14 (14.2) refers to the “independent auditor” which is defined (“Definitions”) as an internationally recognized accounting firm appointed pursuant to Article 23 and as set out in Timor-Leste law. Independence and transparent procurement are central to the credibility of the audit function and, if intended, should be highlighted to avoid any ambiguity.

Article 14. Annual Report

Article 14.2

See comment under Article 8.8 regarding use of the phrase “readily adaptable for public information”. “Reader-friendly” versions of the Annual Report should not replace a requirement to make the Report itself available in full to the public.

The scope of the financial statements listed here may be too limited for comprehensive reporting of the fund. Rather than stating the components that the financial statements shall comprise, it would be better to require these components *as a minimum* in the financial statements. It would also be important to recognize that the trust fund will not operate on a cash basis (like the rest of Government) but will need to operate on a full accrual basis including valuation of investments. This is the only way that performance can be measured.

Article 14.2 (b) refers to “issues” and “matters of concern”... It would be important to reference the procedures contemplated to address such issues.

Within Article 14.2, Sections (d) and (f), benchmark performance would best be defined not just in function of income, but also capital gains and losses on sale of investments.

The importance of Article 14.2 (h) on borrowing to economic management in general has been noted above. It perhaps deserves to be separately highlighted.

Article 16. Composition of the Consultative Council

Articles 16.1

The membership requirements, at least for Articles 16.1 (a) through (e), are very limiting. Some consideration should be given to increasing flexibility at this level of representation to account for the fact that candidates may not be available or willing to serve.

Articles 16.2 through 16.4

Some debate on tenure for the different classes of Council membership seems merited. Ten years is probably too long.... And 3 years perhaps too short, given the learning required to become effective in the job, particularly for those in the 3 year category.

Article 16.5

It is not clear who will appoint the representatives of civil society, the private sector, and religious organizations as stipulated in Article 16.1, Sections (i) through (k). Article 16.5 indicates that these members of the Petroleum Fund Consultative Council will be appointed according to procedures laid down by Parliament. However, it would be preferable to specify a mechanism through which the representatives of these groups will be chosen by members of those groups themselves.

Article 17. Working Principles of the Consultative Council

Article 17.2

See comment above on the use of “timely”.

Article 17.3

See comments above on references to “adapted for public information” and “confidential information”

Article 18. Transparency as a Fundamental Principle

Given the fundamental importance assigned to transparency, some guidance should be given in the text, as noted earlier, on what will be considered grounds for confidential treatment, and by whom?

In addition to the transparency measures outlined in this Article, it may be desirable to require the publication of all payments by private companies (Publish What You Pay, or PWYP). If the

confidentiality provisions currently in the draft Petroleum Fund Act are maintained, it would be important for the types of confidential information to be precisely defined and kept confidential only for a limited period of time (i.e. three years), after which time the information would be published and made available to the public.

As oil revenue will be executed through the Government's budget, it would be desirable to disseminate both oil fund reports and budget information widely and in a form that will be accessible throughout the country. This could be accomplished through actively disseminating the information by radio and TV, reading out key issues in church meetings, using dissemination mechanisms such as Lafaek, and creating a public budget information center.

The Bank welcomes the inclusion of transparency measures such as the publication of quarterly BPA reports, Annual Reports, and audit information in a manner that is readily adaptable for public information. In addition to summarized versions, however, it will also be important to ensure that financial and audit reports are available in their entirety to allow access to those who would prefer to read the technical documents.

Article 20. Payments made as Petroleum Funds Receipts

Article 20.2

The aggregate, sector-wide approach to the reporting of payments is consistent with the minimum criteria adopted by the Extractive Industries Transparency Initiative (EITI). A more ambitious criterion, represented by Publish What You Pay (PWYP), requires publication of payments by company. See comments under Article 8.8 and Article 18 above.

Article 20.3

Some versions of PWYP call for the companies themselves, rather than the auditor, to publish what they pay.... Many companies resist this on the grounds that their payments are often in kind, and argue that it is up to the government, who disposes of in kind payments, to value them.

The Petroleum Fund administrators would be equally obliged to assist the auditor in clarifying any discrepancy between payments and receipts.

Article 20.5

Again, references to "adapted for public information" and "confidential" need to be qualified and/or explained. It should be made clear that the auditor's report will be made public in full without any editing by the Minister.

Article 23

This Article calls for the appointment of an independent auditor "once the hierarchy of the administrative, tax and audit courts is established." It is not clear, however, what the arrangements would be for independent audit in the interim, *before* the establishment of those

courts. According to the Constitution, the interim authority for audits of Government accounts in the Court of Appeals.

It could also be made more clear that this independent auditor, while possessing specialized skills with regard to petroleum related finances, would remain under the purview of the above-mentioned administrative, tax, and audit court (once established) and the Court of Appeals in the interim. Clarifying this link is important to strengthening Constitutional arrangements for audit.

Schedule 1

Para I

An auditor may certify correct application of the formula once inputs are made available, but typically will not have the qualifications to provide those inputs which depend on deep sector and industry market knowledge and experience.

Para II

It would be useful to clarify how the 3% real return assumption will be tested and reviewed in practice and over time. A further concern is that at the moment real returns are at a historic low in the types of investment proposed. It will be important to consider the implications if the fund fails to achieve the required return in the first few years of operation. The approach of other funds is not to set a fixed benchmark, but rather a benchmark determined by a particular security or securities.

Para III

See comment under Para I. Determining “petroleum wealth”, as the formula suggests, will be no easy task. It may change wildly from year to year depending on reserve estimates, development and production profiles and time lines, costs, etc., not to mention prices and price forecasts! This calculation is the driver of the whole Petroleum Fund process. Given its importance and the difficulties involved in arriving at a number, it merits more prominent treatment in the Act, not only as to the qualifications of those performing the calculation, but also as to who makes decisions on permanent versus transitory movements in petroleum wealth sustainable wealth and hence sustainable income. It may be worth requiring two independent estimates of petroleum wealth. Reference is made to R as being the published budget projections of future receipts ... who makes these projections and how comfortable is the Government with the numbers produced? How far out in time do they go? If adequate procedures are in place for their calculation perhaps those procedures only need to be cross-referenced here.