



Establishing a Petroleum Fund for Timor-Leste

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Purpose of this Presentation

- **Starting point:** Timor-Leste possesses significant petroleum resources. As the resources are extracted, there will be a significant rise – and then fall – in revenues.
- **Challenge:** Manage the petroleum wealth wisely.
- **International experiences:** Petroleum can easily be a curse instead of a blessing.
- **Precondition for success:** Need an informed public and broad agreement on the strategy of managing the petroleum wealth. Public consultation and participation is therefore key.
- **Petroleum Fund:** A fund can be a useful tool to manage the petroleum wealth. The fund is to be established 1 July 2005.
- **My job today:** Explain the proposed Fund in the context of management of petroleum wealth. Draw on experiences internationally, including Norway. Make note of your feedback.
- **Next step:** Council of Ministers will propose to Parliament an Act on the Petroleum Fund (probably early 2005).

Agenda

- I. **Why a petroleum fund?**
 - **Save money. Smooth consumption**
- II. Petroleum wealth - a blessing or a curse?
- III. The design of the Petroleum Fund
- IV. When and how to spend the money

Why a Petroleum Fund?

- Petroleum revenues **complicate fiscal policy**
- Petroleum revenues are **different** from other revenues:
 - *Not really income*, but a transformation of wealth (from oil & gas to cash). The petroleum reserves are being depleted, they will eventually run out.
 - "*Free money*". They do not reduce spending in the private sector like other government revenues.
 - They are more *volatile and uncertain* than other revenues.
- A fund can address the need for **stabilisation** (of public spending) and **savings** (for future generations)



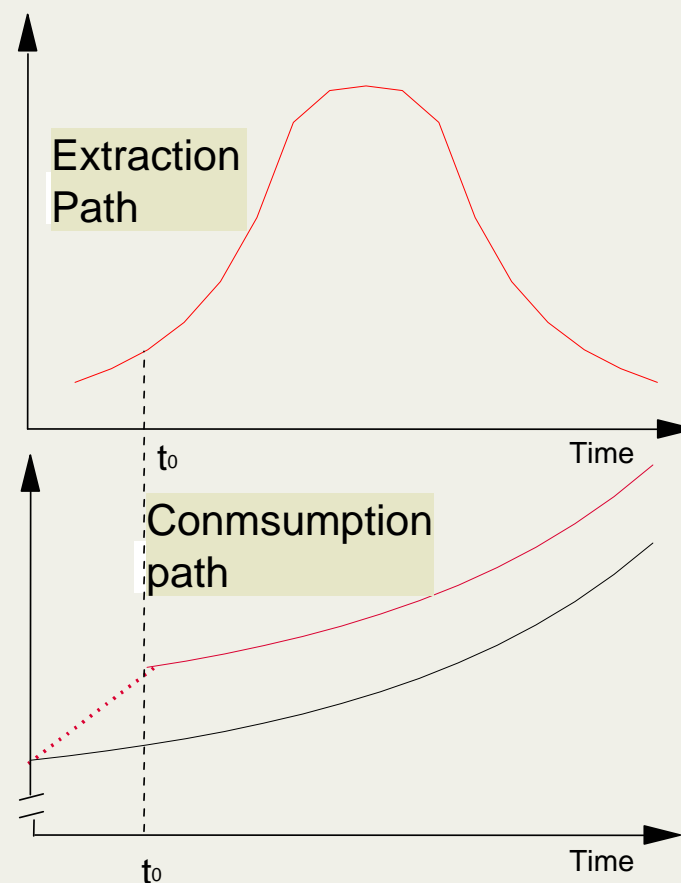
There is a need to save a substantial part of the petroleum revenues – to separate spending from the current income from oil & gas activities. A Petroleum Fund can be a suitable savings instrument

Wealth management – from theory to practise

- 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



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

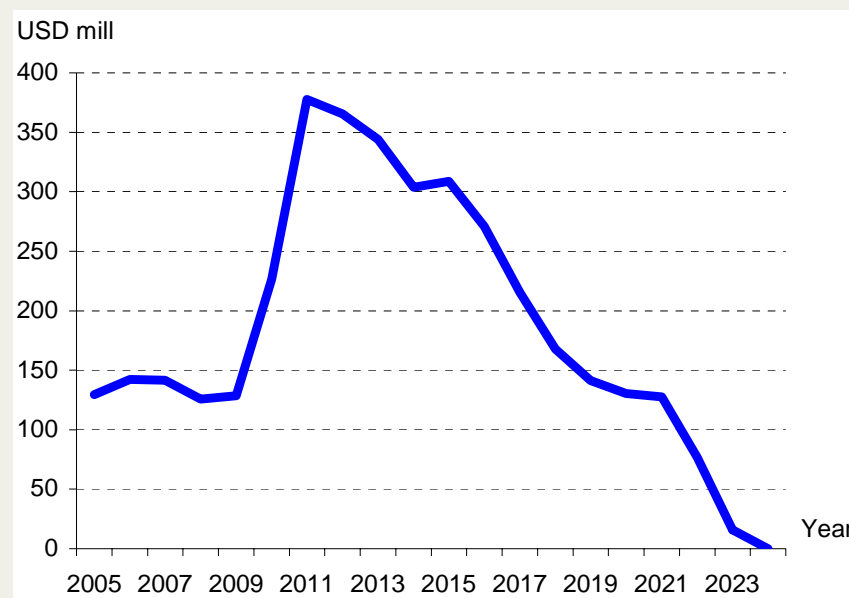




Timor-Leste's petroleum wealth

- Projections show revenues rising to more than \$350m in 2011
- Revenues are large relative to the economy (In 2004-05: CFET expenditure \$75m, combined sources exp \$245m, GDP \$350m.)
- Sum future revenues around \$3.7 bn, but large uncertainty (+/- \$2bn depending on oil prices alone)

Projected petroleum revenues

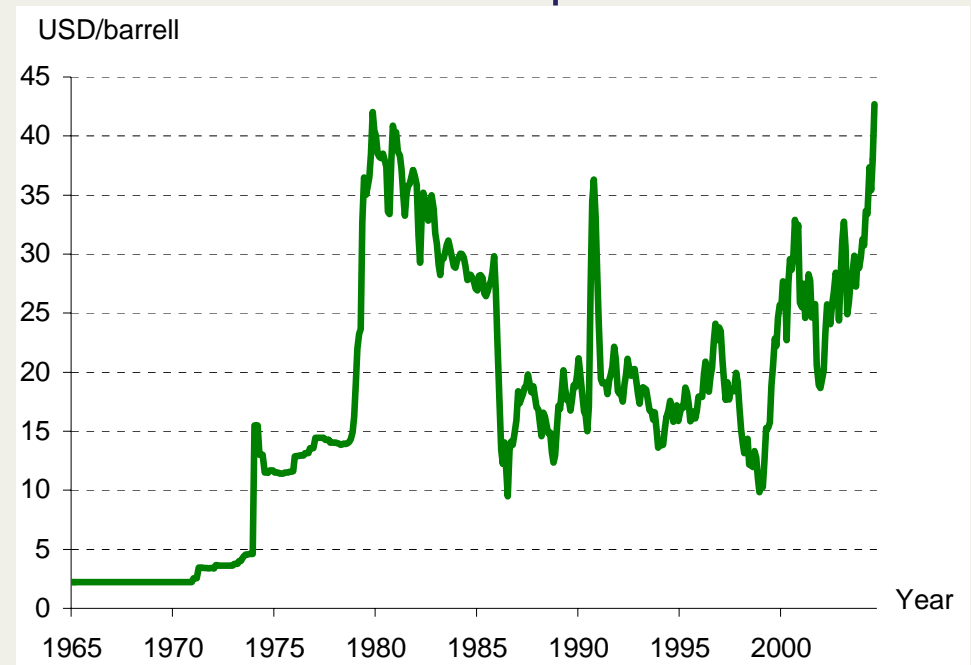


Petroleum revenues are important to Timor-Leste (but not as important as human skills)

Significant uncertainty regarding the size of the expected petroleum revenues

- **Geology:**
New fields to be discovered?
- **Legal:**
Maritime boundaries not settled
- **Operational:**
Petroleum extraction is a complex process, costs uncertain. Reliant on only one field
- **Oil & gas price:**
Large fluctuations (chart)

Historical oil prices



Management of the petroleum wealth needs to take into account this uncertainty

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 - **Blessing if well managed. Curse if poorly managed**
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Petroleum – A Blessing or a Curse?

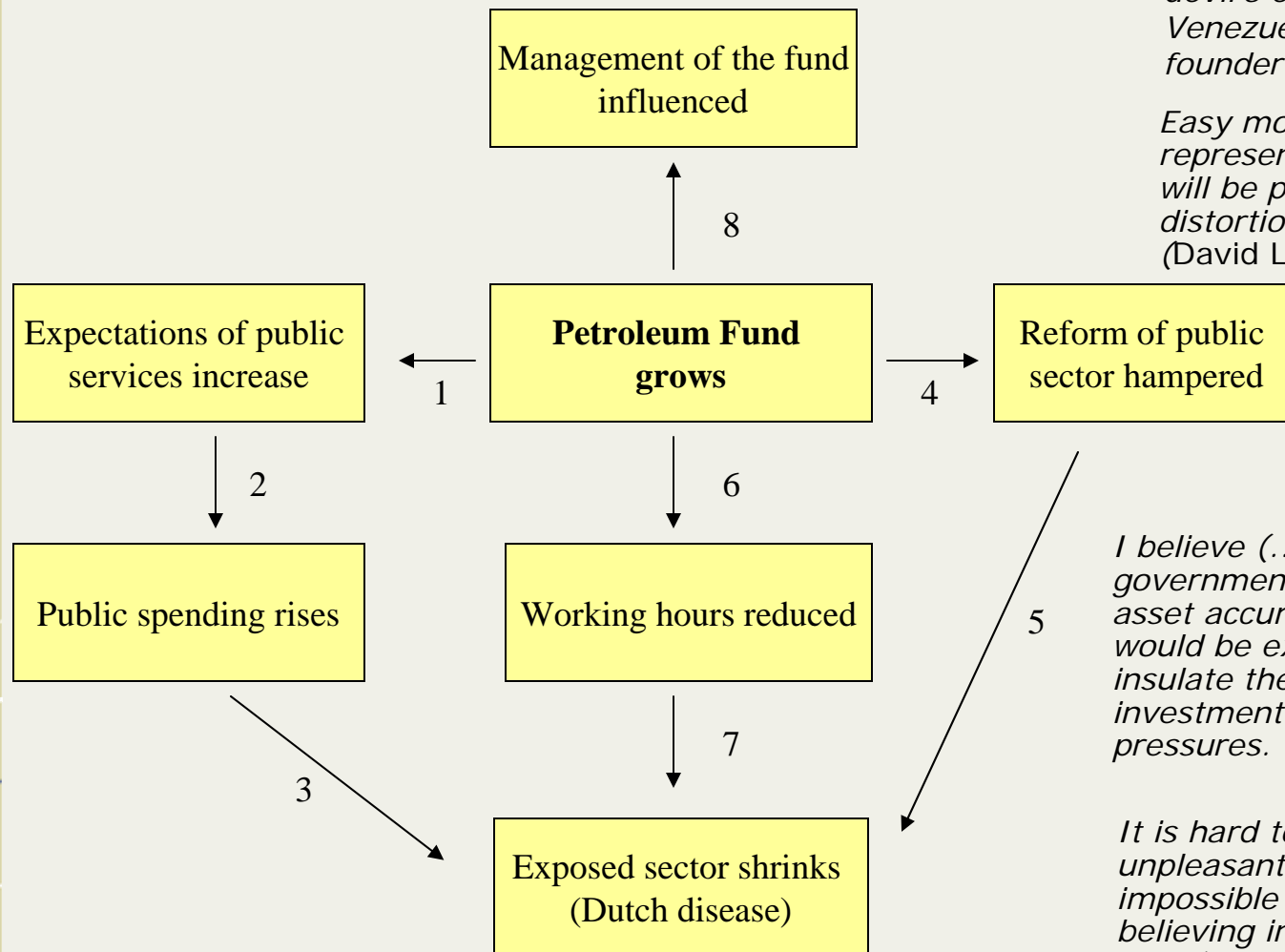
Blessing

- Gift from mother nature
- Will improve the standard of living for the Timorese
- Can be a catalyst for faster economic growth by lifting investment in infrastructure (roads) and human capital (education, health), which again will give rise to further wealth creation

Curse

- Petroleum is "*the devil's excrement*"
- Petroleum gives rise to activities not conducive to the country's welfare
- International experiences give reason for serious concern ("*the resource curse*"):
 - Poverty and lower economic growth
 - Conflict, war and civil strife
 - Corruption
 - Unrepresentative government

What does the oil money do to us?



Oil will bring us ruin. It's the devil's excrement.. (Mr Alfonso, Venezuelan oil minister and a founder of OPEC, early 1970s)

Easy money is bad for you. It represents short-run gains that will be paid for in immediate distortions and later regrets. (David Landes)

I believe (...) that the federal government should eschew private asset accumulation because it would be exceptionally difficult to insulate the government investment decisions from political pressures. (Alan Greenspan)

It is hard to get people to believe in unpleasant truths, but it is totally impossible to avoid people believing in flattery and pleasant lies. (Sigrid Undset)

How to avoid the resource curse?

- Prudent policies, transparency and accountability of operations in a several areas
 - Management and tax regime for the extraction of oil and gas
 - Payments by oil companies (EITI)
 - Planning and execution of government budgets
 - Management of the financial savings (Petroleum Fund)
- Public sector institutions of high quality
- Build consensus on a wise and long-term management of the petroleum wealth to the benefit of all Timorese
- Need an informed public and a clear sense of ownership of the Petroleum Fund amongst the Timorese population



It is important to raise the standard of public understanding, and design policies that emphasize transparency and accountability

Transparency & Accountability with respect to the Petroleum Fund

- High degree of transparency in the design and operations of the fund
- Comprehensive and accessible reporting on management of fund, and on whether Fund outflow is consistent with long-term considerations
- MoPF: Report in budget documents and annual report
 - The inflow and outflow of the fund
 - Whether the outflow of the fund is consistent with long-term considerations
 - The fund's return, accumulated value and investment strategy

Transparency & Accountability with respect to the Petroleum Fund (cont'd)

- BPA: Report quarterly on operational management (fund's value, assets, investment activities, risk control etc)
- External, independent audits (through MoPF and BPA)
- *Investment Steering Committee* to advise MoPF, in order to strengthen the quality of advice preceding decision-making
- Consider establishing an independent "watchdog" - a *Council of Eminent Persons* to monitor and advise Parliament on all aspects of the Fund's operations?



Transparency and accountability must be emphasized in all aspects of the Petroleum Fund, since this is key to secure support for a wise management of the petroleum wealth.

Agenda

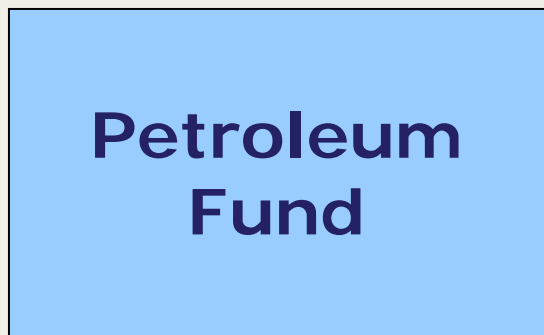
- I. Why a petroleum fund?
 - Save money. Smooth consumption
- II. Petroleum wealth - a blessing or a curse?
 - Blessing if well managed. Curse if poorly managed
- III. **The design of the Petroleum Fund: Inflows, Outflows, Management**
 - **Comprehensive policy. Strengthening existing institutions. Transparency and accountability**
- IV. When and how to spend the money

Design of the Petroleum Fund – key principles

- Integrated with budget
 - Prevent duplication, coordinated policies give better outcomes, build capacity of existing institutions
- Prudent management
 - Safe investments, assets held offshore, unencumbered
 - Domestic investments have more risk, can hurt economy (asset price inflation, poor governance)
- Transparency and accountability
 - Public disclosure of finances, explain policies, mechanisms to prevent misuse, external audits.
 - Prevent unauthorised use of funds, more informed and better decisions, build public confidence
- Sovereignty of Parliament maintained

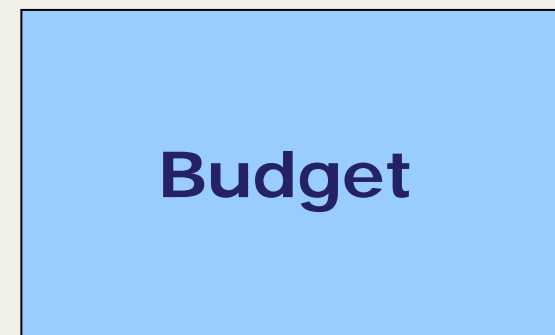
How the proposed Petroleum Fund works

Petroleum revenues +
Return on investments



Transfer
to finance
budget deficit
(excluding
petroleum)

Domestic revenues



Expenditures

- consumption
- investment
(infrastructure,
human capital)

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- IV. **When and how to spend the money (savings policy)**
 - **Should have spending that is sustainable**



Remember that the Petroleum Fund is the savings vehicle, and is distinctly separate from the decision on savings policy.

Savings policy – how much to spend now and how much to save for later?

- The regular government budget decides savings policy. How much is spent on public consumption and how much is saved. And also the decision to save by investing in **'physical assets' or financial assets** (in the Petroleum Fund). Depends on profitability
- Rate of return on some investment projects in infrastructure and human capital in Timor-Leste exceed financial returns. But a crucial constraint is the **capacity of local institutions** to identify and implement these projects.
 - This is a key lesson from other countries (and is not restricted to developing countries)
 - *"No sophistication is needed for the wise decision to deposit fast-growing mineral income in the bank, pending the emergence of a sensible opportunity to spend the money."* (Marion Rodesky)

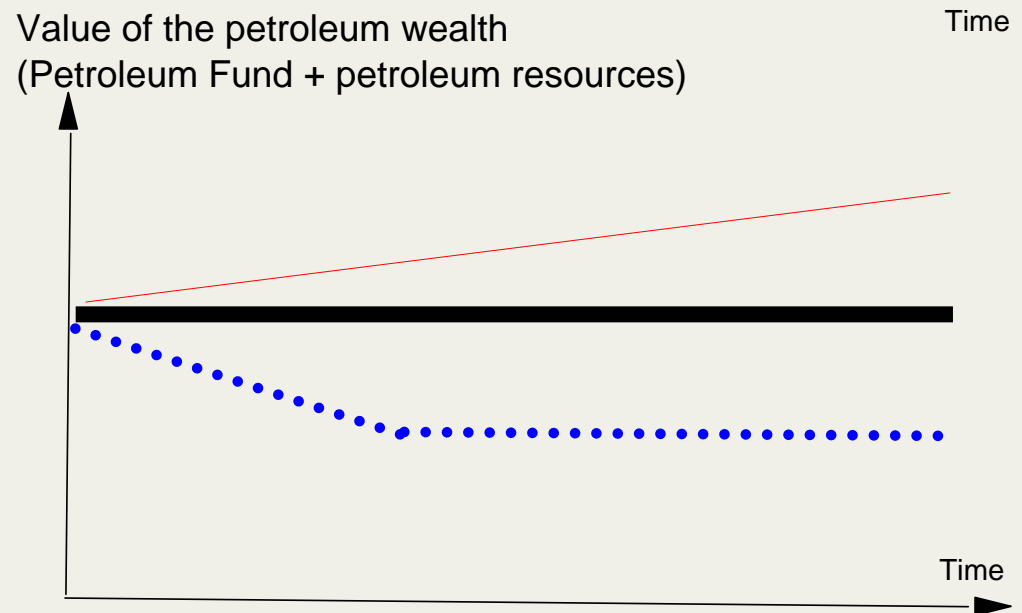
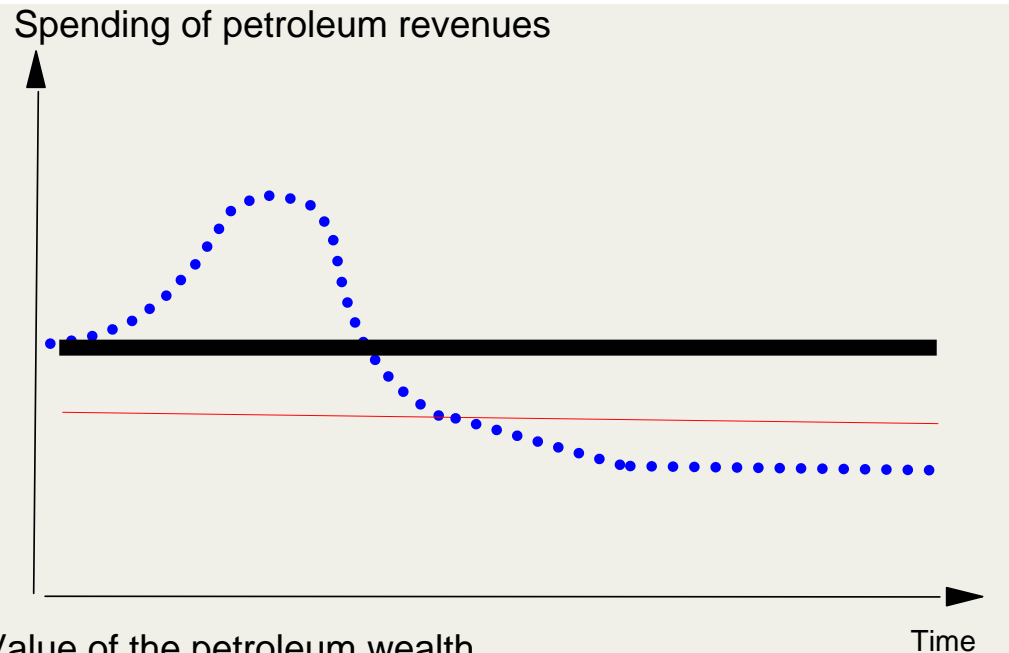
Fiscal policy framework

- Many countries have **fiscal rules or guidelines** (such as limits on budget deficits or debt). The purpose is to implement good fiscal policy by reducing discretion.
- Formalised savings policy or not, attention should be given to whether the **outflow from the Petroleum Fund** is consistent with long-term considerations
- Fiscal policy needs to consider:
 - Inter-generational equity
 - The economy's absorptive capacity
 - Macroeconomic stabilization

Possible fiscal policy guidelines

- Keep constant the value of the petroleum wealth
- Keep constant the value of the petroleum wealth per capita (when population grows)
- Partial drawdown of petroleum wealth in medium term, then stabilise

Note: These charts are intended only as a general illustration. The actual profiles could be quite different, depending on the formulation of policy. There are also different levels of risk surrounding the profiles, which are not shown in the illustrations.



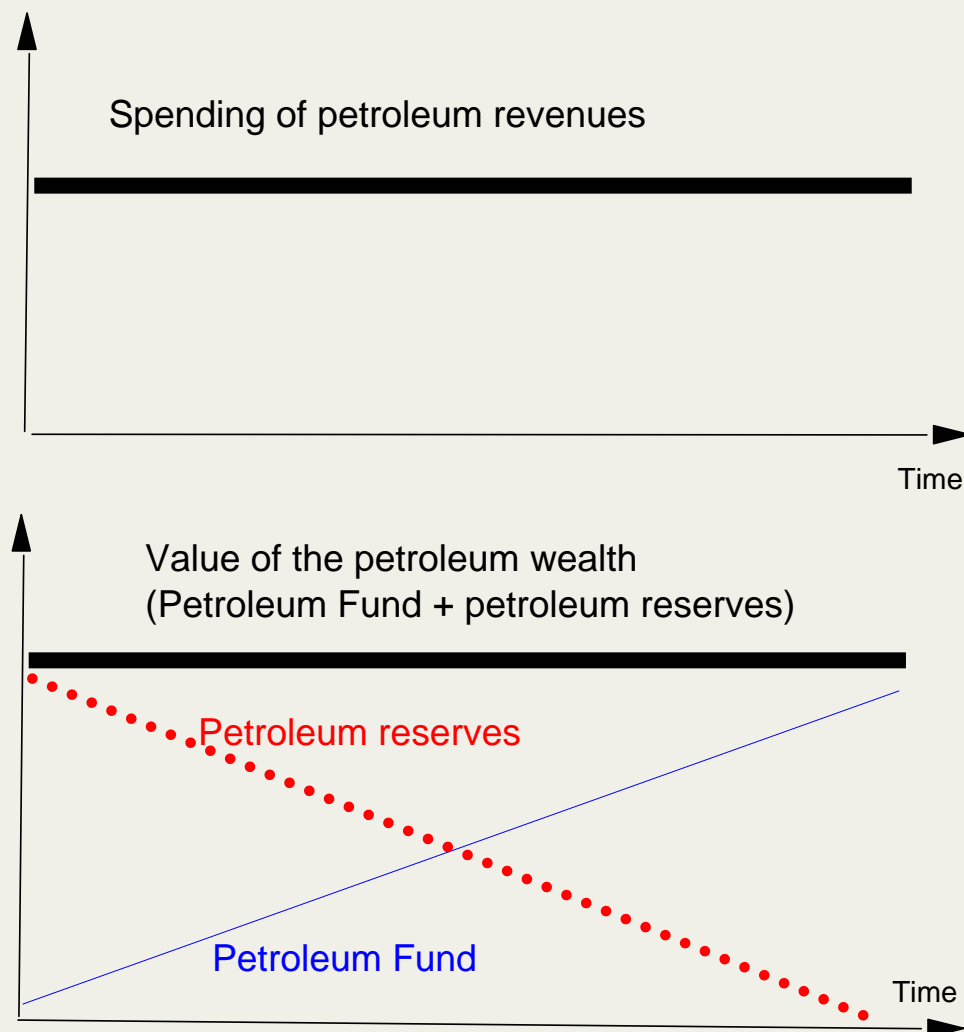
The Government's savings policy

► ***Keep constant
the real value of
the petroleum
wealth***

This means:

Spend the "permanent income" (equal amount can be spent forever)

Note: These charts are intended only as a general illustration.

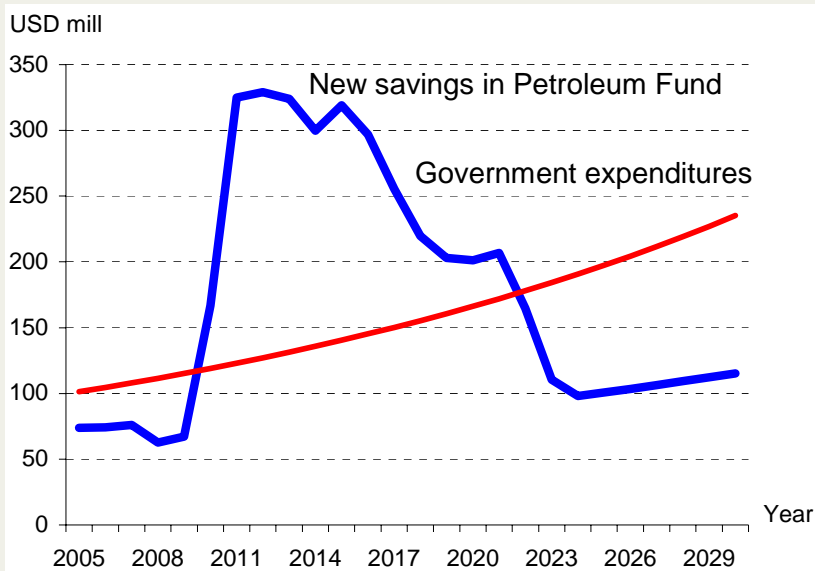


The Government's savings policy: Keep constant real value of petroleum wealth

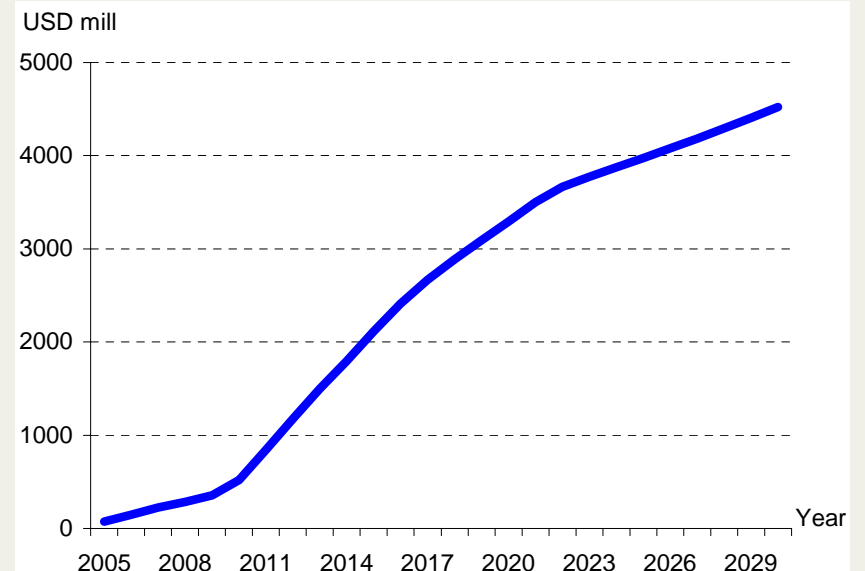
- This means spending the "permanent income"
 - Equal amount can be withdrawn forever
- Sustainable spending for Timor-Leste is over \$100m
 - Domestic revenue (over \$30m)
 - Permanent income from petroleum (over \$70m)
 - But: Expect revisions (eg, due to oil prices)
- Room for gradual increase in spending
 - Spending was \$75m last year
 - Need to make sure extra spending is not wasted
- Savings will rise quickly

Current estimates from savings policy (in nominal terms)

Government spending and financial savings



Accumulated savings in the Petroleum Fund



Summary of Petroleum Fund proposal

- **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:** The amount necessary to finance the government budget 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. MoPF has overall responsibility, while the operational management will be delegated to the BPA.
- **Transparency:** There will be a high degree of transparency of operations, including comprehensive and accessible reporting on management of the Fund and whether the outflow is sustainable. One can consider establishing an independent *Council of Eminent Persons*, acting as a watchdog.



Establishing a Petroleum Fund for Timor-Leste

*Maria Madalena Brites Boavida
Minister for Planning and Finance
The Democratic Republic of Timor-Leste*

November 2004

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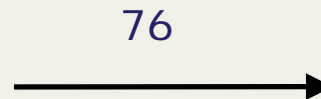
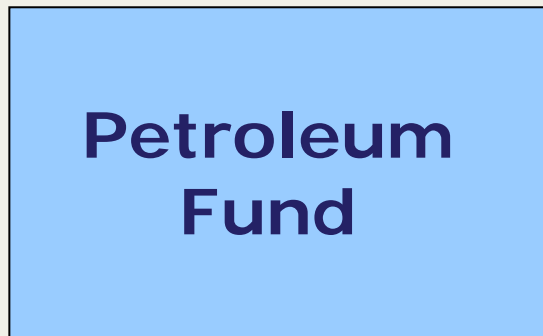
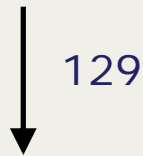
An illustration of how the Petroleum Fund is integrated with the fiscal budget

The Budget and the Petroleum Fund

2006-07 2007-08

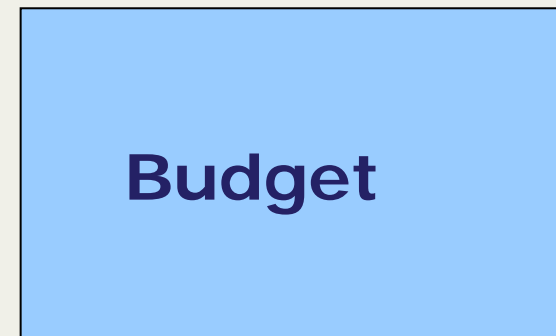
Total revenues	166
Revenues from petroleum activities	117
Return on the Petroleum Fund's investments	12
Domestic revenues	37
Total expenditures	113
Expenditures on petroleum activities	0
Domestic expenditures	113
Total budget balance (before transfer to/from the Petroleum Fund)	53
- <i>Net petroleum revenues</i>	129
= <i>Budget balance excluding petroleum</i>	-76
+ <i>Transfer from the Petroleum Fund</i>	76
= <i>Budget balance (after transfer to/from the Petroleum Fund)</i>	0
<i>Memo: Capital in the Petroleum Fund at end of fiscal year (market value)</i>	224 277

Petroleum revenues +
Return on investments



Transfer
to finance
budget deficit
(excluding
petroleum)

Domestic revenues



Expenditures

- consumption
- investment
(infrastructure,
human capital)

Note: The numbers showing the money flows are estimates for 2007-08, and are taken from the table in the previous slide

An illustration of the Petroleum Fund's accounts

The Petroleum Fund	2006-07	2007-08
Total revenues		129
Net petroleum revenues		117
Return on investments		12
Total expenditures		76
Transfer to the government budget		76
Surplus in the Petroleum Fund		53
Accumulated capital in the Petroleum Fund at end of fiscal year (market value)	224	277

The design of the Fund means that:

- The Fund is an **instrument for saving**, while the **savings policy** is determined in the budget
- A country can save by investing in either '**physical assets**' or **financial assets**
- The budget therefore decides the savings policy:
 - How much is spent on **current consumption**
 - How much is spent on '**physical investments**', ie, investments in infrastructure (roads) and human capital (health, education)
 - How much is saved in **financial assets** (the Petroleum Fund)

Management of the Petroleum Fund - important considerations

- **Clear lines of responsibility** between Ministry of Planning and Finance as owner and BPA as manager. BPAs task: outperforming benchmark (subject to risk limits), cost-efficient management.
- **Openness** on the management by public disclosure of goals and regulations, public reports on the management and full disclosure of the Fund's holdings
- **Control** of the management by
 - Consulting Parliament on important issues
 - Independent and external audits (and performance measurement)
 - Perhaps a *Council of eminent persons*

Management of the Petroleum Fund - clear lines of responsibility

Ministry of Planning and Finance

- Overall responsibility
- Strategic asset allocation
- Risk limits
- Evaluate the operational management

Banking and Payments Authority

- Carry out investment strategy
- Risk management
- Accounting and reporting
- Offer advice to the Ministry on strategic investment decisions

Management of the Petroleum Fund - investment strategy

- The Fund is to be invested **securely in low risk financial assets abroad**.
- Initially: USD denominated fixed income securities with low credit risk and interest rate risk (eg, government bonds with short duration)
- **Why invest abroad?** Reduces risk and reduces the pressure on the domestic economy
 - Investing domestically in small financial market would
 - give less diversification of financial and political risk (ref Kuwait),
 - increased risk of corruption and bad governance,
 - stronger increase in prices and imbalanced economic developments (“Dutch disease” and “the resource curse”)

Establishing a Petroleum Fund for Timor-Leste

Abraão de Vasconcelos




Director Geral

Autoridade Bancária e de Pagamentos de Timor-Leste

Novembro de 2004

Operational Management of the Fund

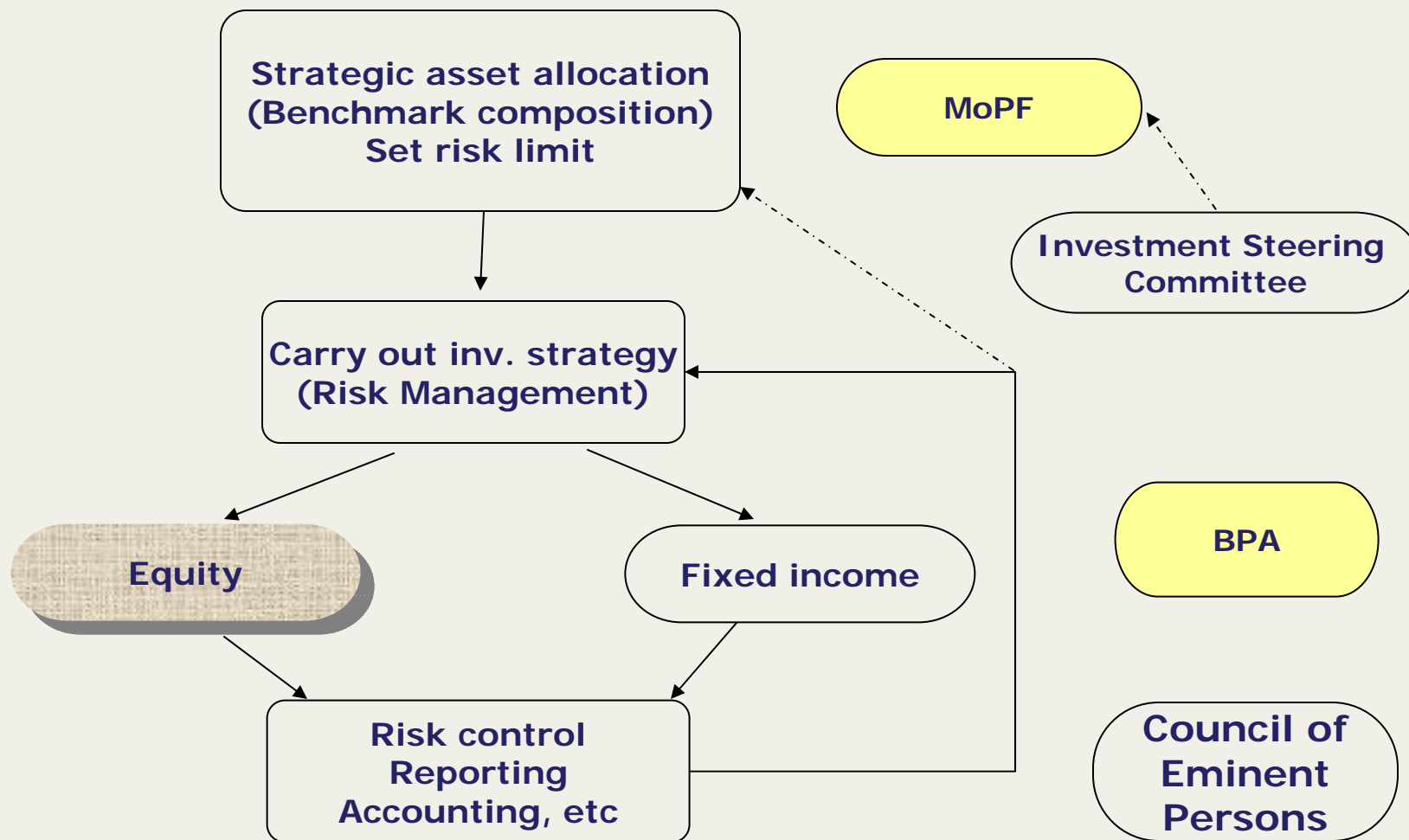
Key elements:

-  Invest the Fund in low risk financial assets
-  Clear division of responsibilities
-  Transparency & accountability

Investment objective

To maximise the long-term economic return on the assets of the Petroleum Fund consistent with investing according to risk-averse policies.

Operational Management of the Petroleum Fund



Transparency & Accountability

- Publish regularly (quarterly basis) report on operational management (fund's value, assets, investment activities, risk control etc)
- Can be accessed through BPA website and/or official government website
- The accounts, records, and financial statements of the Fund will be audited annually by internationally recognized independent auditors