Introduction

This report is produced in accordance with Article 13 of the Petroleum Fund Law which requires the central bank to report on the performance and activities of the Petroleum Fund of Timor-Leste, referred to in this report as the Fund unless the context suggests otherwise.

All monetary references in this report are to United States dollars as the official currency of Timor-Leste.

While every effort has been made to ensure accuracy, the information has not been independently audited or reviewed and is subject to change, in which case changes will be incorporated into subsequent reports.

Executive Summary

The Petroleum Fund was formed by the enactment of the Petroleum Fund law promulgated on 3 August 2005. The law gives the Banking & Payments Authority (BPA) of Timor-Leste the responsibility for the operational management of the Fund.

This report covers the period from 1 July to 30 September 2008.

During this period, the BPA continued to invest all funds received according to the investment mandate agreed with the Ministry of Finance in which a benchmark index of United States Treasury Securities with maturities up to five years is specified together with defined performance measures.

In the course of the quarter the capital of the Fund grew from $3,203.07 million to $3,738.35 million, including gross cash inflows to the fund of $619.87 million consisting of taxpayer contributions to the fund of $256.83 million and royalty contributions of $363.04 million. The cash outflow was $140 million transferred to the State Budget, while the net cash inflow was $479.87 million.

The portfolio return in the period was 1.64% or 164 basis points while the benchmark return for the quarter was 1.71% or 171 basis points. The excess return was 7 basis points below the benchmark within the mandated target ±25 basis points1.

1 In common with standard investment practice figures relating to performance reporting may be slightly different to those used for accounting purposes, arising from the use of different pricing sources and the calculation methodology adopted by the global custodian. To date the BPA has calculated performance using the time weighted rate of return (TWR) based on fair price/ first price which adhere to IFRS and which have provided consistency between performance and financial reporting. It will not be practical to continue this policy in a multi-manager environment. Global custodian calculates investment performance returns based on the last price valuation which is consistent with Global Investment Performance Standards (GIPS). Performance figures in this and future reports will be based on the custodian’s performance calculations. The Fund’s financial reports are unaffected by this change.
The Banking and Payments Authority has been appointed to undertake the operational management of the Fund in accordance with Article 11.3 of the Petroleum Fund Law which states that the Minister shall enter into an agreement with the Central Bank for the operational management of the Petroleum Fund and the Central Bank shall be responsible for the operational management of the Petroleum Fund. The management agreement was negotiated and agreed between the Ministry of Finance and the Banking & Payments Authority, and signed on 12 October 2005.

This mandate set out in the Management Agreement has not changed since the previous report, and is as follows:

### 1. Petroleum Fund Management Mandate

The Banking and Payments Authority has been appointed to undertake the operational management of the Fund in accordance with Article 11.3 of the Petroleum Fund Law which states that the Minister shall enter into an agreement with the Central Bank for the operational management of the Petroleum Fund and the Central Bank shall be responsible for the operational management of the Petroleum Fund. The management agreement was negotiated and agreed between the Ministry of Finance and the Banking & Payments Authority, and signed on 12 October 2005.

This mandate set out in the Management Agreement has not changed since the previous report, and is as follows:

#### 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.**

#### 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 points of the benchmark.

2. The difference in the modified duration between the portfolio and the benchmark shall be less than 0.2 years.

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.

All royalty payments and funds received from taxpayers, other than small amounts that do not collectively reach the minimum investment threshold set by the BPA, have been invested in the mandated benchmark from the day following receipt.
2. Market Trends during the Quarter

The Lehman Brothers bankruptcy and AIG bail-out have triggered further doubts in the financial system forcing the Federal Reserve Bank (Fed) to take dramatic steps to calm the market.

The developments in the US financial market led Treasury yields to trade at a wider range during the quarter particularly the month of September 2008. Overall, US Treasury bond yields decreased significantly. At the short end 3 and 6 month US Treasury benchmark reference bills decreased by 83 and 55 basis points respectively, while 2 year bond yields down by 66 basis points. The 3 and 5 year US Treasury benchmark reference notes decreased by 81 and 35 basis points respectively compared to the previous quarter end. Bond prices and yields move in opposite directions. Lower yields in the Treasury market were due to strong demand for Treasury assets as the economy remains vulnerable. The changes in the yields during the quarter have therefore resulted in higher prices for the securities held in the PF portfolio and a higher capital value of the bonds held in the investment portfolio. The graph below shows the 0-5 year US Government yield curve on 30 September 2008 compared with the previous quarter end 30 June 2008.

During the period, there has no changes to the U.S. Federal Reserve Bank’s key overnight lending rate (the US Federal Funds target rate), therefore the target rate remain at 2.00% as of 30 September 2008.

The following graphs show firstly, the daily performance of the Merrill Lynch US Government bond 0-5 year index during the quarter and secondly, the monthly cumulative performance of the Merrill Lynch US Government Bond 0-5 years index since inception of the Fund.
3. MANAGEMENT DURING THE QUARTER

3.1. Objectives

The BPA’s objective in managing the Fund is to achieve a portfolio return close to the return of the agreed benchmark. Cash received by the Fund has been invested in the portfolio in a timely manner, normally within two working days. This policy is consistent with the passive investment mandate given to the BPA by the Ministry of Finance.

3.2. Operational Implementation

The mandate is operationalised by holding ten of the approximately 102 US Treasury Securities that form the defined benchmark index. The bonds are selected to best replicate the risk and return characteristics of the benchmark.

Daily financial reports on the performance of the Fund are produced for BPA management as part of the management process.

3.3. Strategic Review

During the quarter, a project on implementation options has been conducted in collaboration with Ministry of Finance officials and with support from an international consultancy company in response to the Investment Advisory Board’s recommendation based on Minister’s request to explore the full potential use of the Petroleum Fund Law to diversify the Petroleum Fund asset for a higher yield.

Following the appointment of JPMorgan as the global custodian for the Petroleum Fund, the Petroleum Fund’s US Treasury securities were successfully transferred from the Federal Reserve Bank of New York (FRBNY) to JPMorgan Chase Bank N.A. in late August 2008. These securities are now in the custody of JPMorgan Chase Bank N.A while the FRBNY will continue to execute trades of US Treasury Bonds for the Fund and hold the earmarked receipts account for petroleum revenues.
The global custodian also prepares regular management reports for the Fund, such as custody, performance, compliance and accounting services for the BPA in late August 2008 and the BPA intends to review the format of its future quarterly reports to take advantage of these new reporting services.

3.4. External Managers

Contract negotiations with the Bank for International Settlements as a non-commercial external manager are in progress.

3.5. Capacity Building

Staff assigned to the related Petroleum Fund operational management continued to engage in capacity building, primarily in the form of on-the-job training in various institutions including other Central Banks, and the long term capacity building programs.

4. PORTFOLIO PERFORMANCE

The performance of the Fund relative to the benchmark is calculated and reported using the same basis as the benchmark.

The opening value of the Fund at the beginning of the quarter was $3,203.07 million and the closing value as at 30 September 2008 was $3,738.35 million. The petroleum revenue during the quarter was $619.87 million consisting of petroleum taxpayers contribution to the fund of $256.83 million and royalty contributions to the fund of $363.04 million. The dollar returns (gross of fees) was $55.41 million during the quarter, of which the coupon and interest received was $32.08 million and the change in the market valuation was positive $23.33 million. This represents a return to the Fund based on the Modified Dietz Method of 1.64 percent or 164 basis points for the quarter.

A graphical presentation of the growth in the NAV (Net Asset Value) of the Fund during the quarter is as follows:

<table>
<thead>
<tr>
<th>Absolute return for the Quarter Jul - Sep 08</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening book value (30-Jun-08)</td>
<td>3,203.07</td>
</tr>
<tr>
<td>Receipts during the period</td>
<td>619.87</td>
</tr>
<tr>
<td>Transfer to General State Budget</td>
<td>(140.00)</td>
</tr>
<tr>
<td>Management Fees</td>
<td>-</td>
</tr>
<tr>
<td>Return in the period</td>
<td>55.41</td>
</tr>
<tr>
<td>Closing book value (30-Sep-08)</td>
<td>3,738.35</td>
</tr>
</tbody>
</table>
The major movements in the value of the Fund took place as a result of the taxpayer receipts that are usually received around the middle of each month.

5. MANAGEMENT COSTS

The means by which the management costs of the Fund are to be recognized is determined in the Petroleum Fund law. Article 6.3 of the law states “From the amount received in accordance with Section 6.1, the Central Bank shall be entitled to deduct, by direct debit of the Petroleum Fund account, any reasonable management expenses, as provided for in the operational management agreement referred to in Section 11.3”.

The management fee is intended to cover the actual expenses incurred by the BPA in managing the Fund. There has been no deduction from the Fund for the management fee during the period.

6. TRANSFERS FROM THE PETROLEUM FUND

According to Article 7.1 of the Petroleum Fund law transfers from the Fund may only be made to the credit of a single State Budget account. During the quarter, at the request of government and within the amount appropriated by parliament an amount of $140 million has been deducted from the Fund and transferred to the General State Budget account during the quarter.

7. RISK EXPOSURE OF PORTFOLIO

7.1. Tracking Error

The following graphs illustrate the manner in which the Fund portfolio tracked the benchmark index. The line “Daily Excess Return” measures the difference between the return of the Fund’s portfolio and the benchmark. The excess return for the quarter was 7 basis points below the benchmark, within the ±25 basis points in the investment mandate. The increase in the excess return compared with previous quarters arose from extreme volatility in world financial markets.
The cumulative performance of the Petroleum Fund compared with the cumulative performance of the benchmark over the same period is shown in the graph.

The graph indicates that the cumulative performance of the portfolio is almost identical to the cumulative performance of the benchmark with almost zero point tracking errors. A zero tracking error means that the Petroleum Fund portfolio is performing exactly the same as the benchmark performance over the period.
The mandate given by the Ministry of Planning and Finance to the BPA specifies that the Fund portfolio shall have a Modified Duration within 0.2 years of the benchmark index. The following graphs show, firstly, the modified durations of the portfolio and the index, and secondly, the difference between the portfolio and the index compared with the mandated maximum of ±0.2 years.

The graph shows the modified duration of the Petroleum Fund investment portfolio compared with the modified duration of the benchmark index.

The graph shows the daily difference in modified duration between the investment portfolio and the benchmark. The Management Agreement states that the modified duration of the portfolio shall be managed within ±0.2 years of the modified duration of the benchmark. The duration was within the mandate during the quarter.
7.3. Credit Risk
The Merrill Lynch index comprises Treasury Securities issued by the United States Government, which is rated AAA. All investments by the Petroleum Fund were also in US Treasury Securities with the highest credit rating (AAA). Cash received by the Petroleum Fund pending investment is invested at overnight money market interest rates in an overnight repurchase pool operated by the Federal Reserve Bank of New York.

8. COMPLIANCE STATEMENT
The BPA has undertaken the operational management of the Petroleum Fund within the terms of the mandate set out in the Management Agreement.

8.1. Qualifying Instruments
The Fund was invested in the qualifying instruments within the investment universe specified in the mandate at all times during the quarter. At no time was the Fund invested in instruments other than those disclosed in this report.

8.2. Return on the Portfolio
The performance on the portfolio for the quarter was 164 basis points compared with the benchmark performance of 171 basis points. The difference of 7 basis points lower than the benchmark is within the mandated target of ±25 basis points.

8.3. Modified Duration of the Portfolio
The modified duration of the Fund’s investment portfolio and the mandated index are measured by the BPA daily. The modified duration of the Petroleum Fund portfolio was within the mandate during the quarter.

8.4. Internal Audit
In accordance with the provisions of Article 22 of the Petroleum Fund law number 9/2005 that requires BPA’s Internal Auditor to perform an audit of the Fund every six months. The Internal Auditor has performed an audit on the Fund to 30 June 2008.
9. SUMMARY FINANCIAL INFORMATION

The following financial information is presented for the purpose of assisting the Minister to review the quarterly performance of the Petroleum Fund as set out in this report. The figures have not been audited.

**Balance Sheet**

<table>
<thead>
<tr>
<th>NET ASSETS</th>
<th>Sep-08</th>
<th>Jun-08</th>
<th>Sep-07</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and Cash Equivalents</td>
<td>979</td>
<td>385</td>
<td>1,198</td>
</tr>
<tr>
<td>US Treasury Notes (Market Value)</td>
<td>3,683,115</td>
<td>3,185,709</td>
<td>1,791,223</td>
</tr>
<tr>
<td>Accrued Interest</td>
<td>54,259</td>
<td>16,978</td>
<td>25,488</td>
</tr>
<tr>
<td>Less: Peding Purchases of Securities</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>3,738,353</td>
<td>3,203,073</td>
<td>1,817,908</td>
</tr>
</tbody>
</table>

**CAPITAL**

<table>
<thead>
<tr>
<th></th>
<th>Sep-08</th>
<th>Jun-08</th>
<th>Sep-07</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Balance as at 1 January 2008</td>
<td>2,086,157</td>
<td>2,086,157</td>
<td>1,394,223</td>
</tr>
<tr>
<td>PF Law Art. 6.1(a) Revenue Receipts</td>
<td>712,038</td>
<td>455,205</td>
<td>116,217</td>
</tr>
<tr>
<td>PF Law Art. 6.1(b) DA Receipts</td>
<td>986,386</td>
<td>623,350</td>
<td>265,330</td>
</tr>
<tr>
<td>PF Law Art. 7.1 Transfer to General State Budget</td>
<td>(140,000)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Net Income</td>
<td>93,772</td>
<td>38,362</td>
<td>42,139</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>3,738,353</td>
<td>3,203,073</td>
<td>1,817,908</td>
</tr>
</tbody>
</table>

**Profit and Loss Statement**

<table>
<thead>
<tr>
<th>INCOME</th>
<th>Quarter</th>
<th>Year to Date (YTD)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sep-08</td>
<td>Sep-07</td>
</tr>
<tr>
<td>Money Market Interest</td>
<td>75</td>
<td>139</td>
</tr>
<tr>
<td>Treasury Note Coupons</td>
<td>32,004</td>
<td>10,326</td>
</tr>
<tr>
<td></td>
<td><strong>32,078</strong></td>
<td><strong>10,465</strong></td>
</tr>
<tr>
<td>Market Revaluations</td>
<td>23,332</td>
<td>27,935</td>
</tr>
<tr>
<td>Less: Management Fees</td>
<td>-</td>
<td>(261)</td>
</tr>
<tr>
<td><strong>Net Result for the Period</strong></td>
<td><strong>55,411</strong></td>
<td><strong>38,139</strong></td>
</tr>
</tbody>
</table>

**Note:** The accounting policies and method of computation used to prepare the above figures are the same as disclosed in the most recent annual financial statements of the Petroleum Fund. The year to date figures in 2007 and 2008 are based on the 30 June balance date and 31 December balance date respectively.

Dili, 21 October 2008

Venâncio Alves Maria    Abraão de Vasconselos
Executive Director     General Manager