

# **PETROLEUM FUND OF TIMOR-LESTE**

## **QUARTERLY REPORT**

**For the Quarter ended 30 September 2007**

**Presented to the Minister of Finance**

**by**

**Banking & Payments Authority of Timor-Leste**

### **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.

### **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 2007.

During this period, the BPA continued to invest all funds received according to the investment mandate agreed with the Ministry of Planning and 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 \$1,394.22 million to \$1,817.91 million, including gross cash inflows to the fund was \$381.55 million. The cash outflows were \$260.70 thousands for the management fees while the net cash inflow was \$381.29 million. The return in the period was 2.68 percent, equivalent to an annual return at 11.15 percent for the Petroleum Fund portfolio and the benchmark return was 2.66 percent.

## 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 Planning and 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.

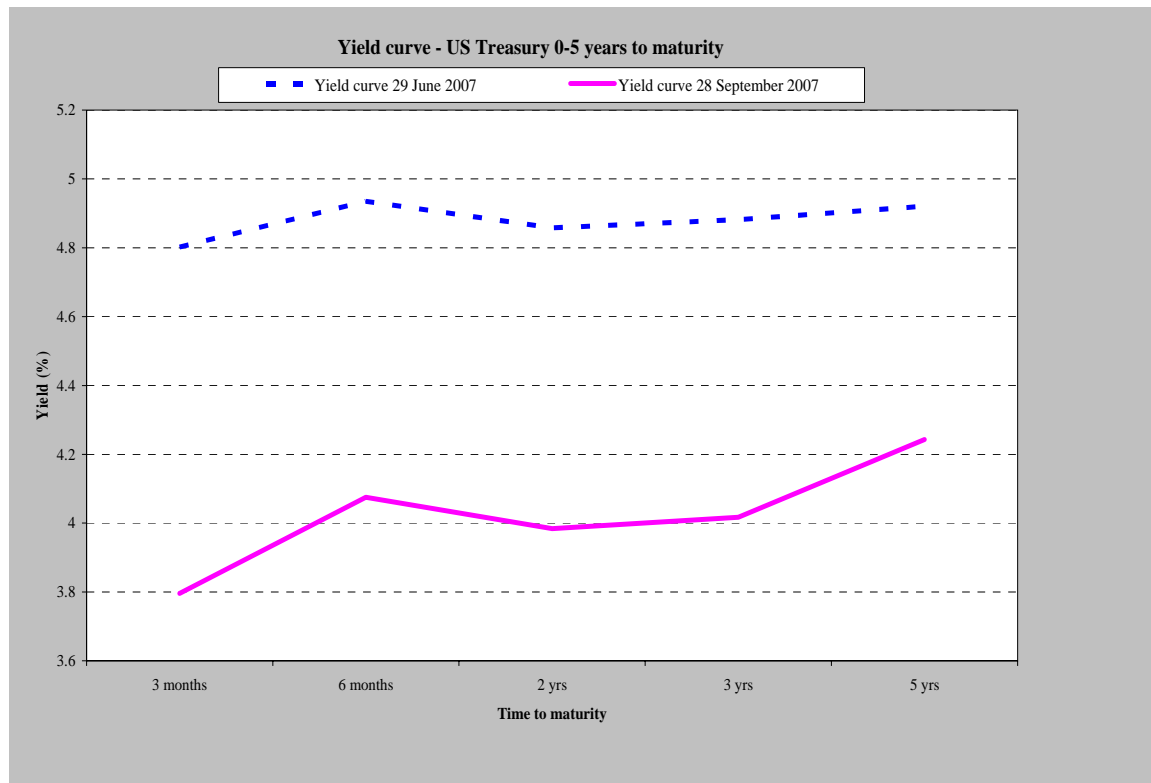
To enable the orderly acquisition of suitable investments, the parameters in this Annex 1 shall apply only from thirty (30) days after the date of entering into force of this Management Agreement.

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.

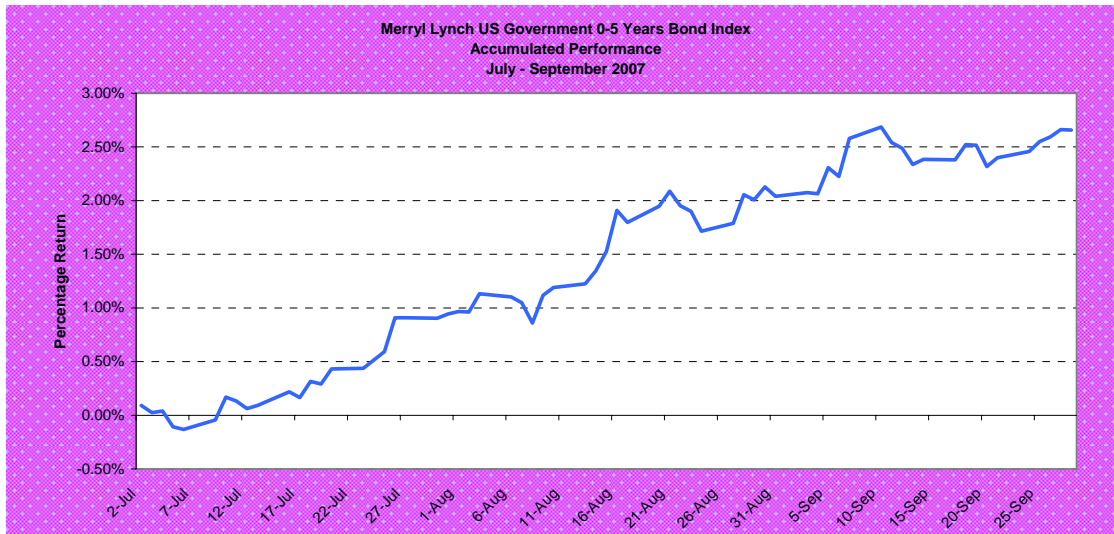
## 2. MARKET TRENDS DURING THE QUARTER

During the period from 29 June 2007 to 28 September 2007 the market yields for US Treasuries experienced a significant drop. In the short end the 3 and 6 months US Treasury benchmark reference bills fell with 101 and 86 basis points respectively. The yields of the 2 and 3 years US Treasury benchmark reference notes fell with around 87 basis points in the period, while the 5 year yield was 68 basis points lower at the end of this quarter compared to the previous quarter end. The bond prices and yield move in opposite direction. The changes in the yields during the quarter have therefore resulted in higher prices for the securities held in the PF portfolio. The graph below shows the 0-5 years US Government yield curve on 28 September 2007 compared with the previous quarter end (29 June 2007).



On 18 September 2007 the U.S. Federal Reserve Bank lowered its key overnight lending rate (the US Federal Funds target rate) by 50 basis points to 4.75%.

The following graph shows the performance of the Merrill Lynch US Government bond 0-5 year's index during the quarter.



### 3. MANAGEMENT DURING THE QUARTER

#### *Objectives*

The BPA's objective in managing the Fund is to achieve a portfolio return closed 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 Planning and Finance.

#### *Operational Implementation*

The mandate is operationalised by holding ten of the approximately 95 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.

The Petroleum Fund Procedures Manual has been developed and implemented to ensure the operational management of the fund. The risk based audit programs been developed and fully operational.

#### *Capacity Building and Technical Assistance*

Staff assigned to the related Petroleum Fund operational management continued to engage in capacity building, primarily in the form of on-the job training, an ongoing finance training course and the long term capacity building programs.

The BPA acknowledges with appreciation the receipt of technical assistance from the Ministry of Foreign Affairs of Norway funded a resident advisor for the entire quarter to further support capacity building and institutional development. The position is organised through the International Monetary Fund.

#### 4. PORTFOLIO PERFORMANCE

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

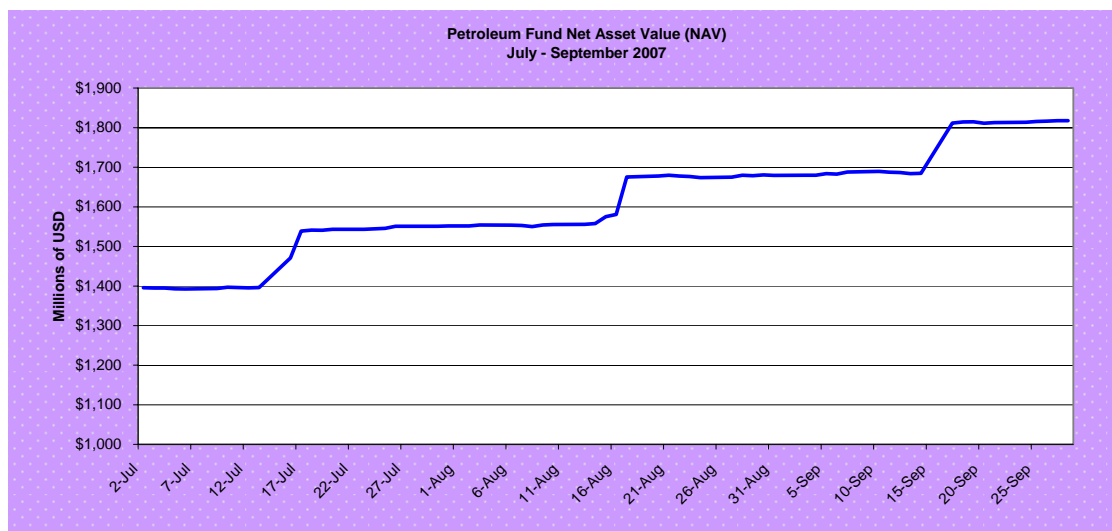
##### *Absolute Return*

In million US\$

Absolute Return for Quarter July-Sept 07	
Opening book value (30 June 07)	1,394.22
Receipts during the period	381.55
Transfer to General State Budget during the period	-
Management Fees	(0.26)
Absolute Return in the period	42.40
Closing book value (30 Sept 07)	1,817.91

The opening value of the Fund at the beginning of the quarter was \$1,394.22 million and the closing value as at 30 September 2007 was \$1,817.91 million. The petroleum revenue during the quarter was \$381.55 million consist of the petroleum **tax payers'** contribution to the fund was \$116.22 million and the **royalties'** contribution to the fund was \$265.33 million. Absolute return was \$42.40 million during the quarter, whereof the coupon and interest received was \$14.46 million and the change in the securities valuation was positive \$27.94 million. This represents a return to the Fund based on the time weighted rate of return of 2.68 percent, or 268 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:



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 recognised 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. Considering the increasing costs of managing the Petroleum Fund, a management fee of US\$1,042,780.00 for the fiscal year 2007/08 has been agreed between the Ministry of Planning and Finance and the BPA. An amount of US\$260.70 thousands management fee has been deducted from the Fund during the period.

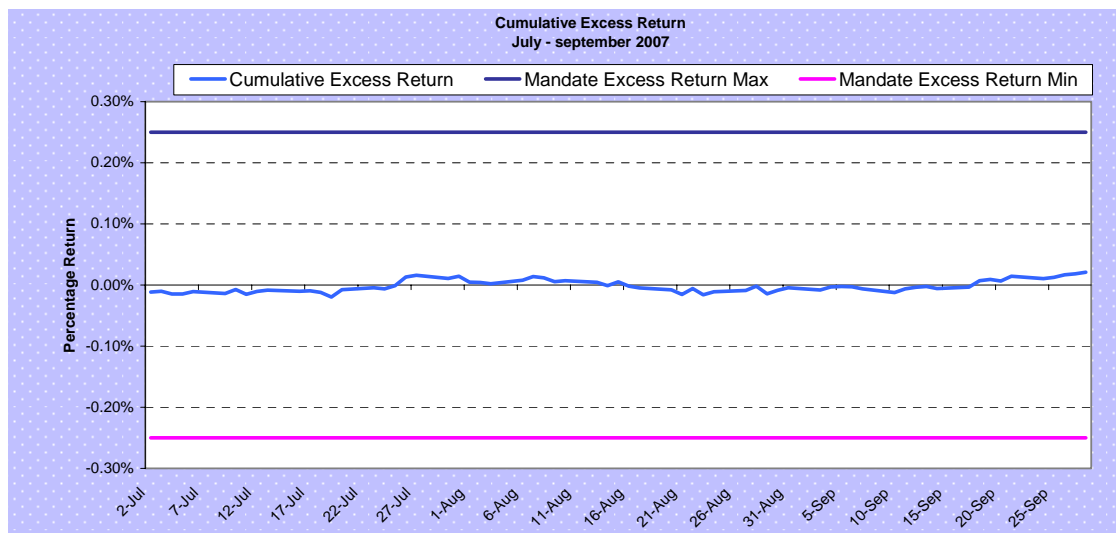
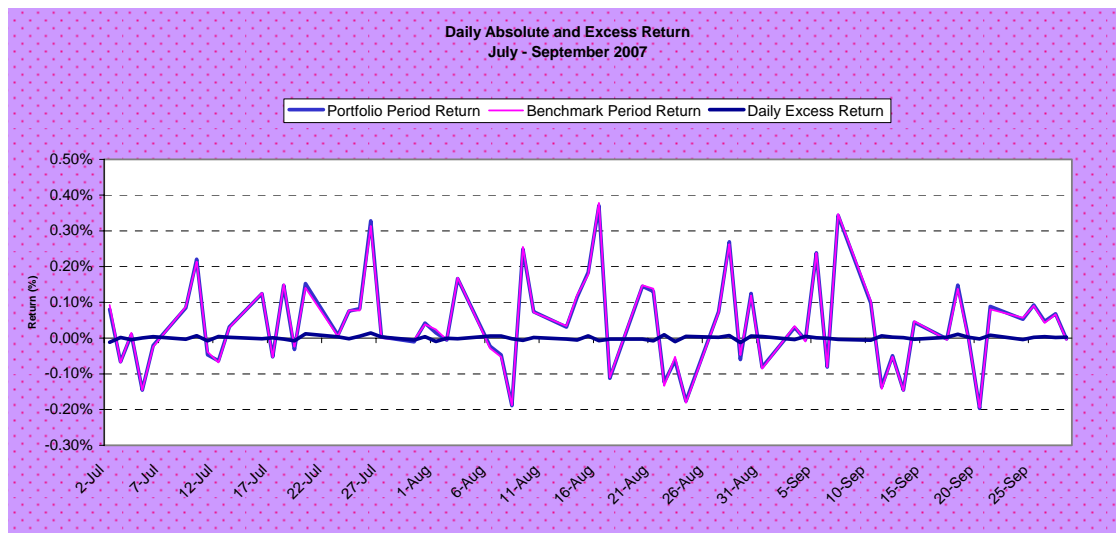
## 6. TRANSFERS FROM THE PETROLEUM FUND

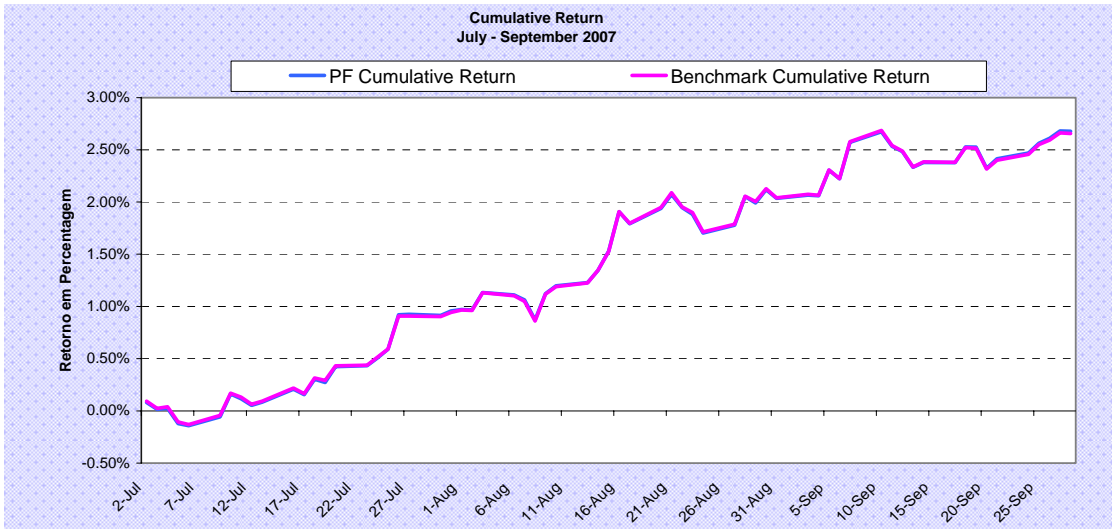
According to Article 7.1 of the Petroleum Fund law transfers from the Fund may only be made to the credit of a single State Budget account. During the quarter, there have been no transfers made from the Fund to the Government.

## 7. RISK EXPOSURE OF PORTFOLIO

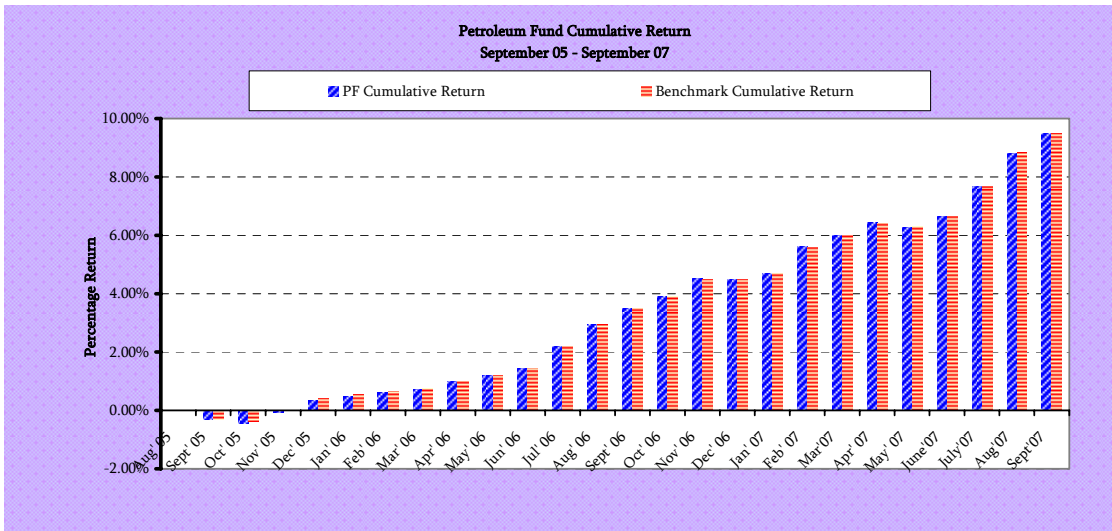
### 7.1 Tracking Error

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 cumulative excess return for the quarter was 2 basis points above the benchmark, within the  $\pm 25$  basis points in the investment mandate.





The cumulative performance of the Petroleum Fund during the quarter compared with the cumulative performance of the benchmark over the same period is shown in the following graph.



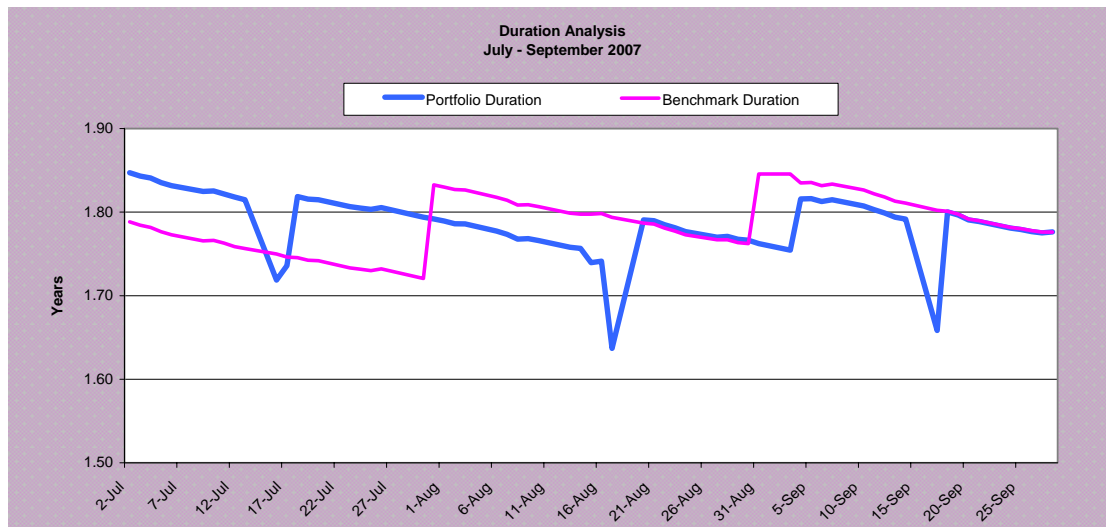
The graph indicates that the cumulative performance of the portfolio is almost identical to the cumulative performance of the benchmark with zero tracking errors. The zero tracking errors mean that the Petroleum Fund portfolio is performed as the benchmark performance over the period.

### 7.2 Duration

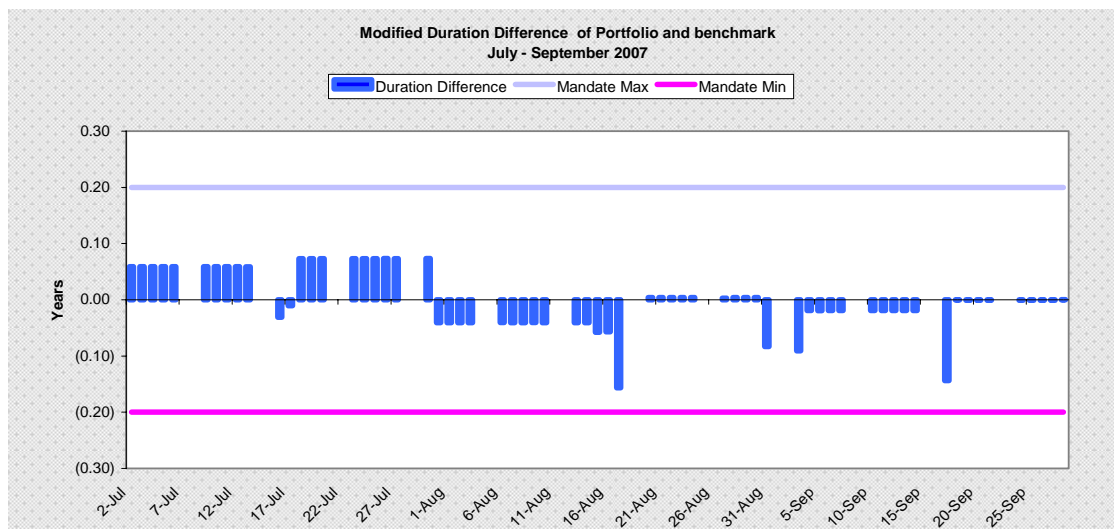
The mandate given by the Ministry of Planning and Finance to the BPA specifies that the Fund portfolio shall have a Modified Duration within 0.2 years of the benchmark index. The following graphs show, firstly, the modified durations of the portfolio and the index, and secondly, the difference



between the portfolio and the index compared with the mandated maximum of  $\pm 0.2$  years.



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



The above 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  $\pm 0.2$  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.

### ***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.

### ***Return on the Portfolio***

The performance on the portfolio for the quarter was 268 basis points compared with the benchmark performance of 266 basis points. The difference of 2 basis points above the benchmark is within the mandated target of  $\pm 25$  basis points.

### ***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.

### ***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 2007.

### ***Accounting Principle***

In accordance with the provision of Article 21 of the Petroleum Fund Law, the accounts and records of the Petroleum Fund shall be presented by using the International Accounting Standard (IAS). The Financial Statements given in this report, as well as the previous reports, is prepared by using the mark-to-market accounting standard.

## 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*

	in thousands \$	
NET ASSETS	Sep-07	Jun-07
Cash and Cash Equivalents	1,198	411
US Treasury Notes (Market Value)	1,791,223	1,386,781
Accrued Interest	25,488	7,031
Less: Pending Purchases of Securities	-	-
<b>TOTAL</b>	<b>1,817,908</b>	<b>1,394,223</b>
CAPITAL		
Opening Balance as at 1 July 07	1,394,223	649,848
PF Law Art. 6.1(a) Revenue Receipts	116,217	498,471
PF Law Art. 6.1(b) DA Receipts	265,330	457,678
PF Law Art. 7.1 Transfer to General State Budget	-	(260,068)
Net Income	42,139	48,293
<b>TOTAL</b>	<b>1,817,908</b>	<b>1,394,223</b>

### *Profit and Loss Statement*

	in thousands \$			
INCOME	Quarter		Year to Date (YTD)	
	Sep-07	Sep-06	Sep-07	Sep-06
Money Market Interest	139	92	139	92
Treasury Note Coupons	14,326	6,648	14,326	6,648
<b>Income</b>	<b>14,465</b>	<b>6,740</b>	<b>14,465</b>	<b>6,740</b>
Market Revaluations	27,935	8,340	27,935	8,340
Less: Management Fees	(261)	-	(261)	-
<b>Net Result for the Period</b>	<b>42,139</b>	<b>15,080</b>	<b>42,139</b>	<b>15,080</b>

#### *Notes:*

- The Management Fees has been reclassified under Profit and Loss as it has been previously classified under Capital Account.*
- The basis on which these financial figures have been prepared is to recognize income as comprising (i) coupon income on an accruals basis, and (ii) changes in market value in the price of the investments that occur after purchase.*

Dili, 10 October 2007

**Venâncio Alves Maria**  
Executive Director

**Abraão de Vasconcelos**  
General Manager