

PETROLEUM FUND OF TIMOR-LESTE

QUARTERLY REPORT

For the Quarter ended 30 June 2008

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 April to 30 June 2008.

During this period, the BPA continued to invest all funds received according to the investment mandate agreed with the Ministry of P 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 \$2,629.96 million to \$3,203.07 million, including gross **cash inflows to the fund of \$598.81 million comprising the taxpayers contribution to the fund was \$246.35 million and the Royalties contribution to the fund of \$352.46 million.** The cash outflow was \$260 thousand for the management fees, while the net cash inflow was \$598.55 million. The portfolio return in the period was -1 % or -100 basis points while the benchmark return for the quarter was -1.02% or -102 basis points. The excess return was 2 basis points above the benchmark within the mandated target ± 25 basis points.

The market value of the benchmark index and the Petroleum Fund portfolio declined in value during the quarter resulted the benchmark losing -1.02% and the Fund losing -1 %.

This loss of value was caused by major factors that adversely affected the market during the quarter primarily increases in United States yields which caused the market prices of the bonds to fall.

Below table shows the returns by quarter, 6 months, one year, two years and the total since inception of the Fund.

Historical Return

	Quarter	Annual*	2-years*	3-years*	Since Inception*
Portfolio	-1.00%	7.34%	6.22%	4.62%	4.62%
Benchmark	-1.02%	7.33%	6.23%	4.58%	4.58%
Excess Return	0.02%	0.01%	0.00%	0.03%	0.03%

* Annulaised.

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

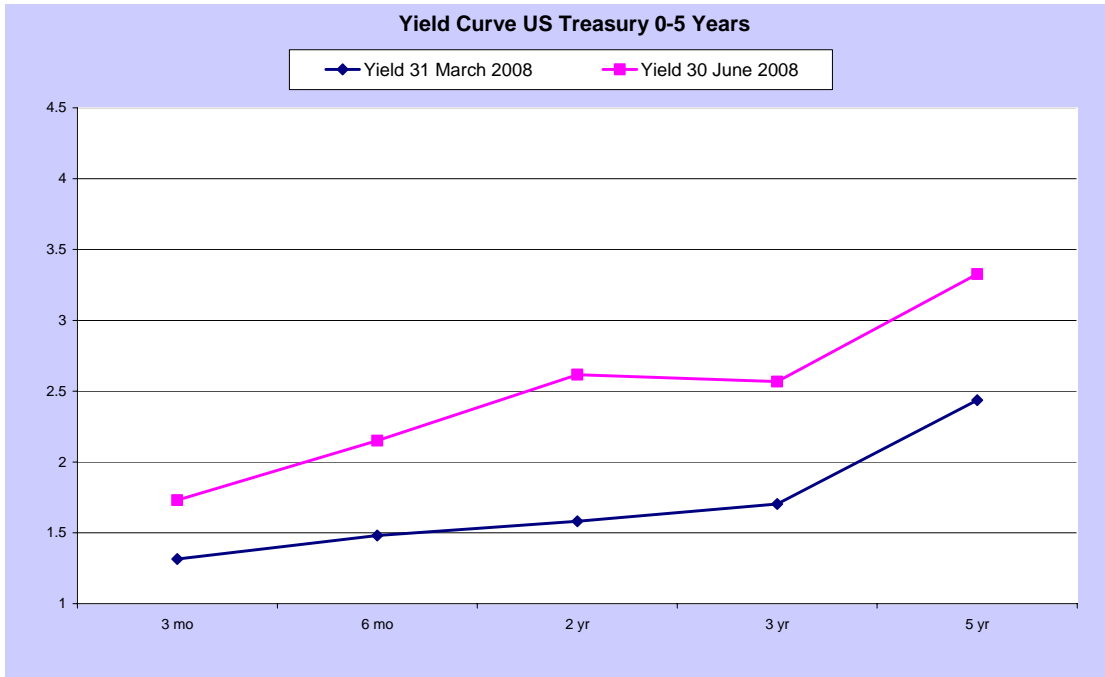
1. The nature of the mandate established by the Minister shall be to passively manage the Fund close to the benchmark, so that in normal circumstances the objective shall be to achieve a return within 25 basis points of the benchmark.
2. The difference in the modified duration between the portfolio and 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.

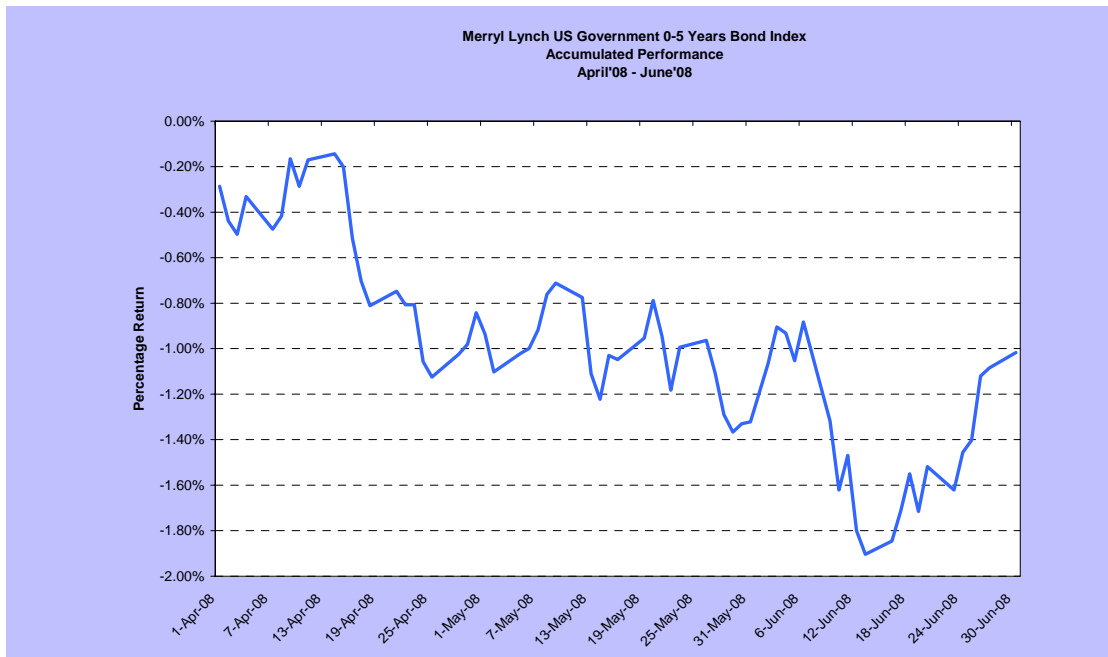
2. MARKET TRENDS DURING THE QUARTER

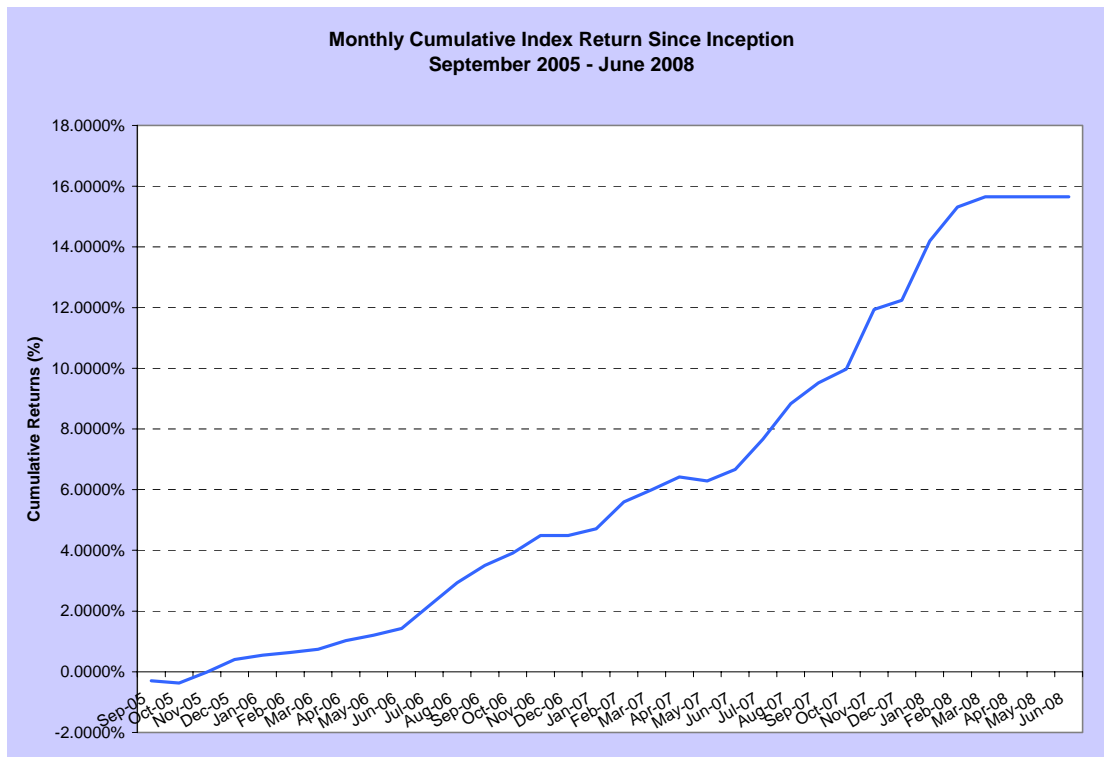
During the period from 31 March 2008 to 30 June 2008 US Treasury bond yields increased significantly. At the short end 3 and 6 month US Treasury benchmark reference bills increased by 41 and 67 basis points respectively, while 2 year bond yields raised by 103 basis points. The 3 and 5 year US Treasury benchmark reference notes increased by 86 and 89 basis points respectively compared to the previous quarter end. Bond prices and yields move in opposite directions. The changes in the yields during the quarter have therefore resulted in lower prices for the securities held in the PF portfolio and a lower capital value of the bonds held in the investment portfolio. The graph below shows the 0-5 year US Government yield curve on 30 June 2008 compared with the previous quarter end 31 March 2008.



On April 30, 2008 the U.S. Federal Reserve Bank lowered its key overnight lending rate (the US Federal Funds target rate) by 25 basis points, resulting in the current level target rate falling to 2.00%.

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

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.

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.

Strategic Review

During the quarter, the project on engaging a global custodian with assistance from an international consultancy company (Mercer) has been concluded with the appointment of JPMorgan on early June 2008 as the Fund’s global

custodian to support the intention of the Government to diversify the Petroleum Fund asset for a higher yield.

The Executive Director of the Petroleum Fund Department of the BPA continued to participate in a Working Group established by the Minister of Finance with the objective to review the optimal strategic asset allocation within the limit of the Petroleum Fund Law and to suggest appropriate changes in investment rules and qualifying instruments in the Petroleum Fund Act and correspondingly in the Management Agreement.

External Managers

Following inconclusive contract negotiations with the International Bank for Reconstruction & Development (IBRD) as a non-commercial external manager, it was decided to cease the negotiation process in June.

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

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.

Absolute Return

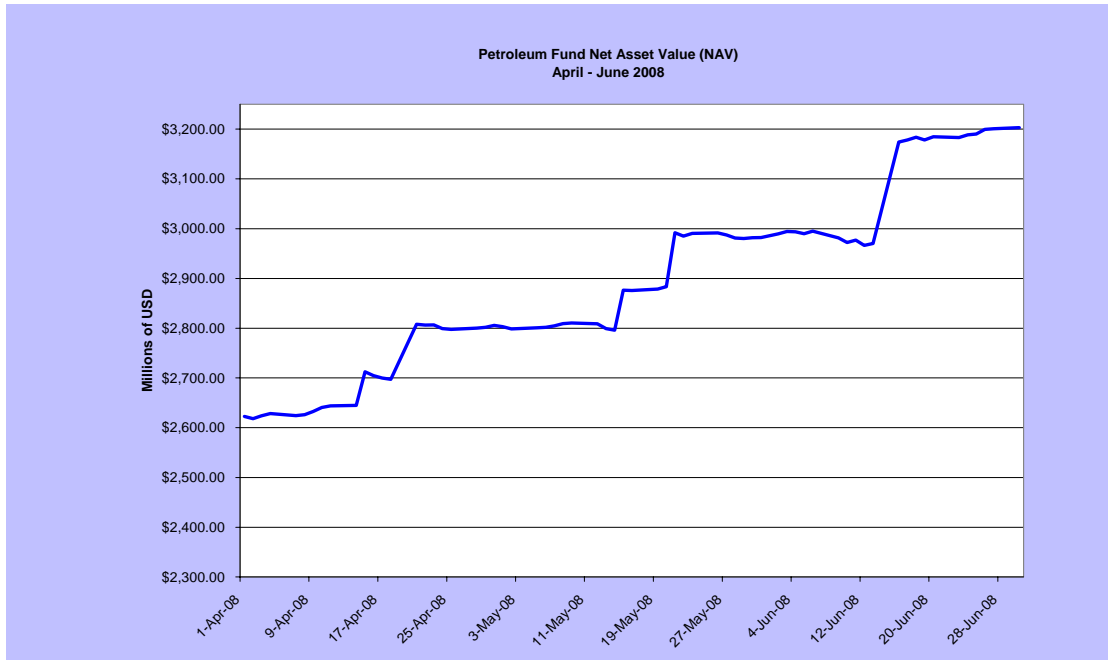
In million US\$

Absolute Return for Quarter April-June 08	
Opening book value (31 March 08)	2,629.96
Receipts during the period	598.81
Transfer to General State Budget during the period	-
Management Fees	(0.26)
Return in the period	(\$25.44)
Closing book value (30 June 08)	\$3,203.07

The opening value of the Fund at the beginning of the quarter was \$2,629.96 million and the closing value as at 30 June 2008 was \$3,203.07 million. The petroleum revenue during the quarter was \$598.81 million consisting of the petroleum **taxpayers** contribution to the fund of \$246.35 million and the **royalties** contribution to the fund of \$352.46 million. The dollar returns (gross of fees) was -\$25.44 million during the quarter, of which the coupon and interest received was \$26.59 million and the change in the security valuation

was negative \$52.03 million. This represents a return to the Fund based on the time weighted rate of return of -1.0 percent or -100 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 period of July 2007 to June 2008 has been agreed between the Ministry of Finance and the BPA. An amount of US\$260,690 management fee was deducted from the Fund during the period.

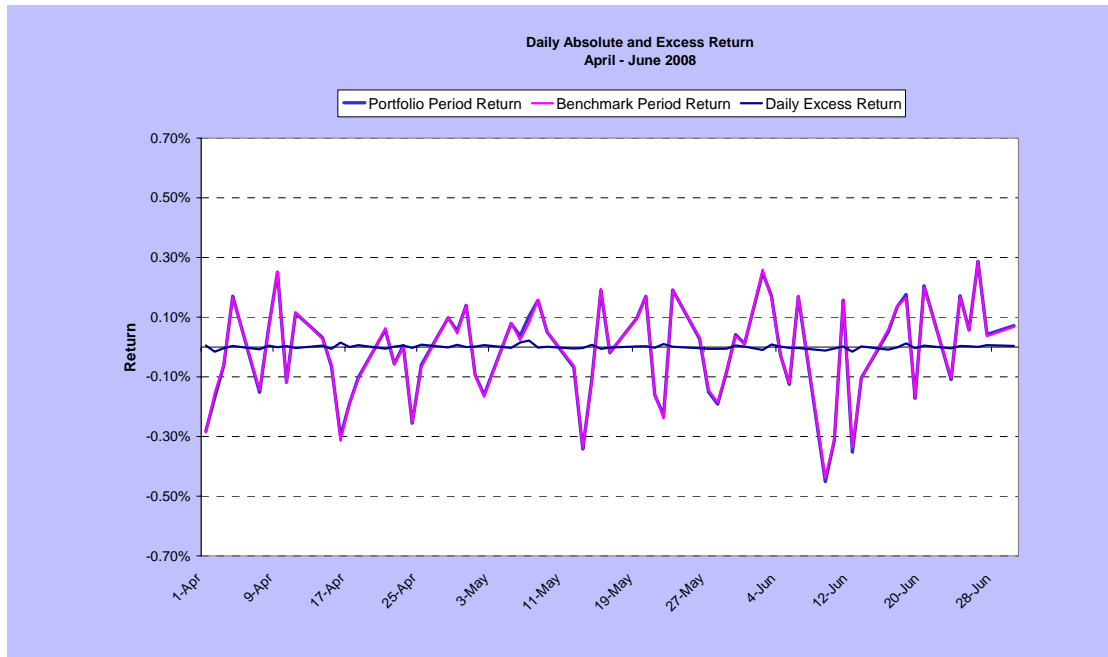
6. TRANSFERS FROM THE PETROLEUM FUND

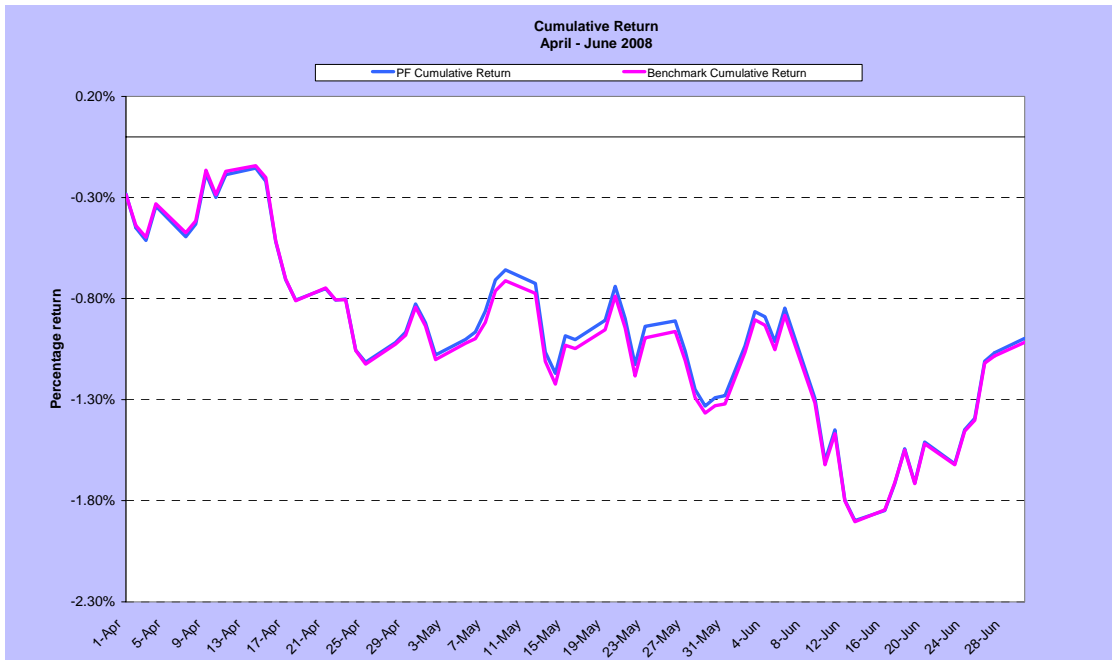
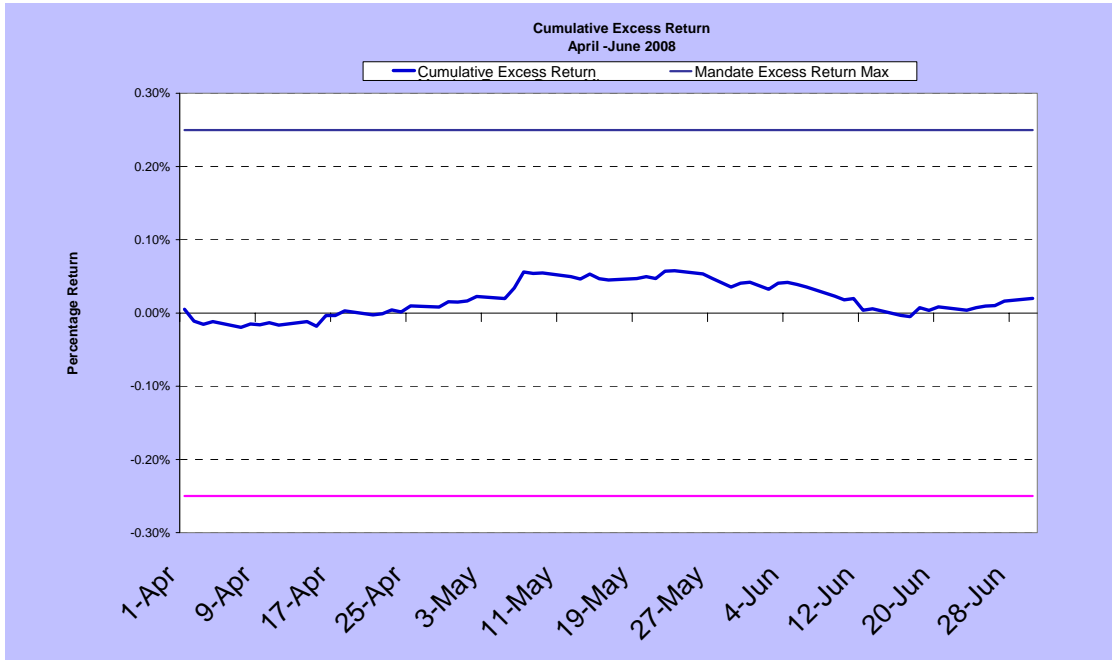
According to Article 7.1 of the Petroleum Fund law transfers from the Fund may only be made to the credit of a single State Budget account. During the quarter, there was no transfer to General State Budget.

7. RISK EXPOSURE OF PORTFOLIO

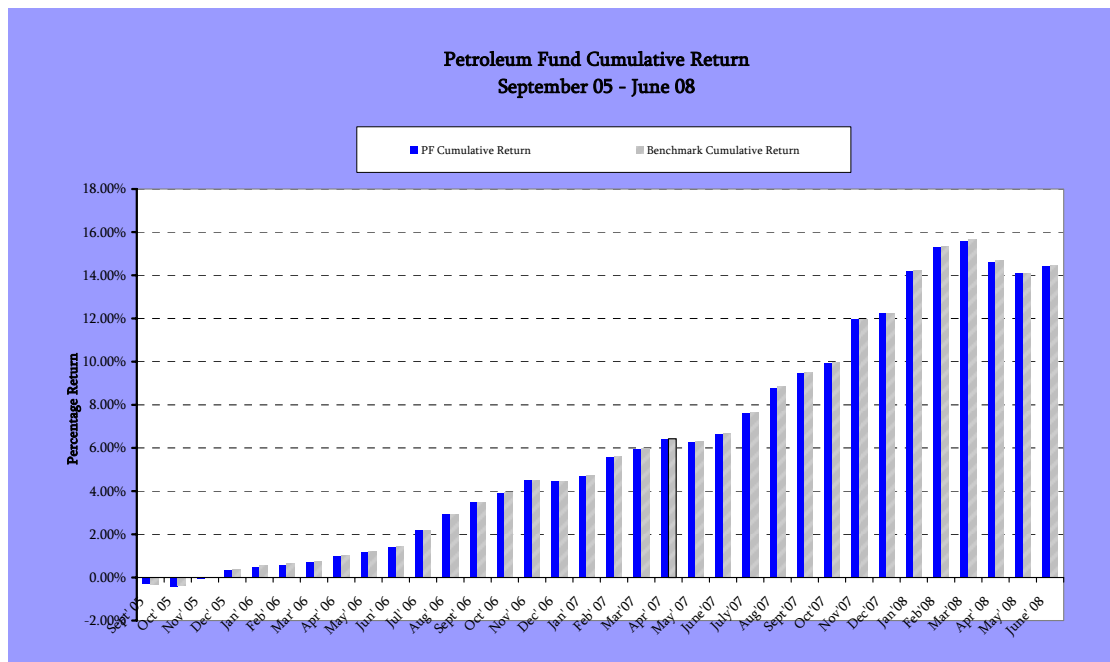
7.1 Tracking Error

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 ± 25 basis points in the investment mandate.





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



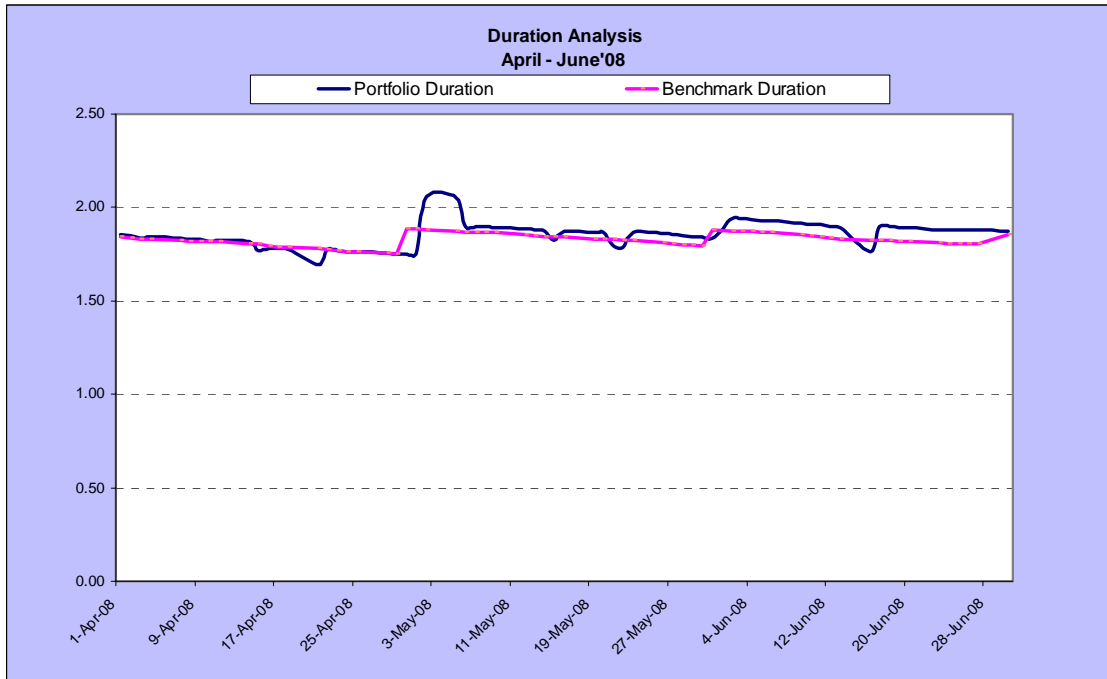
The graph indicates that the cumulative performance of the portfolio is almost identical to the cumulative performance of the benchmark with almost zero point tracking errors. A zero tracking error means that the Petroleum Fund portfolio is performing exactly the same as the benchmark performance over the period.

Cumulative Performance Numbers since Inception

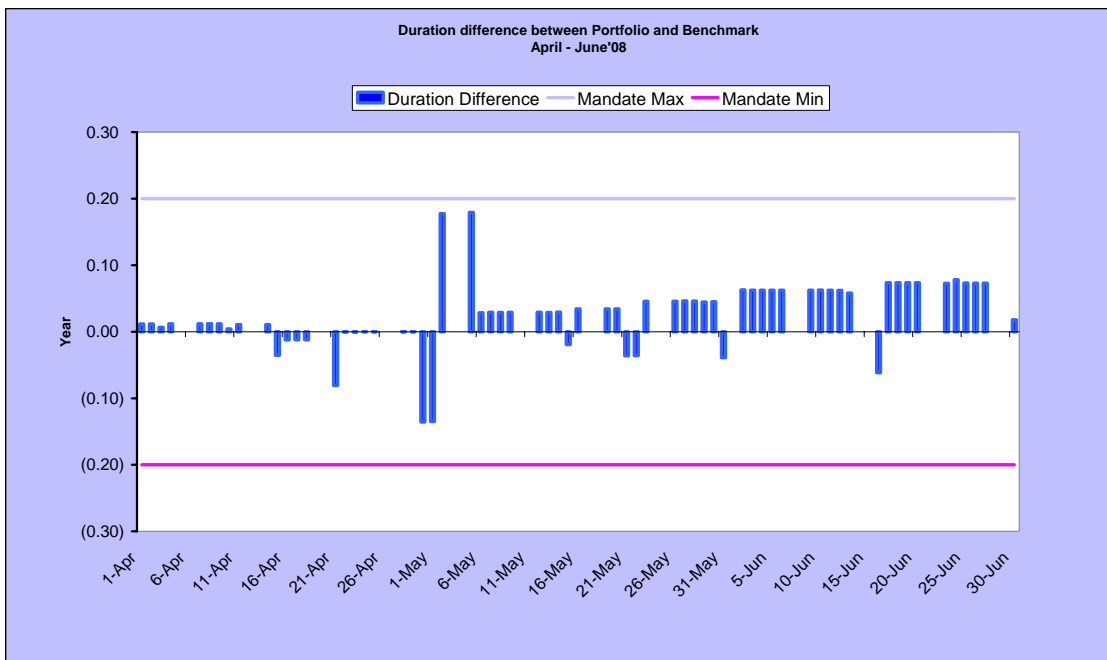
Period	Cumulative Portfolio Return	Cumulative Benchmark Return	Cumulative Excess Return
Aug' 05	0.0000%	0.0000%	0.0000%
Sept' 05	-0.3186%	-0.2994%	-0.0192%
Oct' 05	-0.4310%	-0.3694%	-0.0618%
Nov' 05	-0.0620%	-0.0119%	-0.0501%
Dec' 05	0.3431%	0.3973%	-0.0540%
Jan' 06	0.4914%	0.5476%	-0.0558%
Feb' 06	0.5990%	0.6356%	-0.0365%
Mar' 06	0.7107%	0.7496%	-0.0387%
Apr' 06	0.9912%	1.0086%	-0.0173%
May' 06	1.1933%	1.2055%	-0.0120%
Jun' 06	1.4298%	1.4283%	0.0015%
Jul' 06	2.1942%	2.1846%	0.0094%
Aug' 06	2.9434%	2.9358%	0.0074%
Sept' 06	3.4911%	3.4953%	-0.0040%
Oct' 06	3.9217%	3.9201%	0.0015%
Nov' 06	4.5252%	4.4951%	0.0288%
Dec' 06	4.4811%	4.4744%	0.0064%
Jan' 07	4.6912%	4.7127%	-0.0205%
Feb' 07	5.5844%	5.6037%	-0.0182%
Mar'07	5.9681%	5.9922%	-0.0227%
Apr' 07	6.4156%	6.4222%	-0.0062%
May' 07	6.2699%	6.2927%	-0.0215%
June'07	6.6206%	6.6605%	-0.0374%
July'07	7.6406%	7.6655%	-0.0232%
Aug'07	8.7909%	8.8363%	-0.0417%
Sept'07	9.4760%	9.4942%	-0.0166%
Oct'07	9.9439%	9.9812%	-0.0339%
Nov'07	11.9726%	11.9394%	0.0296%
Dec'07	12.2451%	12.2451%	0.0000%
Jan'08	14.1971%	14.2033%	-0.0054%
Feb'08	15.3103%	15.3171%	-0.0059%
Mar'08	15.5996%	15.6538%	-0.0468%
Apr' 08	14.6433%	14.6799%	-0.0319%
May' 08	14.1082%	14.1152%	-0.0061%
June' 08	14.4472%	14.4778%	-0.0268%

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 ± 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 ± 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 -100 basis points compared with the benchmark performance of -102 basis points. The difference of 2 basis points higher than the benchmark is within the mandated target of ± 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 31 December 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 year-end of the Fund

has been changed from 30 June to 31 December following the government's decision to change its fiscal year.

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	Jun-08	Mar-08	Jun-07
Cash and Cash Equivalents	385	565	411
US Treasury Notes (Market Value)	3,185,709	2,592,399	1,386,781
Accrued Interest	16,978	36,999	7,031
Less: Peding Purchases of Securities	-	-	-
TOTAL	3,203,073	2,629,963	1,394,223
CAPITAL			
Opening Balance as at 1 January 2008	2,086,157	2,086,157	649,848
PF Law Art. 6.1(a) Revenue Receipts	455,205	221,736	498,471
PF Law Art. 6.1(b) DA Receipts	623,350	258,010	457,678
PF Law Art. 7.1 Transfer to General State Budget	-	-	(260,068)
Net Income	38,362	64,060	48,293
TOTAL	3,203,073	2,629,963	1,394,223

Profit and Loss Statement

	in thousands \$			
INCOME	Quarter		Year to Date (YTD)	
	Jun-08	Jun-07	Jun-08	Jun-07
Money Market Interest	120	155	269	458
Treasury Note Coupons	26,472	11,298	46,618	37,013
Income	26,592	11,453	46,887	37,471
Market Revaluations	(52,030)	(3,247)	(8,004)	11,346
Less: Management Fees	(261)	(157)	(521)	(524)
Net Result for the Period	(25,699)	8,049	38,362	48,293

Notes:

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, 16 July 2008

Venâncio Alves Maria
Executive Director

Abraão de Vasconcelos
General Manager