



IV CONSTITUTIONAL GOVERNMENT

Explanatory Memorandum

First Amendment to Law No. 9/2005 of 3 August, “Petroleum Fund Law”

1. Introduction

The Petroleum Fund was established in 2005 with the aim of contributing to the sound management of petroleum resources and a sound fiscal policy. The Petroleum Fund Law regulates the operational management and investment policy of the Petroleum Fund, including the collection and management of petroleum revenue, transfers to the State Budget and includes rules on the responsibility and the supervision of the Government.

Since the establishment of the Petroleum Fund in September 2005, the Fund has gradually increased and reached to \$7,728 million in April 2011. The amount equals approximately 10 times the non-petroleum GDP. In the month that the total petroleum revenues from the Petroleum Fund since its inception is \$9,125 million, while the return on investment increased the Fund by \$696 million.

The Petroleum Fund financed \$3,074 million of the State Budget since its inception in 2005, including withdrawals approved for 2011. Total Estimated Sustainable Income (ESI), equal to 3% of the total Petroleum Wealth, during the six years was \$2,559 million. Following improved budget execution and an overall increase in public spending, transfers above the ESI have been requested since the 2009 budget, in order to alleviate poverty and develop infrastructure. The current Petroleum Fund Act allows withdrawals greater than the ESI, once the documents specified in the law have been submitted to the National Parliament.

The Petroleum Fund’s annual reports submitted to the National Parliament, show the development of the development strategy since the Fund was established in 2005. Since its establishment it has followed a strategy of prudent and simple investment in order to avoid exposure to risk and volatility situations in the first phase, while it was building capacity. The amounts in the Fund were invested only in U.S. Treasury bonds, and the entire portfolio was managed by the BPA.

In June 2009, the Bank for International Settlements (BIS) was appointed as the first external fund manager, to manage 20 per cent of the Petroleum Fund to date. The parameter of the BIS includes U.S. government securities, securities issued by the Australian Government, EU, UK and Japan in local currencies and government, and supranational bonds denominated in U.S. dollars. In October 2010 the company “Schroders Investment Management” was hired to manage an equivalent of 4% of the Petroleum Fund in equities.

The Petroleum Fund Law, approved by the National Parliament in 2005, sets a relatively narrow investment universe. At least 90% must be invested in highly rated securities denominated in U.S. dollars, leaving only a maximum of 10% to be invested in other financial instruments. However, the Petroleum Fund Law states that the range of financial instruments included in the investment universe will be reviewed by the Government and approved by the National Parliament at the end of the first five years of the Petroleum Fund, taking into account the size of the Petroleum Fund and the level of institutional capacity.

In this sense, the Government proposes to the National Parliament to amend the Petroleum Fund Law in order to, inter alia, minimize the over-concentration of the Fund's investments in U.S. Treasuries, reducing the risk associated with the devaluation of the dollar and the fall in U.S. economy. At the same time, it is intended that the rate of return will exceed 3% of the Estimated Sustainable Income which can only be achieved by diversifying the portfolio and the types of investment. It also offers the possibility to use the Fund as collateral for loans by the state to contract for the construction of strategic infrastructure, necessary for national development, thus enabling a better bargaining power and reduce costs associated with loans.

2. Government Review Process

In recent years the government was involved in a review process to ensure that the Petroleum Fund is an appropriate legal framework for future investment of petroleum revenue. The Ministry of Finance appointed a working group to review the law and present options for change. In addition, the Minister of Finance asked the external consultant of the Ministry for matters of the Petroleum Fund, "Towers Watson," to analyze and study various scenarios in terms of future strategic options for investment. The result of this work was brought to the public in various seminars, including the Seminar on Management of the Petroleum Fund in May 2010, and during a visit to Dili in last March, in connection with the report on Strategic Asset Allocation.

In June 2009 the Minister of Finance asked the Advisory Board for Investment (IAB) to provide its opinion regarding the optimal asset allocation strategy for the Petroleum Fund, Santiago Principles' implementation of and amendments to Articles 14 and 15 of the Petroleum Fund Law. The Committee made its recommendation to the Minister of Finance in December 2009.

According to current regulation of the Banking and Payments Authority (BPA), the proposed First Amendment to the Petroleum Fund Law No 9/2005 of August 3 was released the Banking and Payments Authority (BPA) in October 2010, to offer their comments.

3. Summary of proposal

The main proposed changes are as follows:

Legal Personality of the Petroleum Fund

- Change Article 5.2 and introduce a new paragraph 3 to clarify that the FP has no legal personality, ensuring that the Operational Manager has procedural capacity to bring legal actions on behalf of the PF.

Transfers from the Petroleum Fund

- Change Article 9(d) (Transfers Exceeding the Estimated Sustainable Income)
This change is due to the need to clarify the requirements that the government must meet to make transfers exceeding the Estimated Sustainable Income.

Operational Management

- Amend Article 11 (Petroleum Fund Management)
The Government proposes that the Petroleum Fund Law gives flexibility for the possibility that the Banking and Payments Authority (BPA) or other public body established by the National Parliament may be the Operational Manager of the Petroleum Fund in the future.

External Investment Managers

- Amend Article 12 (External Investment Managers)
The Government proposes that the Minister of Finance accept the recommendation of the Operational Manager for the appointment of external investment managers, according to the

requirements included in Article 12.2. This ensures an adequate monitoring system between the Manager of the Global Fund and the Operational Manager. It introduces a new paragraph 3, which allows qualified Timorese citizens occupy the position of External Investment Manager.

Policy and Investment Rules

- To amend Article 14 (Investment Rules)
The Government proposes to establish a goal of long-term investment based on the principles of diversification as well as ensure that the Santiago Principles are implemented. The proposed law also includes improved reporting of investment policy to the National Parliament.

Qualifying Instruments

- Change Article 15 (Qualifying Instruments)
The Government proposes that at least 50% of the portfolio be invested in bonds and up to 50% of the portfolio be invested in equities. The proposal allows the investment of 5% in alternative investments.

Investment Advisory Board

- Amend Article 17 (Investment Advisory Board)
The Government proposes to amend the procedures for the appointment of members and composition of the Investment Advisory Board.

Encumbrance of assets of the Petroleum Fund

- Change Articles 20.1 and 20.2
The Government intends to allow the use of part of the Petroleum Fund as collateral for borrowing, as provided in Rules for Public Debt, to build strategic infrastructure. Similarly, Article 20 is amended to replace the vague provision of belonging by “Timor-Leste” for belong to the State of Timor-Leste.

Then the proposals are outlined in greater detail.

3.1 Legal Personality of the Petroleum Fund

If the Operational Manager of the PF has a situation to take legal action against a third party, the current law is not clear whether the Fund has legal personality or not, and this uncertainty may cause it to be considered that Operational Manager does not have standing to bring actions.

The question of whether the Operational Manager will be considered as having legal standing to bring actions on behalf of the Fund should be determined based on the proceedings and based on the rules relating to the dispute resolution process that the country will be decided.

The laws of Timor-Leste are not relevant to situations where processes should be resolved in accordance with foreign law. The existence of specific regulations on legal issues concerning the legal status of the Fund in the Petroleum Fund Law can thus be advantageous also for cases to be resolved in accordance with foreign law. Obviously, the existence of explicit regulations will also be beneficial for all cases to be resolved in accordance with the law of Timor-Leste.

The legal status of the Fund is discussed in Article 5.2. The text of this article includes a reference to which the Fund is not a legal entity.

The new paragraph 5.3 is also introducing another explanation, clearly indicating the reference that the Fund itself has no rights or obligations in respect of private sector entities or public authorities and cannot initiate legal action not be brought against them.

3.2 Transfers from the Petroleum Fund

Estimated Sustainable Income (ESI) is a parameter that indicates the level of annual withdrawals consistent with the long-term sustainability of petroleum wealth. It is assumed that the ESI is equal to the real long-term return, which should be 3%. The Petroleum Fund Law provides flexibility to spend above the ESI, provided that certain reports and justifications are submitted to the National Parliament before any transfers beyond the ESI are conducted.

The Government believes that the ESI parameter is important to give information about the long-term sustainability and to serve as a framework for financial discipline. Therefore, the Government proposes to maintain the 3% ESI. However there are huge challenges in the development of domestic economy and in terms of promoting sustainable growth in the global economy, so withdrawals exceeding the ESI are needed to invest in infrastructure and human capital development.

The current Petroleum Fund Act allows withdrawals from the Fund above the sustainable yield provided that the Government submit to Parliament a detailed explanation of how the withdrawal in question serves the long-term interests of Timor-Leste, as well as reports on the calculation of the impact of the withdrawal on ESI amounts in future years (Article 9). The definition of detailed explanation can allow multiple interpretations, by which the Government proposes to replace “detailed explanation of how the withdrawal in question serves the long-term interests of Timor-Leste” with “justification of the reasons that lead one to consider as the interest in Timor-Leste in the long run, to make a transfer greater than the Estimated Sustainable Income. “

3.3 Management of the Petroleum Fund

The Government proposes to give the Petroleum Fund Law flexibility for each institution to be the future Operational Manager of the Petroleum Fund. The BPA is currently appointed to this task, but the Government proposes that in future it can be ensured by the Central Bank or any other public entity established by the National Parliament. The organization, however, must operate independently of the Government and there should be a clear division between the global manager of the Fund (the Government) and the Operational Manager.

3.4 External Investment Manager

The intention of paragraph 12.2 is to ensure the existence of a control mechanism between the Government and the Operational Manager of the Fund.

The new paragraph 12.3 is intended to provide legal opportunities for people of Timor-Leste, duly qualified in the sense that they can also compete for the position of external investment manager, relieving some of the requirements in the Law for this position. To ensure proper balance of this situation, the Minister shall obtain the approval of the Council of Ministers.

3.5 Policy and Investment Rules

The Government proposes:

- Allow an equity exposure to 50% of the total portfolio and a minimum 50% exposure to debt securities.
- Allow an exposure to other financial investments (e.g. infrastructure and real estate, etc.) of up to 5% of the portfolio.
- Include the principle of diversification, as well as provisions to ensure that no undue risks are taken in terms of investments in companies or unique investments.
- Update the legal framework with relevant recommendations contained in the Santiago Principles.

Justification of the proposal

One of the main documents taken into account in reviewing the Government Petroleum Fund Law was the report, “Sovereign Wealth Funds: Generally Accepted Principles and Practices” of the international working group on sovereign wealth funds, also known as the “Santiago Principles.” The “Santiago Principles” are the result of a concerted international effort to identify best practices to be applied in the management of SWFs, especially in areas of good governance and policy. The review of the Fund Law takes into account the new principles and intends that Timor-Leste continues to be an international example in the management of SWFs.

The Government took into account the principle of diversification when it conducted a review of the Fund’s investment policies. Getting high rates of return entails risk. When capital is systematically placed in other investments than those which ensure a low risk (such three-month U.S. Treasury bonds), investors expect a higher income as a reward for risk taken. So in the long run, diversifying the portfolio will give the investor a higher rate of return than if the portfolio is limited to bonds with a lower risk level.

Diversification is the process by which a portfolio is composed of different types of financial assets with different risk levels, rather than concentrate the portfolio in any single type of asset. Diversification is the antidote to various risks that are avoidable. Given that different types of assets with different risk levels will behave differently, combining assets with different rates of return decreases the risk and volatility.

For example, in a period when the bonds are giving lower yields, equity markets may be giving higher yields. Having both types of portfolio assets, bonds and stocks, the risk is reduced compared to the situation of having only one type of asset in the portfolio. The diversified investment portfolios are rewarded in the long term. In this sense, the time period is a crucial factor, and Timor-Leste, as a long term investor, can endure short-term fluctuations in order to achieve expected long term benefits.

Table 1 shows the relationship between risk and rates of return based on the calculations of the external consultant to the Petroleum Fund of the Ministry of Finance, “Towers Watson.”

It is important that investors are informed and agree on the risk-benefit relationship. A condition to achieve the expected returns over the long term is to maintain the decided investment policy.

Table 1: Relationship between risk and return rates for different portfolio compositions

Investment strategy	Expected real rate of return		Range of nominal returns in two out of three years		Frequency of negative rates of return (in 100 years)	Worst returns (5 years in 100)	
	% pa	million USD*	% pa	million USD*		% pa	million USD*
Actual	1.9%	152	1.8% to 7.2%	144 to 576	4	Return of 0.2% or worse	Gain of 16 million or worse
50% stocks	4.0%	320	-1.4% to 15.2%	-112 to 1,216	21	Return of -6.7% or worse	Loss of 536 million or worse
100% stocks	5.2%	416	-6.9% to 24.7%	-552 to 1,976	29	Return of -16.9% or worse	Loss of 1352 million or worse

* Based on a balance of the Petroleum Fund of eight billion

The Petroleum Fund has only one expense, transfers to the State Budget. The law restricts the amount of transfers to the Estimated Sustainable Income Fund (ESI). The ESI is defined as the maximum amount that can be subtracted from the Fund in each financial year and leave sufficient resources to transfer the same real value in the following financial year. The ESI is estimated at 3% of the wealth

of the Fund.

A necessary condition for the ESI to be truly sustainable is that the real rate of return is 3% of the Fund. As shown in Table 1, until now the real income of the Fund has been less than 2%. Economic models also show that the expected return with the current investment portfolio will not exceed 2% when the investment policy is not aligned with fiscal policy. The Government proposes to establish a maximum of 50% for investment in equities. Calculations indicate that this way can achieve a long term real rate of return greater than 3%, taking into account a risk level that the state is willing to accept, aligning the investment policy of the Fund with the directive of the ESI spending .

Government proposal

In the review process the Government has taken the position that it is important to establish rules for the investment policy to establish a proper balance between the expected return on investment and the expected risks. A policy that guarantees a higher expected return on investment when compared with the directive of the ESI spending is important because it enables more funding to fight poverty and develop infrastructure and the domestic economy in the medium and long term, but should at the same time ensure that unnecessary risks are not taken.

The Government considers it necessary to diversify the portfolio to a wider range of investments, regions and currencies. Although the current strategy of investment is considered a prudent view of risks and returns, the current portfolio depends too much on one investment class, region and currency. Today more than 90% of the portfolio is invested in U.S. government bonds. The Petroleum Fund should enable greater portfolio diversification in a variety of investment categories, regions and currencies.

In addition, the Government believes that the Petroleum Fund should ensure sufficient flexibility to design the investment strategy and develop it gradually towards the optimal allocation of assets without encountering legal constraints imposed by law. On the other hand, the Government recognizes that it is essential to have a broad consensus among key stakeholders regarding the maximum level of risk that the Fund should be exposed through investments.

Thus, the Government proposes to include higher levels of exposure to equities and alternative investments, which will serve as a guarantee that the portfolio is not exposed to greater risks than those approved by the National Parliament through the adoption of the Law. In addition, the existence of improved reporting mechanisms will keep the National Parliament constantly informed about large allocations of assets and how the government used the flexibility in the Law.

The Government suggests that the maximum level of exposure to equities is set at 50% and the minimum level of exposure to bonds to be placed in 50%. A maximum of 50% of equities ensures sufficient flexibility to follow an optimal investment policy that provides for increased investment returns, while ensuring that risks are not beyond the schedule approved by the National Parliament.

The Government has also suggested amendments to Articles 14 and 15 thereof, including more flexibility in terms of investment instruments with an investment grade lower than required by the current Petroleum Fund Law. However investment in assets below investment grade will not be allowed. The current asset allocation of the portfolio, within the limits of the law, will be set by the Government.

To ensure a broad diversification of the portfolio the government also suggests limiting exposure to single companies and assets. The proposed two requirements: 1) participation not to exceed five per cent of the issued capital by issuing company, and 2) the Petroleum Fund's exposure to any company or individual issuer, except in the case of a sovereign state in the form of eligible investments, not to exceed three percent of the total value of the Petroleum Fund.

The Government also ensures that the text of Article 20 shall not have any implications for the effective implementation of investment policy. Operating combinations of short-term nature and

incidentally can potentially expose the assets at rates shall not be seen as encumbrances in the course of the amounts of the Petroleum Fund by the Investment Manager.

Finally, the Government suggests that the Petroleum Fund Law give the flexibility to invest in other financial instruments, such as *private equity*, and other properties. These investments can add less risk to the portfolio, to contribute to the diversification, but may also represent a major challenge for an operational point of view. Thus the Government suggested limit these investments to a maximum of 5% of the total portfolio.

3.6 Investment Advisory Board

The Government proposes to amend the procedure for appointing members and composition of the Investment Advisory Board. Board members shall be appointed by the Prime Minister, with the opinion of the Minister of Finance, and at least three of them should have considerable experience in investment management. The Director of Treasury and the Director of Operational Management will be members of the Board by virtue of their positions. This will ensure transparent, professional and independent advice to the Minister of Finance.

In order to ensure that all opinions are made independently and without any conflicts of interest, the Government proposes to amend paragraph 17.4 to require that the members of the Investment Advisory Board guarantee in writing that their appointment or their opinion does not create a conflict of interest. In addition, the Minister of Finance may require members of the Committee to submit a statement of their assets in order to avoid any conflict of interest. The purpose of the proposed amendment is to clarify the current requirement in Article 17.4.

3.7 Encumbrance of the Petroleum Fund

Article 20.1 of the current Petroleum Fund Act provides that any amount invested in accordance with the articles 14 and 15 at all times remains the property of Timor-Leste, while Article 20.2 states that any contract or agreement, that proposes to encumber the assets of the Petroleum Fund, through collateral, pledge, mortgage or otherwise, is null and void. This article prevents the Petroleum Fund from being encumbered and used as collateral for borrowing, regardless of whether the amounts borrowed are to be invested in physical assets for the benefit of all Timor-Leste people.

The Government proposes to amend Article 20 to allow a limited margin for the encumbering of assets, insofar as this is required by law and that Parliament approves the use of the Fund as collateral for borrowing. Borrowing through presentation of collateral has advantages in terms of the borrowing costs, but should be subject to conditions detailed in the legislation, including conditions on the expected return and total cost of the loan. An important aspect to consider is that the total cost of borrowing should be lower than the expected return on the Petroleum Fund. There has been no legal framework for the area, so this situation needs authorization from Parliament.

3.8 Amendments to Annex I

The enlargement of the diversity of assets in the portfolio beyond the U.S. Treasury bonds would require amending the discount rate of petroleum wealth and the Estimated Sustainable Income, to reflect the current composition of the portfolio. Also, the formula to calculate the Petroleum Wealth should be revised to reflect the fact that petroleum wealth should be calculated based on the beginning of the financial year, assuming that revenues are received through the years.