

Comments on Timor-Leste Petroleum Fund Draft Act

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The Petroleum Fund Steering Group should be commended for the Draft Act to establish a Petroleum Fund (the “Draft Act”). The Executive Summary provides a very clear and important statement of principles, and the Draft Act provides in general a sound basis for a strong petroleum fund. Nevertheless, the government may wish to further refine certain particulars to provide additional transparency protection and to further assure the regularity of the fund’s operations.

As a preliminary note, the author’s experience is drawn principally from assisting the commission in Sao Tome and Principe which had responsibility for drafting that country’s recently adopted Oil Revenue Law (the “STP Oil Law”).¹ The STP law like the Draft Act created a national oil fund and a permanent reserve and set limits on the amounts to be made available to the budget annually. The Saotomean law also incorporated extensive public integrity and transparency provisions.

These comments are made on the basis of a review of the Draft Act standing alone and do not take account of other legislation which may exist or be pending in Timor-Leste. To that extent some of the issues raised in these comments may already be addressed in existing law or pending legislation and thus need not be considered here. Further, in certain instances I note alternative practice elsewhere without necessarily suggesting that such practice is preferable. Rather, what is important is to insure that the government has made a considered judgment with respect to the issue.

Transparency

Scope of Information. The Draft Act makes a strong commitment to transparency as a principle and has an excellent listing of summary information that should be available in the Annual Report on the Petroleum Fund. The Draft Act, however, does not appear to provide for public access to the underlying data

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¹ Copies of the Sao Tome and Principe law in Portuguese and English are available at http://www.earthinstitute.columbia.edu/cgsd/STP/index_stp.htm.

regarding payments into the fund. Nor does it provide for the public disclosure of individual contracts. This means that unless the government uses its discretion to release such data, the public must rely solely upon the integrity of governmental processes without having available to it the information necessary to confirm the regularity of those processes.

The use of aggregate data as opposed to individual company data has been much debated in the context of EITI. While aggregate data may be the best that can be achieved in some countries, it does not permit civil society or parliamentarians to directly compare payment data reported by the government and payments reported by the companies. Article 20 of the Draft Act tries to address this in part by requiring an audit of the Petroleum Fund. By virtue of Article 19 which counts payments to the government as being made only when received in the Petroleum Fund (a highly desirable provision; the STP Oil Law has an analogous provision), receipts into the fund should necessarily equal payments. As a result the audit provided for in Article 20 would not reveal the diversion of funds prior to payment into the petroleum fund.

Although traditionally oil contracts have been confidential in the developing world, that is not the practice in places such as Norway whose law has otherwise been a guide for Timor-Leste. Moreover, the most recent practice even in developing countries is moving towards disclosure. For instance, the Saotomean law requires disclosure and public access to:

“all contracts relating to the participation of the State or any enterprise or entity owned or controlled in whole or in part by the State, the scope of which directly or indirectly concerns activities related to Oil Resources or Oil Revenues” STP Oil Law, Art. 17.2(k).

In addition the Saotomean law guarantees the public access to individual payment data rather than simply summaries or aggregations of information. Further, in the joint development zone controlled by Nigeria and Sao Tome and Principe, Presidents Obasanjo and de Menezes have signed a declaration of principles, the Abuja Joint Declaration, that requires public disclosure by the governing authority and the companies of individual company data and of contracts.²

Making contracts themselves public ensures the integrity of bidding and negotiations, assuring that awards are made competitively and consistent with whatever rules have been laid down. Without the contracts being public, it is impossible for civil society or interested members of parliament to assure that contracts are being adhered to and payments made accordingly. Making contracts public at the time they are entered assures full public oversight of those agreements

² A copy of the Abuja Joint Declaration is available at the Earth Institute site referenced above.

which will be central to the political economy of the country in the future and is the only way to give such contracting full political legitimacy. This legitimacy is important not only for the citizenry, but also for the companies by providing protection against political second guessing when exploration prospects turn out favorably. Secrecy may protect the negotiators (government and private), but no one has identified a governmental interest in keeping agreements private. The contracts themselves are shared among industry partners; it is only the public that is precluded if they are kept confidential.

In resisting making contracts or payments public, companies often rely on confidentiality clauses and assert that it is the government which prevents them from making such information public. Obviously, the government going forward can make it clear that it will not permit such clauses in its contracts, and the government can seek waivers from existing clauses. Moreover, the government, if necessary, can exercise its sovereign rights as to what should or should not be made public as a matter of policy. Certainly, a self-imposed confidentiality argument has no weight in the debate on a forward looking law.

Confidential Information. The Draft Act mentions in numerous places the need to protect confidential information, but it does not indicate what constitutes confidential information. Confidentiality of proprietary information is important, but to prevent this exception from swallowing the whole, it is also necessary to limit what can be brought within such rubric. The Saotomean law specifically allows the withholding of information only if it is classified as confidential by law or Treaty, and it puts the burden of claiming confidentiality on the proponent. Further, the Saotomean law specifically prohibits making any payment information confidential. What as a general matter should be considered confidential has been widely discussed in the literature, particularly in connection with environmental information. See, *e.g.*, the Aarhus Convention, <http://www.unece.org/env/pp/welcome.html>.

Payer Disclosure. One could reinforce the transparency regime by requiring private parties themselves to make public oil-related payments to the government. This would provide an independent check on government reports and would help ensure that such information is available even if the government fails to carry out its obligations to make such information public. The Saotomean law requires disclosure by both the government and the payer. This obligation is further enforced by requiring that the obligation to disclose agreements be included in all oil resource contracts either explicitly or by operation of law. See STP Oil Law, Art. 21.

Public Information Office. I note that the law has no provisions for a public information office or web facility where those documents which are to be made public will be available. This subject may be treated in other legislation. In

any case it is important to have both web access and access to physical copy in local languages. This access should not only include reports which are readable and understandable in summarizing data but should also include access to the underlying data so that independent checks can be made.

Although not specifically required in the Saotomean law, it has been envisioned having the custodial bank holding the oil fund provide the public with direct web access to the oil fund much in the same way that individuals have direct access to their private accounts. This would provide complete transparency regarding receipts, holdings and expenditures and would do so without any intermediation of the government. Such access would not only provide complete transparency, but it would help provide individual citizens a sense of ownership that would further sustain the independence and maintenance of the oil fund.

Petroleum Fund Consultative Council. The Petroleum Fund Consultative Council under the Draft Act appears to be limited to providing policy advice and acting as a medium of communication with the public. This important but limited role contrasts sharply with the powers and functions given to the analogous entity, the Petroleum Oversight Commission, under the Saotomean law. The Petroleum Oversight Commission has broad responsibilities to monitor and ensure compliance by the government with the law, and it has independent administrative powers to investigate allegations of misconduct. See STP Oil Law, Art. 24. The Draft Act appears premised on the belief that regular government processes to ensure compliance with the law are adequate and that no additional or separate supervising authority is required. Certainly, in a properly functioning governmental environment, there is much to recommend the approach of Timor-Leste in the Draft Act. Human resources are scarce and one should be careful not to overburden them by creating additional administrative authorities. I note the difference in approach only to illustrate the alternative.

Calculation of Estimated Sustainable Income

The Draft Act like the STP law adopts the policy of maintaining the real value of the country's petroleum wealth. Although the mechanics are somewhat different in each law, both approach the issue by limiting the amount of annual spending, reserving the remainder in the oil fund. The key limit in the Draft Act is the "estimated sustainable income" defined in Schedule 1. The formulas in Schedule 1 are simple, but applying them in practice raises a number of practical issues.

Prices. Estimates of future petroleum receipts require one to estimate (i) future production and (ii) future prices. The Draft Act avoids dealing with either of these issues directly by relying simply on published budget projections of future receipts. In fact budget projections even for a few years out are likely to be very

uncertain given the volatility of oil prices; projections for twenty or forty years are mere guesses. Prices within the last five years, for instance, have varied sufficiently to support estimates of future oil wealth that could differ by a factor of four. This variability allows budget planners enormous discretion in determining estimated sustainable income.

The Saotomean law handled this uncertainty by requiring that the price used in estimating oil wealth be the historical weighted average for the 10 years immediately prior to the current budget year. Such a price would be considered very conservative in the present environment, but the use of a ten year average ties the price to an objective calculation. Use of the 10-year historical average has the further advantage of smoothing and preventing sharp changes in the calculated estimated sustainable income from year to year, except when there are major new reserve discoveries. This has the additional and important fiscal advantage of increasing savings from current revenues during years of exceptionally high prices while maintaining sustainable income during years when prices are low.

A similar approach could be used in the Draft Act by adding a requirement to Schedule 1 that in determining the budget projections for future years the price of petroleum if not specified by third-party contracts (e.g., gas contracts) should utilize the weighted average price of the reference crude oil for the 10 years ending December 30 of the year prior to the fiscal year. The reference crude could be defined by reference to similar quality crude oils marketed from the area adjusted for any necessary location or quality differentials. The latter adjustments are very small compared to the basic swings in crude oil prices.

Expected production. A second uncertainty, but not as significant, are the estimates of production in future years. In the Saotomean law, expected production figures are tied to approved field production plans. This is a conservative but relatively certain figure and further reduces the opportunity for manipulation. A similar specification could also be added to Schedule 1.

Discount factor. There is some further ambiguity in the formula in the definition of “i”, the discount factor. First it is not clear how in determining the discount factor one is supposed to average the yield on government securities. It would appear that the intent of the section might be more accurately captured by using for each period the yield on US government securities maturing in the fiscal year of the receipts being discounted. A second technical problem is that for some periods in the future “i” may not exist given the limited maturities now available on US securities. For the out years one could use the yield on the longest dated securities still trading.

The choice of the proper discount factor was an issue in the Saotomean law as well. A fixed rate was suggested, but the final law only provides that a

discount rate of not less than 7 percent should be used. In the present environment, this results in a conservative calculation of the present value.

Audit. As a check on the calculations in Schedule 1, the Draft Act requires that the amount calculated as the estimated sustainable income be certified by an independent auditor. In any ordinary sense, an auditor would not be able to make this certification given that it would require the auditor to certify the future prices and amounts used in the calculation. An auditor could examine the calculation and assure that given the estimator's assumptions the calculation conformed to law, but that would not guarantee the reasonableness of the assumptions. If the changes suggested above were made, an auditor might be able to certify the amount calculated in the sense that the auditor could then tie the calculation of receipts to historical prices, ascertainable facts or material on file such as approved field production plans, and the terms of the relevant contracts.

Expenditure Limitation

The Commission has very clearly made a policy decision that the government with parliamentary approval should be able to invade the corpus of the Petroleum Fund and make current expenditures in excess of the estimated sustainable income. This is consistent with Norwegian practice which sets the amount withdrawn from the oil fund at the level of the non-oil deficit of the budget. Nevertheless, if the ceiling is not to be breached, future governments will have to show strong budget discipline. In the case of Sao Tome and Principe there is no such exception although one must acknowledge the possibility of the law being amended.

Investment Limitations

The Draft Act has a well worked out structure for the management and supervision of investments including performance measures.

Borrowing. Very importantly, as in the case of Sao Tome and Principe, no borrowing is permitted against the assets of the fund.³ The STP Oil Law goes further, however, and makes clear that borrowing against the oil resources of the country is also prohibited. STP Oil Law, Art. 4. Inclusion of a similar provision would prevent the government from borrowing against future production and thus doing indirectly what it is prohibited from doing directly.

Domestic or Related Entities. The Saotomean law also prohibits the oil fund from holding any investment within the country or in any entity controlled directly or indirectly, by any Saotomean or Saotomean company. This

³ Investments held by the oil account can in certain instances be used to collateralize other securities held in the account where such securities are of short duration.

prohibition serves two very important purposes. First, it helps limit political influence in the choice of investments by the fund and enhances the likelihood of a fully professional investment regime. Secondly, it avoids the use of the oil account as an extra budgetary fund to serve governmental purposes without full governmental and parliamentary oversight. Development spending should be authorized by the parliament pursuant to the budget process. Such expenditures could include a separate development fund, but development should not be done through the back door of the oil account. The oil fund itself is supposed to be a permanent endowment for the country's future and should be invested solely from the perspective of protecting and growing that endowment. Requiring the fund to be invested in offshore assets also keeps the oil fund itself from contributing to inflationary pressures in the domestic economy, the "Dutch disease."

Advice: Binding or Not

Advice of Investment Advisory Board. In a number of sections parties are required to "advise" or to provide an opinion to others. In certain sections it is clear that such advice is simply intended to provide the judgment of the advising body, a judgment which the body to whom the advice is given can accept or ignore. In other sections, however, it appears that the intent may be for the advice to be mandatory. For example it is unclear in Article 10.1(b) whether the advice of the Investment Advisory Board to the Minister on the investment instructions is binding or simply input into the Minister's decision.

Opinion of Consultative Council. Another important ambiguity occurs in Article 17.2 where the Petroleum Fund Consultative Council is to submit an opinion to the parliament on the government's proposed appropriation when that appropriation is greater than the estimated sustainable income of the Petroleum Fund for the fiscal year. The last sentence of the section implies that the opinion may be binding in some fashion since the sentence indicates that if the opinion is not provided timely, "Parliament shall make the decision." Given the seriousness of a decision to appropriate amounts in excess of the estimated sustainable income, there should be no ambiguity on this point.

Enforcement

I understand that the enforcement provisions are still being drafted. In that connection the Commission may want to consider creating a private right of action to enforce the law. Such private rights of action while new in the developing world have actually been used successfully in a number of places. Sao Tome and Principe provided in its law a limited form of private action restricted to persons whose interests have been directly affected by administrative decisions; a broader right was discussed and rejected.

Conflicts of Interest; Public Integrity; Procurement

The Draft Act does not include any provisions regarding conflicts of interest or public integrity. The Saotomean law has a number of specific provisions in this regard. See, e.g., STP Oil Law, Art. 21 (all Oil Contracts required to contain certain representations regarding payments to governments officials), Art. 22 (Oil Contracts void unless entered into pursuant to the competitive provisions required by the Act), Art. 30 (prohibiting government officials from holding interests in “Oil Revenue” or representing any entity in which the Oil Revenues deposited into the Oil Accounts are held or invested). I assume that these issues are dealt with in other legislation.