QUARTERLY REPORT

PETROLEUM FUND OF TIMOR-LESTE

For the Quarter ended 30 September 2005

Presented 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.

The Petroleum Fund law was passed unanimously by parliament on 22 June 2005, and promulgated in the *Jornal da República* on 3 August 2005, with the Fund becoming effective the following day.

The Banking & Payments Authority of Timor-Leste (BPA) opened a special account at the Federal Reserve Bank of New York to receive petroleum revenues, and the first payments by taxpayers were made in August. The government transferred the opening balance of the Fund on 9 September 2005, in accordance with Article 48 of the Petroleum Fund law.

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 BPA the responsibility for the operational management of the Fund, and following the passing of the law the BPA commenced operations immediately.

On 9 September the government transferred the balance of the First Tranche Petroleum account (the "Timor Gap" account) held at the BPA together with $125 million from the Consolidated Fund to provide the Petroleum Fund with an opening balance of $205 million.

The BPA invested all funds received in the period according to a mandate agreed with the Minister of Finance in which a benchmark index of United States Treasury Notes with maturities up to five years is specified together with defined performance measures.

The market value of the benchmark index and the Petroleum Fund portfolio declined in value during the three-week period following the transfer of the opening balance, the benchmark losing 0.30% and the Fund losing 0.32%.

This loss of value was caused by three major factors that adversely affected the market during September: first, the aftermath of hurricane Katrina that caused a series of falls in the US bond market, second the Federal Reserve Bank's continuing commitment to addressing inflation, and thirdly another US hurricane, Rita, also negatively impacted the US bond market.

The BPA has managed the Petroleum Fund within the mandate throughout the period.

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, although an agreement had been reached to provisionally implement the terms of the management agreement prior to signature. Accordingly, this report is presented as if the management agreement had been in force.

With the prior approval of the Minister, the BPA proceeded to invest the funds received according to the mandate in the management agreement. This mandate set out in the Management Agreement is as follows:

1. 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.

2. 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.

In practice the mandate was substantially implemented from 9 September 2005, the date at which the government transferred the opening balance of the Fund, and this date has accordingly been selected as the effective date on which the

Fund commenced operations, although some taxpayer funds had been received into the earmarked receipts account at the Federal Reserve Bank earlier and had been invested in the mandated portfolio.

2. PETROLEUM FUND OPENING BALANCE

This section is intended to fulfil the provisions of Article 48.2 of the Petroleum Fund Law which requires that a report on the opening balance of the Fund be included in the first quarterly report. The opening balance of the Fund was $204,603,705 comprising the following elements:

Transfer from "Timor Gap" Account	79,555,666
Accrued Interest on "Timor Gap" account	48,039
Transfer from Consolidated Fund	125,000,000
	$204,603,705

Transfer from "Timor Gap" Account

The "Timor Gap" account was established at the BPA in October 2000 to hold the First Tranche Petroleum (FTP) receipts from the Joint Petroleum Designated Authority pursuant to the terms of the Exchange of Notes Constituting an Agreement between the Government of Australia and the United Nations Transitional Administration in East Timor of 10 February 2000 and the Exchange of Notes Constituting an Agreement between the Government of Timor-Leste and the Government of Australia, of 20 May 2002, and from the Designated Authority pursuant to the terms of the Timor Sea Treaty between the Government of Timor-Leste and the Government of Australia signed on 20th May 2002.

The transactions on the "Timor Gap" account held at the BPA from its inception in October 2000 to 31 August 2005 may be summarised as follows:

Fiscal Year	Amount
FTP receipts 2000/1	3,146,151.20
FTP receipts 2002/3	7,242,805.76
Interest 2001-2003	152,261.52
FTP receipts 2003/4	3,294,479.06
Interest 2003/4	63,371.22
FTP receipts 2004/5	55,616,206.38
Interest 2004/5	566,260.72
FTP receipts July/Aug 2005	9,141,909.22
Interest July/August 2005	332,221.57
Total	**$79,555,666.65**

The total amount held in the account was transferred to the Fund on 9 September 2005 in accordance with the provisions set out in Article 48.1 of the Petroleum Fund law.

Accrued Interest on "Timor Gap" Account

The sum of $48,039 represents the interest on the balance of the "Timor Gap" account from 1 to 9 September 2005, the date on which the balance was transferred to the Petroleum Fund.

Transfer from Consolidated Fund

The sum of $125,000,000 was transferred from the Consolidated Fund of Timor-Leste by order of the Minister of Planning and Finance dated 9 September 2005 in accordance with the provisions of Article 48.1 of the Petroleum Fund law.

3. MARKET TRENDS DURING THE QUARTER

A Stormy Start for the Fund

The market for US government bonds suffered a decline in September resulting in a the worst quarterly performance since the three month ended June 2004. This poor performance was attributed to several factors.

The impact of Hurricane Katrina in the United States in the period prior to the transfer of the opening balance caused bond prices to rise at first, and to fall again, so that in 10 of the 15 trading sessions since the transfer of the opening balance the index posted losses.

Added to the effects of the hurricane, the Federal Reserve Bank made it clear that rising inflation needed to be addressed in priority than a slowdown in the economy in the wake of Katrina. Accordingly, traders increased bets that the Federal Reserve will raise interest rates at its two remaining meetings this year.

A further loss was sustained by the market on 23 September when hurricane Rita changed course making it less likely that it would cause serious damage to refining capacity.

The effect of these three influences was that the benchmark index, and the Petroleum Fund, sustained a market loss on the value of its portfolio in September. It needs to be emphasised that bond markets, in common with equities markets, move in value daily.

The Petroleum Fund, being a long-term investor, holds a substantial portion of its portfolio to maturity, so that these unrealised losses can be expected to reverse over time and the full value of the Fund's investment in bonds at market yield at the time of investment (approximately 3.88% on the opening balance) will be received in the form of periodic coupon payments and the redemption of principal on maturity date.

4. MANAGEMENT DURING THE QUARTER

Objectives

The BPA's objective in managing the Fund during the period since the transfer of the opening balances was to manage the Fund closely to the agreed mandate. The implication of this policy was that cash received by the Fund, particularly the opening balance, was invested in the index in a timely manner. This policy is consistent with the passive investment mandate given to the BPA by the Minister of Planning and Finance.

TWO APPROACHES TO PORTFOLIO MANAGEMENT

The term "**passive management**" is a money management strategy that seeks to match the risk and return of a market segment or index by mirroring its composition. In the case of the Petroleum Fund, the government has decided that the investments should mirror an index comprising all the Treasury Notes issued by the United States government that have five years or less remaining to maturity. In the case of the Petroleum Fund, the BPA as operational manager does not make decisions about when to enter or exit the market, or which proportions of bonds to buy. It merely attempts to copy as closely as possible the index mandate given by the Minister of Planning and Finance.

In contrast, the term "**active management**" is an attempt to beat the market as measured by a popular benchmark or index. Prevailing market trends, the economy, political and other current events, and issuer-specific factors all affect an active manager's decisions. The aim of active fund management — after fees are paid — is to outperform the index for a particular fund (not to mention other fund managers they may be competing against). It should be noted that the risks associated with active management are higher, and accordingly larger losses can be made. Timor-Leste is in the early stages of developing the necessary skills to participate in international markets, and does not have the capacity to consistently outperform other market players. It should be remembered that for every trader outperforming the market, there will be one underperforming.

Which Approach Works Best?

This is a never-ending debate. Hard facts aside, active and passive management are in many ways similar to political parties. The two sides see the investment world in very different ways, both making logical and passionate arguments for their viewpoint.

Passive managers generally believe that it is difficult to beat the market. Therefore, they essentially offer asset class performance that closely matches an index for those investors who are unwilling to assume the risks of active management.

Active managers believe the market can be beaten. While they can't beat it all the time, many active managers do believe there are certain irregularities in the market that can be taken into consideration to achieve potentially higher returns.

Passive management should be viewed as a low-cost way to replicate the performance of a particular asset class. However, active management offers the potential to do even better, although there is no guarantee of superior performance. It is important to have the ability to identify which active managers are the best.

Operational Implementation

The BPA has been planning for the implementation of the operational management of the Petroleum Fund since late 2004. Arrangements have been negotiated and agreed with the Federal Reserve Bank of New York to undertake securities trading on behalf of the Fund, as well as the related settlement and custodian activities.

A market information system, Bloomberg, has been installed and is operational. This allows the BPA to remain in constant contact with international financial markets and news sources. Agreement in principle has been reached with SWIFT for the BPA to become a member, though implementation is not expected to take place until later this year. This system will allow the BPA to exchange financial messages with its banking correspondents and other agents.

The BPA also developed a computerised index tracking model that allows the existing portfolio to be analysed. The model produces recommendations on how to invest incoming cash, as well as providing suggested trades to rebalance the portfolio following changes to the benchmark index. It also provides key performance statistics relating to the Fund portfolio and the index, to enable the portfolio to be monitored.

A separate accounting ledger has been implemented with a full chart of accounts.

Together, these systems allow for the portfolio to be closely managed. Daily accruals of interest and coupon are made, and the market value of the portfolio is calculated and recorded. Daily financial reports are produced for BPA management.

The mandate was operationalised by selecting ten from the approximately 80 US Treasury Notes that form the defined benchmark index. The selected bonds fall within the ten six-month periods for the next five years and have been purchased in amounts that replicate the market value of all bonds in the index falling within the same maturity periods.

The Governing Board of the BPA determined that the Fund should be managed in a new Department headed by an Executive Director. Accordingly the Petroleum Fund Department was formed in early July.

In order to develop a foundation of skills and expertise for the future a number of existing staff were transferred to the Petroleum Fund Department. Eight new staff were recruited by the BPA and assigned to positions in the front office (dealing and trading), the middle office (risk and performance management), the back office (settlements and accounting), and the Secretariat of the Investment Advisory Board.

A training programme was implemented for staff assigned to the Petroleum Fund Department, involving staff travelling to other central banks as well as in-house training courses.

The General Manager and an international advisor visited New York to confirm arrangements with the Federal Reserve Bank of New York, and to make preliminary contact with financial market participants.

The BPA wishes to express its appreciation to the International Monetary Fund for providing an international advisor to help with the establishment of the operational framework.

5. PORTFOLIO PERFORMANCE

Return

The transfer of the opening balance of $205 million from the government on 9 September 2005 marked the first date on which the performance of the Fund could be effectively measured.

From 9-30 September the market value of the benchmark declined in value by 30 basis points while during the same period the Petroleum Fund portfolio declined in value by 32 basis points when accounted for on a full mark-to-market basis. The difference of 2 basis points is within the required target of 25 basis points.

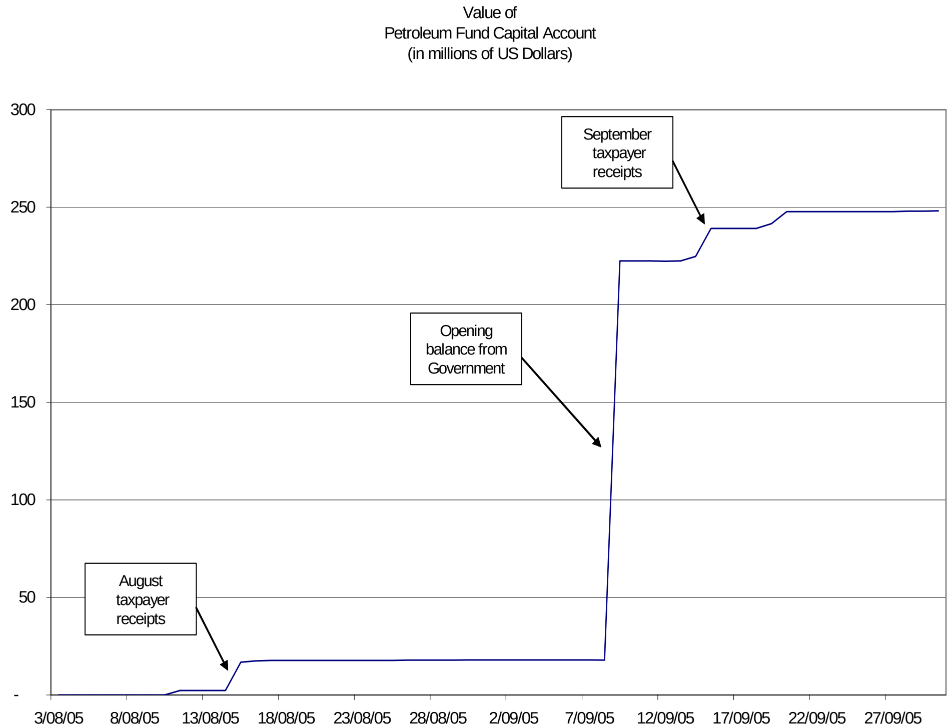
Basis Points

A basis point is one hundredth of one percentage point. Basis points are used in measuring interest rates and yield of various investments. For example, if someone says "The interest rate on bonds has just gone down 50 basis points," it means that the interest rate has gone down 1/2 a percentage point.

The Fund came into being with the publication of the Petroleum Fund law on 3 August 2005. The first inflow of cash occurred shortly afterwards.

The performance of the portfolio is measured from the date of the transfer of the opening balance by the Minister of Planning and Finance.

The growth of the Capital Account of the Fund during the quarter was as follows:



The major movements in the capital of the Fund took place as a result of the Government transferring the opening balance, and from taxpayer receipts in August and September.

The modified duration of the portfolio (excluding the uninvested portion) ranged between 1.84 years and 2.00 years during the quarter.

Modified Duration

The modified duration of a bond is a measure of the price sensitivity of the bond to interest rate movements.

Modified duration follows the concept that interest rates and bond prices move in opposite directions. The formula to calculate the modified duration is used to determine the effect that a 100 basis point (1%) change in interest rates will have on the price of a bond.

6. MANANGEMENT 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

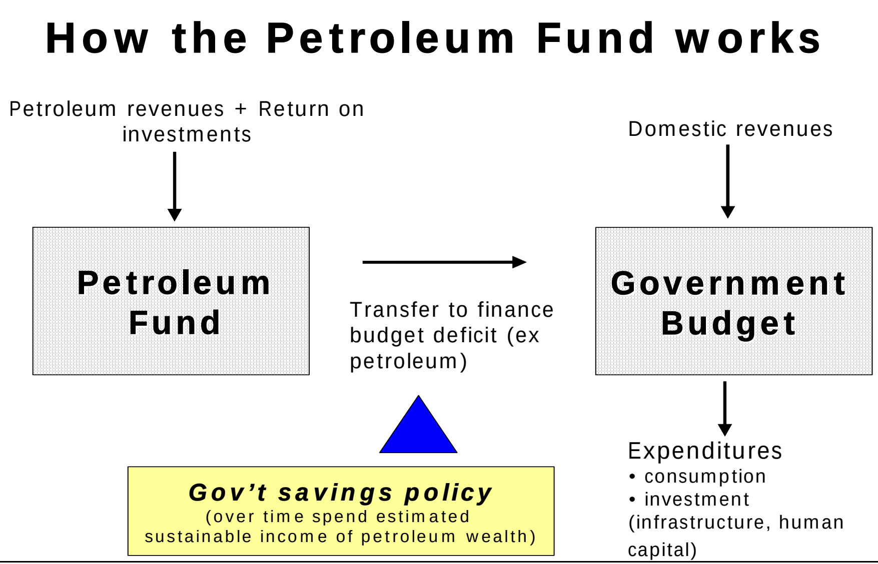
management expenses, as provided for in the operational management agreement referred to in Section 11.3".
The management agreement provides for a management fee of up to $270,000 to be paid from the Fund to the BPA in the fiscal year 2005/6.

No management fees were deducted from the Fund during the quarter ended on that date.

7. 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. No transfers were made from the Petroleum Fund in the quarter ended 30 September 2005.

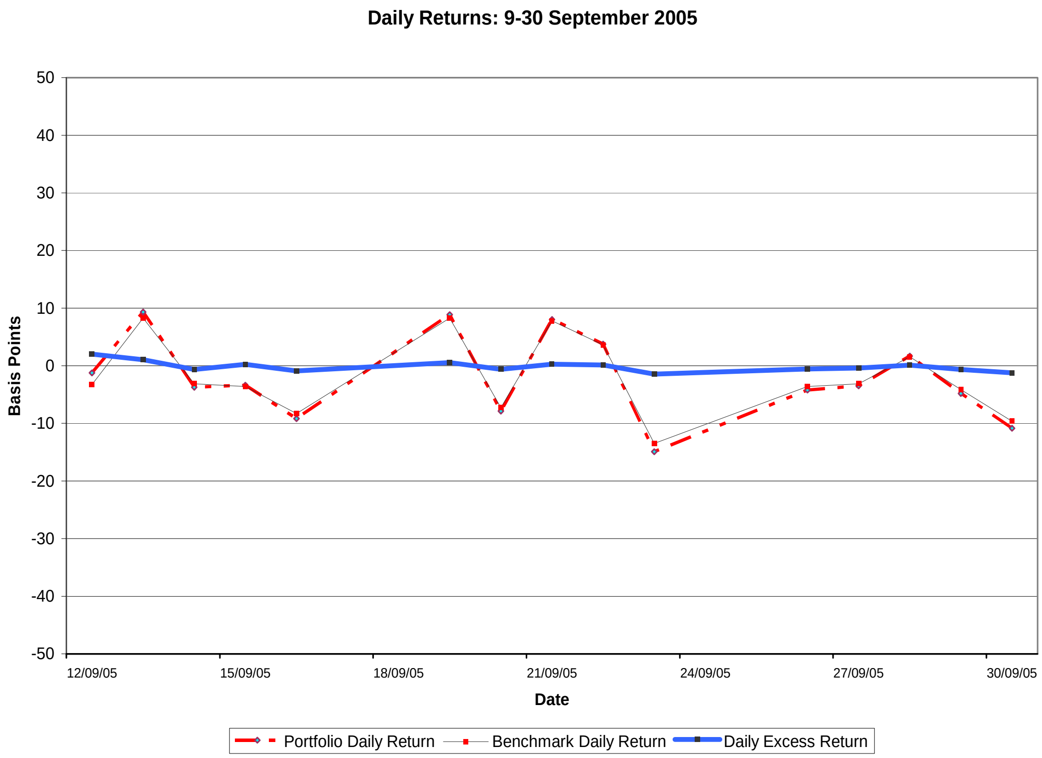
This diagram provides an overview of the relationship between the Petroleum Fund and the Government Budget, and in particular that there are no transfers from the Petroleum Fund except to the Government Budget.



8. RISK EXPOSURE OF PORTFOLIO

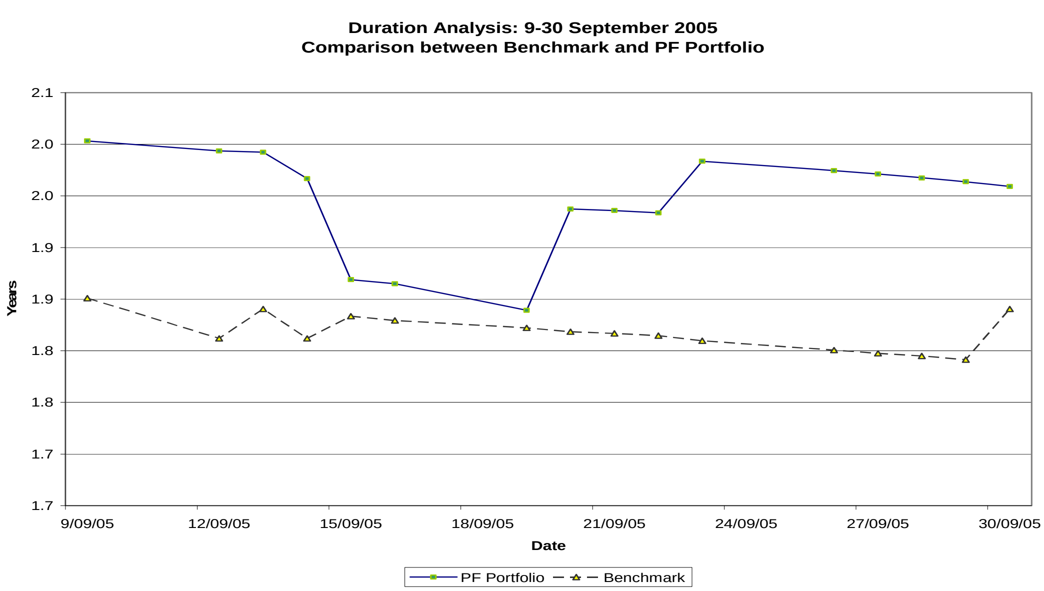
Tracking Error

The following graph illustrates the manner in which the Fund portfolio tracked the benchmark index. The line "Daily Excess Return" measures the difference between the return on the Fund's portfolio and the benchmark. The daily excess return remained within a band of +2 basis points and -1.4 basis points. The cumulative daily excess return for the period was -2 basis points, within the mandated ±25 basis points.

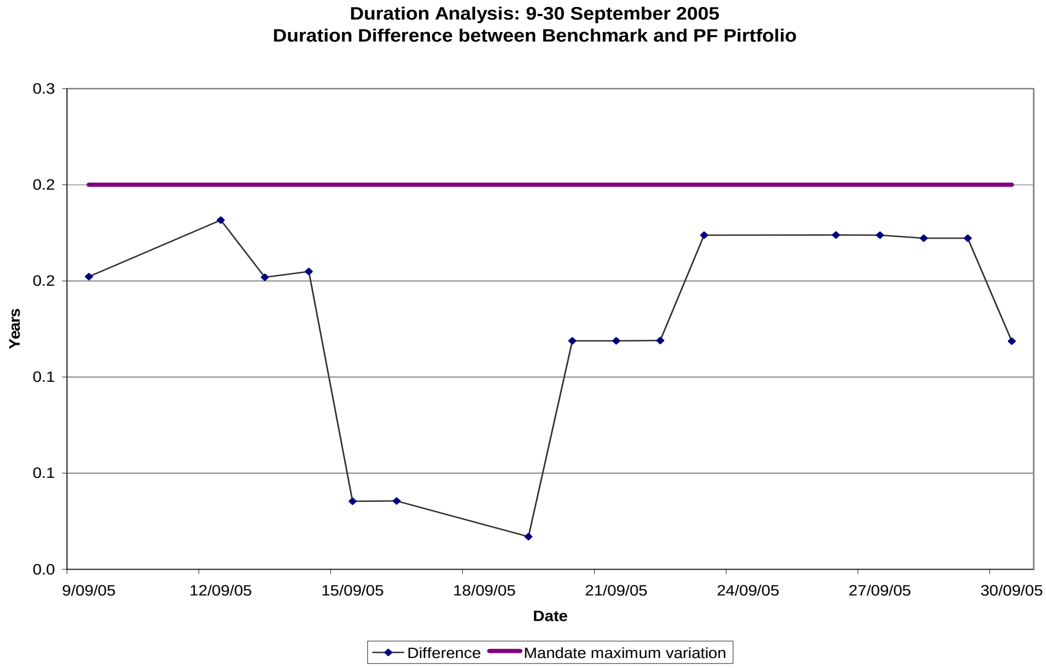


Deviation from Benchmark

The mandate given by the Minister 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 for the period from the operational inception of the Fund, the absolute 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 and demonstrates that the Fund was invested within the 0.2 year mandate specified by the Minister of Planning and Finance.

Credit Risk

The Merrill Lynch index comprises Treasury Notes issued by the United States Government, which is rated AAA.

All investments by the Petroleum Fund were also in US Treasury Notes.

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.

10. 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 return on the portfolio for the quarter under review was -0.32% compared with the index of -0.30%. The difference of 0.02% is within the mandated target.

Modified Duration of the Portfolio

11. The modified duration of the Fund's investment portfolio and the mandated index are measured by the BPA daily. The modified duration of the portfolio remained within the 0.2 years specified in the mandate throughout the period.

11. SUMMARY FINANCIAL STATEMENTS

Balance Sheet

The unaudited balance sheet for the Petroleum Fund of Timor-Leste as at 30 September 2005 was as follows (figures in thousands of dollars):

	$'000
ASSETS	
Earmarked Receipts Account	288
Overnight Repurchase Agreements	300
US Treasury Notes (market value)	243,192
Accrued Coupon	3,587
TOTAL	**$247,367**
CAPITAL	
Transfers from Government	204,604
Receipts from Taxpayers	43,482
Retained Income	611
Unrealised market gain/(loss)	(1,330)
TOTAL	**$247,367**

Profit and Loss Statement

The unaudited Profit and Loss Statement for the Petroleum Fund of Timor-Leste for the period ended 30 September 2005 was as follows (figures in thousands of dollars):

	$'000
INCOME	
Money Market Interest	83
Treasury Note Coupons	528
Income	**611**
Less: Unrealised market revaluations	(1,330)
Net Result for period	**(719)**

These financial statements do not include comparative figures because this is the first year of the Petroleum Fund's operation.

Dili, 21 October 2005

Maria José Sarmento
Acting Executive Director

Abraão de Vasconselos
General Manager