

La'o Hamutuk

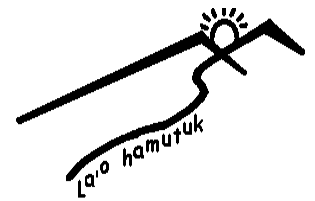
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Submission to the Ministry of Finance Democratic Republic of Timor-Leste

From
La'o Hamutuk

Regarding the Proposed Revision of the Petroleum Fund Law

05 November 2010

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*This submission is based on the English draft revision distributed by the Ministry on 23 October 2010.*¹

Introduction

Timor-Leste is the most petroleum-export-revenue-dependent nation in the world, spending its non-renewable oil and gas wealth to pay for around 95% of state expenditures. But Timor-Leste's petroleum reserves are very limited. Although Bayu-Undan provides more than a billion dollars every year today, it will be used up in less than 15 years.

Fortunately, Timor-Leste established our Petroleum Fund in 2005 to "contribute to a wise management of the petroleum resources for the benefit of both current and future generations."² Experience shows that many oil-rich nations become poorer because they spend all the money as it comes in, and their resource wealth becomes only a story to tell their grandchildren. Often the money is spent on short-term desires rather than invested for long-term benefit; used without good planning; diverted by politicians, companies, criminals or special interests; or diverts attention from developing the non-oil economy. A well-managed, secure Petroleum Fund can help Timor-Leste avoid this "resource curse," together with other forward-looking policies.

The Petroleum Fund Law regulates operational management and investment policy of the Petroleum Fund, including how to collect and manage petroleum revenues, annual transfers from the Petroleum Fund to the General State Budget, as well as what the state must do to guarantee accountability, sustainability, good governance and responsible supervision of the fund.

The 2005 Petroleum Fund Law says that the range of qualifying instruments for investments shall be reviewed after five years, considering institutional capacity, and that any changes require Parliamentary approval.³

This is the fifth year of the Petroleum Fund, but this does not mean that the law has to be changed. Laws should define policies which endure from one government to the next, providing policy continuity and guiding frameworks to help decision-makers act for the long-term national interest. A nation under rule of law needs to implement consistent policies over the long term, not only for the benefit of one set of politicians during their short terms of office.

We don't know if the winners of the next election will make decisions as wise as the current Government, or will enact policies as beneficial to the public interest. But we see this proposed revision as a dangerous step which will tempt future leaders to risk our children's entitlement.

The Petroleum Fund was set up to provide financial sustainability and intergenerational equity. Therefore, we should strengthen the provisions about good governance, transparency, accountability

¹ The text of the proposed revision, compared with the current law is at <http://www.laohamutuk.org/Oil/PetFund/revision/10CompareProposedRevision.htm>. This submission is at <http://www.laohamutuk.org/Oil/PetFund/revision/10LHSubMFRevFPEn.htm> with links to Tetum and documents.

² Preamble, Law No. 9/2005.

³ Article 14.3, Law No. 9/2005: "The range of instruments included as qualifying instruments in Section 15.1 shall be reviewed by the Government, and approved by Parliament, at the end of the first five (5) years of the Petroleum Fund existence, having regard to the size of the Petroleum Fund and the level of institutional capacity."

and fiscal responsibility, as well as the roles of the independent Investment Advisory Board and Operational Manager.

Therefore, La'o Hamutuk would like to share the following observations and suggestions:

1. It's too soon to put half the Fund in the stock market.

Article 14 of the current Petroleum Fund Law says that at least 90% of the Fund must be invested in U.S. dollar-denominated government bonds, and up to 10% can be invested in bonds in other currencies or in equities. However, the Ministry of Finance proposes to increase the maximum percentage in equities to 50%.

The Ministry's principal advisor on this subject, Towers Watson, recommends 25% investment in equities, which the Ministry says is their plan. The Investment Advisory Board (IAB), considering the risk profile, recommended that the maximum amount allowed in equities be increased to 40%, keeping at least 60% in government bonds and allowing up to 5% in other instruments.

If the law is amended to allow half the Fund to be put into equities, this will allow whoever wins the next election to buy more equities without Parliamentary approval. We feel that such a process undermines democracy and rule of law. If the government thinks that 25% is a reasonable percentage of equities, the law should reflect that.

Experts and politicians often repeat that the current conservative investment policy of the Petroleum Fund does not yield a high enough return to make the Estimated Sustainable Income (ESI) sustainable. In reality, with annual inflation in Timor-Leste averaging around 8%, and with our population growing at 2.4% per year, our fund investments would have to earn at least 13.4% to allow a 3% annual withdrawal to be sustainable, which is not achievable in any financial market today. And if withdrawals continue to exceed the ESI every year (as the government tried to do in 2008 and did in 2009 and 2010), this will become an unrealizable fantasy.

Diversification

La'o Hamutuk shares the goal of maximizing the return on the Fund's investments, but riskier investment policies can cause the Petroleum Fund to lose a lot of money. We believe that prudent policies will better protect our people's resources than chasing a mirage.

The revised investment strategy is based on advice from a single consultant (Towers Watson) and a single industry (equities investment advisors like those on the IAB) who have consistently promoted "diversification."

Diversification is one element of an effective investment strategy, not a fundamental principle as the proposed revision claims.⁴ Diversification alone doesn't guarantee a better return – it depends on what particular investments are chosen. Diversity includes bad as well as good, companies which will fail as well as those which will succeed. Economic models and past statistics attempt to predict the

⁴ Article 14.1 of the proposed revision says the Investment Policy "shall apply the principles of diversification".

future – but they are only informed guesses, with no guarantee of success. Increasing risk could lead to increased returns, but it could also lead to losses.

“Diversification” is applicable in many areas, but it is not the sole solution. Diversification of inputs and perspectives is useful in developing good policy, and we encourage wider consultation with experts and citizens to maximize the wisdom applied to improving this Law. Diversification should also be applied to Timor-Leste’s economic development and state revenues, rather than relying almost entirely on the oil and gas sector.

Alternative instruments

The proposed revision allows up to 5% of the fund which can be invested in other eligible instruments, provided that they are overseas and in classes decided by the Minister. We believe that this needs to be more clearly defined and limited. Such investments could include a fictitious company like Asian Champ Investments, a personal bank account held overseas, Australian real estate or Portuguese race horses. Investments like these brought Nauru down from the richest country in the world (per capita) to one of the poorest.

We support the Ministry’s recommendation to continue the prohibition on investing the Petroleum Fund within Timor-Leste. Although it is essential to invest and spend Timor-Leste state funds to develop our infrastructure, human capital and domestic economy, this should be done through the normal State Budget process. Using the Fund directly to do this would undermine our Constitution and democratic principles.

Long-term strategy

All investment experts say that sticking with a strategy for the long-term is essential to getting the best return on investment, especially those like equities where the value of the principal goes up and down according to market psychology and corporate health. We are concerned that the government of a new, poor, petroleum-dependent, democratic country may not be able to stick with a long-term strategy; as the temptations, fears and political pressures will be enormous.

Unfortunately, Timor-Leste doesn’t have any experience in equities investment. We started only last month, when Schrodgers was given a mandate to invest 4% of the Petroleum Fund in equities, but we have yet to see a single report about how the money is invested and what the returns are.

How will Timor-Leste’s Government respond to opposition and public concern when the principal of the Petroleum Fund loses value due to market forces outside their control, or because of a poor decision by an external manager? How can we make sure that we don’t buy when prices are high and sell when they are low?

Timor-Leste’s Petroleum Fund is the only sovereign wealth fund in the world which did not lose money in the 2008 global financial crisis, and we should be proud of this record. At the same time, Norway’s Pension Fund, holding 50% equities, lost \$90 billion in value.⁵ Norway had the courage and

⁵ A March 2009 news story about this is at <http://news.bbc.co.uk/2/hi/business/7961100.stm>. The 2008 Report of Norway’s Government Pension Fund is at www.norges-bank.no/upload/73979/nbim_annualreport08_rev.pdf or <http://www.laohamutuk.org/econ/OGE09/ESI/NorwayPensionFundAR08.pdf>.

the foresight to increase their percentage in equities after losing 20% of their principal, and has since recovered much of the loss. Their experience demonstrates that a professionally-managed, long-term investment strategy without political interference may be able to adapt to short- and medium-term ups and downs of the market.

This is how individual investors like Warren Buffett become rich, but can political leaders of a country with tremendous needs, who have to face the voters every five years, successfully keep to a long term strategy?

The public, Parliament and government have not had any experience dealing with riskier investments or loss of principal. It would be better to wait two years or more, perhaps expanding the 4% in equities to the 10% allowed under the current law, before massively increasing the equities share of the Fund's portfolio.

Investment Policy

We also suggest that this revision give more clarity and effectiveness to the "Investment Policy" discussed in articles 2(q), 11.2 and 14. Changing this from a "strategy" to a "policy" will give the Minister of Finance more power, increasing risk and reducing checks and balances. Although the Minister will be required to seek advice from the Investment Advisory Board (IAB) before changing the Policy, he or she will have a free hand within the Policy.

Since this is such an important document, we urge that it be published in full at the time it is adopted or revised, rather than "reported on"⁶ in the Petroleum Fund's annual report long after it has been put into place.

The IAB's September 2010 "Statement of Investment Beliefs and Principles"⁷ has no legal force, as the IAB can only give advice. However, it could be revised and adopted by the Minister as the "investment policy," after appropriate public consultation and approval by the Council of Ministers, making it more effective than a statement of opinion. Although La'ó Hamutuk does not agree with everything in the IAB Statement, we would welcome a public discussion and official decision on the ideas it encompasses.

2. Don't weaken the sustainable income rule.

The purpose of the Estimated Sustainable Income (ESI) rule is to limit the amount of money that can be transferred from the Petroleum Fund to the General State Budget, protecting our non-renewable resource wealth for future generations.

This revision would change the statement by the Government required under Article 9(d) to spend more than the ESI from "a detailed explanation of why it is in the long-term interests of Timor-Leste to transfer from the Petroleum Fund an amount in excess of the Estimated Sustainable Income" to "Justification as to the reasons why it is in the long term interest of Timor-Leste to transfer an amount exceeding the Estimated Sustainable Income."

⁶ Proposed revision, Article 24.1(c).

⁷ Available on the MoF website and at <http://www.laohamutuk.org/Oil/PetFund/IABInvestPrincSep2010En.pdf>

While a “detailed explanation” involves information and rational discussion, a “justification” could be as simple as “So that my party can get re-elected and continue to implement good policies.”

Article 9 has not been as effective as many had hoped. During 2008, the Government proposed a rectification budget in excess of ESI, but the Appeals Court declared it illegal⁸ because no detailed explanation was provided. An explanation was provided in 2009, but it was later not implemented when money was transferred from the national electricity project to *Pakote Referendum* without consulting Parliament. The 2010 rectification budget again exceeds the ESI, but no detailed explanation was provided. (It has not yet been challenged in court).

We believe that this provision in the original law is better than the proposed revision, but that it should be strengthened rather than weakened. The law should not be changed to make it easier for a government to spend unsustainably.

The underlying objective of the Petroleum Fund – to manage the wealth for the benefit of current and future generations – would be better served by a stronger law encouraging consideration of the non-oil future. This is especially critical because our oil and gas reserves are being exhausted, while our non-oil economy is still miniscule and we remain heavily dependent on temporary oil revenues to pay for imports and public spending. When the oil money is gone, how can Timor-Leste feed, educate and provide health care for our people?

In 2005, La'ó Hamutuk suggested⁹ that the Petroleum Fund Law “should require a specific resolution by the Council of Ministers and the Parliament [separate from the State Budget Law] for each transfer from the Fund to the budget, as in Norway. The resolution should specify the amount of money, what it will be used for, its relation to current Fund income and its impact on future dividends.”

Regarding transfers above the ESI, La'ó Hamutuk recommended that Government's report to Parliament “should also indicate the impact of exceeding the ESI on the total amount which can be withdrawn from the Fund over time, not only on the reduction of the ESI. ... This explanation should include whether or not withdrawals larger than the ESI are anticipated for each of the next few years, and why. There should be a prohibition on exceeding the ESI level for more than two consecutive years.”

If Article 9 is to be revised, we believe that our suggestions from five years ago are still appropriate.

⁸ Court of Appeals decision dated 27 October 2008 on the legality of Law No 12/2008:

“Que nos termos da Lei o Governo deve demonstrar ao Parlamento Nacional que a transferência do montante superior ao Rendimento Sustentável Estimado não só não prejudica as gerações vindouras, como é do interesse a longo prazo para Timor-Leste;

“Concluem, dizendo que o Governo não demonstrou que o valor em excesso, no montante de usd 290,700,000, beneficia o país a longo prazo, violando, deste modo, os artigos 1, 2 e 139 da C.R.D.T-L, bem como a al. d) da Lei n. 9/2005, de 3 de Agosto.”

⁹ La'ó Hamutuk submission to Parliament regarding the Petroleum Fund Law, 1 March 2005, available at <http://www.laohamutuk.org/Oil/PetFund/Act/Parl/LHParl.htm>.

3. Keep the Banking and Payments Authority as Operational Manager.

The current law specifies that the Operational Manager of the Fund is the Central Bank or, until the Bank is established, the Banking and Payments Authority (BPA). This revision allows the Ministry of Finance to reassign operational management to another public entity, as yet undefined, established by Parliament "which shall be accountable to the Government."¹⁰ We believe that this is a bad idea.

During the last five years, the BPA has been professional and nonpartisan, and has gained a lot of experience. It protected our Fund, created mechanisms to implement a complex law, developed a capable staff, arranged for three external managers, exemplified a high level of transparency and been accessible to civil society and the public. As a member of the IAB, the BPA played a key role in blocking the attempt by Asian Champ Investments to scam over a billion dollars from the Fund.

The Ministry says it does not intend to replace the BPA, and we see no justification for changing the law. We are particularly worried that this appears to intend to replace an autonomous, professional manager with one more subject to political pressure, less able to effectively "check and balance" other agencies.

Adding the phrase "accountable to the government" would prevent the BPA from serving as the Fund's Operational Manager. The BPA derives its mandate and powers from UNTAET Regulation 2001/30,¹¹ whose Article 4.2 reads "The BPA shall enjoy complete legal, operational, administrative, and financial autonomy from any other person or entity, including the government and any of its agencies, and subsidiary organs or entities, The autonomy of the BPA shall be respected at all times and no person or entity shall seek to influence any member of the Governing Board, member of Management or employee in the discharge of their duties, or to interfere in the activities of the BPA."

If the BPA or future Central Bank is no longer able to manage the Fund, a similar non-political, independent, professional state institution – outside of Government – should take it on. At this time, however, La'o Hamutuk believes that the BPA should maintain its responsibility, so there is no need to revise this part of the Petroleum Fund Law.

4. Maintain the independence of the Investment Advisory Board.

The current law establishes an Investment Advisory Board (IAB) to advise the Minister of Finance about investment policy and strategies for the Petroleum Fund, including key people from the BPA and the Treasury, two investment management experts and one other person. The proposed revision removes voting power from the BPA and Treasury members and makes the others appointed by the Prime Minister (instead of the Minister of Finance). It also weakens the protection against conflicts of interest.

In general, the Board has performed well, although we are concerned that recent published minutes omit most substantive information, as well as that there is a long delay between when the IAB provides advice to the Minister and when it is published.

¹⁰ Proposed revision to article 11.3.

¹¹ Available at <http://www.laohamutuk.org/Oil/PetFund/Consult/Reg2001-30.pdf>

The IAB deserves credit for preventing the Asian Champ Investments scam, which is one reason we are worried about changing its structure. If all voting IAB members are appointed by the Prime Minister, the Board will become less professional and more subject to political pressures. It would diversify advice and improve checks and balances if some IAB members were not appointed by the Minister of Finance, so we suggest that they be appointed by diverse authorities – the President, Parliament, BPA, Petroleum Fund Consultative Council or other institutions.

In our 2005 submission,¹² La'o Hamutuk wrote that the IAB should include: "people with no personal interest related to investment or other activities of the Fund. This Article should contain language or a reference to another statute prohibiting appointment of people with actual, apparent or potential conflicts of interest, involving either investment or petroleum development. ... The IAB needs people with a broader perspective, including ethical investment, inter-generational equity and management of publicly owned assets."

Although we recognize that allowing the heads of the BPA and Treasury to vote on the IAB could create a potential conflict, we believe that their professional roles and intimate knowledge of the Fund's operation overrides that concern, and they should continue as voting members.

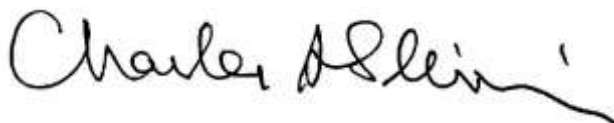
The requirement¹³ to declare assets before taking and after leaving office was added by Parliament in response to suggestions by La'o Hamutuk and others. It could be made more effective, but the proposed revision would weaken it, relying IAB members' honesty to declaring that they have no conflicting interests and leaving it to the Minister of Finance to ask for an assets declaration when he or she sees fit.

Conflicts of interest are more likely when the fund is invested in equities, and will be a challenge for investment professionals whose other clients trade in the same equities markets, buying and selling shares whose price varies in relation to market activities. We feel that weakening the protection against conflicts of interest moves in the wrong direction. It would be better to revise the current article 17.4 to require annual declarations of assets while in office and adding the new requirement that IAB members present a public, written statement prior to their taking office, under penalty of perjury, "that their appointment and advice does not present a conflict with any of their other interests."

Thank you very much for your attention and consideration, and we are happy to discuss these or other relevant concerns with anyone who is interested.



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Charles Scheiner

¹² In our 2005 submission, available at http://www.laohamutuk/Oil/PetFund/Act/Parl/LhtoParl/PFAct_06-05_En.pdf, La'o Hamutuk also suggested that "The IAB should include at least two people appointed by someone other than the Minister, given that the Minister also directly or indirectly appoints all other members. This is essential to ensure independent, objective advice."

¹³ Article 17.4 of the current law.