

## Submissions on the Timor-Leste Petroleum Fund

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The submissions relate to the Petroleum Fund discussion paper that was released on 18 October 2004, available on [www.mopf.gov.tp](http://www.mopf.gov.tp).



## Timor Leste Petroleum Fund discussion paper

**November 2004**

We thank you for the opportunity to comment on this paper. We warmly welcome the emphasis therein on the transparent and accountable management of Timor Leste's putative Petroleum Fund. Such measures will greatly increase the hope that Timor Leste will escape the 'resource curse' of weak growth, corruption, authoritarian government and instability that has afflicted so many oil-rich developing countries.

There need to be clear, specific and comprehensive provisions in the legislation that would govern the establishment and operation of the Fund to ensure that the government's aims are met in practice.

As the paper notes, it is not enough just to say how much money is actually in the Fund by itself. There also needs to be transparency of revenue flows from the oil industry into the Fund to ensure that everything is being properly accounted for. If companies publish what they pay to the government, and the government publishes what it receives, then there is an innate double-check built into the Fund's operations, which will allow more effective scrutiny of oil revenues and which would also help build public trust in the management of that money.

Such transparency provisions, if they are to be effective and durable, need to be embodied in the legal framework that governs the oil industry. A number of civil society organisations, including Global Witness and CAFOD, have suggested that companies should publish all petroleum-related payments to the government, and that the appropriate place to put this requirement would be the Petroleum Act, because this is the law that will govern the interactions of oil companies with the state.

We don't currently know what the final form of the Petroleum Act will be; if it does not contain a requirement for disclosure of payments by companies, then the issue of revenue transparency must be tackled as a priority in the law governing the Fund. We suggest that the Sao Tome and Principe revenue management law, which incorporates an oil fund, could be a useful model for Timor Leste of how to assemble the various provisions in one law.<sup>1</sup>

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<sup>1</sup> Available in English and Portuguese at [www.earth.columbia.edu/cgsd](http://www.earth.columbia.edu/cgsd).

The commitment of the current government of Timor Leste to transparency and public consultation has been exemplary; however, politics is always uncertain and future governments might not share the same commitment. Therefore we think that the Fund's governance and transparency should be strongly enshrined in primary legislation rather than in administrative decree.

Similarly, we strongly endorse the proposal for external, independent audits. Legislation needs to stipulate that the auditor will be chosen through a competitive tender with transparent procedures, and that the conclusions of the auditor will be published in an accessible form, without redactions or omissions. The audit should not only cover the operations of the Fund but also the flow of revenues from industry into the Fund and payments out of the Fund to government departments (to ensure that payments have only been made for approved purposes). The audit should take place at least annually.

None of this would constrain the right of the government and parliament to allocate revenues for public purposes via the national budget. It would simply ensure that the sources and uses of petroleum revenues are clear to citizens.

It also very important that the fund's governing legislation mandates clearly that *all* revenues from oil extraction are to be paid into the fund. This will prevent diversion or misappropriation of money due to the state has plagued countries like Angola and Equatorial Guinea and Indonesia because this operation has not been legal mandated.

The law needs to spell out that all payments made by petroleum companies, their agents and representatives to the government of Timor Leste, its agents and representatives, and relating to the discovery, exploitation, marketing and sale of petroleum, will be paid into the Fund and publicly disclosed by the payer within a specified time period.

The definition of such payments needs to be comprehensive. If it is too restrictive, then companies or people wishing to make improper payments will simply describe their payments so as to fall outside the definition and thus avoid disclosure. The purpose of each payment should also be described – eg royalty, production bonus etc.

The law should require that payments made *on behalf of the petroleum industry by third parties* should go into the Fund, and be declared. Experience from other countries shows that companies that want to pay bribes tend to use third-party consultants to make the payments, so as to obscure the connection between the company and the bribe. If all legitimate payments had to go into the Fund and be declared, this risk would be avoided.

The law needs to spell out clearly the responsibilities of all officials involved in running the Fund and lay out the conditions under which money may legitimately be transferred from the Fund (for example, that money is only allowed to be transferred to the bank accounts of government departments and other institutions that spend public money, and never to individual officials or private persons.) There needs to be an effective legal remedy for dealing with state officials or anyone else who breaks these laws.

Timor Leste could actually ban all petroleum-related payments to the government that are not paid into the Fund. This provision, by making clear that payments into other accounts are illegal and invalid, will protect companies against any future requests for “side payments” by giving them an unambiguous reason to refuse.

We also strongly endorse the idea of a Council of Eminent Persons to monitor the Fund and inform Parliament of all aspects of its operation: in fact, we believe that it would be a serious mistake to create the Fund without an independent oversight body.

We suggest that:

- This Council should publish all its reports to Parliament and its members should be accessible to the media and the public of Timor Leste.
- The Council should be independently funded: that is, funded from a source which cannot be constrained by the government of the day, and with enough money to be able to carry out its tasks effectively.
- The mechanism for choosing Council members should be as broad-based as possible and that it should include representatives of ordinary citizens and civil society organisations.

We believe that these suggestions could easily be integrated into the Petroleum Fund law without creating significant extra cost or impairing the efficient working of industry or government. Indeed, for a small outlay in terms of resources and effort, they would reap a huge return by narrowing the scope for future corruption of oil and gas revenues.

We think it speaks very well of the government’s commitment to consultation and good governance in the oil sector that we have had this opportunity to comment and we thank you again for the opportunity. We hope that interested civil society organisations will get an opportunity to discuss the detailed legislation governing the Fund in due course.

Sincerely,

Global Witness  
CAFOD

## LABEH, CIITT and NeTEJ

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**From:** labeq qi [mailto:labeq2003@yahoo.com]  
**Sent:** Tuesday, November 30, 2004 10:33 AM  
**To:** Thomas Ekeli  
**Cc:** Bruce Taplin; alfredo@presidente-tl.net  
**Subject:** Petroleum Fund for TIMOR-IESTE

The Director,  
Timor Sea Office

27 November 2004

Dearly Catherine,

### **Re: Establishing a Petroleum Fund for Timor-Leste**

Lalenok Ba Ema Hotu (LABEH) as Timorese NGO involved in the development of our nation, we would like to share some brief thoughts with the Timor Sea Office. We are working together to rebuild our nation, to bring it out of the poverty that has been inflicted upon us by centuries of colonialism and brutal military occupation that ended in widespread destruction in 1999.

We appreciate the recent improvement by the Timor Sea Office and the government in conducting a number of public consultations in regards to the proposed Petroleum Regime for Timor-Leste and establishing Petroleum Fund for Timor-Leste. Thank you for giving us another opportunity to participate in the public consultation on establishing a Petroleum Fund for Timor-Leste. We would like to extend our appreciation to the Government once again for its initiatives in conducting the public consultations.

We have also contacted other civil society organizations including “**The Timor-Leste Network for Transparency and Economic Justice (NeTEJ) a network of national NGOs with over 24 member organizations.**” It aims at ensuring transparency, accountability, sustainable development through research, policy dialogue, advocacy and training through the principles of Publish What You Pay (PWYP) and the Extractive Industries Transparency Initiative (EITI). Its aim is to increase transparency over payments by companies and revenues to governments in the extractive industries.

In preparation of this “COMMENTS” we have contacted also The Centro Informasaun Independente ba Tasi Timor (CIITT) and those who know better in the area of draft legislation on natural resources revenue. We have also conducted numerous interviews on our radio talk show on the public opinions on the Petroleum Fund. The public opinion on the Petroleum Fund suggests for an “**Oversight Institution as a core condition for transparency and accountability**” that would monitor the fund and that the **overall**

**responsibility for management of the Fund should not be with the “Minister of Planning and Finance”.**

After careful reading the current discussion paper on establishing a Petroleum Fund for Timor-Leste, LABEH believes that our government has done tremendously well in consulting the public in-regards to the petroleum fund. However, we still found that it lacks some international best practices on transparency and accountability. (Page 13, 14 and 15 of the discussion paper on establishing a Petroleum Fund for Timor-Leste)

Sound governance, taken a step further, is a subset of governance wherein public resources and problems are managed efficiently and in response to the critical needs of our people and the nation. Effective democratic forms of governance rely on public participation, accountability and transparency.

While LABEH welcomed the government initiative on the Petroleum Fund, we feel that the Petroleum Fund contains little detail on the **“Oversight Mechanism of the Fund”**

**Specific issues to consider:**

**Circumstances behind corruption**

- Excessive concentration of powers to the Minister of Planning and Finance (page 13 sub-heading **Management of the Fund paragraph 2**)
- Little internal control and external control mechanism
- Decisions could be taken on a particular individuals’ own authority

Point 9 of chapter 14-15

- Is under consideration
- There is no guarantee that the council would be created
- Petroleum Fund Oversight or Watchdog needs to include the four organs of sovereignty (**the President, the Parliament, the Government and the Court**) with representative from the civil society.

**Recommendations:**

We recommend to our Government to consider as a core condition to promote transparency and accountability to adopt the “Sao Tome and Principe Model Oil Revenue Management Law prepared by Columbia University Oil Advisory Group” this can be viewed at [www.earth.columbia.edu/cgsd](http://www.earth.columbia.edu/cgsd) especially:

**TITLE V**  
**PUBLIC OVERSIGHT**

Chapter 1  
**Ensuring Public Oversight**

**Article 21**  
**Establishment of Petroleum Oversight Committee**

It may require that the president of the national Parliament establish a Petroleum Oversight Committee to oversee the development and use of the resources.

- Oversight Committee to oversee the development and use of the resources
- The mandate of the Oversight Committee
- The composition of the Oversight Committee
- Powers of the petroleum Oversight Committee and
- Access to Information

We would be concerned therefore, if the government were to be advocating a lower standard of transparency and accountability than to follow best practices of transparency and accountability. Timor-Leste ability to prosper in the post oil era will be largely based on its own ability to encourage the development of a diverse economy during the oil era.

Supported by:

The Timor-Leste Network for Transparency and Economic Justice (NeTEJ)

The Centro Informasaun Independente ba Tasi Timor (CIITT)

Lalenok Ba Ema Hotu (LABEH)

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## Martin Sandbu, Columbia University

Comments on Timor-Leste Ministry of Planning and Finance Discussion Paper  
“Establishing a Petroleum Fund for Timor-Leste”

Martin E. Sandbu, Ph.D.<sup>2</sup>

12.11.2004

This memorandum contains a few short remarks on the Discussion Paper laying out the East-Timorese government’s proposed policy for a petroleum fund.

### 1. Fiscal policy considerations surrounding the establishment of a fund

The Discussion Paper gives a clear and fairly comprehensive analysis of the fiscal challenge posed by the special nature of petroleum revenues. The uncertainty, volatility, and non-permanence of oil revenues means that sound fiscal management involves high rates of savings; a petroleum fund is a useful way of facilitating such savings.

An important preliminary question is how exactly petroleum revenues are defined. The Discussion Paper addresses this question and chooses the wise policy of including all revenue flows to the government from petroleum activities, whether they be in the form of tax oil, profit oil, or royalty oil/First Tranche Petroleum. The relevant section (p. 11) is, however, unclear on signature bonuses, production bonuses, and other payments—it should be made unambiguous that all such payments are counted as oil revenues and should be treated equally with respect to the eventual petroleum fund.

The tradeoffs involved in the choice of various savings policies are very well explained and should be taken to heart by all partners in the East-Timorese policy debates. The choice of maintaining constant the real value of the expected oil wealth seems like a prudent savings policy. Note however a mistake in the graph in Box 4: Line (b), showing the level of spending under a savings policy of maintaining the real *per capita* value of petroleum wealth, should be upward-sloping in the top graph. Under this policy, total spending would be lower in early years, but higher in later years, keeping real spending per capita at a constant level. Conversely, the policy advocated by the Ministry involves a *falling* level of per capita spending so long as population growth is positive.

This savings policy, however, is not incorporated in the rules of the fund. The Discussion paper makes it clear that the fund is a mere accounting device, and that the savings policy is to be implemented through the regular budget process, which is to be guided by a “longer-term fiscal policy guideline.” In the absence of such a guideline, or in a situation in which the political economy of Timor-Leste makes such a guideline ineffective in the

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ordinary budget process, the proposed institutional set-up of the fund would do nothing to secure the desired savings policy. The Discussion Paper could be clearer on this. A new, poor nation like East Timor differs fundamentally from the stated model of Norway, precisely in that one cannot simply assume that future annual budgetary processes will respect a fiscal policy guideline if it has no legal force. Nor, indeed, can one assume that future governments will even try to commit to such guidelines. This means that the role of a petroleum fund must be discussed also with a view to how it can *promote* good fiscal policy, not just presuppose it. This is further discussed below.

A similar point can be made about stabilization. The Discussion Paper makes it clear that the level of expenditures must be divorced from short-term revenues, but the proposed structure for the fund does not do this. The stabilization function that a fund could have is again relegated to the budget process, without any reason to believe that such policies will in fact be followed once the oil revenue is flowing in. This is also further discussed below.

## **2. Institutional considerations surrounding the establishment of a fund**

### **a. Institutional independence of the fund**

The Discussion Paper states that the “fund should be coherently integrated into the budget process.” This is an important principle, as such an integration is crucial to facilitate good economic management. Multiple budgets can only serve to confuse the optimal allocation of government spending, and undermine the coherence of the budgetary procedure in the executive and the legislative branches. More importantly, however, a unified budget maximizes transparency and thereby minimizes the opportunity for corruption and mismanagement.

It does *not*, however, follow that the fund must therefore operate “only as a government account rather than a separate institution,” as the Ministry suggests in the Discussion Paper. While it is not exactly clear what is meant by a “separate institution,” there are many intermediate solutions in between the Norwegian model of a fund that is a merely virtual government account, and the “trust fund approach” described in the Discussion Paper’s footnote 4. It is entirely possible to set up a fund that enjoys institutional distance from the executive—thereby providing additional checks and balances on any sitting governments’ ability to overuse oil revenues or draw down the oil wealth for its own political benefit—without having any spending authority on its own.

The Oil Revenue Management Law currently under parliamentary debate in São Tomé e Príncipe is a case in point. Under the proposed Bill of Law, all oil revenues have to be paid into a ‘National Oil Account’ which is managed by an Investment Committee and supervised by an independent Petroleum Oversight Committee. There are strict limits on how much can be spent in every year, so the allowed transfer in part determines the budget process rather than *vice-versa*. This will not lead to multiple budgets, however, since the only transfers allowed are transfers to the national government budget (within

the limits). The limits are secured by requiring the joint signature of several branches of government before the holding bank is authorized to execute a transfer.

The Timor-Leste proposal instead leaves the flow of funds completely to the discretion of the yearly budget process. This means that all the political economy challenges that the Discussion Paper (rightly) raises simply remain where they would have been without a fund: In the yearly budgetary process. The people of Timor-Leste should seriously evaluate whether their governing institutions and public officials are sufficiently experienced that they will be able to implement a sound long-term fiscal policy on the basis of the discretionary budgetary decisions of governments that depends on regular electoral success. While Norway's fiscal policy institutions may have succeeded in this, it is doubtful that the same framework can be successfully transplanted into Timor-Leste's situation.

#### b. Legal status of the fund

The Discussion Paper envisages a fund that is essentially an accounting device. Other options are possible, as discussed above. Whichever option is chosen, the decision has to be made as to the legal status of the fund. At one extreme, the fund could be treated as no more than a separate government account, without even being enshrined in law. At the opposite extreme, the fund could be established by constitutional amendment. The appropriate legal status should be chosen with a view to the possible incentives for future governments to attempt to overturn the restrictions imposed by the fund structure (which in the current proposal are admittedly very weak, therefore arguably not requiring a strong legal protection). While this is a decision to be weighed by the appropriate Timorese stakeholders, it is an issue that has not been sufficiently considered in the Ministry's Discussion Paper.

#### c. Transparency

As the Discussion Paper stresses, transparency is absolutely necessary in the management of oil revenues. The Paper makes important commitments, such as signing up to the recommendations of the Extractive Industries Transparency Initiative, external audits, and accessible reporting of petroleum fund balances and transactions.

There are several additional steps that could be taken to reinforce the transparency of revenue management:

- Not only payments by oil companies (and subcontractors) to the government, but also all their contracts should be published. Confidentiality clauses should be limited to information legitimately considered intellectual property, such as seismic survey data, but all financial agreements should be in the public domain. This allows all concerned observers to verify that the payments made correspond to what is owed, as well as to evaluate whether the government is performing the best it can in negotiations with oil companies.
- One should attempt to make the petroleum fund balance accessible in real time over the internet.

- There should be concrete requirements of how the information is to be made realistically accessible to all citizens of Timor-Leste. This might involve a requirement of translating all relevant documents into local languages, or the establishment of a library or public registry where people can physically access the information.
- There should be an independent watchdog body that would oversee all the government agencies charged with parts of the oil revenue management process. In particular, such an independent group should have the power to enforce the transparency requirements that the oil revenue legislation should include. The Discussion Paper mentions the possibility of a “Council of Eminent Persons,” but the non-committal language (“one can consider establishing...”, p. 15) leaves it unclear what the Ministry’s position on this possibility is.

Again, the Oil Revenue Management legislation of São Tomé e Príncipe provides examples of all of these suggestions.

### 3. Institutional prerequisites for sound fiscal policy-making

As mentioned above, the proposed design of the fund leaves the whole burden of choosing appropriate savings and stabilization policies within the regular annual budget process. As is well understood, this runs the risk of holding fiscal policy hostage to short-term political pressures and encourages a political economy of populism. A large part of the Discussion Paper (p. 6-9) is devoted to explaining the particular challenges of natural resource-dependent economies; yet no remedial policies are proposed, short of the exhortation to follow a long-term fiscal policy guideline.

Essentially, the Ministry proposes a fund structure that serves as an instrument for whatever fiscal policy is produced through the budget process, but begs the question of how to ensure that fiscal policy is sound. Given that one important rationale for an oil fund is to facilitate good stewardship of oil revenues, this is a serious omission.

An alternative view is to see the fund not as a complement to (assumed to be already existing) sound fiscal management, but as an institutional lever to promote it. If the fund was set up to automatically take care of the chosen savings and stabilization policy, the budgetary process would be put in a situation of a country without natural resource revenue. Suppose that the fund was set up not to finance the budget deficit, whatever it might be, but instead followed the São Tomé model of paying out a fixed annual amount in real terms (the permanent income).<sup>3</sup> The annual budget would then have to balance internally generated revenues against expenditures in the ordinary way, without having to take account of the question of saving and stabilizing oil revenues. It would have a predictable, stable, and permanent source of revenue which would allow it to finance permanent primary deficits of a certain size, much as if the country had a positive foreign asset position that paid interest in perpetuity. In such a set-up, countercyclical fiscal

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<sup>3</sup> Essentially this would involve legally enshrining the Ministry’s proposed savings policy as the limit on payouts from the fund.

policy to stabilize the domestic economy could be handled through short-term borrowing like in other countries.

## World Bank

-----Original Message-----

From: ehuybens@worldbank.org [mailto:ehuybens@worldbank.org]

Sent: Tuesday, November 30, 2004 12:18 PM

To: Thomas Ekeli

Cc: Sdhar2@worldbank.org; afozzard@worldbank.org; ralonsoiterme@worldbank.org;

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Subject: World Bank comments on Discussion Paper for Timor-Leste Petroleum Fund

Dear Thomas,

We thank the Government for the opportunity to comment on the Discussion Paper for the Timor-Leste Petroleum Fund, which provides a useful mechanism for discussing a prospective petroleum fund for Timor-Leste and also contains important insights into fiscal and savings policy as they relate to managing petroleum revenue. The paper raises the key issues for Timor-Leste of the depletability and volatility of its main source of fiscal revenue and a major source of national income. It notes the risks involved in being an oil dependent economy in a refreshingly frank way and discusses some of the ways to mitigate that risk, in particular as a means to enhance transparency in oil transactions. The establishment of a Petroleum Fund is one mechanism to help manage the revenue. It correctly notes that such a Fund is neither necessary nor sufficient for avoiding the dutch disease or oil induced governance flaws, but that correctly implemented it can be a force for good. The following comments are offered as a means to stimulate further debate on the issues raised by the paper:

Rules versus Flexibility. There is a tension in the paper between the endorsement of flexible fiscal policy and a savings policy that maintains the real value of petroleum wealth. If the government does not allow itself to borrow and has a firm savings target, then this automatically places a limit on the non-oil fiscal deficit -- and amounts to a fiscal rule. So, while the paper has declared that fiscal policy will be flexible and transfers from the fund will be determined by the non-oil deficit, it appears to have opted for a rigid rule, i.e., maintaining the real value of the petroleum wealth. Such a rule determines how much oil revenue must be saved and how much can be transferred to the budget. This automatically sets a limit on the non-oil deficit. If the government decides to borrow, then it is not the fund that will determine government saving but rather government expenditure. The net accumulation of assets is what counts. Accumulation of assets by the fund can be offset by government borrowing. In this case a fiscal rule would entail setting targets, limits or constraints on the fiscal deficit (i.e. public sector borrowing) or government (net) debt, rather than additional rules on the fund. To sum-up, the government has set a firm target for the fund, maintaining its real wealth. If it doesn't borrow this translates into a fiscal rule. If the government allows itself to borrow then fiscal policy

becomes flexible even though the fund rule is still rigid. Thus, the flexibility or rigidity of fiscal policy is determined by the rules of the fund only in the absence of public sector borrowing.

**Estimating Oil Wealth.** A difficult operational question will be how to determine the value of the country's oil wealth, or the permanent income from oil. Besides the considerable uncertainty about production and reserves there is the major uncertainty of price. The value of the reserves depends on the long-run or expected price. Thus, when confronted with a price change the government has to decide whether the change is permanent (in which case saving/spending should change) or transitory (in which case the windfall should be saved and expenditure change only by the income on the additional assets). Distinguishing between permanent and transitory is no small task and will have to be addressed at some time by the fiscal authority or the fund managers.

**Unintended Adjustments to Spending.** A parallel issue relates to the possibility that the proposed saving policy could lead to unwarranted adjustments to spending. For example, if oil prices increase and the change is judged to be permanent, adhering to the savings policy would imply increased government spending. But if absorptive capacity remains a constraint, an artificial boost to spending is likely to reduce its efficiency and lead to waste. Under these circumstances, the preferred policy may be to accumulate financial assets faster than warranted by the saving policy. This example highlights the need for a degree of flexibility in setting fiscal policy. The paper endorses this view but if our interpretation of the savings policy is correct, there may be a need to ensure that mechanisms to permit needed flexibility are provided for.

**Savings Objective.** The saving policy goal of maintaining the real value of the country's oil wealth would be a reasonable objective if one could safely assume that per capita growth would be positive. However, in light of Timor-Leste's very high fertility rate and the uncertain prospects for economic growth, it is possible that per capita incomes do not increase over an extended period. Under these circumstances, a more conservative savings strategy may be warranted. The paper indicates one such option of keeping constant the value of the petroleum wealth per capita. It may also be possible to design an intermediate objective that falls between these targets, or one that links saving policy to other economic variables.

**Need for Legislation.** Whatever the appropriate rule, the paper does not explore the issue of whether the rule should be a matter of policy or legislated. While legislation can always be changed, the process of changing legislation would be more transparent and more likely to provoke debate. Policy on the other hand, is determined by the executive and implemented through the budget. While the legislature can object, in practice it may be difficult for Parliament to object effectively to fiscal policy changes. A strong case can therefore be made for legislating the savings policy. If this principle is accepted, the question of what rule to legislate and how difficult the legislation should be to change needs to be debated. If the Government wishes to consider the option of legislating a savings policy,

there may be a need to mobilize an expert to provide an overview of the options.

Transparency and Accountability. The discussion paper scores well under this heading. Full transparency (regular, accessible reporting) is intended with respect not only to the Fund accounts and operations, but also with respect to inflows and outflows from the Fund. Transparency typically translates into accountability, but practical procedures for oversight of the Fund will boost its effectiveness (below).

Implementation. While perhaps not relevant for a discussion paper intended to introduce the concept of a petroleum fund, the rules for the composition, selection, appointment, dismissal and reporting of both the Investment Advisory Group and the Council of Eminent Persons will be essential to the success of the Fund in achieving its purposes. These criteria or rules will have to go into the legislation creating the Fund. Finally, the suggestions from Global Witness/Cafod on the means of enhancing transparency provisions are worthy of consideration.

With warm regards, Elisabeth.

Elisabeth Huybens  
World Bank  
Country Manager Timor-Leste  
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670 723 0550

# **La'ó Hamutuk**

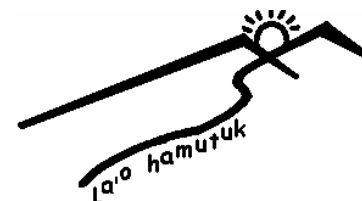
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**Submission to the**

**Petroleum Fund Steering Group**

**Ministry of Planning and Finance**

**Democratic Republic of Timor-Leste**

**from**

**La'ó Hamutuk**

**regarding the**

**Public Consultation Discussion Paper**

**on**

**Establishing a Petroleum Fund for Timor-Leste**

**5 December 2004**

## Summary

- The important, relevant issues are broader than those in the Discussion Paper, and need a wider perspective than that brought by the IMF and others if Timor-Leste is to avoid the resource curse.
- Norway's law has useful elements for Timor-Leste to emulate, but some are not included in the Paper. São Tomé may be a more appropriate example.
- The Petroleum Fund should include all mineral resource revenues, not just Timor Sea oil and gas.
- Assumptions in the Paper about the future value of the U.S. dollar and the future prices of oil and gas may be incorrect, and should be re-examined. Dollars are losing value, and oil, as a globally finite resource, will be more valuable.
- Binding laws or Constitutional provisions are necessary to protect the rights of future generations to the national patrimony, and to insulate the Petroleum Fund from the political and financial pressures of the annual budgeting process.
- Other sectors of the economy and alternative energy sources, need to be developed soon since Timor-Leste's oil and gas will be exhausted within two generations.
- We support the Government's fiscal policy option (a), maintaining the value of our petroleum wealth, although this should be reassessed every few years.
- Care needs to be taken when spending petroleum fund in the annual budget, distinguishing between operating expenses (consumption) and physical and human investment (capital purchases).
- Parliament should be required to enact a resolution whenever money is to be withdrawn from the Petroleum Fund.
- The Fund should not be allowed to be used as collateral for borrowing, or for debt service.
- The Petroleum Fund should be invested in a diversified portfolio, including many long-term securities, and those in other currencies than the U.S. dollar.
- Timor-Leste should adopt guidelines or rules for ethical (socially responsible) investing.
- The Investment Steering Committee should represent diverse sectors of society.
- The Banking and Payments Authority should operate according to the law, with a legally-constituted Governing Board.
- The Council of Eminent Persons should be created, but strengthened and given the legal mandate and obligation to oversee Fund operations, in coordination with the Provedor and the General Prosecutor.
- All petroleum-related payments should go into the Petroleum Fund, with sanctions against payers who fail to comply, and clear and enforceable

mechanisms. Dividends and interest earned by the Fund should be re-deposited in the Fund.

- There should be a presumption of transparency, which must be backed up by an accessible Public Register with specific requirements for what information must be public. This includes not only how much money there is, but where it is deposited and invested.
- The Public Consultation process thus far has been closer to socialization than consultation. We suggest specific steps to make it more effective.
- Long-term economic planning is essential to prepare Timor-Leste for its post-petroleum era.

## Introduction

The East Timor Institute for Reconstruction Monitoring and Analysis, La'o Hamutuk, appreciates the opportunity to submit our comments on the Public Consultation Discussion Paper on "Establishing a Petroleum Fund for Timor-Leste"<sup>1</sup> (hereinafter the "Paper"). The issues discussed in the Paper are among the most critical for the long-term future of the people of our new nation, and we welcome the effort by the Government, the Prime Minister and the Ministry of Planning and Finance to invite civil society to participate in this discussion.

La'o Hamutuk is grateful to people in the government and other East Timorese institutions who helped us with information for this submission, especially Mr. Thomas Ekeli, Petroleum Fund Advisor in the Ministry of Planning and Finance and Mr. Abrão Vasconcelos, General Manager of the Banking and Payment Authority, for their patience and willingness to answer our many questions. In preparing this submission, La'o Hamutuk received invaluable expert advice from Global Witness, the Center on Globalization and Sustainable Development in the Earth Institute at Columbia University, the Open Society Institute, the Harvard Law Student Advocates for Human Rights and several individuals. Although we did not agree with all of their suggestions, we appreciate their support and their work to help Timor-Leste develop a Petroleum Fund that addresses its needs and reality. We have attached memoranda from Columbia and Harvard as Annex II and III of this submission.

Our submission is based on the assumption that this consultation is genuine, and that the drafters of the Petroleum Fund and other fiscal policy legislation approach this task with open minds. We hope you will seriously consider perspectives, approaches and information different from those proposed in the Paper, and we look forward to continuing dialogue and consultation as this legislation is drafted, revised and enacted.

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<sup>1</sup> RDTL Ministry of Planning and Finance, "Establishing a Petroleum Fund for Timor Leste: Public Consultation Strategy Paper" October 2004. Throughout this submission, we will refer to this document as the "Paper." Available at [http://www.mopf.gov.tp/download/tax\\_policy/PF-DiscPaper-Final.pdf](http://www.mopf.gov.tp/download/tax_policy/PF-DiscPaper-Final.pdf)

This submission will discuss some broader issues than the Paper, as we believe it does not adequately consider many critical aspects of the problem. We will discuss some general concepts, and also suggest some specific measures which should be implemented in law. We also discuss aspects of long-term fiscal policy for Timor-Leste which, although not part of the Fund design, is discussed in the Paper as an important element of Timor-Leste's long-term development. Unfortunately, we believe that the Paper does not express adequate attention to long-term planning for future generations of Timor-Leste citizens whose ancestors will have sold and depleted their nation's petroleum birthright. We hope that the influence of International Monetary Fund (IMF) ideology in Timor-Leste will be tempered by others who don't share the limited vision of international financial institutions, which rarely plan beyond one project or generation.

### **The curse of oil**

We share the Paper's view that petroleum wealth can easily become a curse instead of a blessing. In the back-page editorial of La'o Hamutuk's October 2004 *Bulletin*,<sup>2</sup> we discuss how this damnation is prevalent in almost all petroleum-producing countries which weren't rich before they started to develop petroleum, and how Timor-Leste has all the preconditions for this problem.

The description of the curse on page 8 of the Paper does not mention some of the worst manifestations of the "devil's excrement." Nearly all petroleum-revenue-dependent countries experience artificially high prices, substitution of imports for locally produced items, and neglect of non-oil sectors of the economy. Timor-Leste already suffers from all three of these conditions as a result of the large international presence here since 1999 and current free-trade market ideology. They will get much worse over the next decade, as petroleum revenues eclipse the rest of our economy. Any fiscal policy and effective management system for petroleum revenues must take steps to minimize these consequences, which will become devastating after the oil and gas are used up. If they are not dealt with, the good intentions behind the Petroleum Fund will come to nothing.

Unfortunately, good management of government petroleum revenues is not enough to avoid the resource curse. The problem also includes the petroleum companies, international financial institutions, systemic patterns of the petroleum industry, bad or short-sighted political decisions and powerful, industrialized buyers of oil and gas. As we discussed in our submission on the draft petroleum regime,<sup>3</sup> environmental effects, possible conflicts, community consultation, human rights,

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<sup>2</sup> "Can Timor-Leste Avoid the Resource Curse?", *La'o Hamutuk Bulletin*, Volume 5, No. 3-4, page 24 (English edition), October 2004. Available from La'o Hamutuk or at [http://www.etan.org/lh/bulletins/2004/bulletinv5n3b.html#Resource\\_Curse\\_](http://www.etan.org/lh/bulletins/2004/bulletinv5n3b.html#Resource_Curse_)

<sup>3</sup> La'o Hamutuk, Submission to the Timor Sea Office and the Timor Sea Designated Authority regarding the Proposed Petroleum Regime for Timor Leste, September 2004. Available at <http://www.etan.org/lh/misc/PetRegSub/LH%20sub1%20Eng.htm> . Many of the issues discussed in that submission are also relevant to the Petroleum Fund.

long-term planning and other critical aspects of petroleum development must be carefully considered by any country which hopes to benefit from petroleum income.

### **Learning from others' experiences**

One of the factors which may allow Timor-Leste to reduce its chances of following the resource curse pattern is that we are developing our oil and gas later than other nations. We can learn much from their experiences and actions, adopting best practices and avoiding some of the most dangerous pitfalls.

The government of Timor-Leste has chosen to follow Norway's model, regarded by some as the world's most successful. However, La'o Hamutuk believes that Timor-Leste is very different from Norway, so that some aspects of their model may not be appropriate for our situation. We also encourage Timor-Leste to look at the new Petroleum Law adopted by São Tomé and Príncipe, part of which is described in Annex I of this submission.

Norway was fully industrialized, with a high standard of living, before oil production began in 1970. Over the next twenty years, Norway experienced many problems related to oil revenues, including fluctuating oil prices, debt accumulation, and the contraction of non-petroleum sectors of the economy. Norway's petroleum fund, created in 1990, was motivated by escalating inflation and debt. Although Norway's oil and gas revenues continue to make up a large percentage of its total income, the country has managed to keep its economy diversified. In 2005, the Norwegian government expects<sup>4</sup> net petroleum revenues of \$33 billion, with non-oil revenues of \$89 billion. They plan to use \$12 billion of petroleum money to cover the non-oil budget deficit, and to deposit the remaining \$21 billion in their Petroleum Fund. In other words, petroleum revenues will pay for about 11% of the Norwegian national budget.

By contrast Timor-Leste's oil and gas revenues will pay for more than two-thirds of our national budget. At peak production, annual oil and gas income will be larger than our entire non-oil GDP. Without proper safeguards, our country's struggle to diversify its economy will be made more difficult by oil and gas production.

Norway has an affluent, well-educated population with a long tradition of democracy, professionalism and integrity in government administration. La'o Hamutuk hopes that Timor-Leste will eventually attain that condition, but it will not happen for generations. In the meantime, our citizens' grandchildren must depend on legal safeguards to preserve their petroleum wealth, even if Norway doesn't need them.

Nevertheless, Timor-Leste can learn some important lessons from Norway. Unfortunately, the Paper does not incorporate some of the most important and relevant components of Norway's system, leading us to wonder if "Norway Plus" has become "Norway Minus."

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<sup>4</sup> [www.statsbudsjett.no/2005/english.asp?id=3#m](http://www.statsbudsjett.no/2005/english.asp?id=3#m)

- We recommend that Timor-Leste's legislation emulate Norway's and prohibit the Fund being used as collateral for government borrowing. This would support our current Government's sensible policy of not going into debt, and reassure those worried that a future government might simultaneously spend and borrow, especially when oil prices are high.
- As discussed below, we believe that Norway's Ethical Guidelines for fund investment are an important principle for Timor-Leste to adopt.
- Norway requires a Parliamentary resolution to transfer money from the Norwegian Petroleum Fund to the government budget, and Timor-Leste should enact a similar requirement to make transfers more deliberate and transparent than envisioned in the Paper, and to ensure that everyone knows that this is being done.

La'o Hamutuk is not aware of many successful models of petroleum revenue management, and we have not been able to examine good practices other than Norway and São Tomé. Last January, however, we organized seven representatives of Timor-Leste NGOs to visit Nigeria to learn about the consequences of bad practice. They observed "corruption and repressive government, environmental and social damage, and human rights abuses" as a result of petroleum development, and concluded that "oil and gas revenues do not necessary lead to economic growth. Mismanagement of oil and gas revenues leads to poverty and lack of development."<sup>5</sup>

### **Timor-Leste's oil and gas resources**

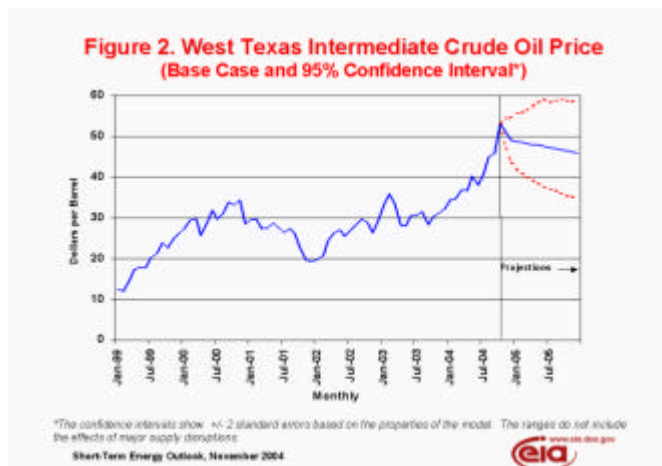
As the Paper mentions, oil and gas revenues are not "income" for Timor-Leste, but are really a conversion of the nation's existing, non-renewable wealth from one form to another, from petroleum to cash. As Timor-Leste has no other significant resources which can readily be marketed internationally, our oil and gas have a key role in ensuring our nation's economic independence and survival. They also are an essential commodity to industrialized countries, whose economy and lifestyles rely heavily on the planet's finite petroleum reserves.

In the first sentence of the Executive Summary and on page 11, the Paper states that the Petroleum Fund is for oil and gas wealth "in the Timor Sea." We hope that this is a misstatement, and that the Fund will be used for revenues from all of Timor-Leste's petroleum wealth. The law which defines the Fund should specifically refer to revenues from the entire territory of RDTL, including terrestrial and maritime areas, the Exclusive Economic Zone, and any joint development areas, including the one defined by the Timor Sea Treaty. We also encourage the designers of this policy to consider how it would apply to other mineral and non-renewable resources this nation may exploit in the future, since such depletable resource extraction also converts mineral to financial assets.

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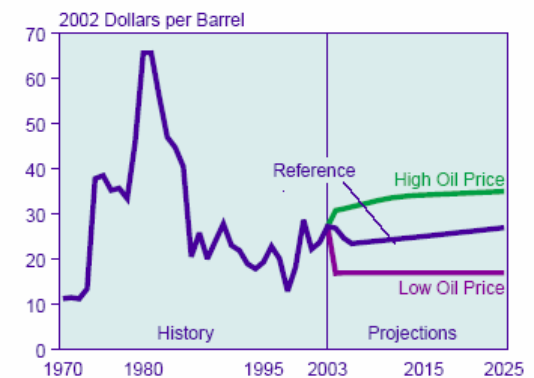
<sup>5</sup> The report from La'o Hamutuk's intercambio to Nigeria is available at <http://www.etan.org/lh/misc/04Nigeria%20Exch%20Rept.htm>

Timor-Leste is entering into this process at a time of high and rising oil and gas prices, with revenues from Bayu-Undan far exceeding projections from only a year ago. World oil prices have quadrupled and natural gas prices have tripled since the Indonesian occupation ended in 1999. This will not last, but it creates an illusion of great wealth, leading to false optimism. Although a Petroleum Fund can insulate against fluctuations in oil and gas prices, the price trend at the time it is designed will subconsciously influence the designers.<sup>6</sup>



Nevertheless, current prices are not as high as Figure 2 on page 7 of the Paper indicates. That graph fails to adjust for inflation; a more accurate view is shown on the graph at right.<sup>7</sup> In constant dollars current oil prices are 40% lower than in the early 1980s.

Figure 26. World Oil Prices in Three Cases, 1970-2025



However, global oil production rates have now exceeded the rate of new discoveries, and in the three to five decades that Timor-Leste will be selling its petroleum, the value of that resource will become significantly higher. The Paper assumes that “the real value of the petroleum wealth” (page 19) is constant; in fact, it will increase over time, both from new discoveries in Timor-Leste’s territory and from escalating global petroleum prices as finite resources are used up.

Sources: **History:** Energy Information Administration (EIA), *International Energy Annual 2001*, DOE/EIA-0219(2001) (Washington, DC, February 2003), web site [www.eia.doe.gov/ieaf](http://www.eia.doe.gov/ieaf). **Projections:** 2003-2004—EIA, *Short-Term Energy Outlook*, on-line version (April 2004), web site [www.eia.doe.gov/emeu/steo/pub/contents.html](http://www.eia.doe.gov/emeu/steo/pub/contents.html). 2004-2025—EIA, *Annual Energy Outlook 2004*, DOE/EIA-0383 (2004) (Washington, DC, January 2004).

The Paper assumes that oil prices will decline gradually to \$27/barrel, but makes no allowance for inflation or the declining value of the U.S. dollar, so this assumption is that prices will continue to go down in real terms. In reality (as in the previous graph), oil prices will probably rise over the long term, even if there is a short-time decline from the current peak, and gas prices will follow the same

<sup>6</sup> Graph from *Short-Term Energy Outlook* – November 2004 published by the U.S. Department of Energy’s Energy Information Administration (EIA), accessible at <http://www.eia.doe.gov/emeu/steo/pub/steo.html>. Graph is at <http://www.eia.doe.gov/emeu/steo/pub/gifs/img003.gif>

<sup>7</sup> Graph from “World Oil Markets” in *International Energy Outlook 2004* by EIA, downloadable from <http://www.eia.doe.gov/oiaf/ieo/pdf/oil.pdf>. Additional information on world oil price trends can be found at <http://www.eia.doe.gov/emeu/cabs/chron.html>

trend. Oil and gas resources are globally limited, with new discoveries now happening more slowly than reserves are being depleted. As the world inevitably moves away from this environmentally damaging and increasingly expensive fuel, oil and gas still in the ground in fifty years from now could be even more valuable as a chemical feedstock.

Like everyone else, Timor-Leste will no longer use fossil fuels for electricity, transportation and fuel by the end of this century. If we begin now to convert to local, renewable energy sources, and base the development of our economy on such sources, we will save money, increase our energy independence (especially after our oil and gas are depleted), have a more sustainable economy and be more responsible global citizens.

The graphs and discussion in the Paper appear to assume that Bayu-Undan and nearly-depleted Elang-Kakatua are Timor-Leste's only petroleum resources. While this is appropriately conservative, it is not consistent with the actual situation and could result in incorrect long-term planning. With a fair, legal determination of the Timor-Leste/Australia maritime boundary, Timor-Leste's petroleum reserves are nearly three times as large as the Paper considers; even under the unfair *Timor Sea Treaty* and unratified International Unitization Agreement for Greater Sunrise, our proven offshore resources are much more than the Paper supposes. Onshore resources, unknown at present, could also be significant.

One decision which can help manage Timor-Leste's petroleum wealth is to determine when and how rapidly to convert our oil and gas to dollars. As La'o Hamutuk has written in *The Case for Saving Sunrise*<sup>8</sup>, developing our fields sequentially rather than simultaneously will help stabilize, prolong and probably increase revenues from our oil and gas; this applies to other fields as well. Although the current impasse with Australia may force the Government to follow our suggestion, we remain concerned that other decisions about petroleum development are being rushed to explore and exploit most fields as rapidly as possible. These decisions should be made in light of the long-term planning and "resource curse" concerns which motivate the Petroleum Fund.

### **Spending our children's inheritance**

Article 139 of the Constitution of Timor-Leste declares that undersea and underground resources belong to the State of Timor-Leste, not to a Government which holds office at a particular instant in time. The current consultation will lead to laws and policies that will be in place long after current government officials, advisors, contractors and political parties have faded from the scene. Since our current enlightened leadership will not be here forever, Timor-Leste needs to protect itself against potential abuses from hypothetical ill-intentioned, corrupt institutions and individuals who will be attracted by the many billions of dollars available from our resources.

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<sup>8</sup> "The Case for Saving Sunrise" by Charles Scheiner, La'o Hamutuk, July 2004. Available at <http://www.etan.org/lh/misc/04sunrise.html>

During the Public Consultation, the Prime Minister was asked about the future, when another Government might not be as concerned as the current one about preserving petroleum revenues for future generations. He said that he was not responsible if the people voted for a future government, implying that re-electing his party forever was the best way to safeguard Timor-Leste's petroleum birthright. La'o Hamutuk does not get involved in electoral or party politics, but we encourage the current Government to establish structures that protect the people of Timor-Leste regardless of who is in power in the future. This was the rationale behind writing a Constitution three years ago, and it should also underlie the Petroleum Fund and Fiscal Policy.

Timor-Leste will have converted all its oil and gas to cash within two or three generations, an irreversible process. The issues discussed in this Paper will largely determine the quality of life for our grandchildren. If we have not developed non-oil sectors of our society and economy to be self-sufficient in food and other basic necessities, and to generate enough foreign exchange to import what we cannot produce, Timor-Leste will soon revert to its current status as the poorest country in Asia, with unacceptable levels of disease, lack of services and poverty. We should learn the lesson of Nigeria, Africa's largest oil producer, which can no longer feed its people – although they exported food before 1960, when the first of \$300 billion worth of oil was extracted from their soil.

We are concerned that the proposed Fund design puts all decisions about the use of petroleum revenues into the annual budgeting process, which of necessity looks only at the next twelve months. In this environment, it will be virtually impossible to consider the impact on the post-petroleum part of Timor-Leste's history. As we discuss later in this paper, we believe it is essential for binding restrictions to limit how quickly petroleum revenues are spent, and for what. Non-binding "guidelines" can be ignored or violated without anyone being aware. It would be better to establish lasting principles during the current deliberative process (even if they might be amended or repealed later), than to expect the budgetary process, inevitably influenced by short-term pressures for pork barrel projects, patronage and political gain, to make wise, long-term financial decisions year after year.

## **Fiscal policy**

Some of the most important issues discussed in the Paper involve long-term fiscal policy for Timor-Leste: how much of the oil and gas revenues should be spent immediately, how much should be invested in physical and human assets which will help build Timor-Leste's economy for a post-petroleum future, and how much should be invested in financial instruments to earn interest and provide revenues after oil and gas reserves are depleted?

We agree with the Government that the optimum fiscal policy for Fund at the present time is the one described as (a) on page 17 of the Paper – maintaining the value of Timor-Leste's petroleum wealth. Our population is growing rapidly, and we should anticipate the expenses of educating and providing services for the many babies being born today and for their grandchildren's grandchildren. Nevertheless,

we believe the conservative assumptions about future petroleum prices and Timor-Leste's total petroleum reserve limit spendable current petroleum income to an unacceptably low level under the more far-seeing guideline (b), maintaining fund withdrawals per capita. We also expect that physical investment over the next few years will provide a base to increase Timor-Leste's economic output, resulting in an increase in non-oil tax revenues and a decline in the birth rate. This fiscal policy should be re-evaluated every two or three years, since over time we will have more accurate estimates of the factors in this paragraph.

Guidelines (a) and (b) involve estimating the total value of Timor-Leste's petroleum wealth for all time, basing withdrawals on that estimate. But that calculation has a very high degree of uncertainty – not only because the size of the reserves is unknown and future oil prices are unpredictable, but because when the petroleum is sold will affect its price. The 2004-5 RDTL budget<sup>9</sup> estimates the expected revenue from Bayu-Undan through 2008, and comes up with a range from \$49.8 to \$277.9 million. As the Budget Discussion Paper says, "There are very large risks to Timor Sea revenues over the next four years." If projecting petroleum revenues for only four years is so uncertain, it is clearly not possible to make a reasonable estimate of what they will be for forty years or more.

We are not economics experts, but the formula illustrating a "Sustainable Fiscal Policy Guideline" in Appendix III of the Paper seems counter to common sense. It assumes that the value of money in the Petroleum Fund appreciates over time (and hence is discounted to adapt to inflation and the time value of money), but that oil and gas in the ground loses value over time (based on a constant price in dollars-of-the-day,<sup>10</sup> which ignores inflation). But petroleum is a globally finite resource which will probably increase in price as worldwide supplies are depleted over the next decades. It is unlikely that U.S. dollars will appreciate – during the two and a half years since Timor-Leste became independent, the U.S. dollar declined 39% relative to the Euro. Given the precarious state of the U.S. economy and the large number of dollars loaned to the U.S. government by foreign creditors who may shift their investments to more stable currencies, the decline will probably continue.<sup>11</sup>

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<sup>9</sup> RDTL Ministry of Planning and Finance, Combined Sources Budget 2004-5, Background Paper for Discussion at the Development Partners Meeting, 17-19 May 2004. Table 2.7 on page 11.

<sup>10</sup> This is not apparent in the formula but is stated explicitly on page 7 of the Petroleum Fund Discussion Paper, which assumes that petroleum prices fall gradually toward \$27/barrel in dollars-of-the-day. Other estimates on that page also assume that petroleum prices decline at the rate of inflation over the long term.

This very conservative assumption may be appropriate for budgeting and to design the RDTL petroleum tax regime, but they lead to significant undervaluing of Timor-Leste's Petroleum wealth.

<sup>11</sup> For one of many discussions of this in the current U.S. mainstream media, see "Going Down" by John Cassidy in the *New Yorker* magazine, 6 December 2004, accessible at [http://www.newyorker.com/printable/?talk/041206ta\\_talk\\_cassidy](http://www.newyorker.com/printable/?talk/041206ta_talk_cassidy)

Other current articles discuss concerns of some Asian lenders who have much debt in U.S. dollars ("Dollar's Fall Tests Nerve of Asia's Central Bankers", *New York Times*, 4 December 2004, accessible at <http://www.nytimes.com/2004/12/04/business/worldbusiness/04banker.html>) and the possible replacement of the dollar by the Chinese yuan as a global currency ("As Dollar

These debatable assumptions could create an incentive to convert the petroleum to cash as quickly as possible. We hope that Timor-Leste's actual fiscal policy, and any guidelines and/or laws which implement it, will use a model which more closely reflects real-world U.S. dollar and petroleum prices.

Countries with oil revenue windfalls have far more difficulty implementing sound fiscal policy than those without such income. A critical reason for a well-designed petroleum fund is to try to overcome this impediment, to encourage wise economic and financial planning which would have to be undertaken to survive if there were no oil money. Oil money makes it too easy to make bad short-term decisions; the negative consequences of those decisions become apparent only decades later, when a different government is in power. An effective petroleum revenue management system is one component of avoiding this problem.

A Petroleum Fund does not ensure solid fiscal policy, but it can encourage responsible planning and management, helping to shelter each year's revenues from immediate political and economic demands, making it more likely that wise decisions will be made for long term. In many countries, oil income prevents sound financial decisions –a Fund can assist Timor-Leste's future leaders in making decisions that are no worse than if we had no gas or oil. In order to accomplish this, we believe that the Fund structure should incorporate rules, not just non-binding guidelines or benchmarks, to limit how quickly the money can be spent. This will be discussed in more detail below.

### **Spend, save or invest?**

When economists design fiscal policy, they often consider only economics in evaluating the benefits of different options.<sup>12</sup> In this world view, everything is measured in dollars, including investment in human capital, and evaluated by its "rate of return." This way of thinking does not consider people's quality of life, the health of non-workers, culture, recreation, environmental preservation, etc. Since the State of Timor-Leste exists to serve its citizens, not to satisfy the metrics of the IMF or other experts, we hope that a less materialistic evaluation of the results of different kinds of expenditures will be used.

We can group government expenditures (including money from petroleum revenues) into three categories:

1. **Operational expenditures or consumption:** day-to-day costs of keeping the nation functioning, with no long-term return. Examples: patching holes in

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Drops, China's RMB Could Emerge as Currency of Empire", Pacific News Service, 3 December 2004, accessible at [http://news.pacificnews.org/news/view\\_article.html?article\\_id=48c4060c511c280e7a7f051ba34ca324](http://news.pacificnews.org/news/view_article.html?article_id=48c4060c511c280e7a7f051ba34ca324) )

<sup>12</sup> See, for example, footnote 2 of Annex V of the IMF's *Democratic Republic of Timor-Leste: 2004 Article IV Consultation—Staff Report* from October 2004, on page 39: "...return on 'physical' assets will be given by the form of increased output ... improvements in productivity (and economic growth) ..."

streets and sidewalks, operating public utilities, repairing or replacing government vehicles, police, military, government salaries, curative health care, veterans benefits, etc.

2. **Physical investment or capital purchases:** expenditures which contribute to the future development of Timor-Leste, increasing the capacity for future economic and human activity. Examples: building new roads, constructing electricity and water systems that will last for decades, education and preventive health care (such as eradicating malaria).
3. **Financial investment:** putting the money in a Petroleum Fund which is loaned (invested) and repaid with interest or dividends.

Some of the discussions around the Petroleum Fund do not clearly distinguish between the first two types of expenditures.<sup>13</sup> However, both are part of the government budget, whose deficit is proposed to be paid for with petroleum revenues. The automatic transfer of Petroleum Fund money to meet the annual budget deficit encourages excessive spending in category 1 (which will have the strongest popular demand), without adequate attention to category 2.

In the Prime Minister's foreword to the Paper, he asks "How much should we spend of the petroleum wealth now, investing in infrastructure and human development, and how much should we save for the future?" But most current spending is not "investment in infrastructure and human development," but operational costs of the government for the coming year, that will leave no lasting benefit.

La'o Hamutuk agrees with the Paper that both kinds of expenditures are needed, and that it is appropriate to use some petroleum revenues for current consumption and to invest some in physical assets, while saving the balance for the future. We concur that public services, especially health, education and infrastructure (such as roads) are urgent – but we are also concerned about intergenerational equity. We hope that the Government will also invest in human capacity, including education and training for Timorese workers and students, so that eventually we will not have to rely on foreign experts or contractors.

We believe that the transfer of money from the Petroleum Fund to the annual Government budget should not be automatic, invisible or effortless. Rather, as in Norway,<sup>14</sup> we believe that the Council of Ministers and Parliament should have to enact a resolution – separate from approval of the budget – every time it wants to withdraw money from the Petroleum Fund. Such a 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. If our lawmakers debate and vote each time they

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<sup>13</sup> See, for example, the second paragraph on page 16 of the Paper which confuses current spending with saving in physical assets.

<sup>14</sup> Norway Act no. 36 of 22 June 1990, §3 ("The Fund's capital may only be used for transfers to the central government budget pursuant to a resolution by the Storting (Norwegian parliament). The Fund's capital may not be used in any other way, nor may it be used to provide credit to the central government or to private sector entities.").

use up part of our national patrimony, they will be more careful about squandering their children's inheritance. This will also help make the Fund more transparent to the public, and elected officials can be held accountable for their decisions about spending Fund assets.

We agree that the Parliamentary budgeting process should be kept separate from the management of the Fund, and requiring such a resolution would not infringe on Parliament's mandate. We also believe that the Fund can be a valuable tool to encourage sound fiscal management, and a mechanism to help implement it. To that end, as discussed in the next section, Timor-Leste should enact regulations to limit how much money can be withdrawn from the Fund and how it can be spent.

### **Rules to protect rights of future generations**

Because of the difficulties of managing petroleum wealth, and because the current deliberative and consultative process of designing the Petroleum Fund is less subject to narrow political pressures and lobbying by special interest groups than the annual budget process, we believe it is important to include rules in the Fund legislation to help protect against irresponsible decisions by future Governments and Parliaments. Such rules could take the form of law or of a provision in the RDTL Constitution. In either case, a future Parliament could amend them – but the public would know what their representatives were doing and hold them accountable. A non-binding benchmark or guideline, as proposed in the Paper, can be modified or violated at will.

We do not believe that these rules should define budgeting decisions in detail. We are also not proposing specific rules at this time, but rather advocating the concept of rules which could be developed over the next few months in consultation with the Government, civil society, international experts, Parliament and others, to be incorporated in the Fund legislation.

However, we would like to suggest a few examples of good rules which could be enacted. If the Petroleum Fund drafting committee decides to consider incorporating such rules, La'o Hamutuk would be glad to work with you to design them and to help ensure that civil society is consulted.

- **Prohibiting the use of the Fund as collateral against borrowing**, and/or prohibiting the use of Fund monies for debt service. We believe this is a very important principle, adopted by Norway and other countries, which should be incorporated in the Fund legislation. Since the RDTL Government has already made the commendable decision not to borrow money, and since borrowing against petroleum revenues has led to crises in many countries, this is an important and non-controversial rule to implement.
- **Limiting annual withdrawals from the Fund to a fixed amount per capita**, fixed amount, percentage of its balance, fraction of its income over the past year, and/or fraction of the national budget.

- **Limiting Fund withdrawals to amounts consistent with the fiscal policy principle** of “maintaining the real value of the petroleum wealth,” or another appropriate long-term fiscal policy.
- **Requiring that money from the Fund** (or a certain percentage of it) **be spent for investment in physical and human assets**, rather than operational expenditures. Examples of other possible requirements for allocation of Petroleum Fund money could include development in under-served areas, public health, education, rural infrastructure, or development of non-oil sectors of the economy such as agriculture. São Tomé e Príncipe, for example, has such a requirement. (See Annex I to this submission about São Tomé’s oil law).

In Brazil, popular participation led to a Constitutional obligation that the government invest a certain fraction of GDP in education, health, and underdeveloped areas, and other countries have similar laws. Such a principle may be beneficial for Timor-Leste, but it is beyond the scope of the Petroleum Fund and fiscal policy consultation.

- **Prohibiting the use of Fund money for certain types of government activities** which have often been abused in other countries, such as weapons purchases; expansion of the military or police; huge, non-productive “prestige projects” or excessive payments to individual officials.
- **Incorporating intergenerational equity, energy independence, sustainable development, environmental protection and human rights protection** into how the Fund will be spent. Petroleum development negatively impacts these areas all over the world, and Timor-Leste will have to act affirmatively to avert these consequences. Like some of the other suggestions on this list, this could be implemented with simple additions to the “Key Principles” (Box 3, page 15 of the Paper) or the fiscal policy guidelines if the drafters continue to reject legislative regulation.

Article 95 of the RDTL Constitution gives our Parliament exclusive responsibility to make laws on “the budget system” and oversight responsibilities over the actual budget and its execution. It does not, however, assign to Parliament the responsibility to create the budget itself. Articles 115 and 145 give the Government responsibility to prepare the budget; all Parliament does is approve it. Article 140 assigns responsibility for promoting national and foreign investment to the State; one could argue that a petroleum fund would fall under this as well.

Timor-Leste struggled for decades against Indonesian occupation to create a democracy where actions of public officials are governed by the rule of law, not by the whim of individuals. This struggle is ongoing in various sectors of our and other societies – for example, Timor-Leste’s law on Domestic Violence is a positive move toward protecting the rights of women and children. During the public consultation, the Prime Minister mentioned many times that future generations of Timor-Leste have as much right to petroleum revenues as the present generation, and we agree. As with other rights, laws are the best way to protect these rights of future

generations. Such legislation does not threaten the sovereignty of future Governments and Parliaments. Rather, it implements Article 139 of our Constitution that says that our petroleum resources belong to the State of Timor-Leste, not to any transitory government.

We were surprised by the view of some international advisors, including people designing the Petroleum Fund, that the current government should not adopt fiscal policy goals which constrain the options of future governments or attempt “to lock in ‘good’ fiscal policy.”<sup>15</sup> During the UNTAET period, international advisors (including some from the IMF) had no such reluctance. Before Timor-Leste had even held an election, the IMF and UNTAET adopted the U.S. dollar as East Timor's currency, a decision with long-term consequences. In another example, UNTAET promised oil companies the same contractual terms they had received during the illegal Indonesian occupation, and then negotiated the *Timor Sea Treaty* (signed within hours of independence) which is binding on governments of Timor-Leste for thirty years. Although these undemocratic decisions may not have been wise, they illustrate that a government – especially an elected, representative one – should feel free to enact legislation which may constrain the decision-making space of future governments if it is in the long-term interests of the citizenry.

Of course, unforeseen circumstances – such as the discovery of large new petroleum reserves, long-term changes in the global petroleum economy, or an emergency facing our nation – could make it advisable or necessary for a future Government to change laws controlling how Fund monies are used, on either a one-time or permanent basis. This is of course possible under our Constitution; any regulation or law can be repealed or modified using the same process which enacted it in the first place. Even a Constitutional amendment can be undone with another amendment to the Constitution. We believe that this is a justifiable and reasonable level of “rigidity,” necessary to protect the rights of future generations.

At a seminar in Dili last March, an international advisor in the Ministry of Planning and Finance rejected a suggestion to give the Fund Constitutional status because it would take too long. But when we are establishing systems which must be effective for generations, the 120 days it takes Parliament to amend the Constitution is a blink of an eye.

The authors of Timor-Leste's Constitution made it difficult to amend before May 2008, but it may still be appropriate to add an article institutionalizing the Petroleum Fund and the Council of Eminent Persons oversight mechanism. Furthermore, some of the rules suggested above may be appropriate to enshrine in the Constitution, as they are in Alaska and elsewhere. During this public consultation, our leaders repeatedly stated that broad public support for the Fund is essential if it is to be effective. Once that support has developed, many political parties would agree to incorporate it in the Constitution, making it easy to obtain the necessary four-fifths approval in Parliament.

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<sup>15</sup> “Establishing a Petroleum Fund for Timor Leste: Public Consultation Strategy Paper” October 2004, page 18 footnote 9.

## Investing the Petroleum Fund

According to the Paper and speakers at the Public Consultation, the Fund will be invested in low-risk, high-liquidity financial assets outside Timor-Leste. We have several concerns about this recommendation, and also believe that there should be additional rules about how Timor-Leste's future generations invest their inheritance.

As discussed above, the U.S. dollar is falling rapidly, and is likely to continue to do so as the U.S. economy increases its dependence on money borrowed from overseas. We believe that U.S. dollar-denominated securities are not the most secure or highest-returning investments Timor-Leste can make, and we encourage the Fund's managers to be more creative. The Banking and Payments Authority (BPA) has invested the FTP money Timor-Leste has already received in U.S. Treasury Notes (although officials have refused to reveal where the money is invested, we believe this to be true.) In the public consultation, the Minister for Planning and Finance mentioned "USD denominated fixed income securities ... (eg government bonds with short duration)"<sup>16</sup> as the proposed Petroleum Fund investment strategy. We believe this decision has already cost the people of Timor-Leste a significant amount of money. Furthermore, we do not think that Timor-Leste's citizens would want to loan our capital to help cover United States government deficits resulting from their invasion and occupation of Iraq in defiance of the United Nations.

La'o Hamutuk disagrees with the Fund designers' inclination for short-duration, high-liquidity investments. Not only does this lower the rate of return Timor-Leste will receive, it also reinforces a mindset of withdrawing the money soon after it is deposited. Since the fiscal policy guidelines expect that most of the money in the Fund will be there for decades, it would be better to have a more diversified portfolio, with a significant number of longer-term securities to encourage saving.

One additional drawback of short-term, overseas investments is the necessity for frequent redemption and purchases of securities. This could result in a much money being paid in commissions to brokers or bankers in international financial centers. Since a 1% commission on the Fund will be more than ten million dollars, the incentives for mismanagement are large.

In view of the government's stated commitment to follow the model of Norway's petroleum fund, we hope that it adopts their Ethical Guidelines for investment of petroleum revenues.<sup>17</sup> These include a negative screening and exclusion process of

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<sup>16</sup> "Establishing a Petroleum Fund for Timor-Leste" presentation at public consultation, slide 33.

<sup>17</sup> Ethical Guidelines for the Government Petroleum Fund issued 19 November 2004 (Ministry of Finance, Norway) available at <http://odin.dep.no/fin/engelsk/p10001617/p10002777/bn.html>. Norway's Ethical Guidelines are based on two premises:

"The Government Petroleum Fund is an instrument for ensuring that a reasonable portion of the country's petroleum wealth benefits future generations. The financial wealth must be managed with a view to generating a sound return in the long term, which is contingent on sustainable development in the economic, environmental and social sense. The Fund's financial

companies that engage in or contribute to unethical actions. A five-member “Council on Ethics” makes recommendations for exclusion. The Council’s recommendations are made public, which we feel is highly important in keeping information available, and if successfully implemented would increase the public’s sense of ownership of the Fund.

Timor-Leste may prefer investments which are consistent with our nation’s priorities and foreign policy, supporting our political and economic interests. For example, we should not invest in TNI-controlled businesses or Australian government securities (until that government respects our sovereign rights in the Timor Sea). We should also avoid investments with negative environmental or social consequences, or which contribute to war and repression. Using our investment money to promote democracy and human rights is one way that Timor-Leste can implement our moral and Constitutional<sup>18</sup> duty of solidarity with those struggling against oppression. The principle of socially responsible investment should be added explicitly to the Fund’s “Key Principles” in Box 3 on page 15 of the Paper by inserting the words “socially conscious” after “low risk” in point #6; it should also be implemented in law.

In addition to the lucrative commissions mentioned above, there will be other pressures on the Fund managers to invest in particular companies or securities. The Paper proposes that the Ministry of Planning and Finance make the investment decisions, based on advice from an Investment Steering Committee (ISC). We are concerned that the Ministry will be vulnerable to short-term political pressures, since it is also responsible for collecting revenues, preparing Timor-Leste’s budget and managing money for government operations. The center of the Government’s daily financial operations is not the best place to make optimal long-term decisions, and our preference would be for an independent, non-political body to make investment decisions about the Petroleum Fund.

We support the Investment Steering Committee, which should include members from civil society appointed independently of the Ministry and the BPA, perhaps by the President and/or Parliament. (São Tomé’s law has such a provision; see Annex I.) The ISC could help buffer the Ministry from political pressures by presenting its investment recommendations publicly and to the Parliament. This will help citizens feel a greater sense of ownership of the Fund, and will require the Ministry to explain if it declines to take the ISC’s advice. We also suggest that written guidelines for investment be developed, with public consultation, to help provide insulation against special interests or political manipulation.

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interests should be consolidated by using the Fund’s ownership interests to promote sustainable development.

“The Government Petroleum Fund should not make investments that entail an unacceptable risk that the Fund is contributing to unethical actions or omissions, such as violations of fundamental humanitarian principles, gross violations of human rights, gross corruption or severe environmental degradation.”

<sup>18</sup> Article 10, RDTL Constitution: “1. The Democratic Republic of East Timor shall extend its solidarity to the struggle of the peoples for national liberation.”

## Democracy and accountability

Timor-Leste is a Constitutional democracy, which means that the elected government is responsible to represent the wishes and priorities of the citizenry. La'o Hamutuk is concerned that the structure envisioned in the Paper assigns a large amount of power to the Banking and Payments Authority (BPA) and the Ministry of Planning and Finance (MoPF), neither of which is directly chosen by the voters. Both of these institutions have day-to-day financial and administrative responsibilities, and may not always have the generations-long perspective necessary to safeguard our great-grandchildren's inheritance.

We are not proposing that operational and investment responsibilities be vested in another body. However, we feel that legal, structural and oversight components of this system need to be significantly strengthened. This is not undemocratic – these components will be implemented through the democratic legislative process, and could be changed by a future Parliament. But they are necessary if the Fund is to accomplish its stated objectives.

Independent oversight and supervisory bodies are not unusual around the world, or even in Timor-Leste. The Board of Governors of the Banking and Payments Authority (once it becomes functional) is one such body, as are the Constitutionally-mandated independent Electoral Commission and the Superior Councils for the Judiciary, Public Prosecution, and Defense and Security. Protecting future generations' rights to the national patrimony is another responsibility which must transcend politics; it should be overseen by a similar body, with members representing various sectors of society and appointed by different organs of government and society. From the perspectives of sovereignty and democracy, such a body would be no less legitimate than, for example, the Ministry of Planning and Finance.

Indeed, the experience to date with the Banking and Payments Authority is not encouraging. The BPA was created three years ago by UNTAET Regulation 2001/30. Sections 16 of that Regulation defines a Governing Board to “formulate policies for the operations of the BPA and supervise their implementation.” The subsequent section enumerates fifteen specific powers of the Governing Board, many of which are essential prerequisites to the basic operation of the BPA. The seven members of the Governing Board include three BPA managers and four outside persons; five must be present to constitute a quorum. The UNTAET Transitional Administrator failed to appoint the necessary members; on 17 April 2002 he issued Executive Order 2002/6 temporarily restructuring the BPA Governing Board to eliminate all outside members; any two of the three top BPA staff would constitute a quorum. This order, which expired two months later, was retroactive to 30 November 2001, perhaps to legitimize extra-legal operations. Upon independence, the responsibility to appoint the BPA Governing Board passed to the Prime Minister, subject to Parliamentary approval. Two and a half years later, the Banking and Payments Authority continues to operate with only three

members of its Governing Board, so it cannot conduct business in a legal meeting.<sup>19</sup> Timor-Leste is fortunate that there not been significant apparent corruption or incompetence in the BPA, but it is unacceptable to rely on the personal integrity of individuals without any legal safeguards.<sup>20</sup>

In the case of the BPA, laws exist (as no RDTL successor legislation has been enacted, UNTAET Regulation 2001/30 remains in effect) for an accountable structure, but they are not followed. As the Government considers structures to manage and oversee the Petroleum Fund, we hope they will be legally appointed before they receive millions of dollars in public funds.

## **Oversight**

Effective oversight is essential to any system managing large amounts of public money. We wish the Paper had further developed the Council of Eminent Persons concept and recommended its adoption, rather than merely suggesting it as a possibility. We do not agree that an independent institution to oversee oil wealth management is “dangerous.”<sup>21</sup> In fact, the Council should have the scope and the authority to carry out its critically important role as trustees for future generations of Timor-Leste citizens.

When it establishes the Council, Timor-Leste should avoid structural mistakes made by other countries. Fewer than half of the Council’s members should hold any position in the Government or Parliament; they should represent various sectors of government, civil society and other institutions. Given the inter-generational responsibilities of the Petroleum Fund, the Council should include both young and elder members. A minority of the members could be appointed by the Prime and Finance Ministers, but others should be chosen by Parliament, the President, and other public institutions. In other countries where the Government appoints the entire oversight body, the body doesn’t even appear to be impartial or effective.

The Council should be able to initiate its own inquiries, as well as receive requests from citizens. It should have complete access to all information in the possession of the Ministry of Finance, the Banking and Payments Authority and the Petroleum Ministry.

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<sup>19</sup> UNTAET Regulation 2001/30 says: “24.6 A quorum for the conduct of business at any meeting of the Governing Board shall consist of five members of the Governing Board.” The Board is required to meet at least monthly, but none of the meetings since June 2002 have had a legal quorum.

<sup>20</sup> This problem was described in the January 2004 *La'o Hamutuk Bulletin* (Volume 5, No. 1), available at <http://www.etan.org/lh/bulletins/bulletinv5n1.html>. After it was published, BPA General Manager Luis Quintaniero (who has since returned to Portugal) told us that we “didn’t understand” the situation, that he and his subordinates at the BPA were able to perform all the functions of the Governing Board. He was not disturbed by the lack of oversight, independent perspectives or legal legitimacy.

<sup>21</sup> Thomas Ekeli, e-mail correspondence with Lao Hamutuk, 26/11/2004

We believe that the Paper's suggestion that the Council report to Parliament does not go far enough. If it discovers situations which warrant further investigation or criminal prosecution, it must have a binding obligation to refer cases and present information to the Provedor and to the General Prosecutor.

The Council should review not only the legality of Fund operations, but also the wisdom of operational decisions. If members of the Council feel it appropriate, they should publish reports or findings in the media, and speak to the public. If the Fund managers fail in their duty of transparency, the Council should make information available to the media and the public about Fund balances, inflows, expenditures, and interest.

The Office of the Provedor should be filled before the Petroleum Fund commences, as the Council of Eminent Persons will probably not have the capacity to investigate Fund operations in detail. The Provedor's mandate includes investigating anyone with responsibility for public funds or assets, which means not only the MoPF and the BPA, but also Fund operations outside Timor-Leste. During public information and socialization processes relating to the Fund, citizens should be encouraged to request the Provedor to look into any apparent corruption, but also into misguided investment decisions or other maladministration.

In addition to the Provedor, the Fund should be subject to independent, external, annual audits, the reports from which should be public documents. The audits should include any transfer and use of Fund monies inside and outside of Timor-Leste.

### **Comprehensiveness**

The Paper is not specific about what money goes into the Petroleum Fund, or about how it gets there. We believe that these principles should be legally binding not only on the government but on any oil companies, subcontractors, or their agents which make any kind of oil-related payments – taxes, royalties, FTP, bonuses, or anything else -- to any Timor-Leste public agency or official. All direct or indirect petroleum-related payments should go into the Fund; other oil-related payments should be prohibited by law. Although the Paper implies that all interest, dividends and other income earned by the Fund will be redeposited into the Fund, this is not explicitly stated, and should be.

At present, oil companies make pay their payments to the Timor Sea Designated Authority (FTP is subsequently transferred to a special account in the BPA) and to the Ministry of Planning and Finance (East Timor Revenue Service). We suggest that a special account, managed by the Fund's managers, be established to receive petroleum-related payments directly from companies and their subcontractors or agents. Since no confidentiality should be applied to oil revenues (unlike to other taxpayers), and since oil revenues will be handled separately from other tax receipts, the revenue stream should be separated from the start. Petroleum-related payments should be required to go into this account managed by the BPA, subject to the same transparency and oversight regulations as the Petroleum Fund itself. Companies that make payments elsewhere should be prosecuted, which would

discourage a common pathway to corruption in other countries. Contracts with oil companies should include provisions which render the contract invalid if a company makes illegal payments or fails to comply with transparency provisions.

## Transparency

“Transparency” has become a cliché among people worldwide who are concerned about the resource curse. We agree that it is important, but it takes much more than repeating the word to create the situation where the public is fully informed, takes ownership and responsibility for Fund operations, and where corruption and misuse of funds are deterred. La'o Hamutuk strongly urges the Fund's designers to implement transparency throughout this system. Articles 40.1, 41.1 and 53.1 of Timor-Leste's Constitution guarantee the rights of media, citizens and consumers to information, which makes transparency a mandatory legal right, and not just a prerequisite for good Fund management.

There should be a presumption of transparency in every aspect of the Fund's operation. Every item of information should be available to the public unless there is a compelling reason (such as national security or personal privacy, neither of which apply to institutional actions) to keep it private. The principle of commercial or other confidentiality that applies to other taxpayers and bank accounts is not appropriate for the Petroleum Fund. If Fund managers or others decide that certain information should not be available, they must explain their reasons in each case to Parliament and to the public.

In La'o Hamutuk's submission reviewing the draft Petroleum Regime,<sup>22</sup> we detailed how the Public Register should be made accessible and what information it should include. We will not repeat all those points here, but they are appropriate for the Petroleum Fund as well as for petroleum operations. We incorporate that section of our previous submission into this one by reference. If the Public Register in the Petroleum Laws is established consistent with our recommendations for accessibility,<sup>23</sup> the same Register or a similar one could be used for the Petroleum Fund.

Some of our earlier recommendations for inclusion in the Register apply directly to the Petroleum Fund, including:

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<sup>22</sup> La'o Hamutuk Submission to the TSO and TSDA regarding the Proposed Petroleum Regime for Timor-Leste, September 2004, pages 4-6, available at <http://www.etan.org/lh/misc/PetRegSub/04submission.html#Submission>

<sup>23</sup> As we wrote: “The Public Register should be available for inspection in Dili. No fees should be charged (except perhaps for photocopying at 5¢/page or less) of Timor-Leste citizens or institutions for inspecting it. The Register should also be available on the internet, similar to the *Jornal da República*. Most documents and reports can be in the original language or Portuguese, but the most important ones, such as Regulations and Authorizations, should also be available in Tetum and/or Bahasa Indonesia (at least for the next few years). Efforts should also be made to include explanations or summaries of these documents to make them more accessible to less technically trained citizens.”

5. Full texts of every quarterly and annual Production Statement, Value of Production and Pricing Statement, Cost Recovery Statement, and Statement of Expenditure and Receipt.
6. All payments of \$1,000 or more to the TSDA, the Government of Timor-Leste (or to any agency or agent of that government or Authority) in connection with petroleum development by any person, corporation or other business. This includes not only income and other taxes and royalties, but any other payments (including bonuses, finder's fees, etc.) within or outside of Timor-Leste, for the purpose of facilitating or implementing Petroleum activities in Timor-Leste. Each payment report should include the date the payment was made, the amount, the payer, the payee, the purpose of the payment, and any services or goods received in return.
8. All contracts between the Operator and customers for sales of Petroleum from Timor-Leste.
9. Information on loans taken out by Timor-Leste, the Designated Authority or its agents in connection with petroleum development or in anticipation of petroleum revenues. At minimum, this should include dates, amounts, repayment schedules, actual repayments, conditions and collateral offered.

In addition to the documents listed above, the following should also be included on a timely basis in the Public Register in relation to the Petroleum Fund:

1. Quarterly statements showing all balances, deposits, withdrawals, interest received and other transactions in all accounts (including the one proposed above) relating to petroleum revenues. This should include the date, amount, payee/payer, and reason for the payment.
2. An enumeration of all investments held by the Fund, including the amount, location, date purchased, commission or brokers fee paid, and dividends or interest received. If the Fund owns more than 1% of any corporation or other investment, the percentage of ownership should be given, as it is for Norway's Petroleum Fund.<sup>24</sup>
3. Any investment strategy, guidelines or recommendations made by the Investment Steering Committee, as well as whether or not they were obeyed.
4. All external and internal audit reports.
5. All rules, guidelines, policies, principles, strategies and other such guidance for Fund operations and/or investment.
6. All contracts with and reports by petroleum companies (see details in our earlier submission).

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<sup>24</sup> See, for example, pages 36-50 (PDF version) of The (Norwegian) Government Petroleum Fund Annual Report for 2003 from Norges Bank, available at [http://www.norges-bank.no/english/petroleum\\_fund/reports/](http://www.norges-bank.no/english/petroleum_fund/reports/)

La'o Hamutuk is concerned about the current lack of transparency regarding the interim Petroleum Fund, the approximately \$20 million already received in FTP money that is being held by the BPA, which will be transferred to the Petroleum Fund once it is established. Although the amount of money is periodically reported, we and others in civil society and the media have repeatedly asked where this money is invested. In response to a formal letter to the Prime Minister, we were told this information is in the annual government budget,<sup>25</sup> however it is not. Other public officials told us to look in the annual report of the BPA,<sup>26</sup> that report is confusing, with no specific information about where the FTP account is saved. We still have no clear answer, nor any explanation of why this information is not easily available to the public.

The Fund Discussion Paper (page 14) stresses the importance of a public “sense of ownership” of the Fund, and we agree. Ownership requires knowing not only how much is in the Fund, but where it is. If, as the Prime Minister has stated, only NGOs are interested in where the Fund invests its money, both government and civil society have much work to do.

## **Public consultation process**

We appreciate the opportunity to provide our views on the issues raised in this discussion Paper, and hope that the Public Consultation will be a two-way communication. Unfortunately, most of what has been done thus far fits the pattern of socialization rather than consultation.

The invitation for the public consultation meeting on 16 November said “The agenda will include presentations by H.E. the Prime Minister, the Minister for Planning and Finance and the Director General for the Banking and Payments Authority, followed by a session of questions and answers.” Although this is what happened, there was no time to consult the public. Genuine consultation involves more than questions from the floor which can be answered – it includes alternative views, debates, and issues which require follow-up exploration. Unfortunately, the public is hardly ever asked for their views on pending legislation, which may explain why civil society attendance was so limited, and why there were so few questions that the meeting ended early. Although the Prime Minister’s opening of the Public Meeting appropriately signaled the critical importance of this issue for the future of Timor-Leste, his role as the primary presenter and responder to questions may have intimidated some people from speaking up.

The Petroleum Fund Discussion Paper (page 14) says that a “thorough public consultation” was recently conducted on the proposed petroleum regime. Although

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<sup>25</sup> There are many budget documents. The most comprehensive we have been able to find, which is referred to in the most recent quarterly Bulletin of the BPA, is at [http://pascal.iseg.utl.pt/~cesa/tl%20orcamento%202004\\_05.zip](http://pascal.iseg.utl.pt/~cesa/tl%20orcamento%202004_05.zip) . We also searched in the documents presented at the May 2004 Development Partners Meeting.

<sup>26</sup> The BPA annual report for 2003-4 can be downloaded from [http://www.bctl.east-timor.org/publications/ABP\\_relatorio\\_anual\\_2004\\_pt.pdf](http://www.bctl.east-timor.org/publications/ABP_relatorio_anual_2004_pt.pdf)

the consultation on this regime was more extensive than most others on Timor-Leste legislation, it is not yet over (the revised draft laws have not yet been made public) and was far from thorough. In La'o Hamutuk's submission to that process, we suggested steps for a genuine public consultation; to our knowledge there is no plan to implement much of what we proposed. We notice a change from that August public meeting, where most of the presenters and speakers were internationals, to the one on the Petroleum Fund, where Timorese took the leading roles, and we hope it indicates that citizens of Timor-Leste are increasingly able to replace international "experts" in designing complex systems.

We would like to suggest the following steps for the continuation and completion of a public consultation on the Petroleum Fund and Fiscal Policy:

1. All submissions to this process, including ours, should be made available to the public.
2. A concerted effort should be made to socialize these issues among the Timor-Leste population both within and outside of Dili. In addition to public meetings, material in accessible languages (in a shorter form than a 24-page academic-level paper) should be distributed through churches, schools, local community groups and other channels. After people understand the issues and decisions this legislation involves, there should be a mechanism for their input to be considered. Special efforts should be made to involve young people, as the Petroleum Fund is primarily to protect their inheritance.
3. After submissions and community input have been considered, the Petroleum Fund discussion Paper should be revised, explaining why each chosen option is being proposed, and which ideas suggested during the consultation process were accepted and rejected.
4. When the Petroleum Fund and Fiscal Policy legislation is drafted, it should be made available for discussion and comment. There should be another public consultation meeting, with more opportunity for substantive discussions, before the Council of Ministers acts on the legislation. If new issues or changes of thought emerge, the legislation should be revised before going to the Council.
5. During the Parliamentary approval process, there should be further opportunities for public input.
6. Once the legislation is passed and promulgated by the President, all key positions and boards should be filled before the Petroleum Fund receives any money. We believe that it may be challenging to do all this in seven months, but it is more important to do it right than to do it quickly.
7. The need for public consultation continues after the Fund is in place. At least once each year, the Fund should issue a written report of its progress and status, including a public hearing. Each such hearing should include the opportunity to review the structure, rules and guidelines of the fund, and discuss possible changes. It would also be appropriate to review the Fiscal

Policy in light of updated information on Timor-Leste's needs and economy, and on petroleum prices and development.

## **This is only the beginning**

Establishing the Petroleum Fund and developing a fiscal policy and investment strategy are the first and easiest steps away from the resource curse. Far more difficult is to develop other sectors of Timor-Leste's economy for the day – within the lifetimes of many people alive today – when all our oil and gas is used up.

As we did in our other submission, we strongly urge Timor-Leste to undertake a major long-term planning process, involving the public and others, to develop non-petroleum sectors of Timor-Leste's economy over the next half-century. The National Development Plan prepared in 2002 looked only to 2020, when we are likely to be receiving maximum revenues from oil and gas. But thirty years after that, Timor-Leste may have no petroleum resources. If we have not developed other sectors of our economy, we will be condemned to perpetual poverty and dependence on imported energy.

If we do not begin this planning and prioritization process now, before large resource revenues flow into our treasury, we will be like people in so many other countries who lament that petroleum was ever discovered under their land and seas. In rich countries, investment managers, oil companies and oil consumers will have benefited from our resources, but their rightful owners, the people of Timor-Leste, will only have suffered.

## **Annex I: São Tomé e Príncipe: an example to learn from**

### **São Tomé is very similar to Timor-Leste**

São Tomé e Príncipe and Timor-Leste share similar history, geography and economic status. Both are small island countries, São Tomé with 182,000 people and Timor-Leste with about one million. Both are former Portuguese colonies whose liberation movements supported each other in the 1970s. São Tomé was one of the last countries in Africa to gain independence, in 1975. Timor-Leste was the last Portuguese colony to gain independence, due to the Indonesian invasion in that same year.

Both countries are in extreme poverty, unable to invest in programs to develop growth and improve living standards, largely dependent on foreign assistance. Agriculture is their main economic activity, in particular coffee developed during the Portuguese colonial period.

Both São Tomé and Timor-Leste have petroleum reserves under their territorial waters, shared in joint development zones with huge neighbors, Nigeria and Australia. The small countries see this as a chance for economic independence and to improve their people's living standards. But the governments of both countries are also aware that oil revenues bring dangers. São Tomé experienced this last year, with oil greed underlying a bloodless coup attempt. In order to avoid the negative experiences of other oil-producing countries, both governments are currently writing laws and regulations to manage their petroleum activities and revenues, which are expected to increase markedly in the next few years.

### **A Strong petroleum fund**

São Tomé just enacted legislation for its Petroleum Fund, which differs significantly from the Norwegian model and the proposed model for Timor-Leste.

We are not suggesting that São Tomé's model is perfect, or that it would be the perfect model for Timor-Leste. But we believe that Timor-Leste can improve its Fund design by learning from the best aspects of São Tomé's legislation, especially given how similar the two countries are socially, historically and economically.

Unlike Norway, São Tomé e Príncipe is building a "strong" fund, one that specifies the maximum that can be withdrawn each year (the Annual Funding Amount) and the minimum that must be saved for future generations. Its legislation sets percentages, not amounts, adjusted depending on the stage of the exploration.

As with the proposed Fund for Timor-Leste, money withdrawn from the São Tomé fund – within the limits established – goes into the national budget. To make it clear how the money is to be allocated, there are two accounts:

**The National Oil Account** receives all petroleum revenues, some of which (the Annual Funding Amount) are then transferred to the government budget, with the balance being transferred to the Permanent Reserve.

**The Permanent Reserve** is intended to convert oil assets into permanent financial wealth, to benefit future generations of São Toméans. This money can only be used in exceptional situations.

This mechanism not only helps identify the petroleum revenue (as does Petroleum Fund proposed for Timor-Leste), but it protects the birthright of future generations of São Toméans.

Article 9 of their law prevents the Annual Funding Amount from being spent unwisely, such as for private projects or increasing military expenditures, and commits the money to development priorities that benefit the majority of the people: "The Annual Funding Amount must be essentially used for education, health, infrastructure, rural development and to enhance the institutional capacity of the State."

### **Democracy and transparency**

São Tomé's law also sets good examples in the areas of democracy and transparency.

As with the proposed Fund for Timor Leste, the Annual Funding Amount of the São Tomé's oil money to be used for budget expenditures is decided in the budget process and approved by the National Assembly, within limits specified by law. But their law also creates two bodies to decentralize decision-making and promote broader participation:

**Investment and Management Committee:** comprised of the Ministry of Planning and Finance, the Governor of the Central Bank, one member appointed by the President, and two appointed by Parliament (one of whom is appointed by the opposition). Unlike the Investment Steering Committee proposed for Timor-Leste, this Committee is more than advisory. It presents an investment policy to the government, subject to Parliamentary approval, according to principles in the governing law. Those principles include a prohibition of investments in São Tomé's territory or controlled directly or indirectly by São Tomé citizens.

**Petroleum Oversight Committee:** comprised of eleven people including representatives of the judiciary, NGOs and unions. This committee has administrative and financial autonomy, with power to investigate and monitor every aspect of the implementation of the Petroleum Fund law and to report to the competent bodies if the law is not respected. This independent committee also selects an international audit company to perform one of the two annual audits for the oil funds.

Both the São Tomé law and the Timor-Leste discussion Paper advocate transparency, but São Tomé implements clear principles to enforce the government's responsibility to make information public and accessible. These include the requirement to publicize any contract, deal or operations relating to oil revenues within ten days of approval. They also restrict confidentiality clauses, and forbid confidentiality regarding financial aspects.

### **National Forum: an example of true public consultation**

To involve the public in the design of São Tomé's Petroleum Fund, the government held a National Forum to consult the people on how they wanted oil revenues to be invested. The National Forum was a unique experiment in participatory democracy and a chance to educate São Toméans about their country's anticipated oil revenues. It illustrates São Tomé's determination to escape the closed-door politics too often associated with oil economies. The main purposes of the Forum were to give accessible information about the most pressing issues facing the country and help to align expectations between São Toméans and their national leadership, thereby facilitating governance, transparency and accountability.

The Forum included 55 public community meetings around the country, in which citizens were presented with a popular information Bulletin<sup>27</sup> explaining the oil situation, and asked about their priorities for public investment. The *Boletim de Informação Popular* focused on imminent possible oil revenues, aiming to give a basic understanding of the country's potential oil reserves, the new law through which revenues are to be managed, and how those revenues will interact with the national economy.

Citizens were given a questionnaire as a means to gather information for decision makers and create space for public dialogue. Groups of 20-40 people gave their answers, in a deliberative process. Citizens were asked how oil revenues should be used, as explained in the *Bulletin*, as well as demographic information. Groups were also asked their priorities in the areas of health, education, water and sanitation, energy sources, roads and transportation, and justice and internal order.

The results of the questionnaire were presented at a series of national-level meetings, providing a foundation upon which citizen delegates and political leaders could base their arguments.

*Attached: São Tomé e Príncipe Petroleum Revenue law, as approved by Parliament in November 2004. Much information about this law is available at*  
[http://www.earthinstitute.columbia.edu/cgsd/STP/index\\_oillaw.htm](http://www.earthinstitute.columbia.edu/cgsd/STP/index_oillaw.htm)

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<sup>27</sup> An English translation of a draft of this Bulletin can be downloaded from  
[http://www.earthinstitute.columbia.edu/cgsd/STP/National%20Forum/bulletin\\_english\\_3.1.pdf](http://www.earthinstitute.columbia.edu/cgsd/STP/National%20Forum/bulletin_english_3.1.pdf)

## Annex II: Comments from Dr. Martin E. Sandbu

*La'o Hamutuk requested advice from the Center for Global and Sustainable Development at the Earth Institute, Columbia University, New York, USA to help us better understand the issues involved in the petroleum fund for Timor-Leste. Although we have incorporated some of the ideas we received from Dr. Martin Sandbu in our submission, we thought it would be helpful to the Timor-Leste Petroleum Fund Steering Group to have his entire memo, which follows.*

### Comments on Timor-Leste Ministry of Planning and Finance Discussion Paper "Establishing a Petroleum Fund for Timor-Leste"

Martin E. Sandbu, Ph.D.<sup>28</sup>

12 November 2004

This memorandum contains a few short remarks on the Discussion Paper laying out the East-Timorese government's proposed policy for a petroleum fund.

#### 1. Fiscal policy considerations surrounding the establishment of a fund

The Discussion Paper gives a clear and fairly comprehensive analysis of the fiscal challenge posed by the special nature of petroleum revenues. The uncertainty, volatility, and non-permanence of oil revenues means that sound fiscal management involves high rates of savings; a petroleum fund is a useful way of facilitating such savings.

An important preliminary question is how exactly petroleum revenues are defined. The Discussion Paper addresses this question and chooses the wise policy of including all revenue flows to the government from petroleum activities, whether they be in the form of tax oil, profit oil, or royalty oil/First Tranche Petroleum. The relevant section (p. 11) is, however, unclear on signature bonuses, production bonuses, and other payments—it should be made unambiguous that all such payments are counted as oil revenues and should be treated equally with respect to the eventual petroleum fund.

The tradeoffs involved in the choice of various savings policies are very well explained and should be taken to heart by all partners in the East-Timorese policy debates. The choice of maintaining constant the real value of the expected oil wealth seems like a prudent savings policy. Note however a mistake in the graph in Box 4: Line (b), showing the level of spending under a savings policy of maintaining the real *per capita* value of petroleum wealth, should be upward-sloping in the top graph. Under this policy, total spending would be lower in early years, but higher in later years, keeping real spending per capita at a constant level. Conversely, the policy advocated by the Ministry involves a *falling* level of per capita spending so long as population growth is positive.

This savings policy, however, is not incorporated in the rules of the fund. The Discussion paper makes it clear that the fund is a mere accounting device, and that the savings policy is to be implemented through the regular budget process, which is to be guided by a

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“longer-term fiscal policy guideline.” In the absence of such a guideline, or in a situation in which the political economy of Timor-Leste makes such a guideline ineffective in the ordinary budget process, the proposed institutional set-up of the fund would do nothing to secure the desired savings policy. The Discussion Paper could be clearer on this. A new, poor nation like East Timor differs fundamentally from the stated model of Norway, precisely in that one cannot simply assume that future annual budgetary processes will respect a fiscal policy guideline if it has no legal force. Nor, indeed, can one assume that future governments will even try to commit to such guidelines. This means that the role of a petroleum fund must be discussed also with a view to how it can *promote* good fiscal policy, not just presuppose it. This is further discussed below.

A similar point can be made about stabilization. The Discussion Paper makes it clear that the level of expenditures must be divorced from short-term revenues, but the proposed structure for the fund does not do this. The stabilization function that a fund could have is again relegated to the budget process, without any reason to believe that such policies will in fact be followed once the oil revenue is flowing in. This is also further discussed below.

## **2. Institutional considerations surrounding the establishment of a fund**

### **a. Institutional independence of the fund**

The Discussion Paper states that the “fund should be coherently integrated into the budget process.” This is an important principle, as such an integration is crucial to facilitate good economic management. Multiple budgets can only serve to confuse the optimal allocation of government spending, and undermine the coherence of the budgetary procedure in the executive and the legislative branches. More importantly, however, a unified budget maximizes transparency and thereby minimizes the opportunity for corruption and mismanagement.

It does *not*, however, follow that the fund must therefore operate “only as a government account rather than a separate institution,” as the Ministry suggests in the Discussion Paper. While it is not exactly clear what is meant by a “separate institution,” there are many intermediate solutions in between the Norwegian model of a fund that is a merely virtual government account, and the “trust fund approach” described in the Discussion Paper’s footnote 4. It is entirely possible to set up a fund that enjoys institutional distance from the executive—thereby providing additional checks and balances on any sitting governments’ ability to overuse oil revenues or draw down the oil wealth for its own political benefit—without having any spending authority on its own.

The Oil Revenue Management Law currently under parliamentary debate in São Tomé e Príncipe is a case in point. Under the proposed Bill of Law, all oil revenues have to be paid into a ‘National Oil Account’ which is managed by an Investment Committee and supervised by an independent Petroleum Oversight Committee. There are strict limits on how much can be spent in every year, so the allowed transfer in part determines the budget process rather than *vice-versa*. This will not lead to multiple budgets, however, since the only transfers allowed are transfers to the national government budget (within the limits). The limits are secured by requiring the joint signature of several branches of government before the holding bank is authorize to execute a transfer.

The Timor-Leste proposal instead leaves the flow of funds completely to the discretion of the yearly budget process. This means that all the political economy challenges that the Discussion Paper (rightly) raises simply remain where they would have been without a fund: In the yearly budgetary process. The people of Timor-Leste should seriously evaluate

whether their governing institutions and public officials are sufficiently experienced that they will be able to implement a sound long-term fiscal policy on the basis of the discretionary budgetary decisions of governments that depends on regular electoral success. While Norway's fiscal policy institutions may have succeeded in this, it is doubtful that the same framework can be successfully transplanted into Timor-Leste's situation.

#### b. Legal status of the fund

The Discussion Paper envisages a fund that is essentially an accounting device. Other options are possible, as discussed above. Whichever option is chosen, the decision has to be made as to the legal status of the fund. At one extreme, the fund could be treated as no more than a separate government account, without even being enshrined in law. At the opposite extreme, the fund could be established by constitutional amendment. The appropriate legal status should be chosen with a view to the possible incentives for future governments to attempt to overturn the restrictions imposed by the fund structure (which in the current proposal are admittedly very weak, therefore arguably not requiring a strong legal protection). While this is a decision to be weighed by the appropriate Timorese stakeholders, it is an issue that has not been sufficiently considered in the Ministry's Discussion Paper.

#### c. Transparency

As the Discussion Paper stresses, transparency is absolutely necessary in the management of oil revenues. The Paper makes important commitments, such as signing up to the recommendations of the Extractive Industries Transparency Initiative, external audits, and accessible reporting of petroleum fund balances and transactions.

There are several additional steps that could be taken to reinforce the transparency of revenue management:

- Not only payments by oil companies (and subcontractors) to the government, but also all their contracts should be published. Confidentiality clauses should be limited to information legitimately considered intellectual property, such as seismic survey data, but all financial agreements should be in the public domain. This allows all concerned observers to verify that the payments made correspond to what is owed, as well as to evaluate whether the government is performing the best it can in negotiations with oil companies.
- One should attempt to make the petroleum fund balance accessible in real time over the internet.
- There should be concrete requirements of how the information is to be made realistically accessible to all citizens of Timor-Leste. This might involve a requirement of translating all relevant documents into local languages, or the establishment of a library or public registry where people can physically access the information.
- There should be an independent watchdog body that would oversee all the government agencies charged with parts of the oil revenue management process. In particular, such an independent group should have the power to enforce the transparency requirements that the oil revenue legislation should include. The Discussion Paper mentions the possibility of a "Council of Eminent Persons," but the non-committal language ("one can consider establishing...", p. 15) leaves it unclear what the Ministry's position on this possibility is.

Again, the Oil Revenue Management legislation of São Tomé e Príncipe provides examples of all of these suggestions.

### **3. Institutional prerequisites for sound fiscal policy-making**

As mentioned above, the proposed design of the fund leaves the whole burden of choosing appropriate savings and stabilization policies within the regular annual budget process. As is well understood, this runs the risk of holding fiscal policy hostage to short-term political pressures and encourages a political economy of populism. A large part of the Discussion Paper (p. 6-9) is devoted to explaining the particular challenges of natural resource-dependent economies; yet no remedial policies are proposed, short of the exhortation to follow a long-term fiscal policy guideline.

Essentially, the Ministry proposes a fund structure that serves as an instrument for whatever fiscal policy is produced through the budget process, but begs the question of how to ensure that fiscal policy is sound. Given that one important rationale for an oil fund is to facilitate good stewardship of oil revenues, this is a serious omission.

An alternative view is to see the fund not as a complement to (assumed to be already existing) sound fiscal management, but as an institutional lever to promote it. If the fund was set up to automatically take care of the chosen savings and stabilization policy, the budgetary process would be put in a situation of a country without natural resource revenue. Suppose that the fund was set up not to finance the budget deficit, whatever it might be, but instead followed the São Tomé model of paying out a fixed annual amount in real terms (the permanent income).<sup>29</sup> The annual budget would then have to balance internally generated revenues against expenditures in the ordinary way, without having to take account of the question of saving and stabilizing oil revenues. It would have a predictable, stable, and permanent source of revenue which would allow it to finance permanent primary deficits of a certain size, much as if the country had a positive foreign asset position that paid interest in perpetuity. In such a set-up, countercyclical fiscal policy to stabilize the domestic economy could be handled through short-term borrowing like in other countries.

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<sup>29</sup> Essentially this would involve legally enshrining the Ministry's proposed savings policy as the limit on payouts from the fund.

## **Annex III: Memo from Harvard Law Students Advocates for Human Rights**

*La'o Hamutuk requested advice from a group at Harvard Law School, Cambridge, Massachusetts, USA<sup>30</sup> on human rights issues which may be relevant to Timor-Leste's Petroleum Fund. Although we did not feel that all of their points were appropriate to include in our submission, it may be helpful to the Timor-Leste Petroleum Fund Steering Group to have their entire memo, which follows.*

### **A Human Rights Centered Analysis of East Timor's Proposed Petroleum Fund<sup>31</sup>**

**Prepared for La'o Hamutuk  
by  
Harvard Law Students Advocates for Human Rights  
Nate Meyer with Tyler Giannini, Advisor<sup>32</sup>  
November 26, 2004**

#### **Summary**

In a Public Consultation Discussion Paper, East Timor has recently proposed a Petroleum Fund (hereinafter "the Fund") to manage the revenues it receives from petroleum development.<sup>33</sup> Though it follows a Norwegian model,<sup>34</sup> the East Timor Fund is unlikely to be nearly as effective. The Fund, as currently envisioned, could easily be subject to abuse because there are no serious checks on parliament to prevent it from accessing and potentially depleting the Fund. In addition, the law raises several human rights concerns. First, the Fund's structure and maintenance of assets abroad<sup>35</sup> raises potential issues of distribution of benefits to Timorese populations. Similarly, Fund investments should be made in socially conscious investments that uphold principles of human rights. Furthermore, the Fund's transparency provisions are not strong enough; they neither mandate that records be clearly and widely publicized, nor that they be in languages accessible to minority population groups. Finally, the Discussion Paper does not explicitly include any guidelines and/or rules that might incorporate human rights or environmental protection measures into the way the Fund is managed or utilized.

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<sup>30</sup> The advisor to the group, Tyler Giannini, can be contacted at [giannini@law.harvard.edu](mailto:giannini@law.harvard.edu)

<sup>31</sup> These comments primarily focus on human rights issues, though many of the comments could be applied to other arenas like energy independence (see *supra* discussions on guidelines that include human rights protection).

<sup>32</sup> Thanks also to James Cavallaro and Amy Lehr for their review and comments on the memo.

<sup>33</sup> *Establishing a Petroleum Fund for Timor-Leste*, Public Consultation Discussion Paper, Ministry of Planning and Finance, October 2004.

<sup>34</sup> *Id.* at 4.

<sup>35</sup> *Id.* at 13.

## **A Description of the Fund**

The Fund would segregate all of the government's petroleum revenues into a Petroleum Fund, which would be invested in low-risk foreign assets and investments. As fashioned in the Discussion Paper, the revenues of the Fund would routinely be used to offset any budget shortfalls,<sup>36</sup> and the remainder would stay under investment. Through sound financial management by East Timor, the idea is to turn the revenues from petroleum into a long-term savings fund; this would be done by avoiding unsustainable short-term expenditures.<sup>37</sup> The Ministry of Planning and Finance and the equivalent of the central bank (the Banking and Payments Authority) will manage the Fund.<sup>38</sup> Fund spending is a function of the nation's budgetary policy, and more specifically the size of the deficits the parliament runs up; although there is discussion of the sustainability goals in the Discussion Paper,<sup>39</sup> the Fund contains no constraints in this area.

## **An Essential Weakness of the Fund**

The Discussion Paper asserts that the East Timor Fund is modeled after the Norwegian model.<sup>40</sup> In most respects, this is true. However, there is a fundamental difference between the funds that makes the East Timor model unlikely to be nearly as effective as the Norwegian model. The East Timor Fund provides for easy funding of budget shortfalls with the Fund capital.<sup>41</sup> In contrast, the Norwegian fund, the only comparable program,<sup>42</sup> requires that the parliament pass a specific resolution each time it seeks to access its fund capital, thus making it far more difficult to spend the money.<sup>43</sup> This is a crucial difference; the Timorese parliament will be able to treat the fund money as simply part of the budget, and will be free to spend it at will. The proposed East Timor process also makes the process of accessing the money less public; while Norway requires a congressional resolution (with the accompanying parliamentary procedures and safeguards), the automatic transfer in the Timorese fund would be relatively quiet.

Norway effectively puts petroleum revenues in a "lockbox." East Timor has the box part, with segregated funds, but does not lock it with anything resembling a procedural barrier. Without this lock, the Fund may not justify its costs.

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<sup>36</sup> *Id.* at 11 ("The outflow from the Fund will be the amount necessary to finance the government budget deficit (excluding petroleum revenues). This design creates a direct link from the budget deficit (excluding petroleum) and the use of the Fund's capital. Increased government expenditure or lower tax incomes (from domestic activities) result in smaller net allocations to the Fund."). The Discussion Paper does acknowledge some possibilities for borrowing, but devotes more attention to the routine off-setting for budget deficits by the Fund. *Id.* at 13.

<sup>37</sup> *Id.* at 8, "Petroleum Wealth, a Blessing or a Curse?"

<sup>38</sup> *Id.* at 13.

<sup>39</sup> *Id.* at 16-24.

<sup>40</sup> *Id.* at 4.

<sup>41</sup> *Id.* at 11.

<sup>42</sup> Chad has a more limited fund that involves some oversight of petroleum spending, and setting aside 10% of revenues in a limited fund. Charles McPherson, "Petroleum Revenue Management in Developing Countries," *World Bank*, at 13-14.

<sup>43</sup> Norway Act no. 36 of 22 June 1990, §3 ("The Fund's capital may only be used for transfers to the central government budget pursuant to a resolution by the Storting (Norwegian parliament). The Fund's capital may not be used in any other way, nor may it be used to provide credit to the central government or to private sector entities.").

## **Human Rights: Foreign Investment**

The Fund's assets will be invested in "low risk financial assets abroad", which raises several concerns, especially given the major weakness in the Fund discussed above.<sup>44</sup> First, by definition, this means that funds coming into Timor will be held abroad, which will potentially prevent them from being used for improvements or management within Timor. Due to concern over the possibility of corruption and fears of upsetting local economies,<sup>45</sup> very little of the Fund may end up being used for long-term investments within East Timor (e.g. roads, housing, etc.) if the budgetary process over-emphasizes long-term savings instead of short or medium-term "physical asset" development.<sup>46</sup> If such political decisions are made to defer use of the Fund, the downside of this policy could implicate economic and social rights of the current population (noting that these needs should be balanced against inter-generational equity and other policy considerations). Although there may be very good reasons for this policy (corruption, economic distortion, and risk avoidance), the interests of Timorese in local investment must be raised.

The second concern raised by the maintenance of the Fund abroad is that the benefit of these funds could end up in a tiny handful of Timorese managers and bankers in international financial centers. This concern is especially strong when one considers there are no safeguards to prevent overspending of the Fund (as there are in Norway); this is the opposite scenario from the first concern raised immediately above. If, for example, the money in the Fund is spent each year, then in practice, money will flow offshore each year to the Fund and then return to East Timor through its national budget. In its most extreme, the Fund could be little more than a means of siphoning several million dollars of petroleum money to investment bankers as they manage the transfer of the Fund's assets in and out of the country.<sup>47</sup>

Finally, no matter where the Fund's assets are maintained—locally or abroad—there should be specific requirements to maintain "socially conscious" investments. In addition to mandatory requirements, these could be added explicitly to the Fund's Key Principles (Box 3: #6): "The investment of fund resources to be exercised according to written and approved

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<sup>44</sup> *Id.* at 13.

<sup>45</sup> *Id.* at 13 ("The Petroleum Fund's savings are to be invested securely in low risk financial assets abroad, so that they are available when there is a need to draw on them. By investing a large part of the petroleum revenues securely in international financial markets, one reduces the risk of the Fund's savings ('not all eggs in one basket'). This strategy also has the benefit of putting less pressure on the domestic economy and contributes to a balanced economic development. (Had the Fund invested large savings in assets in Timor-Leste, these activities could contribute to a rapid increase in prices and accelerate the structural changes in the economy frequently associated with the use of petroleum revenues.) There is also a concern that investing domestically may increase the risk of corruption and bad governance.").

<sup>46</sup> *Id.* at 16. The Discussion Paper points out that the Fund can be spent in two ways, on "physical assets' (e.g. infrastructure like roads, education to improve the human capital) or in financial assets (e.g. bank deposits, bonds and equities – channeled through the Petroleum Fund)." *Id.*

<sup>47</sup> International bankers and the Fund's managers will incur fees under any scenario if the Fund is maintained abroad, and as mentioned this may be worth the cost of preventing corruption and local economic distortions and inflation. The scenario in the text highlights that if the Fund is not accumulating long-term savings, then the primary beneficiaries of the Fund will be international bankers.

guidelines which emphasize a conservative, low risk, **socially conscious** approach to the placement and management of funds.”<sup>48</sup>

### **Human Rights: Guidelines and/or Rules**

The Discussion Paper mentions that “many countries have introduced fiscal rules”, but then it dismisses adopting such rules because “they do not allow future governments to react to unforeseen circumstances, such as wars, epidemics, demographic changes etc.”<sup>49</sup> It goes further to state that the main considerations for assessing fiscal policy should be: 1) inter-generational equity, 2) the economy’s absorptive capacity, and 3) macroeconomic stabilization objectives.<sup>50</sup> While the Discussion Paper professes to not address “how” the Fund will be spent,<sup>51</sup> this cursory discussion of guidelines leaves human rights and other social protections absent from the Fund’s framework.

Given that the Discussion Paper specifically recognizes that “many petroleum producing countries are associated with negative developments like: poverty and lower economic growth; prone to conflict, war and civil strife; corruption; and unrepresentative government,” structuring the Petroleum Fund to prevent such ills would seem appropriate.<sup>52</sup> The Fund, for example, could be established to include explicit reference to human rights principles, norms and protections.

Several alternatives exist for including human rights protections in the Fund’s framework. For example, the Fund’s Key Principles (Box 3) could include reference to human rights and environmental protection or sustainable development or even the goal of reaching energy independence. Similarly, in addition to inter-generational equity and economic considerations for how the Fund will be spent, the Fund could explicitly seek to improve human rights protection and sustainable development and to prevent negative outcomes associated with petroleum producing countries in the past.<sup>53</sup> Another approach would be to create specific rules or percentages of the Fund to be devoted to promoting human rights or increasing energy independence or some other specific social issue of importance.

A “watchdog” mechanism could be used to verify compliance with the guidelines and/or rules that are eventually adopted. To alleviate concerns that guidelines and/or rules might overly constrict the Fund and discretion of future governments in times of war or crisis, specific procedural rules (e.g. supermajorities or declarations of national emergencies) could be created to allow for deviations from the normal provisions.

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<sup>48</sup> Discussion Paper at 15 (bolded and italicized language added to original text).

<sup>49</sup> *Id.* at 18-19.

<sup>50</sup> *Id.* at 19.

<sup>51</sup> *Id.* at 5.

<sup>52</sup> *Id.* at 8.

<sup>53</sup> This would explicitly add a fourth consideration to the Discussion Paper’s Fiscal Policy Guidelines: 1) Inter-generational equity, 2) The economy’s absorptive capacity, 3) Macroeconomic stabilization objectives, **and 4) human rights protection and sustainable development and the prevention of negative outcomes associated with petroleum producing countries in the past.** *Id.* at 19 (bolded and italicized language added to original list).

## **Human Rights: Transparency**

The Discussion Paper states that transparency is a clear goal of the Fund, and provides for Fund reports and spending to be made public.<sup>54</sup> However, transparency in this case is limited to reporting in the regular budget reports and in a single annual report.<sup>55</sup> As stated above, there need not be debates about the spending, so the Fund's activity will not necessarily appear in government policy discussions. There are also no requirements that the single annual report be published in all languages spoken in the country. This makes it unlikely that spending of the Fund's assets will be easily accessible to most of the population. Without aggressive supervision and publicity by civil society organizations, spending and management of the fund, while theoretically public, will likely be relatively obscure. The goal of transparency is a good one, and the 'watchdog' provision would be a good step,<sup>56</sup> but more specifics are needed. This limited transparency raises human rights concerns, and could be remedied with relative ease by employing very specific reporting requirements.

## **Conclusions and Recommendations**

The Timorese government should follow the Norwegian model and require parliamentary approval for every transfer from the Fund to the budget. If there are no spending constraints accompanying it, the Petroleum Fund may be ineffective, and will raise human rights concerns.

The Timorese government should also ensure that the Fund is managed through "socially conscious investments." Furthermore, at a minimum, the government should include specific reference to human rights and sustainable development in the Fund's key principles. The government should also more thoroughly consider other guidelines and rules that seek to ensure human rights protection and sustainable development through the management and use of the Fund. The Timorese government should adopt clear and specific disclosure standards to ensure that the public has easy and easily understandable access to the uses of the Fund. Finally, the government should create some specific 'watchdog' mechanism to verify the Fund is managed and used appropriately and in line with its key principles.

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<sup>54</sup> *Id.* at 14.

<sup>55</sup> *Id.* at 14-15 ("The Ministry of Planning and Finance will report on the Petroleum Fund through the regular budget documents and a separate annual report. . .

The Banking and Payments Authority will report regularly (probably every quarter) on the operational management of the Fund, both to the Ministry of Planning and Finance and to the public.

There will be independent external, independent audits to bolster confidence that money going to, from or remaining in the Petroleum Fund are not misappropriated.

One can also consider establishing an independent Council of Eminent Persons to monitor and inform Parliament on all aspects of the operations of the Fund. This council could act as a "watchdog", where the aim is to contribute to an informed public debate and a sound management of the petroleum wealth. The council could comprise a few eminent persons in whom there is a wide degree of trust and respect within the Timorese community. One could also contemplate including someone widely respected internationally, with integrity and knowledge about the management of petroleum wealth, who could contribute with an international perspective.")

<sup>56</sup> *See id.*, *supra* note 55.