

PETROLEUM FUND OF TIMOR-LESTE

QUARTERLY REPORT

For the Quarter ended 31 December 2006

Presented to the Minister of Planning & Finance

by

Banking & Payments Authority of Timor-Leste

INTRODUCTION

This report is produced in accordance with Article 13 of the Petroleum Fund Law which requires the central bank to report on the performance and activities of the Petroleum Fund of Timor-Leste, referred to in this report as the Fund unless the context suggests otherwise.

All monetary references in this report are to United States dollars as the official currency of Timor-Leste.

EXECUTIVE SUMMARY

The Petroleum Fund was formed by the enactment of the Petroleum Fund law promulgated on 3 August 2005. The law gives the Banking & Payments Authority (BPA) of Timor-Leste the responsibility for the operational management of the Fund.

This report covers the period from 1 October 2006 to 31 December 2006.

During this period, the BPA continued to invest all funds received according to a mandate agreed with the Ministry of Planning and Finance in which a benchmark index of United States Treasury Securities with maturities up to five years is specified together with defined performance measures.

In the course of the quarter the capital of the Fund grew from \$847.1 million to \$1,011.8 million, including cash inflows of \$155.6 million. The return in the period was 0.96%, equivalent to an annual return at 3.88%, for the Petroleum Fund portfolio and the benchmark return was 0.95%.

1. PETROLEUM FUND MANAGEMENT MANDATE

The Banking and Payments Authority has been appointed to undertake the operational management of the Fund in accordance with Article 11.3 of the Petroleum Fund Law which states that the Minister shall enter into an agreement with the Central Bank for the operational management of the Petroleum Fund and

the Central Bank shall be responsible for the operational management of the Petroleum Fund.

The management agreement was negotiated and agreed between the Ministry of Planning and Finance and the Banking & Payments Authority, and signed on 12 October 2005.

This mandate set out in the Management Agreement has not changed since the previous report, and is as follows:

1. QUALIFYING INSTRUMENTS

The assets of the Fund shall be invested in the classes of instruments as described below. The indices indicated with each asset class shall be used to measure the performance of the Fund.

Debt instruments issued by the United States and other qualifying sovereign governments:

Index: Merrill Lynch 0-5 year government bond index

Short-term liquidity instruments maintained by the Fund limited to budgeted monthly appropriations from the Fund to the state budget account described in Article 13 based on cash projections supplied to the Central Bank by the Minister shall be excluded from the Fund for the purpose of benchmark comparison, but the Central Bank shall otherwise be accountable for the return on these instruments.

2. MANDATE

1. The nature of the mandate established by the Minister shall be to passively manage the Fund close to the benchmark, so that in normal circumstances the objective shall be to achieve a return within 25 basis points of the benchmark.
2. The difference in the modified duration between the portfolio and the benchmark shall be less than 0.2 years.

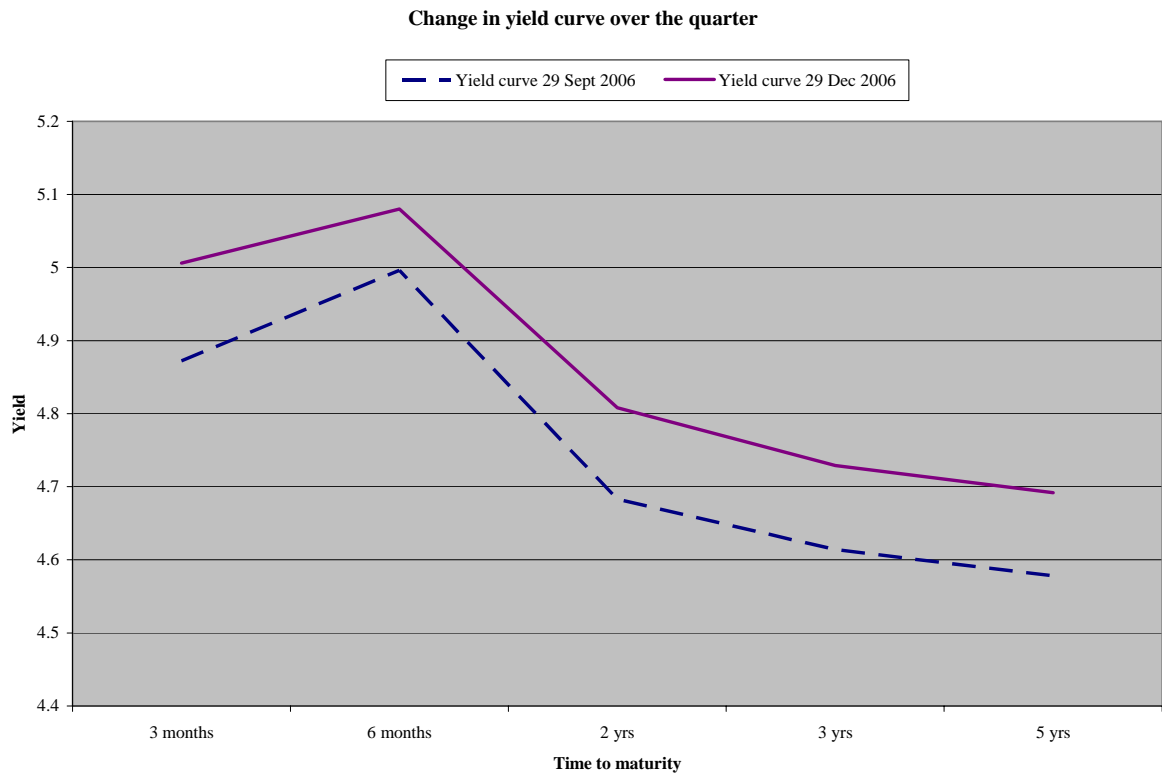
To enable the orderly acquisition of suitable investments, the parameters in this Annex 1 shall apply only from thirty (30) days after the date of entering into force of this Management Agreement.

All royalty payments and funds received from taxpayers, other than small amounts that do not collectively reach the minimum investment threshold set by the BPA, have been invested in the mandated benchmark from the day following receipt.

2. MARKET TRENDS DURING THE QUARTER

The yield of the 3 months to 5 years US Treasury benchmark reference bills and notes had a minor upward shift in the period, with changes in the bond yields ranging from 8 to 13 basis points (see graph). The bond prices and yield move in opposite direction. The minor changes in the yield have resulted in almost unchanged market prices for the bonds held in the portfolio during the quarter. The

following graph shows changes in the bond yield curve during October to December 2006.



There have been no changes to the US Fed Funds target rate during the quarter. The last rate change was on 29 June 2006 when the interest rate increased with 25 basis points to 5.25%.

The following graph shows the performance of the Merrill Lynch US Government bond 0-5 year's index during the quarter.



Merryl Lynch US Government 0-5 Years Bond Index
Accumulated Performance
October-December 2006



3. MANAGEMENT DURING THE QUARTER

Objectives

The BPA's objective in managing the Fund continued to be to manage the Fund closely to the agreed mandate. The implication of this policy was that cash received by the Fund was invested in a portfolio with the same characteristics as the mandated index in a timely manner, normally within two working days. This policy is consistent with the passive investment mandate given to the BPA by the Ministry of Planning and Finance.

Operational Implementation

The systems described in the previous quarterly reports have continued to operate and have allowed the portfolio to be closely managed on a daily basis. Daily financial reports on the performance of the Fund are produced for BPA management as part of the management process.

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

During the quarter, staff assigned to the Petroleum Fund Department continued to engage in capacity building, primarily in the form of on-the job training.

During the quarter, the Petroleum Fund procedures manual were being developing to ensure the operational management of the fund. The risk based audit programs

been developed and fully operational. The internal audit manual and programmes been developed to provide guidance for internal audit for the operational management of the Petroleum Fund in fulfilment of its obligations required under Article 22 of the Petroleum Fund Law and the Operational Management Agreement.

Technical Assistance

The BPA acknowledges with appreciation the receipt of technical assistance from international agencies during the quarter, as follows:

- The Ministry of Foreign Affairs of Norway/the Norwegian Petroleum Directorate funded two resident advisors for the entire quarter to further support capacity building and institutional development. One of these positions is organised through the International Monetary Fund.

4. PORTFOLIO PERFORMANCE

The performance of the Fund relative to the benchmark is calculated and reported using the same basis as the benchmark.

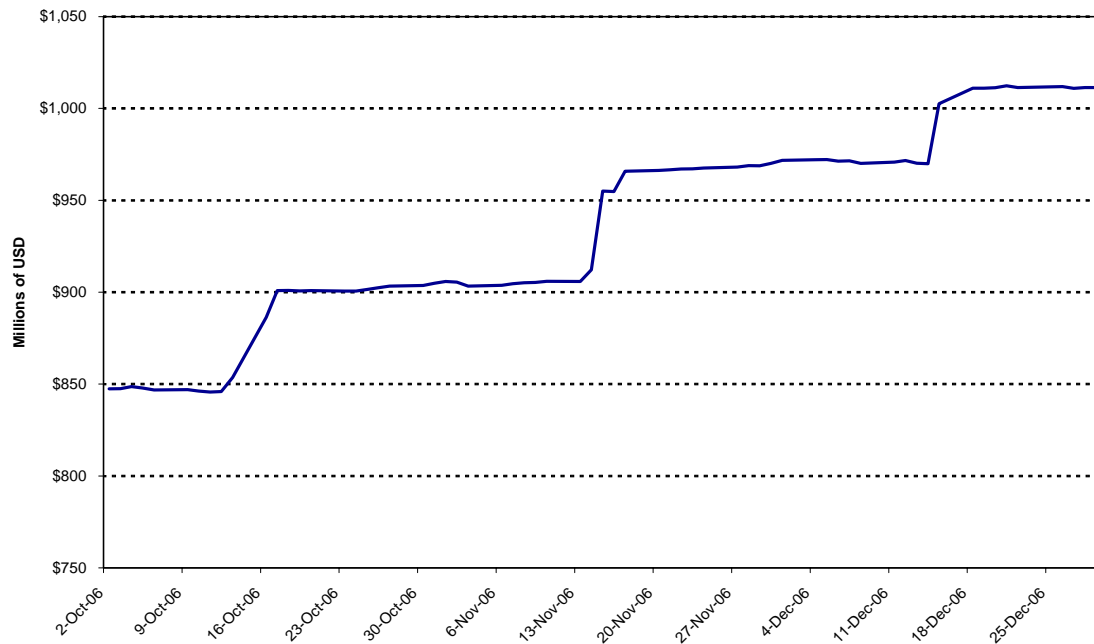
Absolute Return

Absolute Return for Quarter Oct-Dec 06	
Opening book value (30 Sept)	847.1
Receipts during the period	155.6
Absolute Return in the period	9.1
Closing book value (31 Dec)	1,011.8

The opening value of the Fund at the beginning of the quarter was \$847.1 million and the closing value as at 31 December 2006 was \$1,011.8 million. The petroleum tax payers' contribution to the fund was \$124.1 million and the royalties' contribution to the fund was \$31.5 million. Absolute return was \$9.1 million during the quarter, whereof the coupon and interest received was \$8.8 million and the change in the securities valuation was \$0.3 million. This represents a return to the Fund based on the time weighted rate of return of 0.96%, or 96 basis points for the quarter.

A graphical presentation of the growth in the NAV of the Fund during the quarter is as follows:

**Value of Petroleum Fund Capital Account
October- December 2006**



The major movements in the value of the Fund took place as a result of the taxpayer receipts that are usually received around the middle of each month.

5. MANAGEMENT COSTS

The means by which the management costs of the Fund are to be recognised is determined in the Petroleum Fund law. Article 6.3 of the law states “From the amount received in accordance with Section 6.1, the Central Bank shall be entitled to deduct, by direct debit of the Petroleum Fund account, any reasonable management expenses, as provided for in the operational management agreement referred to in Section 11.3”.

The management fee is intended to cover the actual expenses incurred by the BPA in managing the Fund. Considering the increasing costs of managing the Petroleum Fund, the BPA suggested a new management fee structure for the fiscal year 2006/07. During the period there was no management fee deducted from the Fund.

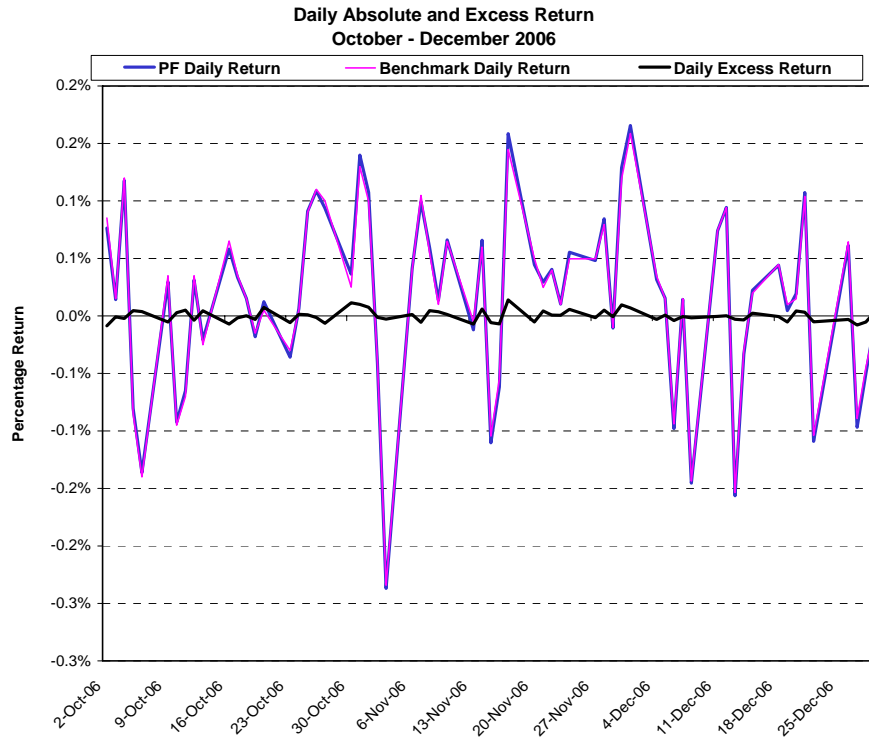
6. TRANSFERS FROM THE PETROLEUM FUND

According to Article 7.1 of the Petroleum Fund law transfers from the Fund may only be made to the credit of a single State Budget account. No transfers were made from the Petroleum Fund in the quarter ended 31 December 2006.

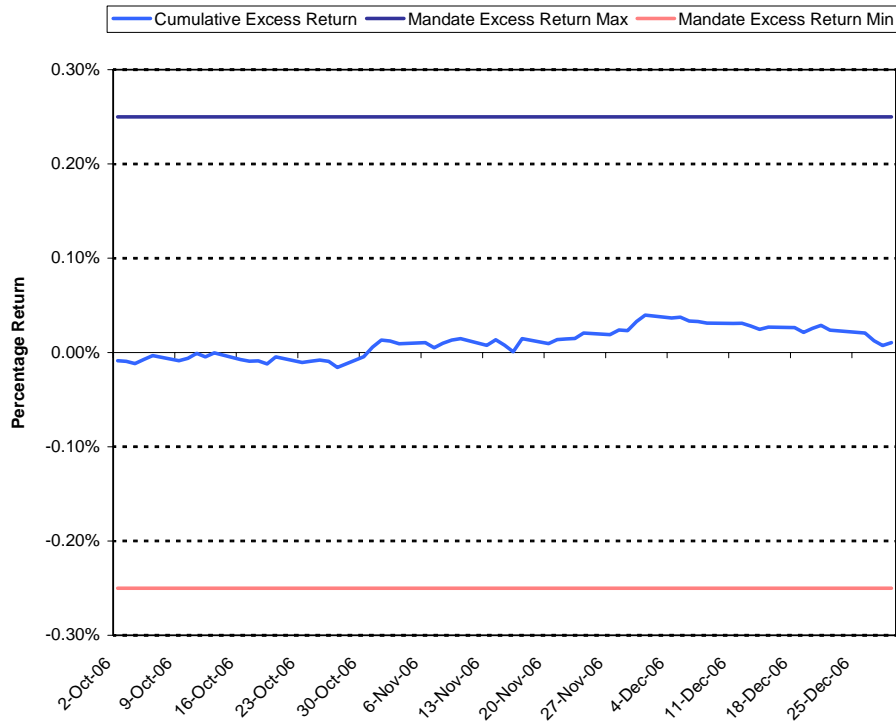
7. RISK EXPOSURE OF PORTFOLIO

7.1 Tracking Error

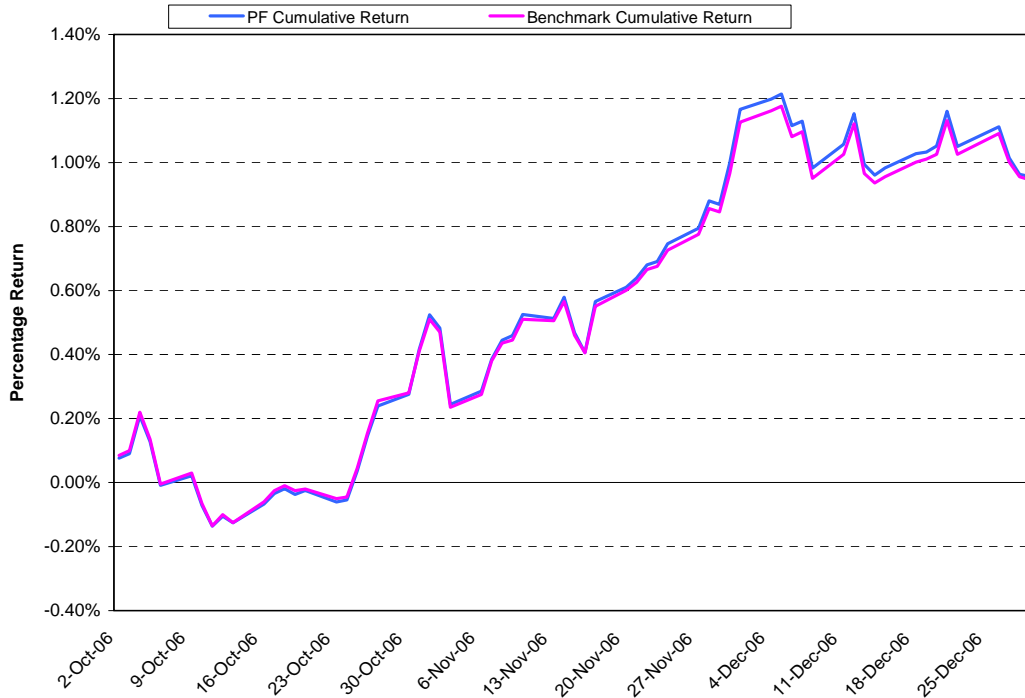
The following graphs illustrate the manner in which the Fund portfolio tracked the benchmark index. The line “Daily Excess Return” measures the difference between the return on the Fund’s portfolio and the benchmark. The cumulative excess return for the quarter was 1 basis point above the benchmark, within the ± 25 basis points in the investment mandate.



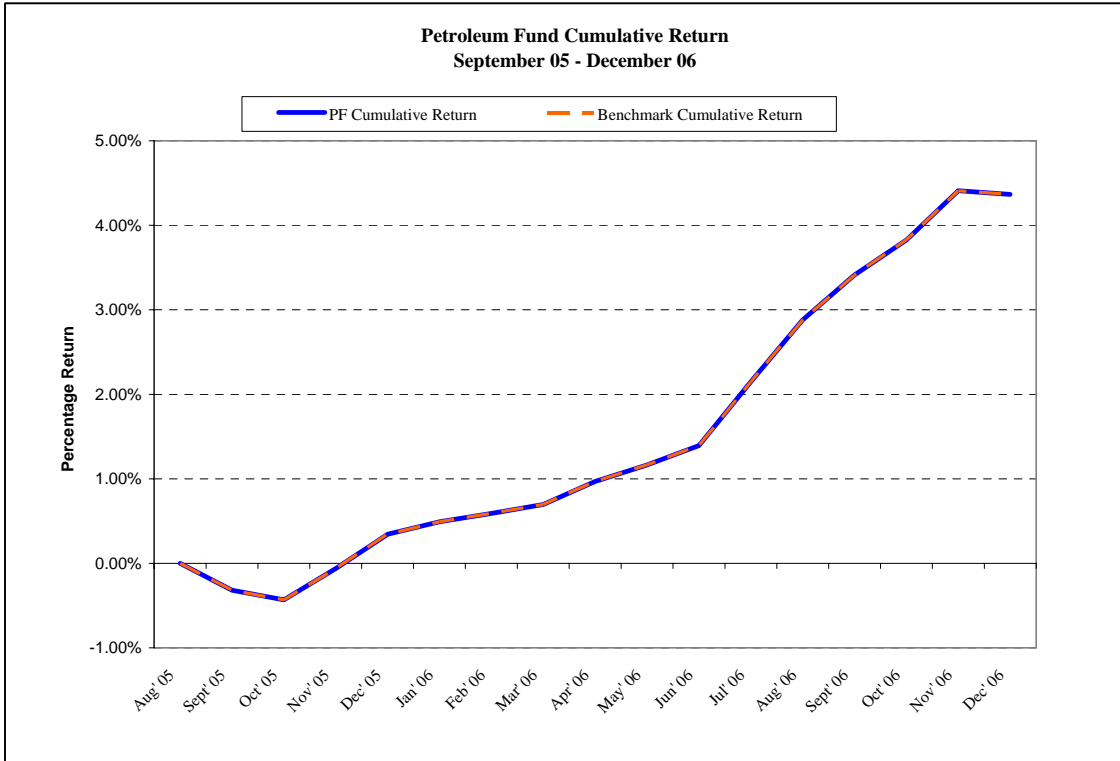
**Cumulative Excess return
October - December 2006**



**Cumulative Return
October - December 2006**

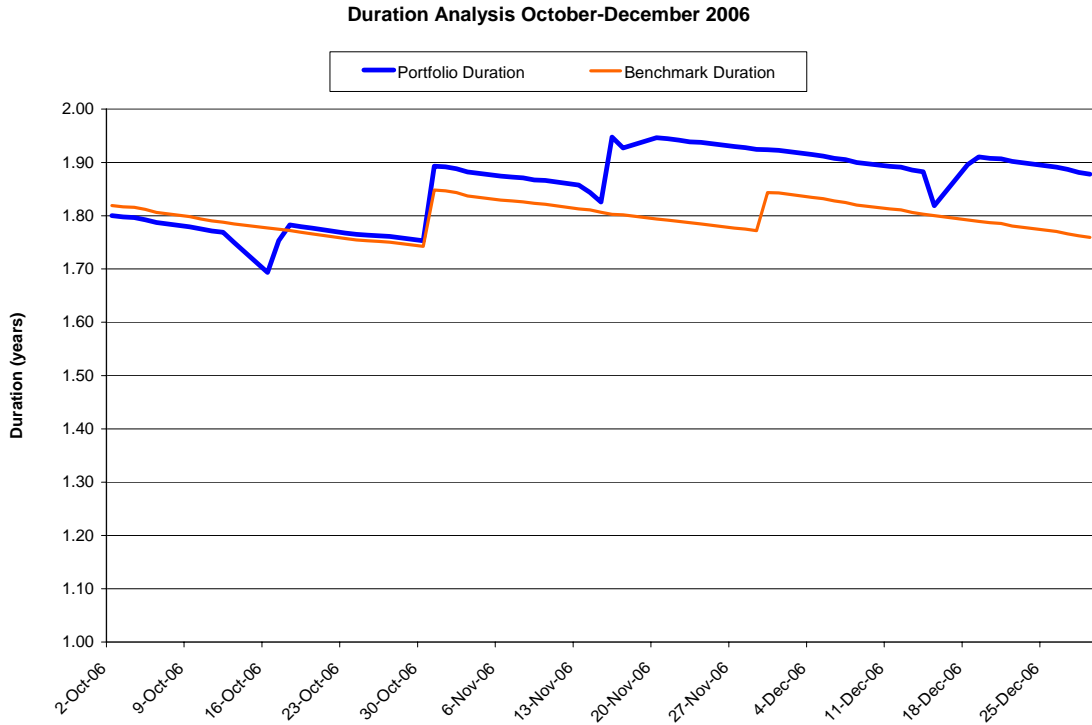


The performance of Petroleum Fund during the quarter compared with the performance of the benchmark over the same period is shown in the following graph.



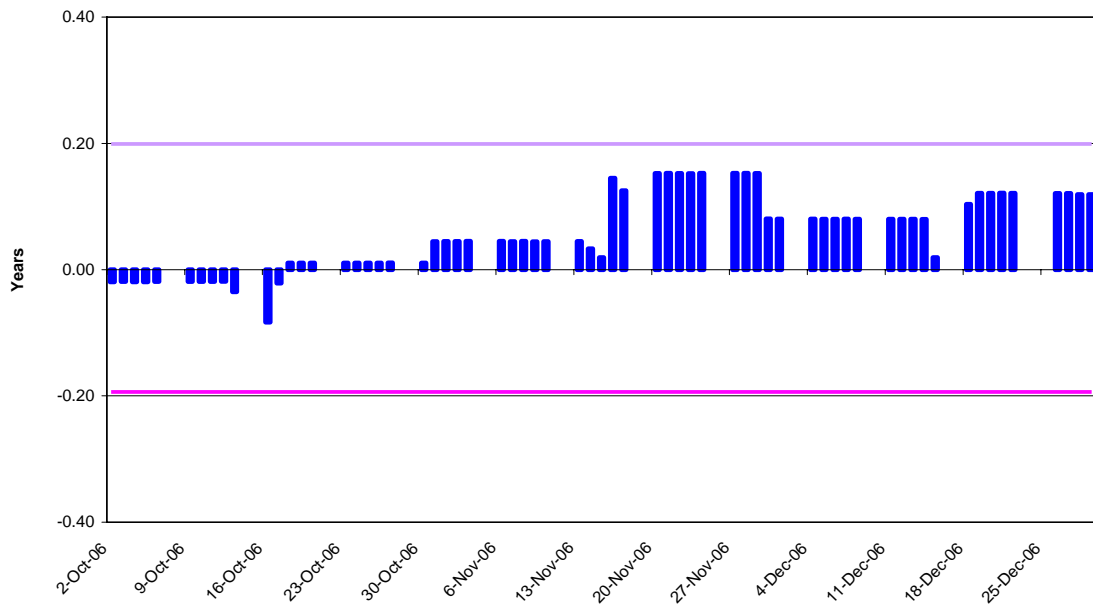
7.2 Duration

The mandate given by the Ministry of Planning and Finance to the BPA specifies that the Fund portfolio shall have a Modified Duration within 0.2 years of the benchmark index. The following graphs show, firstly, the modified durations of the portfolio and the index, and secondly, the difference between the portfolio and the index compared with the mandated maximum of ± 0.2 years.



The above graph shows the modified duration of the Petroleum Fund investment portfolio compared with the modified duration of the benchmark index.

**Difference between Modified Duration of Portfolio and Benchmark
October-December 2006**



The above graph shows the daily difference in modified duration between the investment portfolio and the benchmark. The Management Agreement states that the modified duration of the portfolio shall be managed within plus or minus 0.2 years of the modified duration of the benchmark. The duration was within the mandate during the quarter.

7.3. Credit Risk

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

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

Cash received by the Petroleum Fund pending investment is invested at overnight money market interest rates in an overnight repurchase pool operated by the Federal Reserve Bank of New York.

8. COMPLIANCE STATEMENT

The BPA has undertaken the operational management of the Petroleum Fund within the terms of the mandate set out in the Management Agreement.

Qualifying Instruments

The Fund was invested in the qualifying instruments within the investment universe specified in the mandate at all times during the quarter. At no time was the Fund invested in instruments other than those disclosed in this report.

Return on the Portfolio

The performance on the portfolio for the quarter was 96 basis points compared with the benchmark performance of 95 basis points. The difference of 1 basis point is within the mandated target of ± 25 basis points.

Modified Duration of the Portfolio

The modified duration of the Fund's investment portfolio and the mandated index are measured by the BPA daily. The modified duration of the Petroleum Fund portfolio was within the mandate during the quarter.

Internal Audit

In accordance with the provisions of Article 22 of the Petroleum Fund law number 9/2005 that requires BPA's Internal Auditor to perform an audit of the Fund every six months. The Internal Auditor has performed an audit on the Fund to 30 June 2006.

Accounting Principle

In accordance with the provision of Article 21 of the Petroleum Fund Law, the accounts and records of the Petroleum Fund shall be presented by using the International Accounting Standard (IAS). The Financial Statements given in this

report, as well as the previous reports, is prepared by using the mark-to-market accounting standard.

9. SUMMARY FINANCIAL STATEMENTS

Balance Sheet

The unaudited balance sheet for the Petroleum Fund of Timor-Leste as at 31 December 2006 was as follows:

	in thousands \$	
NET ASSETS	Dec-06	Sep-06
Cash and Cash Equivalents	1,293	498
US Treasury Notes (Market Value)	1,005,185	834,932
Accrued Coupon	5,286	11,630
Less: Peding Purchases of Securities	-	-
TOTAL	1,011,764	847,059
CAPITAL	Dec-06	Sep-06
Opening Balance as at 1 July 06	649,848	649,848
Article 6.1(a) Revenue Receipts	278,507	154,403
Article 6.1(b) DA Receipts	59,240	27,728
Net Income	24,169	15,080
TOTAL	1,011,764	847,059

Profit and Loss Statement

The unaudited Profit and Loss Statement for the Petroleum Fund of Timor-Leste for the quarter ended 31 December 2006 is as follows:

	in thousands \$			
INCOME	Quarter		Year to Date (YTD)	
	Dec-06	Dec-05	Dec-06	Dec-05
Money Market Interest	64	44	155	127
Treasury Note Coupons	8,740	3,025	15,388	3,577
Income	8,804	3,069	15,544	3,704
Unrealised Market Revaluations	286	(713)	8,626	(2,042)
Net Result for the Period	9,090	2,356	24,169	1,662

Notes: The basis on which these financial figures have been prepared is to recognize income as comprising (i) coupon income on an accruals basis, and (ii) changes in market value in the price of the investments that occur after purchase.

Dili, 12 January 2007

Venâncio Alves Maria
Executive Director

Abraão de Vasconcelos
General Manager