PETROLEUM FUND OF TIMOR-LESTE

QUARTERLY REPORT

For the Quarter ended 31 March 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 BPA the responsibility for the operational management of the Fund, and following the passing of the law the BPA commenced operations immediately.

This report covers the period from 1 January 2006 to 31 March 2006.

In the course of the March quarter the capital of the Fund grew from $370.2 million to $508.1 million.

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

Although the United States government bond market experienced its largest quarterly drop since June 2004, the benchmark yielded +35.1 basis points and the Petroleum Fund (on a cash weighted basis) yielded +35.2 basis points.

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

According to Merrill Lynch data (which covers the whole US Treasury Note market and not just the sector in which the Petroleum fund is invested) investors in US Treasury Notes suffered a 1.2 per cent loss for the quarter, the most since a 3.1 per cent drop in the quarter ended June 2004. This fall in prices has been attributed to concern that faster inflation will cause the Federal Reserve Bank to increase its interest-rate target more than forecast.

It should be noted that market trends – whether positive or negative – will reverse over time for investors such as the Petroleum Fund that holds Treasury Notes to maturity. Because yields move inversely to prices, the yield obtained on new funds received by the Petroleum Fund has been steadily increasing.

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 Minister 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 Notes that form the defined benchmark index. The selected bonds fall within the ten six-month periods for the next five years and have been purchased in amounts that replicate the market value of all bonds in the index falling within the same maturity periods.

Staff assigned to the Petroleum Fund Department have continued to engage in capacity building, primarily in the form of in-house training.

Technical Assistance

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

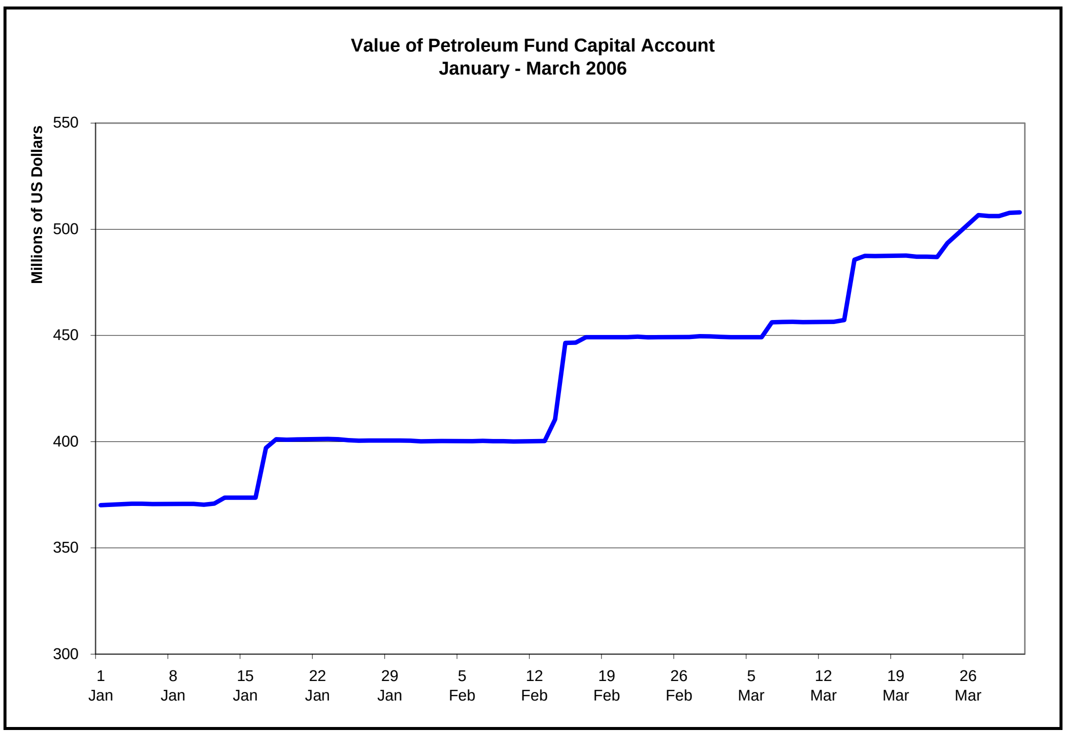
- The Norwegian Petroleum Directorate funded a resident advisor for the entire quarter to further support capacity building and institutional development.

4. PORTFOLIO PERFORMANCE

Return

The opening balance of the Fund at the beginning of the quarter was $370.2 million, and the closing balance as at 31 March 2006 was $508.1 million. Investment income of $4.1 million was earned from the Fund during the quarter. This represents a return to the Fund based on the weighted average capital of 35 basis points for the quarter.

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



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

5. MANANGEMENT COSTS

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

The management agreement provides for a management fee of up to $270,000 to be paid from the Fund to the BPA in the fiscal year 2005/6. This management fee is intended to cover the actual expenses incurred by the BPA in managing the Fund.

Management fees of $30,000 per month (being a pro rata for the nine months during which the Management Agreement will be in force) were deducted from the Fund during the quarter.

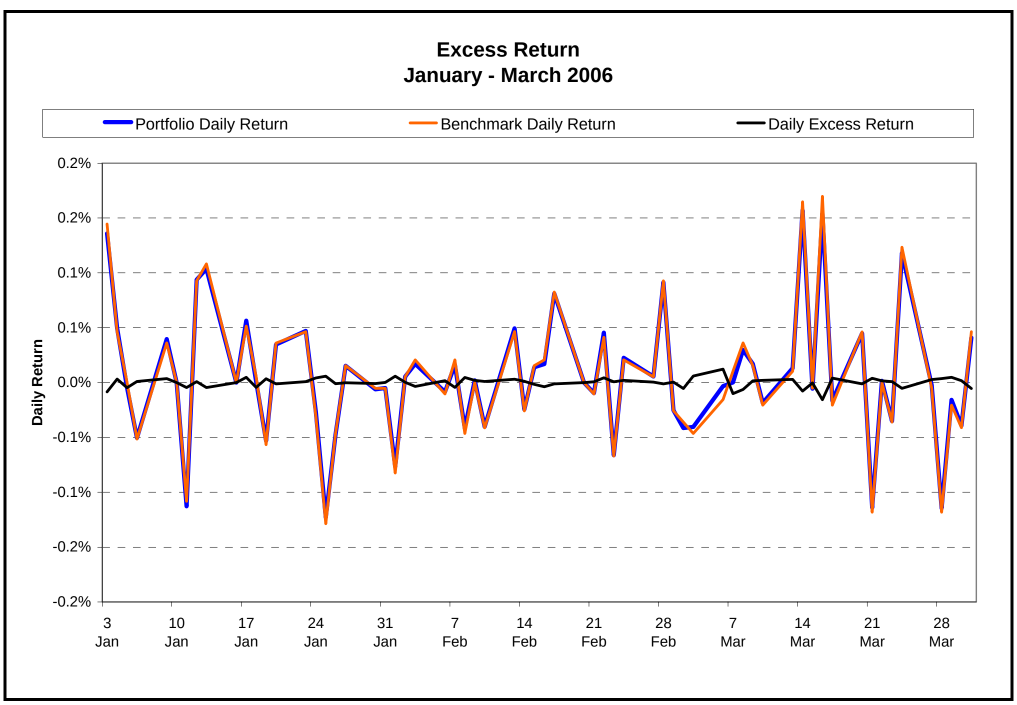
6. TRANSFERS FROM THE PETROLEUM FUND

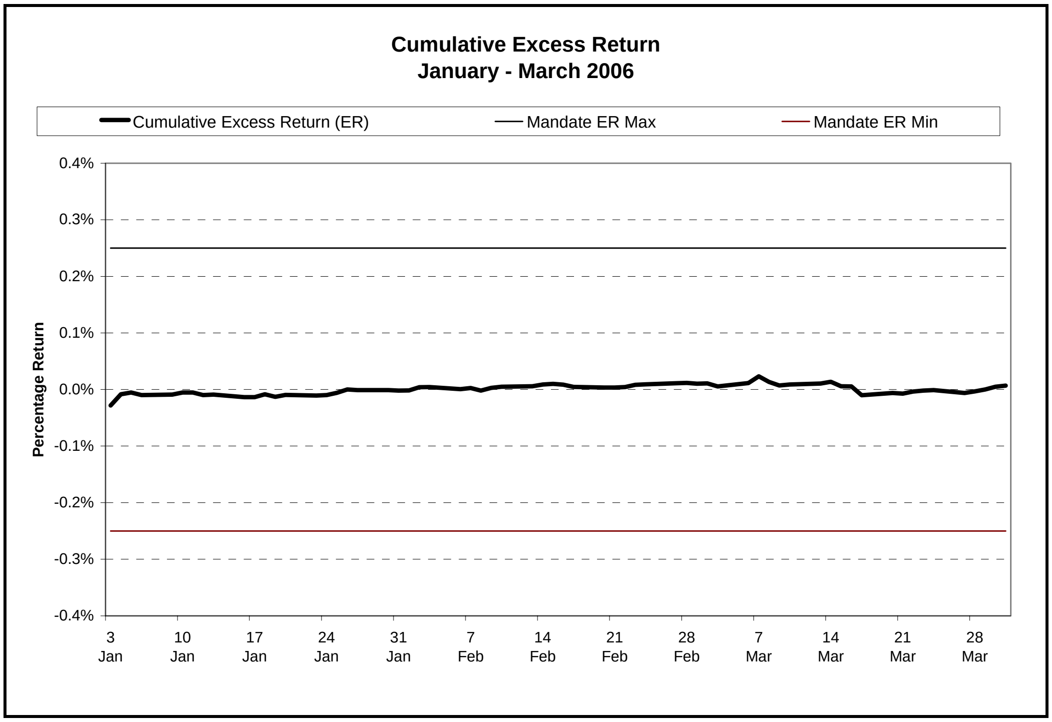
According to Article 7.1 of the Petroleum Fund law transfers from the Fund may only be made to the credit of a single State Budget account. No transfers were made from the Petroleum Fund in the quarter ended 31 March 2006.

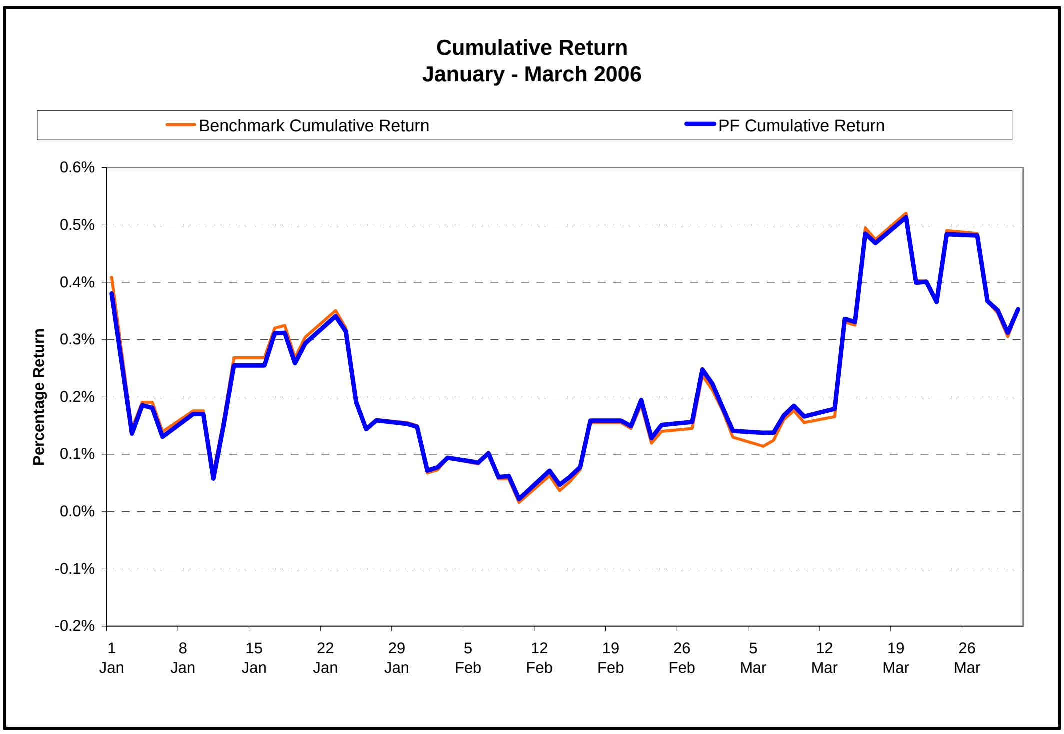
7. RISK EXPOSURE OF PORTFOLIO

7.1 Tracking Error

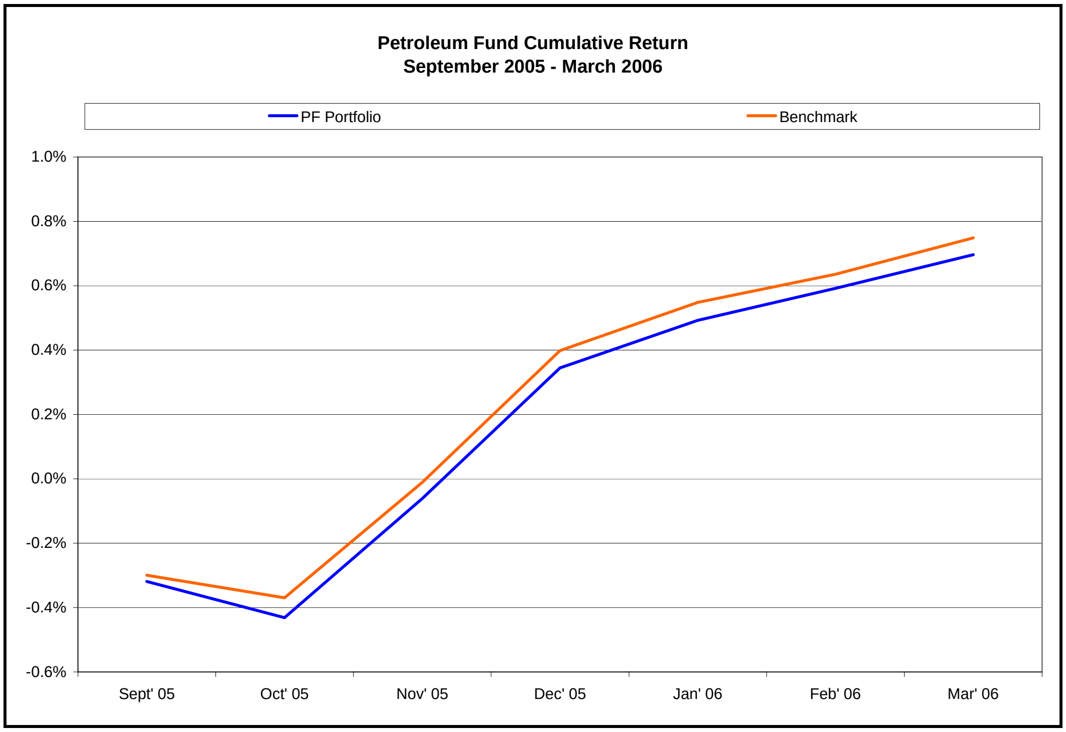
The following graphs illustrate the manner in which the Fund portfolio tracked the benchmark index. The line "Daily Excess Return" measures the difference between the return on the Fund's portfolio and the benchmark. The daily excess return remained within a band of +1.2 basis points and -1.6 basis points. The cumulative daily excess return for the quarter was 0.1 basis points above the benchmark, within the 25 basis points in the investment mandate.





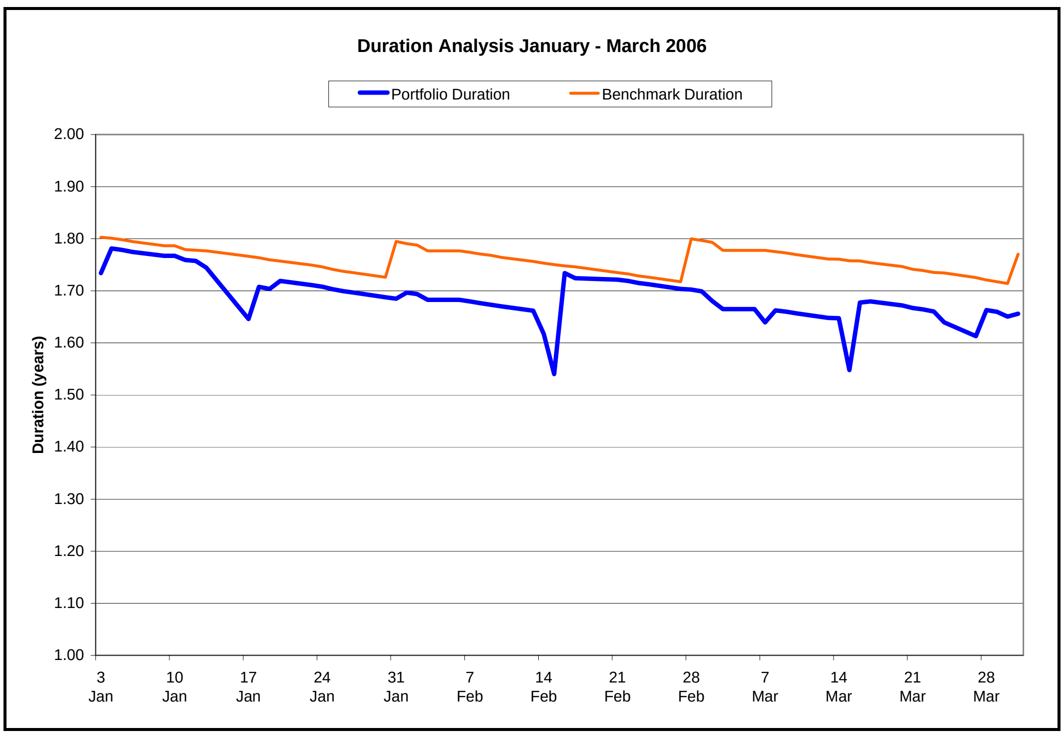


The yield of Petroleum Fund since its inception compared with the yield of the benchmark over the same period is shown in the following graph. The performance shortfall is attributed to the cost of acquiring the investments and rebalancing costs.

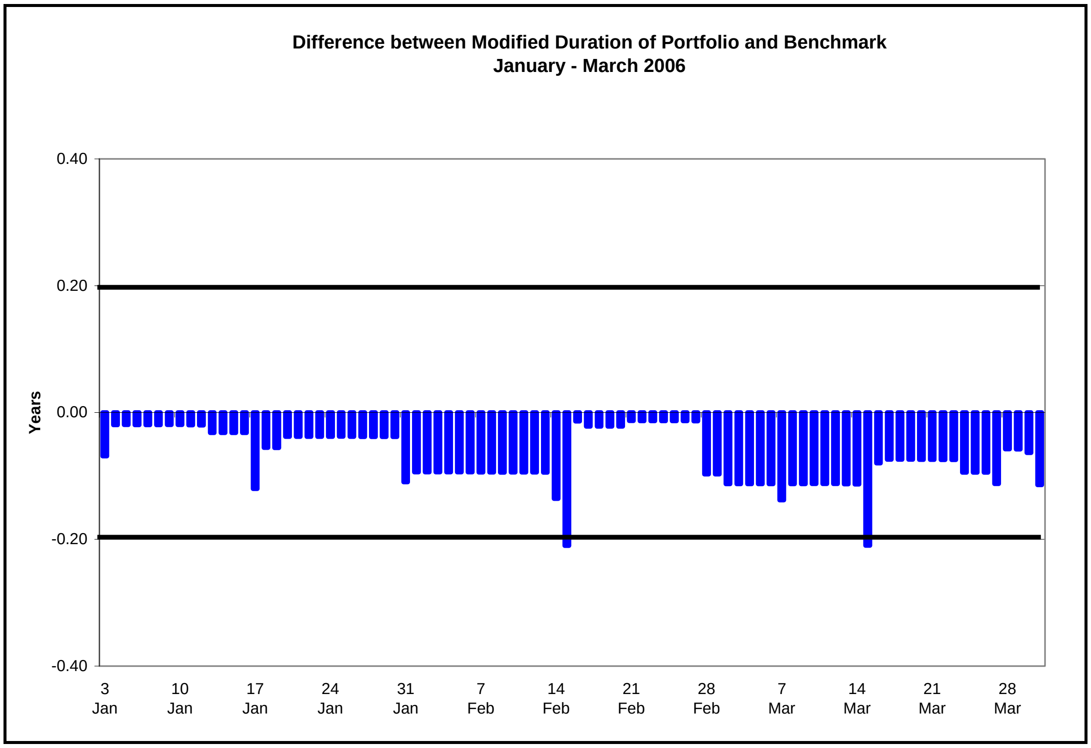


7.2 Duration

The mandate given by the Minister of Planning and Finance to the BPA specifies that the Fund portfolio shall have a Modified Duration within 0.2 years of the benchmark index. The following graphs show, firstly, 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.



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 mandate was breached on two days outside of the control of the BPA because large receipts from taxpayers, which affect the calculation of modified duration, lowered the modified duration of the Petroleum Fund portfolio relative to the benchmark. On both occasions the money was invested the next day.

7.3 Credit Risk

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

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

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

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 return on the portfolio for the quarter under review was 35.2 basis points compared with the index of 35.1 basis points. The difference of 0.1 basis points 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, the calculation of which includes deposits by taxpayers that are outside the control of the BPA, fell outside the mandate on two days 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 31 December 2005.

9. SUMMARY FINANCIAL STATEMENTS

Balance Sheet

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

	In $ thousands
NET ASSETS	
Earmarked Receipts Account	218
Overnight Repurchase Agreements	2,000
US Treasury Notes (market value)	500,475
Accrued Coupon	7,384
Less: Pending Purchases of Securities	(1,974)
TOTAL	**$508,103**
CAPITAL	
Opening Balance from Government	204,604
Article 6.1(a) Revenue Receipts	249,845
Article 6.1(b) DA Receipts	50,657
Article 6.1(c) Investment Income	7,803
Unrealised market gain/(loss)	(4,626)
Management Expenses	(180)
TOTAL	**$508,103**

Profit and Loss Statement

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

		In $ thousands
INCOME	**Quarter**	**Year to Date**
Money Market Interest	40	167
Treasury Note Coupons	4,060	7,636
Income	4,100	**7,803**
Less: Unrealised market revaluations	(2,584)	(4,626)
Net Result for period	**$1,516**	**$3,177**

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

Note: *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, 17 April 2006

Maria José Sarmento
Acting Executive Director

Abraão de Vasconselos
General Manager