



Financial Year
2009

Petroleum Fund Annual Report



Language:
English

National Directorate of the Petroleum Fund
Ministry of Finance
Democratic Republic of Timor- Leste
August 2010



Petroleum Fund Annual Report 2009

The Petroleum Fund continued to grow in 2009 despite modest return on the investments in the international financial market. The Fund's value increased by US\$ 1,180 million during the year and ended at US\$ 5,377 million by year end 2009. The nominal net investment return was +0.6 per cent.

The total petroleum revenue receipts were US\$ 1,660 million while the net investment return was US\$ 31.5 million. The Government transferred a total amount of US\$ 512 million to Treasury's Account (CFET), which was US\$ 104 million above the Estimated Sustainable Income (ESI) within the amount appropriated by Parliament.

A first major step of portfolio diversification took place in 2009 when the Bank of International Settlements (BIS) was appointed as the Fund's first external manager. The BIS manages 20 per cent of the total portfolio, whereas 8 per cent of the overall Fund portfolio is invested in other foreign Government and Supranational bonds. Progress has also been made in preparing the Fund for investments in global equities.

The Fund established in 2005

The Petroleum Fund of Timor-Leste was established under the provisions of the Petroleum Fund Law no 9/2005 which was promulgated on 3 August 2005.

The Government is responsible for the overall management of the Petroleum Fund, while the Banking and Payments Authority of Timor-Leste (BPA) is responsible for the operational management. The Ministry of Finance, on behalf of the Government, entered into a Management Agreement with the BPA on 12 October 2005. It has been partially modified on several occasions later.

In- and outflow of the Fund

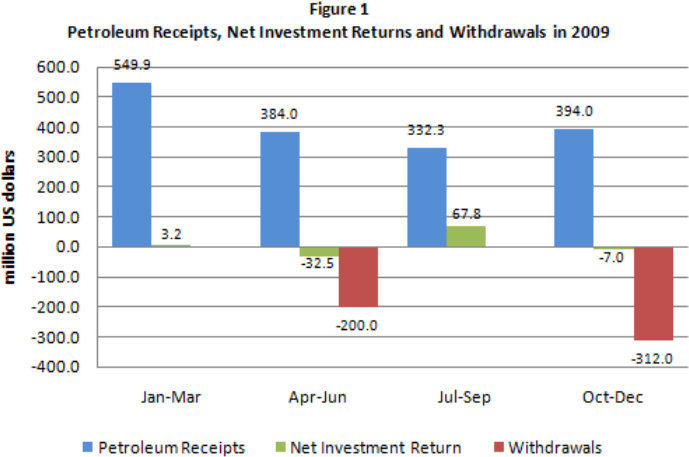
The Fund's balance is affected by three factors; a) petroleum receipts, b) net investment return, and c) withdrawals.

Petroleum receipts

Taxes, royalties, profit oil/gas and other petroleum receipts totaling US\$ 1,660 million were paid to the Petroleum Fund during the Financial Year 2009. US\$ 661 million of the total amount were petroleum taxes, US\$ 994 million were royalties and profit oil/gas and US\$ 5 million were other petroleum receipts. The amounts were in accordance with Article 6.1 (a), (b) and (e) of the Petroleum Fund Law respectively.

The quarterly petroleum receipts varied between US\$ 332 and 550 million and the highest amount received was in the first quarter of 2009, ref. figure 1.

The total petroleum receipts paid since the inception of the Fund is US\$ 5,979 million, including initial transfers of US\$ 80 million from the Timor Gap Account and US\$ 125 million from the Consolidated Fund of Timor-Leste (CFET).

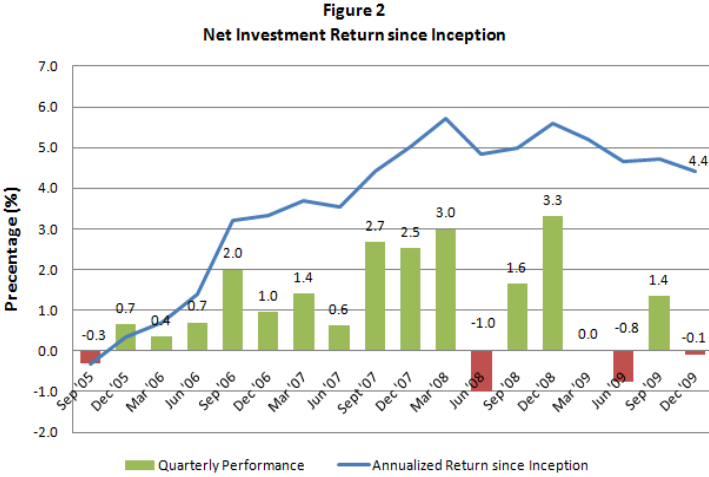


Net Investment Return

The gross return on investments during the Financial Year 2009 was US\$ 34.1 million. In accordance with the Operational Management Agreement, a management fee to the BPA of US\$ 2.6 million has been withdrawn from the Petroleum Fund. Thus, the net investment return for the period is US\$ 31.5 million, totaling \$US 401 million since the inception of the Petroleum Fund.

The net investment return for 2009 is equivalent to +0.6 per cent of the portfolio. The modest return was a result of downward market revaluation of the portfolio due to US interest rate movements during the year.

During the first six months of 2009 the US Government bond yields increased significantly, in particular during the second quarter of the year, resulting in 0 and -0.8 per cent investment return respectively for the two quarters. The US Government bond yields decreased once again in the third quarter, giving a quarterly performance of +1.4 per cent. The last quarter of the year gave a negative performance of -0.1 per cent.



Although other Government bonds were added to the portfolio the last six months of the year, it did not have a major impact on the overall performance of the portfolio. Figure 2 shows the quarterly net investment return since inceptions of the Fund and the annualized return. Since inception the annualized return has been 4.4 per cent at year end 2009.

The net investment return consists of three factors. The coupon rate, which is the fixed return received from holding bonds, is always positive, market revaluation might be positive or negative subject to changes in the bond yields, and the management fee, deducted from the gross investment return is negative and funds the operational management of the portfolio. Table 1 shows the investment return, in US dollars, quarter by quarter in 2009.

Table 1: Investment Return in 2009

million US dollars	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Total
Investment Income	40.1	42.9	52.9	43.7	179.6
Market revaluation	-36.9	-74.5	15.2	-49.3	-145.5
Management Fee		-0.9	-0.4	-1.3	-2.6
Net Result	3.2	-32.5	67.7	-7.0	31.5

The average yield to maturity of the investments made through the Financial Year 2009 has been estimated at 1.1 per cent. During 2009 inflation in the USA was 2.7 per cent. The real return on the investments, based on the yield on the portfolio and the yield to maturity, is -2.1 per cent and -1.6 per cent respectively.

The investment performance was generally in line with the yield on the benchmark portfolio; Merrill Lynch US Government bonds 0-5 year index (GVQA) for the first six months and a composite benchmark consisting of GVQA and the benchmark included in the BIS's investment mandate for the rest of the year. The negative difference between the portfolio and the global benchmark for 2009 was 7 basis points (0.07 percentage points), mainly due to transaction and rebalancing costs.

Withdrawals

The Government withdrew a total amount of US\$ 512 million to the CFET during the Financial Year 2009. This was US\$ 104 million above the Estimated Sustainable Income (ESI). The withdrawals since inception are shown in table 2 together with petroleum receipts, net investment return and the ESI.

Table 2: Petroleum Receipts, Net Investment Return, Withdrawals and ESI

million US dollars	2005/06	2006/07	Trans 2007 (6 months)	2008	2009
Opening balance	205	650	1,394	2,087	4,197
Petroleum revenues	438	956	640	2,284	1660
Net investment return	7	48	92	223	31.5
Withdrawals	0	-260	-40	-396	-512
ESI	103	283	133	396	408
Closing balance	650	1394	2087	4197	5377

Petroleum Fund Balance

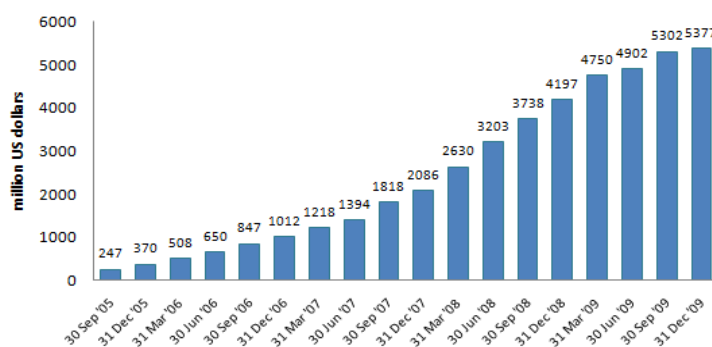
The market value of the Petroleum Fund as of 31 December 2009 was US\$ 5,377 million. This is an increase of US\$ 1,180 million during the year. Figure 3 shows the market value of the Petroleum Fund since inception of the Fund in September 2005.

The Investment Strategy

From the outset the Fund's investment strategy has been simple and prudent in order to avoid exposure to risk and volatility during the first years of operations taking into account the skills and capacity among key stakeholders. The Fund was invested in US Government bonds only and measured against Merrill Lynch US Government bonds 0-5 years index. Until June 2009 the entire portfolio was managed by the BPA.

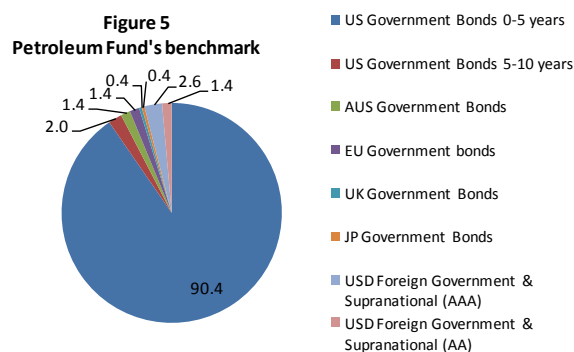
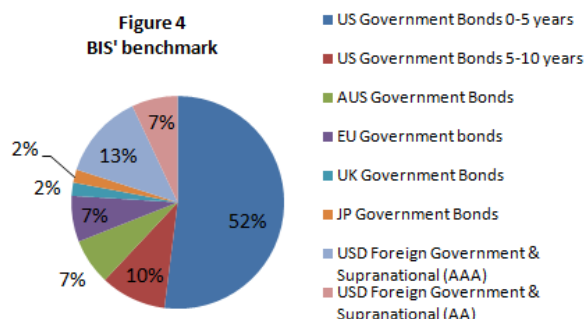
In June 2009 the Bank for International Settlements (BIS) was appointed as the first external manager of the Petroleum Fund to invest US\$1 billion in a broader range of Government and Supranational bonds. This was equivalent to 20 per cent of the Petroleum Fund at that point of time, whereas the rest of the Fund, equivalent to 80 per cent of the overall Fund remained under the BPA's internal management.

Figure 3
Market Value of the Petroleum Fund



From June 2009 the global benchmark for the Petroleum Fund has consisted of the average between the two investment mandates adopted for the BIS and BPA respectively, and with same weights as the initial allocation, i.e. 80 per cent of the benchmark defined for the BPA's investment mandate and 20 per cent of the benchmark defined for the BIS' investment mandate.

Whilst the BPA's portfolio consists of US Government bonds 0-5 years only, the BIS benchmark comprises both US Government bonds 0-5 and 5-10 years, Government bonds issued by Australia, EU, UK and Japan in local currencies and foreign Government and Supranational bonds denominated in USD. Figure 4 shows the BIS' portfolio while figure 5 shows the allocation of the entire Petroleum Fund.



Future development of the investment strategy

The Government aims at continuing the diversification of the investments of the Petroleum Fund including exposure to equities. In order to exploit the flexibility of the current Petroleum Fund Law, which allows for investing up to 10 per cent in other financial investments than cash deposits and high rated bonds denominated in US dollar and issued or guaranteed by governments or supranational institutions, the Ministry of Finance requested the BPA in 2009 to start the selection process of a global equity manager with a target allocation of 4 per cent of the overall Petroleum Fund. Once this investment mandate is implemented, the current Petroleum Fund Law is fully utilized and further diversification requires amendments to the Petroleum Fund Law.

The Ministry of Finance engaged the world wide investment consultants Towers Watson in 2009 to assist the Ministry of Finance in analyzing future investment strategy options. The

result of their work shows that an exposure to equities of minimum 25 per cent is required to achieve a long term real investment return of 3 per cent, which is equivalent to the expected long term real investment return of the Petroleum Fund (Estimated Sustainable Income).

The Government is currently reviewing the Fund's investment strategy as well as future investment strategy options and will submit proposed amendments to the Petroleum Fund Law to the National Parliament in due course.

Advice from the Investment Advisory Board

The Investment Advisory Board (IAB) of the Petroleum Fund held eleven meetings during 2009. The minutes from the meetings are available on www.bancocentral.tl. The Investment Advisory Board has provided four recommendations to the Minister of Finance in accordance with the requirements of Article 16 in the Petroleum Fund Law:

1) Proposal to engage Bank for International Settlements (BIS) as an external portfolio manager for the Petroleum Fund

On 4 February 2009 the Minister of Finance sought advice from the IAB regarding a proposal from the BPA to engage the Bank for International Settlements (BIS) as an external portfolio manager of the Petroleum Fund.

IAB provided its advice on 17 March 2009. It recommended to appoint the BIS as an external manager of the Petroleum Fund and to outsource an initial amount of US\$1 billion. The Board made some recommendations regarding use of derivatives and advised on amendments to the Management Agreement between the Ministry of Finance and the BPA accordingly.

Based on the IAB's recommendation, the Minister approved the appointment of the BIS as the external portfolio manager of the Fund and amended the Investment Guidelines in line with the proposal from the IAB. The BPA signed a contract with the BIS and outsourced the management of US\$1 billion in June 2009.

2) Petroleum Fund's investment strategy and impact of the financial crisis

On 30 July 2009 the Minister requested the Investment Advisory Board to provide an opinion on the impact of the financial crisis on the US market and how it might affect the investment return of the Petroleum Fund in the short, medium and long term. Moreover, the Minister requested the IAB to provide an advice on how best to minimize the adverse effects, if any, on the Fund's investments from the short, medium and long term effects of the financial crisis.

In a letter dated 2 September 2009 the Investment Advisory Board (IAB) discussed the potential impact of the Petroleum Fund from the international financial crisis, outlined factors which are important to take into account when designing the future investment strategy and provided a recommendation on the short and medium term strategy to cope with any adverse effects that might occur.

3) A proposal for depositing part of the Petroleum Fund in cash

In a letter dated 15 September 2009 the Minister sought advice from the IAB on a proposal received from Asia Champ Investments Ltd to deposit USD 1.2 billion in an account in Hong Kong & Shanghai Banking Corporation (HSBC).

On 18 September 2009 the IAB recommended the Minister not to accept the proposal and suggested the Minister to request the BPA to confirm the assumptions on which the Board's conclusion was reached. Also, the IAB advised that all explicit investment decisions should be managed by the operational manager of the fund in accordance with the procedures established in the Petroleum Fund Law and the Management Agreement.

4) The Petroleum Fund's long term investment strategy and PF Law amendments

In a letter dated 25 June 2009 the Minister requested the IAB to provide advice related to the future investment policy and strategy, including the optimal strategic asset allocation and the short, medium and long term investment strategies, implementation of the Santiago-principles for Sovereign Wealth Funds into the Petroleum Fund Law and amendments of Articles 14 and 15 of the Petroleum Fund.

On 16 December 2009 the IAB provided advice on issues related to the Fund's investment strategy and specific amendments to Articles 14 & 15 of the Petroleum Fund Law. The IAB recommended including a minimum allocation to fixed instruments of 60 per cent and a maximum allocation to listed equities of 40 per cent in the revised Petroleum Fund Law. The IAB suggested that the Fund should aim for increasing the exposure to equities to 25 per cent as soon as practicable (1-2 years after the new Law has been adopted).

Audit of the Petroleum Fund

Deloitte Touche Tohmatsu has been appointed Independent Auditor of the Petroleum Fund for 2009. Deloitte Touche Tohmatsu has produced a report in accordance with Article 35 of the Petroleum Fund Law, and which is available in this report as Annex IX.

The previous report provided by the Auditor and included in the Petroleum Fund Annual Report based on Guidelines adopted by the Extractive Industries Transparency Initiative (EITI) is no longer deemed necessary as the Government has commenced issuing annual EITI Reports on a separate basis.

The Petroleum Fund 2009 Report is also available at www.mof.gov.tl and www.bancocentral.tl.

Signed on 27 August 2010

Emilia Pires
Minister of Finance

Annexes:

- I Statement by the Director of Treasury
- II Audited Financial Statements
- III Comparison of income derived from the investment of Petroleum Fund assets with previous three Fiscal Years
- IV Comparison of nominal income on the investment of Petroleum Fund assets to real returns

- V Comparison of income derived from the investment of Petroleum Fund assets with the benchmark performance index
- VI Comparison of Estimated Sustainable Income with the sum of transfers from the Petroleum Fund
- VII Statement on borrowings
- VIII A list of persons holding positions relevant for the operations and performance of the Petroleum Fund
- IX Article 35 report on Petroleum Fund Receipts from Deloitte Touche Tohmatsu
- X Advice provided by the Investment Advisory Board
 - a) IAB letter dated 17 March 2009 regarding a proposal to engage Bank for International Settlements (BIS) as an external portfolio manager for the Petroleum Fund
 - b) IAB letter dated 3 June 2009 re IAB's recommendation dated 17 March – correction of Annex 1 of the Management Agreement
 - c) IAB letter dated 2 September 2009 regarding the Petroleum Fund's long term investment strategy and Petroleum Fund Law amendments
 - d) IAB letter dated 2 September 2009 regarding the Petroleum Fund investment strategy and the impact of the financial crisis
 - e) IAB letter dated 18 September 2009 regarding a proposal for depositing part of the Petroleum Fund in cash
 - f) IAB letter dated 16 December 2009 regarding the Petroleum Fund's long term investment strategy and Petroleum Fund Law amendments