

## Chapter 4      **MANAGING TIMOR-LESTE'S PETROLEUM REVENUE**

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The Government of Timor-Leste aims to avoid the resource curse and has established mechanisms to manage its petroleum revenue to achieve that aim. Chapter Three described Timor-Leste's institutions that provide the landscape in which decisions about petroleum revenue are made. This chapter details how the Government of Timor-Leste manages Timor-Leste's petroleum revenue. The Petroleum Fund Law (Democratic Republic of Timor-Leste 2005d) is a cornerstone of the Government's petroleum revenue management plans, and thus the primary focus of this chapter. This chapter begins by describing the development of the Petroleum Fund Law, then its objectives, the receipt and investment of petroleum revenue. But, there are other institutional mechanisms that are used to manage Timor-Leste's petroleum revenue. For example, the Petroleum Fund Law does not define how petroleum revenue is spent, the Parliament makes that decision. Therefore, this chapter also describes the role of other institutions in managing Timor-Leste's petroleum revenue, particularly in terms of expenditure (outflow), transparency and accountability. First, however, the chapter is introduced with a description of Timor-Leste's petroleum fields, which provide the revenue, and an overview of the Government of Timor-Leste's institutions that are directly involved in processing Timor-Leste's petroleum revenue.

Timor-Leste is blessed with oil and gas deposits both on and offshore. Gunn (1999) reports that low grade crude oil was identified in several areas of Timor-Leste in 1947 and this concurs with suggestions that during World War II the Japanese fuelled their planes by extracting petroleum from onshore seeps<sup>84</sup>. In the late 1960s, Portugal began to consider exploitation of Timor-Leste's offshore petroleum resources. The Oceanic Exploration Company approached the Portuguese Government to obtain a license to explore an area of the Timor Sea to which Australia had made claim. Despite Australia's opposition, Portugal granted the concession to PetroTimor (a company later incorporated by Oceanic) in January 1974 (Antunes 2003), by which time Australia had negotiated a maritime boundary with Indonesia. As Portugal had not been party to those negotiations, the 1972 boundary between Indonesia and Australia left a gap in the boundary between Portuguese East Timor and Australia. That gap came to be known as the 'Timor Gap'.

After Indonesia invaded Timor-Leste, the question of establishing a maritime boundary that closed the gap between Timor-Leste and Australia became pertinent to proceeding with the

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<sup>84</sup> Photos of Timor-Leste's onshore seeps can be seen on the Government's Oil and Gas Directorate's website (National Directorate of Oil and Gas 2006).

exploitation of petroleum resources in the Timor Sea. The negotiations between Indonesia and Australia proceeded slowly until in 1989 they agreed to defer the establishment of a permanent maritime boundary and established a Joint Zone of Cooperation instead. Australia and Indonesia shared the proceeds of petroleum exploitation from that zone equally. This arrangement was known as the ‘Timor Gap Treaty’ and although it had no legal basis, it was the precursor to agreements that Timor-Leste and Australia would make in the future.

The issue of establishing a permanent maritime boundary, between Timor-Leste and Australia, is one that, once Timor-Leste had gained its independence, caught the attention of civil society and the media, both in Timor-Leste and Australia. A campaign was waged that highlighted the stark difference between the wealth of the two nations (Timor Sea Justice Campaign 2005). A permanent maritime boundary has never been established between Timor-Leste and Australia. The history of maritime boundary negotiations between Timor-Leste and Australia, and between Indonesia and Australia, is complex. However, maritime boundary negotiations are not the subject of this thesis, and will not be explained<sup>85</sup>.

Timor-Leste’s petroleum fields have been discussed in terms of three ‘petroleum provinces’ (Gusmão Soares 2006b), and these are depicted in Figure 4.1<sup>86</sup>. The three provinces differ in terms of their size, development status, and the nature of their institutional and administrative arrangements. Some onshore seeps are used locally, to fuel cars and generators, but formal exploration of Timor-Leste’s onshore oil and gas seeps is expected to begin in 2008 (Gusmão Soares 2006b). However, this strategy is still evolving and decisions about the development of Timor-Leste’s onshore oil and gas will be taken by the new government (Gusmão Soares 2006b).

In 2005, 11 acreage areas were released for exploration in Timor-Leste’s sovereign offshore area. Five areas have since been awarded to companies for exploration (Gusmão Soares 2006a). Exploration of some areas began in 2006, with production (dependent on discovery) expected in 2013. The petroleum resources found and exploited in these areas, and any proceeds from them, will be 100% East Timorese. The Government of Timor-Leste emphasised transparency in the process to bid for exploration of these areas. Article 12 of the Government Decree on Bidding Rounds for the Award of Petroleum Contracts states that ‘a summary of the proposals evaluation results, and a significant summary of the Report shall be published in the *Jornal da República* [the Government Gazette], as well as through public media considered adequate by the Minister of Natural Resources, Minerals and Energy Policy, Minerals and Energy Policy, within ten (10) working days’ (Democratic Republic of Timor-Leste 2005a). The Production

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<sup>85</sup> For details of the history of the administration of petroleum resources in the Timor Sea, read ‘A Study of the Offshore Petroleum Negotiations Between Australia, the U.N. and East Timor’ by Munton (2006).

<sup>86</sup> For more detailed maps of Timor-Leste’s oil and gas seeps, refer to the Government of Timor-Leste’s Oil and Gas Directorate’s website: (National Directorate of Oil and Gas 2006) and Charlton (2002).

Sharing Contracts were also published, and made available on the National Directorate of Oil and Gas' website (National Directorate of Oil and Gas 2006).

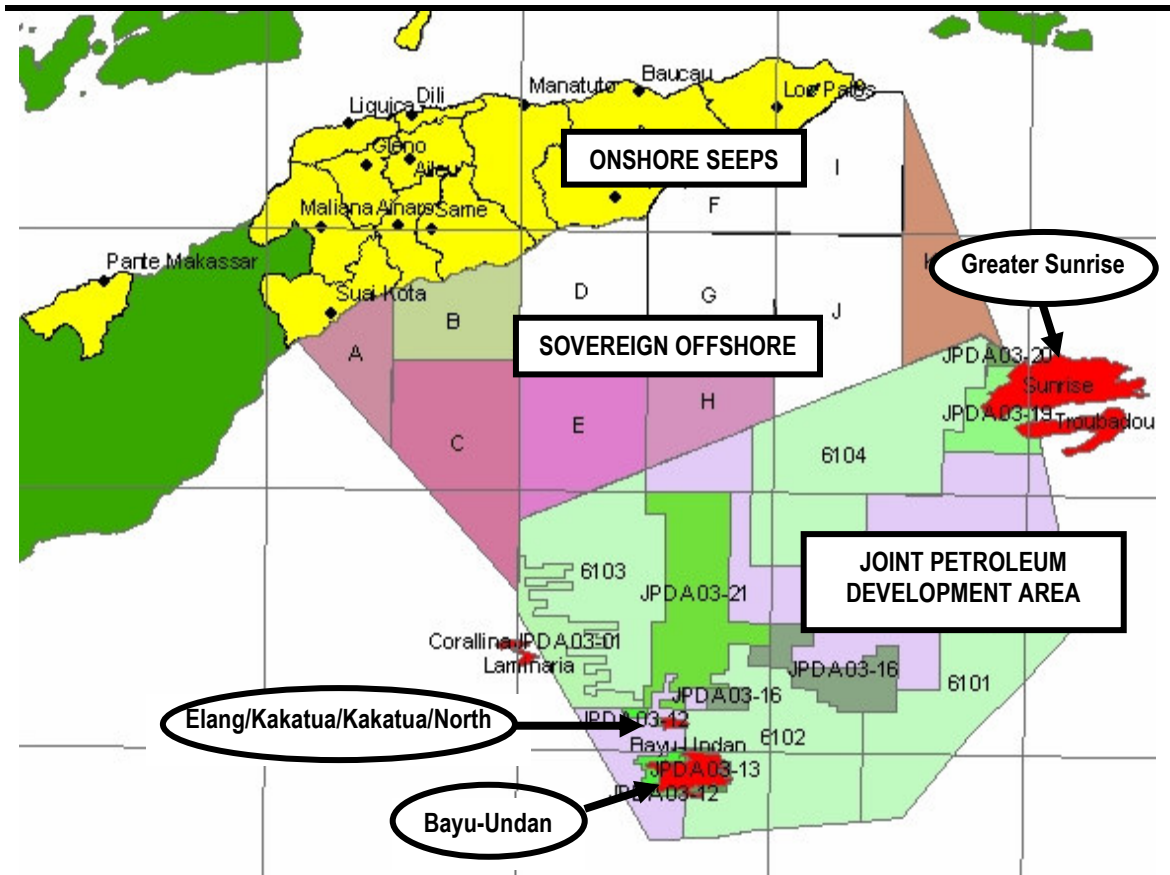


Figure 4.1 Timor-Leste's Onshore, Sovereign Offshore and Joint Petroleum Development Areas (Gusmão Soares 2006b)

In the absence of a legally defined maritime boundary, Timor-Leste and Australia agreed to share revenue from the exploitation of petroleum resources in the Joint Petroleum Development Area (JPDA) of the Timor Sea (depicted in Figure 4.1). Exploration of the JPDA (then known as Zone of Cooperation A under the Timor Gap Treaty) began in 1992 (during Indonesian occupation), and three petroleum fields, of note, have or will be exploited. Production from Elang/Kakatua/Kakatua North began in 1998, and those fields are now almost exhausted. Bayu-Undan was discovered in 1995, and is the field that currently provides the majority of revenue to the Government of Timor-Leste. Bayu-Undan is estimated to contain 400 mm bbls (million barrels) of liquids and 3.4 tcf (trillion cubic feet) of gas (Gusmão Soares 2006b). However, Greater Sunrise, discovered in 1974, is the largest of the petroleum fields identified to date, and is estimated to contain 350 mm bbls of liquids and 7.7 tcf of gas (Gusmão Soares 2006b). Greater Sunrise has also received the most attention because of its size, the negotiations between Timor-Leste and Australia relating to administration of revenue from the field, and the establishment of a permanent maritime boundary.

The Timor Sea Treaty (2002) legislates the management of revenue from the JPDA. Timor-Leste gets 90% and Australia gets 10% of the revenue from petroleum field production within the JPDA. Elang/Kakatua/Kakatua North and Bayu-Undan sit entirely within the JPDA so Timor-Leste receives 90% of the revenue from those fields. But, the Greater Sunrise gas field sits only 20% inside it which means, in theory, Timor-Leste would get just 18% of the production revenue from this field under the Timor Sea Treaty (2002). However, in the absence of the delimitation of a permanent maritime boundary, which might change the portion of Greater Sunrise belonging to Timor-Leste, Timor-Leste negotiated with Australia so that Timor-Leste would receive a larger share of the Greater Sunrise field<sup>87</sup>. On 23 February 2007, the Certain Maritime Arrangements in the Timor Sea (CMATS) Treaty (2006) and the Greater Sunrise International Unitisation Agreement (2004) came into force. Pursuant to the CMATS Treaty, revenue from Greater Sunrise will be equally shared by Timor-Leste and Australia, and the resolution of a permanent maritime boundary will be deferred for at least 50 years.

There are a range of institutions involved in the management of Timor-Leste's petroleum revenue. The resources of the JPDA are currently managed by the Timor Sea Designated Authority (TSDA) on behalf of both Timor-Leste and Australia. The East Timorese ministry responsible for petroleum activities was supposed (under the Timor Sea Treaty) to assume the responsibilities of the TSDA in April 2006, but that transfer of responsibility has been extended until July 2007, whilst the Government of Timor-Leste 'seeks to create a National Petroleum Regulatory Authority' (Campos 2007). The TSDA is responsible for transferring all of the revenue from exploitation of petroleum fields within the JPDA to the Petroleum Fund.

Within the Government of Timor-Leste, there are a range of institutions across several ministries involved in managing petroleum revenue. The Oil and Gas Directorate sits in the Ministry of Natural Resources, Minerals and Energy Policy. Institutions such as the East Timor Revenue Service (which collects tax, including that from companies exploiting Timor-Leste's petroleum fields<sup>88</sup>), the Macroeconomic Planning, and the Budget department are located within the Ministry of Planning and Finance. The Banking and Payments Authority (Timor-Leste's Central Bank) also has responsibilities in managing the Petroleum Fund. The Timor Sea Office (TSO) is structurally located within the office of the Prime Minister, illustrating the importance

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<sup>87</sup> Some legal opinions (e.g. Lowe et al. 2002) suggest that, based on current international maritime law, Timor-Leste could be entitled to a larger share of the Greater Sunrise petroleum field. There is also another oil field, Corallina/Laminaria, situated outside the JPDA, to the west, which, under the current arrangement, sits within Australia's maritime boundaries. If a permanent maritime boundary were decided, some or all of Corallina/Laminaria might belong to Timor-Leste (depending on where the maritime boundary lay). But, exploitation of Corallina/Laminaria has already begun and Australia has taken 100% of the revenue from this petroleum field to date.

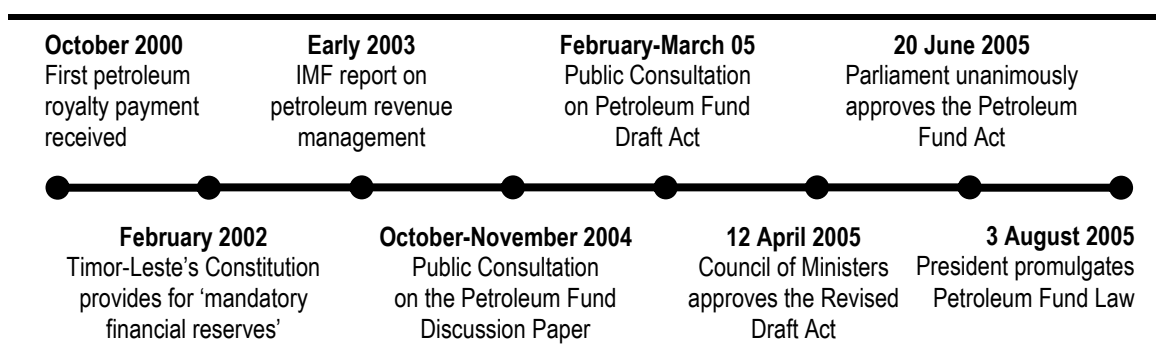
<sup>88</sup> Timor-Leste's Oil and Gas Directorate (2006) explains how tax and production revenue from the JPDA are handled: 'Both Timor-Leste (90 per cent) and Australia (10 per cent) may tax contractors' profits under each country's tax rules. The Timor-Leste share of tax revenue is paid directly by companies into the Timor-Leste Petroleum Fund while production shares are paid to the TSDA as a PSC partner and then forwarded to the Petroleum Fund.' (National Directorate of Oil and Gas 2006: 'Answers to questions put at Timor-Leste's presentations in Singapore, London, Calgary and Houston, September 2005')

of its work. The primary task of the TSO is to establish permanent maritime boundaries with Timor-Leste's neighbours, Australia and Indonesia (Timor Sea Office 2004a).

#### 4.1 The development of Timor-Leste's Petroleum Fund Law

The Government of Timor-Leste decided to establish a Petroleum Fund to manage their petroleum revenue and they chose to create a separate law for that purpose (rather than enshrine the Petroleum Fund in the Constitution<sup>89</sup>). The Petroleum Fund Law (Democratic Republic of Timor-Leste 2005d) institutionalises some mechanisms that may assist Timor-Leste to manage their petroleum revenue sustainably, and avoid the resource curse. Timor-Leste's Petroleum Fund Law is provided in Appendix 2. In brief, the Petroleum Fund Law establishes the Petroleum Fund for Timor-Leste (hereafter referred to as the Petroleum Fund), which sets the parameters for operation and management of the Petroleum Fund, governs the collection and management of receipts associated with petroleum wealth, regulates transfers to the State Budget, and provides for government accountability and oversight of these activities.

The development of the Petroleum Fund Law is summarised in Figure 4.2. Timor-Leste received its first payment of petroleum revenue in October 2000 (Timor Gap Joint Authority for the Zone of Cooperation 2000). At that time (under an arrangement put in place by the United Nations Transitional Administration in Timor-Leste) royalties were deposited into a specific account of the Timor-Leste's Central Bank and accrued in that account. Taxes earned from petroleum exploitation were not saved, but spent via the budget process along with domestic revenue. This was an interim arrangement with no detailed plans for how petroleum revenue should be invested or when and how it should be spent. The arrangement allowed taxes from petroleum exploitation to be spent outside a petroleum revenue framework and thus a more rigorous approach was needed before substantial amounts of petroleum revenue began to flow.



**Figure 4.2 The road to a Petroleum Fund (Drysdale 2007)**

<sup>89</sup> Although this is a choice of some significance it will not be explored in this thesis, because it was not ranked highly by the research participants as an issue of importance (see Chapter Five).

On 9 February 2002 Timor-Leste's constitution was approved. Section 139 of the Constitution established the basic conditions for management of Timor-Leste's natural resources and paved the way for some form of petroleum revenue management:

The resources... shall be owned by the State and shall be used in a fair and equitable manner in accordance with the national interests... The conditions for the exploitation of the natural resources... should lend themselves to the establishment of mandatory financial reserves (Constituent Assembly of East Timor 2002 :59).

Thereafter, the Government of Timor-Leste sought the opinion of the World Bank, the IMF, and the Asian Development Bank on how best to manage their petroleum revenue (Alkatiri 2003a). In early 2003, the IMF provided the Government with a report suggesting they establish a Petroleum Fund. That report was not made available to the public, and no reason was given for this lack of transparency. Statements by the Government about their plans for petroleum revenue management focussed on the IMF's suggestion that the model for Timor-Leste's petroleum revenue management should be based on Norway's Petroleum Fund.

The Government's decision to create a Petroleum Fund Law with many similarities to Norway's Fund was based on the assumption that Norway's model was appropriate within the East Timorese context. But, other than the fact that both countries exploit petroleum resources, there are few similarities between Norway and Timor-Leste. Even the contribution that petroleum wealth makes to each country's GDP differs markedly. Norway's petroleum industries, including crude oil and gas extraction, account for just 22.5% of GDP (Government of Norway n.d.). Timor-Leste's petroleum revenue is closer to 80% of GDP. Norway has a diverse industrial society and is the world's third largest oil exporter. Norway began exploiting petroleum resources in the North Sea in 1971, and has 35 years' experience in the industry. Norway's institutions, particularly its petroleum institutions, are much stronger, and they have a good deal more experience in the industry than Timor-Leste<sup>90</sup>. Norway's constitution is 200 years old, and Norway has one of the most democratic systems in Europe. Even before Norway's petroleum revenue flowed, Norway was a relatively rich, industrial nation. If sustainable petroleum revenue management depends on institutional strength as well as mechanisms to manage petroleum revenue wisely (as Chapter Two suggests), then Norway is well placed to manage its revenue effectively. If the balance of Norway's Fund is an indication of managing its revenue well, then it has — the market value of Norway's 'Government Pension Fund-Global' (formerly the Norwegian Petroleum Fund) is now NOK1,712.3 billion (the equivalent of about US\$277 billion). Timor-Leste, on the other hand, does not have the experience and institutional strength to complement the Petroleum Fund. Timor-Leste can

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<sup>90</sup> Norway is often used as an example of a country that has avoided the resource curse, but Roed Larsen suggests there has been some decline in their good fortune in recent years (Roed Larsen 2003).

‘appropriate’ the mechanisms<sup>91</sup> that Norway has used for its own benefit, but the success of that model will depend on institutional strength that Norway can not gift.

In Chapter Three (Table 3.1), the GDP and HDI of countries relevant to Timor-Leste were documented. Whilst Norway is a developed nation, ranked first of all the countries in the UN’s HDI (UNDP 2006a), Chad and São Tomé e Príncipe have more similarities with Timor-Leste. Chad provides an example of a country with institutions that are so weak that petroleum companies would not invest in the building of the pipeline there without the backing of the World Bank (Walsh 2004). The World Bank put conditions on their support of the project that included the establishment of a petroleum revenue management framework. Chad and Timor-Leste are similar in some ways. Chad has a long history of civil war, continued political instability, a weak judicial system, widespread corruption and a lack of institutional capacity. But, having won independence in 1960, Chad has had almost 50 years to develop. Today, Chad ranks 171<sup>st</sup>, of 177 countries, in the UN’s HDI (UNDP 2006a). Chad’s GDP per capita (PPP) is US\$2,090, life expectancy in Chad is 44 years, only 35 percent of the school age population is in school and only 26 percent of the adult population is literate (UNDP 2006a). Chad’s HDI ranking (171<sup>st</sup>) is lower than Timor-Leste’s (142<sup>nd</sup>), but its GDP per capita is higher (Timor-Leste’s is \$367).

São Tomé e Príncipe has even more similarities to Timor-Leste. São Tomé and Príncipe are small islands in the Gulf of Guinea; both were Portuguese colonies that became independent on 12 July 1975. There is a Joint Development Zone between São Tomé e Príncipe and its large neighbour, Nigeria, which operates under an arrangement that has similarities to the Timor Sea Treaty between Timor-Leste and Australia. São Tomé e Príncipe fares slightly better in the HDI than Timor-Leste, ranking number 127 (UNDP 2006a). São Tomé e Príncipe’s GDP per capita (PPP) is US\$1,231, life expectancy in São Tomé e Príncipe is 63 years, 63 percent of the school age population is in school and 83 percent of the adult population is literate (UNDP 2006a). São Tomé e Príncipe established a Petroleum Fund Law in October 2004. As at 2006, signature bonuses have been received, but petroleum fields have not yet been exploited. Chad and São

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<sup>91</sup> The main similarity between the Timor-Leste Petroleum Fund and the Norwegian model is that the outflow from the Petroleum Fund is the sum needed to cover the non-oil budget deficit, making net allocations to the Petroleum Fund equal to the total budget surplus including oil revenues. But, there are many other similarities. In both countries:

- The Ministry of Finance is responsible for the management of the Petroleum Fund
- The operational management is carried out by the Central Bank
- The Petroleum Fund is placed in a separate account and invested separately
- The fund's capital is invested offshore
- The Fund can be invested in bonds and equities
- Fund management is in accordance with guidelines set by the Ministry of Finance
- Withdrawals are sanctioned by Parliament
- The Fund is managed prudently
- The Ministry of Finance has an advisory council on investment strategy (In Norway the Investment Strategy Council, in Timor-Leste the IAB).
- The Central Bank publishes quarterly reports on the management of the Petroleum Fund, as well as an annual report and the reports are made public. (Government of Norway n.d.)

Tomé e Príncipe's experience in managing their petroleum wealth are used as examples in this chapter because of their similarities to Timor-Leste.

Despite some similarities to the Norway model, Timor-Leste attempted to develop a Petroleum Fund model that was distinctly East Timorese and served East Timorese purposes. Recognising the national importance of this institution, on 18 October 2004, the Government launched a public consultation on the Petroleum Fund that ran for six months and sought feedback on a Petroleum Fund Discussion Paper (MOPF 2004b) and the Petroleum Fund Draft Act (Ministry of Planning and Finance and Petroleum Fund Steering Group 2005). An analysis of this consultation process can be found in 'Portrait of a Petroleum Fund Consultation' by Drysdale (2007). The consultation process attempted to give all East Timorese an opportunity to participate in the Petroleum Fund Law's development. Public meetings were held throughout the consultation process, both in Dili and in the districts. Government officials (including the Prime Minister) attended and presented at the public meetings. The consultation documents were available from the Ministry of Planning and Finance website (MOPF 2007) in three languages (Portuguese, English and *Tetum*) and the meetings were (for the most part) conducted in *Tetum*. At least one meeting was televised and several meetings were broadcast on radio.

On 12 April 2005 a revised Petroleum Fund Draft Act was approved by the Council of Ministers (Democratic Republic of Timor-Leste 2005c) and sent to Parliament. Following further consultation by the Parliamentary Committee responsible for Economic and Financial matters, the Parliament made one amendment to the revised Petroleum Fund Draft Act before it was passed on 20 June 2005. This was the first occasion on which an Act had been passed unanimously by the Parliament of Timor-Leste, thereby symbolising parliamentary unity on this important issue of petroleum revenue management. The Petroleum Fund Law (Democratic Republic of Timor-Leste 2005d) was promulgated by the President, without amendment, on 3 August 2005, almost five years after Timor-Leste received its first petroleum royalty payment.

## 4.2 Timor-Leste's Petroleum Fund objectives

Broadly speaking, a natural resource fund (a Petroleum Fund in Timor-Leste's case) is an institution and a mechanism that distinguishes natural resource revenue from other revenue. By establishing a Petroleum Fund a state illustrates an intention to distinctly manage the funds from exploitation of petroleum resources, and this is a first step in accounting for such funds separately<sup>92</sup>. Where no Petroleum Fund exists, to determine how much revenue is received from the exploitation of petroleum resources, let alone how the revenue is spent (or mis-spent), particularly where institutions are weak, is more difficult (and in some cases impossible).

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<sup>92</sup> 'Petroleum Fund' and 'Natural Resource Fund' are used interchangeably throughout.

In this way, a Petroleum Fund can support fiscal discipline and the Preamble of Timor-Leste's Petroleum Fund Law states 'The Petroleum Fund shall be a tool that contributes to sound fiscal policy' (Democratic Republic of Timor-Leste 2005d). However, the mechanisms through which a Petroleum Fund does that may vary from one fund to the next. Davis et al. (2001; 2003) have provided the most comprehensive analysis of natural resource fund objectives to date. Depending on the mechanisms put in place a natural resource fund may achieve one or more of these objectives. This section explores three objectives that Timor-Leste's Petroleum Fund Law aims to achieve; stabilising the flow of petroleum revenue, financing the State budget, and saving some petroleum revenue for use in the future.

#### **4.2.1 Stabilising the flow of petroleum revenue**

The impact of the volatility of the flow of petroleum revenue was explained in Chapters Two and Three. A Petroleum Fund may serve to stabilise the flow of revenue by insulating the Government, and the economy, from revenue shocks that arise from the unpredictable nature of resource extraction and petroleum prices. Instead, this volatility and uncertainty is transferred to the Petroleum Fund, and the State uses a mechanism to limit expenditure. In this way a state can reduce the risk of 'Dutch disease' or volatility in the exchange rate, because revenue is not spent as quickly (or slowly) as it comes. Such funds are often referred to as 'stabilisation funds' (Davis et al. 2001; Davis et al. 2003).

The degree of flow stability and certainty attained depends on how the flow to, and from, the Petroleum Fund is mechanised. Sometimes the amount deposited or withdrawn from a Fund is based on contingencies that relate to externalities, such as oil price or production. The basis of a contingency-based approach is that when revenue is greater, more revenue is saved, and vice versa when revenue drops. Such funds operate in response to external factors, so they could quickly accumulate revenue, or are rapidly exhausted. Thus, a fund based on contingencies provides less stability, because a state can not be certain of the annual spending amount that will be available to it, and must expect fluctuations in available revenue<sup>93</sup>. If, instead, a state uses a rule for fund deposits, and withdrawals, which is not affected by externalities, the flow of petroleum revenue can be more stable.

Timor-Leste's Petroleum Fund Law stabilises the flow of petroleum revenue by creating the effect of a reservoir. Whilst some funds might save only a specified portion of petroleum revenue (perhaps just the interest earned), all of Timor-Leste's petroleum revenue is invested in the Petroleum Fund and small scale portions of revenue are withdrawn when needed (just as a reservoir gate allows water through when it is needed). In Timor-Leste's case, deposits are not

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<sup>93</sup> Davis and Ossowski (2001) explain that contingent funds with fixed rules can be difficult to design and operate, and may also be less transparent (particularly if the fund is financed from elsewhere, or funds are loaned).

contingent on any externalities and withdrawals depend only on the total estimated income (not short-term factors, such as price or production). The aim of this mechanism (which will be explained further in section 4.3.3) is that the withdrawals can, potentially, be of equal value every year. In this way the Government can plan its expenditure based on its long-term strategies rather than in response to the effects of the petroleum industry. This is indicative of Timor-Leste's prudent approach to petroleum revenue management.

The flow of petroleum revenue into a fund is also affected by decisions about when petroleum fields are exploited. This is pertinent in Timor-Leste's case, particularly because Timor-Leste has petroleum reserves that are both unexplored and unexploited. In Timor-Leste, there is no over-arching Government policy, or law, that determines when a petroleum field, once identified, should be exploited. This means that, in effect, decisions to exploit are not based on the need for revenue to fulfil the Government's strategies. Chapter Three (section 3.3.1) explained that revenue from the exploitation of Bayu-Undan is more than enough to sustain current levels of Government expenditure forever. The only reason, the Government gave to exploit the Greater Sunrise petroleum field was because there is a small risk that Bayu-Undan could fail (Borges and Lobato 2006). This rationale does not hold as a reason to explore or exploit other petroleum fields, but the Government is proceeding to do so. The revenue that these fields will generate will cause the Petroleum Fund to grow substantially and, like the water in the proverbial reservoir alluded to earlier, this revenue will put pressure on the mechanisms that affect the outflow from the Petroleum Fund. Despite the Petroleum Fund's allusion of stability, stability could be eroded as the ratio of the Petroleum Fund's balance relative to its outflow grows.

#### **4.2.2 Financing the State budget**

Timor-Leste's Petroleum Fund is also a financing fund, which is a fund that provides a source of revenue to fund a state's budget. When the Budget is in deficit, a withdrawal from the Fund is made to finance the Budget gap. Such a mechanism assumes there is enough revenue in the Petroleum Fund to finance that gap, and relies on the good governance of other institutions to ensure the Budget is not increased because the Petroleum Fund has the revenue to finance it. If a fund's sole purpose is to finance the State budget then the only withdrawals from such a fund would be to the Budget. Such integration between Timor-Leste's Petroleum Fund and the Budget provides a robust mechanism that can facilitate monitoring of petroleum revenue and enhance transparency and accountability.

The Norwegian 'Government Pension Fund-Global' (formerly the Norwegian Petroleum Fund) is also a financing fund, and this is the most significant similarity between Norway and Timor-Leste's Fund; all petroleum revenue is transferred to the Petroleum Fund and withdrawals cover the non-oil budget deficit. The Preamble of Timor-Leste's Petroleum Fund Law states the

Petroleum Fund is ‘coherently integrated into the State Budget’ (Democratic Republic of Timor-Leste 2005d). Figure 4.3 illustrates how East Timorese petroleum revenue flows from its receipt, into the Petroleum Fund and then to the State Budget for expenditure. The Figure also shows that other revenue<sup>94</sup> flows into the State Budget, which means that once petroleum revenue is deposited into the State Budget account it is indistinguishable from other revenue. Another option for Timor-Leste is to fund State Budget expenditure by taking a loan from an international financial institution (such as the IMF or the World Bank), but (as explained in Chapter 3) the Government of Timor-Leste has a policy of remaining debt-free.

The Petroleum Fund is an earmarked receipts account held by the Central Bank (under Article 5.2 of the Petroleum Fund Law) and all petroleum revenue must be deposited into that account. Other than management expenses paid to the Central Bank the only transfers out of the Petroleum Fund are electronic transfers ‘to the credit of a single State Budget account’ (Article 7.1). These transfers (or appropriations) must be approved by Parliament, and take place only after the publication of the Budget Law. The fact that the Petroleum Fund is integrated with the Budget means the mechanism is clear, and therefore simple for civil society to understand and to monitor. Other countries have developed much more complex models that hamper wise petroleum revenue management because of their complexity.

### **4.2.3 Saving for the future**

Timor-Leste’s Petroleum Fund can also be described as a savings fund. In Chapter Two the dilemma of simultaneously meeting current and future generations’ needs was discussed. A savings fund is designed to assist the Government to create a store of wealth for future generations. The rationale for saving is that all non-renewable resources are finite and, based on that rationale, a state must recognise and plan for the eventual decline and exhaustion of this natural resource income (Davis et al. 2003). A savings fund has the potential to meet the needs of both current and future generations, if the mechanism that determines expenditure results in enough revenue to do so. However, even if the mechanism ensures revenue is equitably spent now and in the future, there are other factors that determine whether the relevant generation’s needs are met (e.g. the quality of institutions and governance). Despite those other factors, ensuring that revenue is shared equitably between current and future generations is a necessary starting point.

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<sup>94</sup> Domestic revenue, autonomous agency revenue and donations were explained in section 3.2.3.

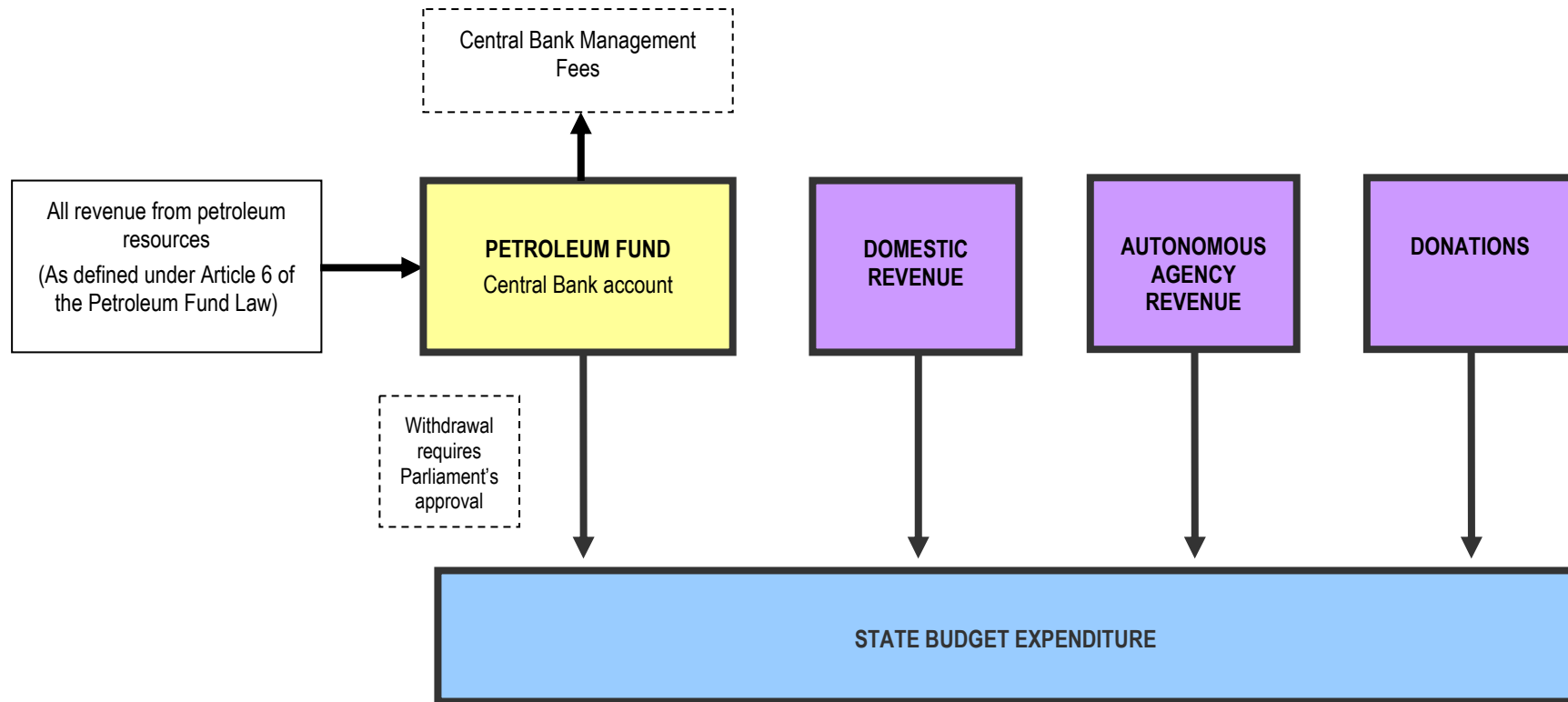


Figure 4.3 The flow of Timor-Leste's Petroleum Revenue

Timor-Leste's Constitution, under the heading of Economic, Social and Cultural Rights and Duties, has regard to sustainability in an environmental context. Figure 4.4 presents Section 61 (Environment) of the Constitution. Sub-section 61(1) is specifically about the sustainability of the environment. This sub-section illustrates the concept of current generations having regard to preserving environmental benefits for future generations. As sub-section 61(1) is not specifically about the use of the environment, but rather about its preservation, it's only relevance to petroleum revenue management is that it recognises that the exploration and exploitation of natural resources may impact on the environment (and that in turn may impact on potential revenue).

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The Constitution of the Democratic Republic of Timor-Leste - Section 61

Environment

1. **Everyone has the right to a humane, healthy, and ecologically balanced environment and the duty to protect it and improve it for the benefit of the future generations.**
  2. **The State shall recognise the need to preserve and rationalise natural resources.**
  3. **The State should promote actions aimed at protecting the environment and safeguarding the sustainable development of the economy.**
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Figure 4.4 Section 61 of Timor-Leste's Constitution (Constituent Assembly of East Timor 2002)

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Sub-section 61(2) suggests that natural resources should be preserved, but how one preserves and rationalises natural resources at the same time (or what that means) is not explained. The phrase 'recognise the need' suggests the word 'preserve' does not mean the State intends all natural resources should be preserved in their pristine entirety. The State exploits its petroleum resources to create revenue, and thus does not illustrate an intention to preserve resources. Perhaps, instead, the meaning of the Constitution is that some non-renewable natural resources can be exploited (e.g. minerals and petroleum) whilst stocks of renewable natural resources (e.g. forest) should be preserved. Another interpretation is that the value of the natural resources (rather than the natural resources themselves) is preserved. Section 61(3) supports this last interpretation. Section 61(3) suggests that the State's position is that natural resources may be exploited if the environment is protected and sustains the economy.

Thus, the Constitution does not ensure that petroleum revenue is saved for future generations, and nor is saving revenue for expenditure in the future the primary objective of Timor-Leste's Petroleum Fund Law. Arguably, though, saving petroleum revenue is a corollary of the other objectives of Timor-Leste's Petroleum Fund Law. Petroleum revenue may be saved for future expenditure as a consequence of the fact that all petroleum revenue is placed in the Petroleum Fund to begin with. If, for example, the amount of the Budget was increased such that all the revenue in the Petroleum Fund was withdrawn, there would be none saved for future

generations<sup>95</sup>. However, Timor-Leste's Petroleum Fund Law does specify that management of the Petroleum Fund shall be in accordance with the principle of good governance for the benefit of current and future generations (Article 11.4). The mechanism (which will be explored in section 4.3.3), by which the Petroleum Fund regulates expenditure, also provides for petroleum revenue to be spent sustainably. However, the use of that mechanism is not legally binding; it is just used as a guide for the decision-makers. Thus, it is within the law for the decision-makers to choose to spend more revenue now, and leave less for future generations. For this reason, once again, the Petroleum Fund relies on the good governance of other institutions to achieve sustainable management of Timor-Leste's petroleum revenue, and to ensure that some revenue is saved for expenditure in the future. Some comparable funds have a mechanism by which such an event (i.e. leaving no revenue for future generations) could be avoided. For example, Chad's Revenue Management Law (1999) puts ten per cent of its revenue into a 'Future Generations' Fund, and the Oil Revenue Management Law of São Tomé e Príncipe requires that a portion of the oil revenue be transferred to a sub-account, the Permanent Fund, for the benefit of future generations of São Toméans. In theory, these special funds would provide some revenue for future generations in the event that other accounts were misused.

This section has identified three objectives that Timor-Leste's Petroleum Fund Law attempts to achieve, either by design or consequence. By virtue, or as a corollary, of its existence a natural resource fund can also achieve a number of other objectives. For example, a natural resource fund may achieve political objectives and assist the Government to resist spending pressures. If there are constraints on spending resource wealth and there are public processes and mechanisms (such as parliamentary approval) which must be undertaken to enable spending it is more difficult for revenue to be misused. Such barriers, or limits, to expenditure could be used as a reason or an excuse in the face of pressure from the public who perceive that funds could be better spent elsewhere.

Timor-Leste's Petroleum Fund has mechanisms, the functions of which are to stabilise the flow of petroleum revenue, save revenue for future generations, and to finance its budget simultaneously. For the most part, these objectives will simultaneously be met, but there may be occasions when they conflict. Further, the mechanism which regulates expenditure is only a guide and if not used as a rule, the amount of petroleum revenue withdrawn may become erratic and differ markedly from one year to the next, thereby making it difficult for the Government to plan. This would be the result of a lack of governance across the board, in the context of which the mechanisms of a fund would possibly be of little assistance.

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<sup>95</sup> The fact that the word 'future' is not defined in the Petroleum Fund Law is noted. This means that saving for the future does not necessarily mean future generations, but perhaps in the next 10 or 20 years.

## 4.3 Institutional mechanisms to manage petroleum revenue in Timor-Leste

The details of how Timor-Leste's Petroleum Fund Law works will determine the way in which petroleum revenue is handled. This section explores these details, proceeding logically from the definition and receipt of petroleum revenue, and its deposit into the Petroleum Fund (inflow), to the investment of the revenue and, finally, the expenditure of the revenue (outflow). The analysis of the mechanisms the Government uses to manage petroleum revenue are based on two objectives; ensuring that Timor-Leste's petroleum revenue can not be illegally used (i.e. outside the terms of the Law), and the wise use of Timor-Leste's petroleum revenue.

### 4.3.1 Petroleum Fund inflow

The definition of what constitutes petroleum revenue must be known and commonly understood, and the definition should be as comprehensive as possible, otherwise rent-seekers will find loop holes to achieve their ends. Definitions of petroleum revenue or, rather, the revenue that must be deposited into a country's petroleum fund, can differ markedly. Gary and Reisch (2005) claim that in Chad, much of the oil revenue falls outside of the Law because Chad's Revenue Management Law (1999) applies to only three fields (Komé, Miandoum and Bolobo). Further, only direct revenue (dividends and royalties) must be deposited into Chad's Petroleum Fund, whilst so-called indirect revenue (taxes and customs duties on oil production) goes into the nation's public accounts (in theory)<sup>96</sup>.

Under Timor-Leste's Petroleum Fund Law, petroleum revenue is called 'Petroleum Fund Receipts' and defined under Article 6 (Figure 4.5). Timor-Leste's definition of petroleum revenue appears to be encompassing (although not as comprehensive as Norway's<sup>97</sup>). However,

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<sup>96</sup> According to Gary and Reisch (2005), such in-direct revenue may represent as much as 45% of total revenue over the life of the project.

<sup>97</sup> Norway's definition of petroleum revenue (Government of Norway 1990) is much more detailed, as follows:

The cash flow is the sum of

- total tax revenues and royalty deriving from petroleum activities collected pursuant to Petroleum Taxation Act (no. 35 of 13 June 1975) and the Petroleum Activities Act (no. 72 of 29 November 1996),
- revenues deriving from tax on CO<sub>2</sub> emissions due to petroleum activities on the continental shelf,
- revenues deriving from the State's Direct Financial Interest in petroleum activities, defined as operating income and other income less operating expenses and other direct expenses,
- central government revenues from net surplus agreements associated with certain production licences,
- dividends from Statoil ASA,
- transfers from the Petroleum Insurance Fund,
- central government revenues deriving from the removal or alternative use of installations on the continental shelf,
- any government sale of stakes representing the State's Direct Financial Interest in petroleum activities,
- less
- central government direct investments in petroleum activities,
- central government expenses in connection with the Petroleum Insurance Fund,
- central government expenses in connection with the removal or alternative use of installations on the continental shelf,

the definition assumes that all petroleum revenue is received by Timor-Leste (the Government). The Petroleum Fund Law does not require companies to publish what they pay to the Government, or to individuals (inside or outside of the Government), so there is no audit of the amounts received. If an individual were to receive a payment from a petroleum company, they could argue that it was not a Petroleum Fund receipt under the definition (as Article 6 refers to amounts received by Timor-Leste).

<b>Petroleum Fund Law - Article 6</b>	
<b>Petroleum Fund Receipts</b>	
6.1	The following amounts are Petroleum Fund gross receipts: (a) The gross revenue, including Tax Revenue, of Timor-Leste from any Petroleum Operations, including prospecting or exploration for, and development, exploitation, transportation, sale or export of petroleum, and other activities relating thereto; (b) Any amount received by Timor-Leste from the Designated Authority pursuant to the Treaty; (c) Any amount received by Timor-Leste from the investment of Petroleum Fund Receipts; (d) Any amount received from direct or indirect participation of Timor-Leste in Petroleum Operations; and (e) Any amount received by Timor-Leste relating directly to petroleum resources not covered in paragraphs (a) to (d) above.
6.2	In the event that Timor-Leste participates in Petroleum Operations indirectly, as provided for in paragraph 6.1(d), through a national oil company, the receipts of the Petroleum Fund shall include the following: (a) Any amount payable by the national oil company as tax, royalty or any other due in accordance with Timor-Leste law; and (b) Any amount paid by the national oil company as dividend.
6.3	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.

Figure 4.5 Petroleum Fund Law definition of petroleum revenue (Democratic Republic of Timor-Leste 2005d)

A lack of transparency, such as this, is open to exploitation. When the Government of Chad was accused of mispending a signature bonus, they argued that signature bonuses did not come under the definition of petroleum revenue in the law. During the consultation to develop Timor-Leste's Petroleum Fund Law, Sandbu (2005) pointed out the definition of Petroleum Fund receipts did not specifically include signature or production bonuses. Other submissions (e.g.

- any government purchase of stakes as part of the State's Direct Financial Interest in petroleum activities.
- Net financial transactions associated with petroleum activities are the sum of:
- gross revenues from government sale of shares in Statoil ASA,
  - less
  - government capital contributions to Statoil ASA and companies attending to government interests in petroleum activities.

Global Witness and Catholic Agency for Overseas Development 2004) suggested that petroleum-related payments not paid into the Petroleum Fund should be banned or prohibited.

There are potentially gaps in Timor-Leste's definition of petroleum revenue that are yet to be tested. But, already a situation can be imagined in which revenue that might be considered petroleum revenue by some, under Article 6, will not be deposited into the Petroleum Fund. In a presentation on 'local content'<sup>98</sup>, Soares (2006b) talked about projects funded by petroleum companies covered under Production Sharing Contracts and also Memorandums of Understanding (MoUs) with other countries which undertake petroleum industry-related activities in Timor-Leste (e.g. an MoU with Kuwait to promote the construction of an LNG plant and bring a pipeline onshore). At the same time, a diagram (Soares 2006a) showed that the revenue from such projects would not flow through the Petroleum Fund and stated 'the independent investment projects give no revenue to Government', because the projects are the responsibility of the Petroleum Company. Although it might seem clear to the Government and the Petroleum Companies that this revenue is distinct from 'Petroleum Fund Receipts' under the Petroleum Fund Law, in practice, with less well-intentioned decision-makers, this arrangement could provide an opportunity for Petroleum Companies to provide funds to corrupt decision-makers under the auspices of a 'local content' project.

### **4.3.2 Investing petroleum revenue**

Another important aspect of managing Timor-Leste's petroleum revenue wisely is how that revenue is invested. Timor-Leste's petroleum revenue will be invested entirely offshore (Article 14 & 15), which has three benefits. First, it allays concerns there might be bias in investment choices (for example, political elites investing in family businesses). Second, investing offshore can help to avoid corruption, because investing in Timor-Leste would provide more opportunities for corruption (with businesses competing for contracts, for example). Third, there are currently few opportunities to invest revenue (certainly not billions of dollars) in Timor-Leste, because industry and infrastructure are not yet developed. So it is not possible to invest wisely in Timor-Leste now. For these reasons, to invest in Timor-Leste at this time would entail higher risk and lower return, and thus investing the revenue offshore offers a conservative approach to investment. Timor-Leste is not unique in choosing to invest their revenue offshore; Norway, São Tomé e Príncipe and Chad also invest their Petroleum Funds entirely offshore.

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<sup>98</sup> A Draft Decree Law on Local Content (Ministry of Natural Resources Minerals and Energy Policy 2007) was released for public consultation on 30 May 2007. Local Content, or Timor-Leste content 'Timor-Leste content means the money and resources provided by Authorised Persons in the petroleum sector to Timor-Leste for sustainable development, or money spent by Authorised Persons on Timorese goods and services.' (Ministry of Natural Resources Minerals and Energy Policy 2007 :2).

Timor-Leste's choice of investment strategy is also conservative. The Petroleum Fund Law specifies that not less than 90% of the revenue will be invested in 'qualifying instruments'<sup>99</sup>. These qualifying instruments are defined in Article 15 (Figure 4.6). By investing Timor-Leste's petroleum revenue in this way, the majority of investments will potentially provide a lower return, but also will carry a lower risk of loss (than if revenue was invested elsewhere). The other 10% (or less) of the Petroleum Fund may be invested in other instruments so long as they are 'issued abroad, liquid and transparent, and traded in a financial market of the highest regulatory standard' (Article 14). These investments could potentially provide a higher return, but may also incur a greater risk of loss.

#### **Petroleum Fund Law - Article 15**

##### **Qualifying Instruments**

- 15.1 Subject to other provisions of this present article, a qualifying instrument is:
- (a) a debt instrument denominated in United States Dollars that bears interest or a fixed amount equivalent to interest, that is:
    - (i) rated Aa3 or higher by the Moody's rating agency or rated AA– or higher by Standard & Poor's rating agency; and
    - (ii) issued by or guaranteed by the World Bank or by a sovereign State, other than Timor-Leste, provided the issuer or guarantor is rated Aa3 or higher by the Moody's rating agency or rated AA– or higher by Standard & Poor's rating agency; or
  - (b) a United States Dollars deposit with, or a debt instrument denominated in United States Dollars that bears interest or a fixed amount equivalent to interest issued by:
    - (i) the Bank for International Settlements;
    - (ii) the European Central Bank; or
    - (iii) the Central Bank of a sovereign State, other than Timor-Leste, with a long-term foreign currency rating of Aa3 or higher by the Moody's rating agency or AA– or higher by the Standard & Poor's rating agency;
    - (iv) a bank designated by Moody's rating agency with a long-term foreign currency rating of Aa3 or higher or designated by Standard & Poor's rating agency with a long-term foreign currency rating of AA– or higher.

Figure 4.6 Petroleum Fund Law definition of qualifying instruments (Democratic Republic of Timor-Leste 2005d)

The original draft of the Petroleum Fund Act suggested that 100% should be invested in qualifying instruments (a more conservative investment approach). However, during the Petroleum Fund Consultation, the World Bank (2005a), the IMF (2005b) and Timor-Leste's Central Bank (BPA 2005) each suggested that at least a small proportion of the Petroleum Fund should be invested in higher risk, but similarly well-managed assets. The rationale for allowing a small portion of the Fund to be invested elsewhere was to allow the Central Bank staff to

<sup>99</sup> Article 15 of the Petroleum Fund Law also requires all investments to be invested in United States dollars. Participants in this research responded that the choice of investment currency was not relatively important (see Chapter Six) so this aspect of Timor-Leste's petroleum revenue management will not be explored.

develop the capacity to learn about these kinds of investments. With that in mind, the Government responded by allowing a 90:10 ratio<sup>100</sup>. However, under the Law, this arrangement can be revised after five year's of the Petroleum Fund's existence, which means that the portion of the Fund that can be invested in higher risk assets could increase.

There are other provisions under the Petroleum Fund Law to ensure Timor-Leste's investments are soundly managed. An Investment Advisory Board or IAB<sup>101</sup> (Article 16) advises the Minister of Planning and Finance with respect to investment strategy, including benchmarks for desired investment returns, risk of investments, instruction for External Investment Managers, and their performance. The duties of the External Investment Managers are to maximise the return on the Petroleum Fund investments, with regard to appropriate risk, abide by an Operational Management Agreement and take instructions from the Minister (Article 12.5). The External Investment Managers are appointed by the Central Bank and are bound by several constraints on the decisions they make regarding investment of the Petroleum Fund. Revenue saved in the Petroleum Fund must be prudently managed, invested securely in low-risk financial assets offshore, and investment performance is periodically evaluated.

Timor-Leste's plan to invest its petroleum revenue offshore in low risk instruments fits with its aim for prudent management of its petroleum revenue. Unfortunately, Timor-Leste's conservative plans to manage its petroleum revenue well may not prevent poor investment choices. There are examples of countries that had plans in place to manage their natural resource wealth well, but failed. Nauru is a country that was once rich with the revenue earned from exploitation of its phosphate resources. In 1968, each Nauruan man, woman and child was worth \$3.5 million (today's equivalent of \$500,000 then) as a result of their good phosphate fortune (Hughes 2003). Their resource revenue was invested in a portfolio. The investments proved to be high risk and within a matter of decades Nauruans went from having the highest per capita income in the world to one of the poorest (Hughes 2003). The Nauruans have seen their once-vast portfolio of \$US800 million in assets dwindle to little more than US\$250 million (Pettafor 2004). Nauru is now so poor that the Australian Government considered a plan to relocate the citizens of Nauru to Australia, because their environment and economic prospects are such that they will continue to be aid-dependent (Forbes 2003). Nauru had plans to manage their revenue wisely, but they received poor investment advice and their institutions have progressively weakened<sup>102</sup>.

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<sup>100</sup> As at December 2006, 100% of Timor-Leste's Petroleum Fund is invested in qualifying instruments.

<sup>101</sup> Members of the IAB (defined under Article 17.1) are the Director of Treasury, the Head of the Central Bank, two persons appointed by the Minister with significant experience in investment management, and one other person appointed by the Minister of Planning and Finance.

<sup>102</sup> In 2004, *The Australian* newspaper reported that the Nauruan Government was in crisis; the Nauruan Parliament could not stand because the two sides could not agree on a speaker. Mining has left much of Nauru uninhabitable and they had plans to make the island an offshore banking centre (at one time 400 offshore banks were registered to one

In an attempt to diffuse the potential for poor investment decisions in Timor-Leste, a local NGO, *La'o Hamutuk* (2005) suggested that each investment manager's portfolio should be limited to no more than 30% of the Petroleum Fund, but the Petroleum Fund Law remains without this restriction. Under the Petroleum Fund Law, Timor-Leste's Central Bank could appoint just one investment manager who could be responsible for the entire Fund (Article 12). At the present time only 10% of the Petroleum Fund can be invested in instruments other than those designated qualifying instruments, but in future this portion could be much higher (if the Petroleum Fund Law is changed). If one investment manager was responsible for a large portion of Timor-Leste's Petroleum Fund and made a poor investment decision there could be disastrous implications for Timor-Leste (particularly if the amount that could be invested in 'other instruments' was much greater than 10%).

Further, despite Timor-Leste's plans to invest conservatively, the Petroleum Fund Law provides for the range of qualifying instruments to be reviewed after five years (Article 14.3) and, in any case, the Law can be amended by Parliament at any time. Timor-Leste's Central Bank has stated it will choose lower risk investments until their staff build the capacity to manage investments of higher risk. At some point, therefore, Timor-Leste's investment strategy may change and, potentially, involve greater risk. The Norwegian model is as an example of how a Petroleum Fund can evolve. The Norwegian Parliament passed its equivalent petroleum fund law in 1990 (Government of Norway 1990) and the first net transfer was in 1996. In 1998 investment in equities was introduced into the benchmark, and in 2004 Ethical Guidelines on Investment were introduced<sup>103</sup> (Government of Norway 2004). In 2005 the Norwegian Petroleum Fund Law was amended and the 'Petroleum Fund' became the 'Government Pension Fund-Global'; the Petroleum Fund's main objective now is 'to facilitate government savings necessary to meet the rapid rise in public pension expenditures in the coming years' (Government of Norway 2005). Timor-Leste's model will evolve as well; the Petroleum Fund Law is not static, change may be inevitable.

### 4.3.3 Petroleum Fund outflow

Decisions on how much revenue is withdrawn from the Petroleum Fund, and for what purpose, are perhaps the most important that the Government must make. The Petroleum Fund Law does not specify how many withdrawals can be made each year, but withdrawals 'shall only take

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government mailbox), but rumours of money laundering caused the Group of Seven countries to consider sanctions. Nauru bowed to international pressure and revoked the banking licences. (Pettafor 2004)

<sup>103</sup> Norway's Ethical Guidelines on Investment are based on two premises; that the instrument ensures that a reasonable portion of the country's petroleum wealth benefits future generations and that the Petroleum Fund should not make investments which constitute an unacceptable risk that may contribute to unethical acts or omissions, such as violations of fundamental humanitarian principles, serious violations of human rights, gross corruption or severe environmental damages. (Government of Norway 2004)

place after the publication of the Budget law, or any subsequent changes thereto' (Article 7.3). Generally, as the Government prepares an annual budget and a mid-year budget update, one assumes there could be one or two withdrawals annually. Each withdrawal must be approved by Parliament and the Parliament must previously have been informed of the value of ESI<sup>104</sup>. The calculation of ESI is explained in Schedule 1 of the Petroleum Fund Law (see Appendix 2), and is the amount of money that can be withdrawn from the Petroleum Fund each year so that the Petroleum Fund will always provide for State Budget expenditure.

The calculation of ESI is revised each year because it depends on the total expected petroleum revenue (and this is affected by various factors such as oil price, production, etc.) The value of ESI also depends on how much revenue is actually withdrawn from the Petroleum Fund each year because there is no rule that says Parliament must withdraw an amount equal to ESI each year. Parliament may choose to withdraw more or less than ESI. If less than the value of ESI is withdrawn each year, the value of the Petroleum Fund will increase (all else being equal). If more than the value of ESI is spent<sup>105</sup> (and all else is equal) the value of the Petroleum Fund will decline until eventually (sooner or later, depending on the extent of over-expenditure) there is no revenue left in the Petroleum Fund. The formula for ESI (provided in Appendix 2) is not based on contingencies, and is relatively easy to determine, which for East Timorese citizens wanting to monitor petroleum revenue is a blessing.

A Petroleum Fund from which an amount that is the value of ESI is withdrawn every year will be sustainable, but ESI is a guide, not a rule, and Timor-Leste's Petroleum Fund Law has no ceiling on withdrawals and no minimum balance<sup>106</sup>. The Law lacks a mechanism to regulate expenditure above ESI and theoretically the Parliament could approve a withdrawal of the entire Fund. Thus, ensuring the amount withdrawn from the Petroleum Fund each year is sustainable does not depend on the Petroleum Fund Law, but on good governance and the strength of institutions; the Parliament in particular. Nevertheless, the experience of other countries indicates that having a rule for withdrawals does not stop rent-seekers. Elek (2001) explains that Papua New Guinea established a Mineral Resources Stabilization Fund (MRSF) in 1974, including rules for withdrawal which would, in theory, provide a stable flow of revenue.

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<sup>104</sup> The Petroleum Fund Law legislates that the Independent Auditor must also certify the amount of ESI (Democratic Republic of Timor-Leste 2005d :Article 8).

<sup>105</sup> If the Government or the Parliament proposes to make a transfer that exceeds ESI, under Article 9, the Government must provide the Parliament with a report estimating the amount by which ESI would be reduced for that Fiscal Year as a result. The Independent Auditor must also certify this report. The Government must also provide a detailed explanation of why it is in the long-term interests of Timor-Leste to transfer from the Petroleum Fund an amount in excess of the ESI. (Democratic Republic of Timor-Leste 2005d)

<sup>106</sup> Concerns that there are no rules or ceilings to limit the amount Parliament can withdraw from the Petroleum Fund were raised in the submissions (e.g. Drysdale 2005a) when the Petroleum Fund Act was drafted, but the Government chose to proceed without amendment. In the Petroleum Fund Discussion Paper circulated by the Government (MOPF 2004b) there were three options for a 'fiscal policy guideline' and the paper referred to another three 'inferior' strategies, but concluded by outlining the Government's 'preferred' policy (ESI) and there was little or no debate on this issue.

However, as time passed the fiscal discipline weakened and withdrawals from the MRSF increased.

Another difficulty with using the value of ESI as a guide (or a rule for that matter) is that it assumes other variables are constant. This model of petroleum revenue management assumes that variables such as the spending requirements of government and the size of the population are constant from year to year, which they are not. The population of Timor-Leste will vary significantly from year to year and thus the spending requirements of government will alter, particularly in the health and education sectors. With Timor-Leste's population growth the highest in the world at 4.7% (UNDP 2006a), this is not an insignificant factor in terms of planning the State's expenditure.

Timor-Leste's Petroleum Fund Law does not include guidelines or rules for how the petroleum revenue should be spent. Rather, the Parliament is the institution that decides how the Budget is spent. São Tomé e Príncipe's Bill of Law on Oil Revenues does specify that petroleum revenue should be spent on poverty reduction, certain priority sectors, and institutional development. São Tomé e Príncipe's Law also specifically reserves seven percent for the island of Príncipe, and ten percent for local governments. Chad is another example of a country that has rules for expenditure of its petroleum revenue. Chad's Revenue Management Law (1999) stipulates that 80% of petroleum revenue must be directed to expenditure on priority sectors (public health and social welfare, educational infrastructure, rural development, environment and water resources), and 5% must be directed to the decentralised authorities in the oil-producing regions<sup>107</sup>. Unfortunately, Chad also provides an example of how such laws can be broken, and petroleum revenue mismanaged. Until 2005, no revenue had been disbursed to the oil-producing regions (Gary and Reisch 2005). Given Chad's Revenue Management Law does not specify which regions revenue should be disbursed to, all the investments could be made in one region, according to political preference, for example (Open Society Institute and Revenue Watch Iraq 2005). Further, despite the intention of spending on priority sectors, shortly after Chad's oil revenue began to flow, the Government spent US\$4 million of a US\$25 million signing bonus (referred to in section 4.3.1) to purchase military equipment. Technically, the decision-makers argued, this money was not covered by the agreements with the World Bank, but Greg Binkert (the World Bank's director in Chad) acknowledges that it broke the spirit of the scheme the Bank was trying to foster (Walsh 2004)<sup>108</sup>.

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<sup>107</sup> Gary and Reisch (2005) point out institutions related to the judiciary, or the rule of law, are not priority sectors. Given the lack of strength in these institutions and the poor implementation of Chad's Revenue Management Law, they probably should be.

<sup>108</sup> Chad's President Deby told the World Bank that he regretted spending the money on weapons, but other senior figures in the Chadian government retain a 'flexible' attitude to the oil revenues. The Government's national oil coordinator, Haroun Kabadi, said the oil revenues should only be reserved for social spending, but this could not be guaranteed in 'an emergency'. (Walsh 2004)

Another option for expenditure of petroleum revenue is to provide individual payments to citizens. Citizens of Alberta, Canada and Alaska, USA have enjoyed annual dividend payments from their Petroleum Funds, but in these states petroleum revenue is not central to the economy. Both states receive substantial amounts of revenue from other domestic sources and can use that revenue to build roads, schools, hospitals, etc. In these countries, the petroleum payments are a ‘bonus’ for most of their citizens, not a necessity, as they might be elsewhere. For countries that do not have enough domestic revenue to fund their state’s budget it might be counter-productive to use their petroleum revenue to fund individuals’ needs. However, there are some that disagree.

Sala-i-Martin and Subramanian (2003) have argued that if natural resource revenue is being mismanaged by the Government (and not benefiting the people) then it does make sense to distribute the revenue as dividend payments. They use Nigeria as an example of a country where such a plan would have benefits:

Of course, one implication of our proposal would be that the Government would lose revenue. In fact, if our proposal were to be implemented, the Government would [lose] all the revenue that it now collects directly from the sales of oil. Although this would seem tragic to some, this is indeed what happens to most governments in the world. And, as most of those governments, if the Nigerian authorities want to raise resources for necessary public expenditures, they would have to raise them by taxing the Nigerian citizens and companies. Our reading of the evidence is that it would be much more difficult to mismanage the resources that come from taxes than those that fall from the sky like manna. This would therefore create the right incentives for governance, incentives that are now sorely missing, and would contribute to reduce corruption and the rest of the problems that affect the Nigerian institutions today. (Sala-i-Martin and Subramanian 2003 :18)

However, if the reason revenue does not benefit the people is because the Government is corrupt, and the institutions are weak, such a state is unlikely to have the capacity, let alone the will, to put in place the mechanisms to distribute such wealth to its citizens (nor the mechanisms to gather taxes to fund state expenditure in other ways as Sala-i-Martin and Subramanian suggest). Such a proposal was suggested for Iraq (Vieth 2003), but would have provided Iraqis with just an extra US\$110 a year (Palley 2003). There are many Iraqis who do not have that much money each year, but such a payment will not greatly enhance the lives of the poor people if the Government does not also have the institutional strength and the funds to re-build the country’s infrastructure and social services<sup>109</sup>.

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<sup>109</sup> Casassas et. al. (2004) have suggested that Timor-Leste should establish a system of ‘Basic Income’. However, they have not explained how the Government would fund its State Budget if petroleum revenue were used to fund a Basic Income instead, and nor have they provided any long term financial analysis of whether Timor-Leste’s petroleum revenue could sustain both a Basic Income and State expenditure.

In Timor-Leste's case, once revenue is withdrawn from the Petroleum Fund and deposited into the Budget it is indistinguishable from other state revenue (as Figure 4.3 illustrated) and there are no guidelines that dictate its expenditure. Rather, state expenditure in Timor-Leste, as a whole, is dictated by the National Development Plan (Planning Commission 2002). This means that plans for State expenditure do not revolve around the idea that petroleum revenue is abundant, but rather plans for expenditure sit within a separate institution, and they are debated and approved by the Parliament.

## **4.4 Monitoring petroleum revenue**

Chapter Two illustrated that transparency and accountability are crucial to trust in public institutions. Civil society's trust in the Government of Timor-Leste is fragile, as discussed in Chapter Three. Transparency and accountability in the management of petroleum revenue are paramount, and will be essential if Timor-Leste is to manage its petroleum revenue wisely, and avoid the resource curse. Institutions that hold the Government to account and ensure petroleum revenue is managed transparently must be strong, otherwise members of the Government will potentially be able to subvert such mechanisms, and the mismanagement of petroleum revenue and conflict will increase. This section reviews the Petroleum Fund Law and other institutional mechanisms that are designed to ensure the transparent and accountable management of Timor-Leste's petroleum revenue.

### **4.4.1 Transparency**

The resource curse can not be avoided, and misuse of petroleum revenue can not be prevented, without transparency. Transparency, or transparent accounting, is widely regarded as the key to resolving issues of waste and corruption (Department for International Development 2007). Independent reporting of transactions is now widely demanded of countries that have problems with corruption. Governments and NGOs have also established a number of initiatives in order to improve accounting mechanisms between energy companies and governments, thereby enhancing transparency. Such initiatives are designed to improve accountability in Government, and to promote better fiscal management.

Timor-Leste has adopted transparency as a fundamental principle of the Petroleum Fund Law; 'The management of the Petroleum Fund shall always be carried out, and the related duties of all relevant parties shall be discharged, with the highest standard of transparency' (Article 32.1). However, the Government has not set a good example of transparency. Prior to the development of the Petroleum Fund Law, the Government of Timor-Leste sought advice from the IMF regarding management of their petroleum revenue. The IMF provided the Government with a report that was never made public. The IMF claimed it was up to the Government to release it

(Al-Eyd 2004), and the Government claimed they could not release it without the permission of the IMF (Alkatiri 2004). This is an example of a lack of transparency by both the Government of Timor-Leste and the IMF. Transparent management of petroleum revenue requires three actions; the preparation of relevant information by the responsible authority, the publication of that information, and the cognisant observation of that information. The Petroleum Fund Law provides some mechanisms to facilitate these actions and this section analyses those provisions.

The balance of the Petroleum Fund and some details of its investment (e.g. market trends, portfolio performance and any withdrawals from the Petroleum Fund) are available on a quarterly basis through Timor-Leste's Central Bank. The Central Bank has published a quarterly report on the Petroleum Fund since the Petroleum Fund was established. On some occasions, access to the quarterly reports through the Central Bank's website has been delayed because of technical difficulties, but the Reports are generally available in Portuguese, *Tetum* and English.

However, analysis of the reporting of Petroleum Fund revenue and associated provisions under the Petroleum Fund Law reveals anomalies in Timor-Leste's quest for transparency. Analysis of the Petroleum Fund Law reveals that the Government has enabled a range of information to be made available to the public, but not all information provided under the Law is made available to the public. Table 4.1 lists the information generated by the Petroleum Fund Law, and distinguishes that which is available to the public and that which is not. Information not available to the public includes the declaration of assets of the IAB and the Consultative Council (explained in section 4.4.2). If a declaration of assets is not made available to the public, it serves little purpose (particularly if the internal mechanisms which judge the validity of those declarations are corrupt). The requirement that the individuals from these institutions declare their assets was included in the Law as an amendment by the Parliament. Both IAB and Consultative Council members must 'on occasion of taking and vacating office, submit a declaration concerning their assets and income from property and capital, including information relating to their bank accounts' (Articles 17.4 and 27.6).

By contrast to the requirements of the IAB and the Consultative Council, the Petroleum Fund Law does not require the External Investment Managers, or any other individual or institution with responsibilities under this law, to declare their assets. The former Prime Minister Alkatiri reported that the Government would 'commence on worlds best practice declaration of interests for public officials' and '[the] petroleum laws already prohibit public officials (including members of parliament and parliamentarians) from directly or indirectly holding an interest in any entity that seeks or holds authorization for a petroleum activity authorization or PSC

<b>Information provided to the public</b>	<b>Relevant Section of Law</b>	<b>Responsibility for preparation</b>
Quarterly Report	13.2	Central Bank
Annual Report includes:	23	Government
- Audited financial statements	24.1(a)	Indep. Auditor
- List of the qualifying instruments	24.1(a)	Indep. Auditor
- Advice provided by the IAB	24.1(b)	Minister
- Payments made as Petroleum Fund Receipts	24.1(b)	Minister
- Discrepancy between payments made and which should have been made	24.1(b)	Minister
- Statement identifying any accounting issues	24.1(c)	Dir. Treasury
- Income derived from Petroleum Fund investment cf. previous three years	24.1(d)	Government
- Comparison of nominal income on investment with real return	24.1(e)	Government
- Comparison of income derived with benchmark performance indices	24.1(f)	Government
- Comparison of ESI with the sum of transfers from the Petroleum Fund	24.1(g)	Government
- Members of the IAB	24.1(i) (iii)	Government
- The identity of the External Investment Managers	24.1(i) (iv)	Government
- Members of the Petroleum Fund Consultative Council	24.1(i) (vi)	Government
- Sources of the information provided in the Annual Report	24.2	Government
Instructions relating to the Petroleum Fund	32.5	Minister
Operational Management Agreement (between Central Bank and the Minister)	32.5	Minister
Reports specifying ESI (current & past year)	32.5	Government
Auditor's certification of ESI	32.5	Auditor
Report estimating reduction in ESI if a transfer in excess of ESI is proposed	32.5	Government
Auditor's certification of reduction in ESI if a transfer in excess of ESI is proposed	32.5	Auditor
A detailed explanation of why it would be in the long-term interests of Timor-Leste to transfer an amount exceeding ESI	32.5	Government
Consultative Council advice to Parliament	31.1	Parliament
<b>Information not provided to the public</b>	<b>Relevant Section of Law</b>	<b>Responsibility for preparation</b>
External Investment Manager's Contracts	12	Central Bank
Details about External Investment Managers' qualifications and performance record	12.2	Central Bank
Details of the significant experience in investment management of appointees to the IAB	17.1(c)	Minister
The level of remuneration for members of the IAB	17.3	Minister
The person appointed to sit on the secretariat of the IAB	17.3	Minister
Declaration of assets of the IAB	17.4	Government
Quarterly Management Report to the Minister	21.2	Dir. Treasury
Internal audit	22	Relevant institution
Declaration of assets of Consultative Council	27.6	Parliament
The level of remuneration for members of the Consultative Council	30.6	Parliament
Information on any aspect of the operation or performance of the Petroleum Fund for the purpose of its monitoring of the Petroleum Fund (provided to the Consultative Council)	31.1	Minister Central Bank
Clear reasoning for the motives for treating information or data as confidential. Note: after five years confidential information can be published	32.2	Minister Parliament Central Bank Cons Council

**Table 4.1 Information provided (and not provided) by the Petroleum Fund Law**

[Production Sharing Contract],<sup>110</sup> (Alkatiri 2005). Policies or laws of this kind have not been generated to date. However, in April 2007, the Presidential Candidate, Francisco ‘Lu Olo’ Guterres, declared his pecuniary interests in a media statement (Moucho and Fernandes 2007).

The usefulness of information that is available to the public is also limited because of timeliness and the confidentiality provisions in the Petroleum Fund Law. Most information that must be made publicly available is not available immediately. Much of the information is provided in the Annual Report, which means it can be up to twelve months before some information is available. The institution responsible for preparation of the information must ensure that the published form does not include ‘confidential’ information, and information declared confidential is made available only after five years. Confidential information is defined under Article 32.2 (Figure 4.7). This definition is open to interpretation and could result in information being kept from publication. For example, if a Minister of Finance or Natural Resources was known (internally) to be corrupt, this information could be claimed confidential because its disclosure would ‘significantly affect the functioning of the Government’ (under Article 32.3c). Five institutions (the Central Bank, the Minister, the Parliament, the Petroleum Fund Consultative Council and the Independent Auditor) must prevent the disclosure of confidential information under the Petroleum Fund Law. While some people participating in the consultation on the draft Petroleum Fund Act acknowledged that some information could legitimately be classified confidential (for example, seismic survey data: Sandbu 2005), other consultees argued that ‘every item of information should be available to the public’ (La'o Hamutuk 2004 :21).

Access to the information that is publicly available (in theory) is also a problem. Timor-Leste’s Petroleum Fund Law does not actually specify where or how the information should be made available. Most information is available on the internet, but the majority of East Timorese people do not have access to the internet. Timor-Leste has no public registry (although some submissions on the draft Petroleum Fund Act suggested it: La'o Hamutuk 2004; Sandbu 2005). São Tomé e Príncipe’s Petroleum Fund Law states that oil-related payments and contracts are to be made public through a public information office and through the web. No such public information office has been established in Timor-Leste, and a culture of secrecy often prevents government employees providing information to the public that should be freely available. Access to information is also hampered by issues of communication. The Government generally

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<sup>110</sup> The Law on Petroleum Activities (2005) states that a ‘Public Officer’ means a civil servant or equivalent individual, members of Parliament or of Government, Judges or Public Prosecutors. Under Article 7 a Public Officers’ right is restricted as follows:

1. A Public Officer shall not acquire, attempt to acquire or hold:
  - a. an Authorisation or an interest, whether direct or indirect, in an Authorisation; or
  - b. a share in a corporation (or an Affiliate of it) that holds an Authorisation.
2. Any instrument that grants or purports to grant, to a Public Officer, an interest, whether direct or indirect, in an Authorisation shall, to the extent of the grant, be void.
3. The acquisition or holding of an Authorisation, interest or share by the minor children or spouse of a Public Officer shall be deemed to be an acquisition or holding by the Public Officer.

provides information in several languages, even though it is not required by law. However, another effective barrier to communicating the information is the low literacy rate, and the low level of education of the wider East Timorese population.

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**Petroleum Fund Law - Article 32.2**

32.2 Information or data whose disclosure to the public could, in particular:

- (a) prejudice significantly the performance of the Petroleum Fund;
- (b) be misleading, as it relates to:
  - (i) incomplete analysis, research or statistics;
  - (ii) to frankness and candour of internal discussion;
  - (iii) the exchange of views for the purposes of deliberation; or
  - (iv) the provision of confidential advice;
- (c) significantly affect the functioning of the Government;
- (d) amount to the disclosure of confidential communications;
- (e) substantially prejudice the management of the economy;
- (f) substantially prejudice the conduct of official market operations; or
- (g) result in or lead to improper gains or advantages;

may be declared as confidential. The declaration of confidentiality shall, taking into account the principle of transparency and the right of the public as regards to access to information, provide a clear reasoning on the motives for treating such information or data as confidential.

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Figure 4.7 Petroleum Fund Law definition of confidential information (Democratic Republic of Timor-Leste 2005d)

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The Government of Timor-Leste presents an intention that petroleum revenue, and government as a whole, will be managed transparently. There have been many examples of projects, designed by the Government of Timor-Leste, to encourage transparency and accountability. For example, the International Conference on Transparency and Accountability was held in November 2003 (Democratic Republic of Timor-Leste 2003). Donors have also advised the Government on how to strengthen their institutions of governance (Bowles et al. 2006). The former Prime Minister, Mari Alkatiri, placed particular emphasis on this objective and established the Alkatiri Initiative to prevent corruption, nepotism and collusion (Cheema et al. 2006). Alkatiri also signed Timor-Leste up to the Extractive Industries Transparency Initiative (EITI) (Alkatiri 2003b). Established by the then British Prime Minister, Tony Blair, following the World Summit on Sustainable Development in Johannesburg in 2002, and known as the Blair Initiative, the EITI is a program designed to promote transparency in the transfer of revenue from exploitation of natural resources (in Timor-Leste's case petroleum) between companies and government officials through publishing amounts paid, received and later debited. Again, this commitment gives the impression that corruption will be combated and transparency will prevail. But, there is no legal requirement on companies to publish their payments under Timor-Leste's Petroleum Fund Law (despite suggestions in the consultation on the draft Petroleum Fund Act by Global Witness and Catholic Agency for Overseas

Development 2004). This raises doubts about the Government's commitment to the EITI, as this is one of the criteria for the EITI's implementation. Alkatiri explained:

I would like to take the opportunity to express my government's position on the calls for legislative measures on our part to compel petroleum companies to publish what they pay. The reality is that there is reluctance on their part with respect to the potential loss of commercial proprietary and confidential and sensitive information. (Alkatiri 2005)

The TSDA does publish the amounts it receives from companies exploiting petroleum resources in the JPDA. Unfortunately, ConocoPhillips (the only operator currently paying revenue to the TSDA) does not, in turn, publish what it pays to the TSDA, so it is not possible to compare the amounts received with the amounts paid.

The Government of Timor-Leste has some mechanisms in place for the transparent management of petroleum revenue, but there are also some gaps and barriers that may hamper efforts to avoid the resource curse. Some corrupt governments will do as they please, regardless of the mechanisms put in place to enhance transparency. The current arrangements in Timor-Leste suit a government that is well governed, but if individuals came to power that wished to subvert the system, as it stands, they could, potentially without attracting notice. Thus, it is essential that there are also mechanisms and institutions in place to ensure the Government is held to account in its plans to manage Timor-Leste's petroleum resources, and all of the resulting revenue, transparently.

#### **4.4.2 Accountability**

The Petroleum Fund Law delineates the responsibilities of the positions within (and also some external to) the Government with respect to petroleum revenue. The Government of Timor-Leste has established three institutions (the Office of the Inspector General, the Ombudsman for Human Rights and Justice, and the Prosecutor General) that have various roles in holding the Government and others to account under the Laws of Timor-Leste. This section explores the roles and responsibilities accorded under the Petroleum Fund Law, and the institutions that are responsible for undertaking the requirements of the Petroleum Fund Law.

Figure 4.8 identifies the links between the actors and their responsibilities under the Petroleum Fund Law. The Ministry of Planning and Finance, the Treasury, the Parliament, the Central Bank and the Ombudsman for Human Rights and Justice are all separately-established government institutions that have responsibilities under the Petroleum Fund Law (these institutions are dark grey in the figure). The IAB (and its secretariat), the External Investment Managers appointed by the Central Bank, the Consultative Council (and the annual forum on issues relating to the Petroleum Fund), and the Independent Auditor are institutions specifically established under the Petroleum Fund Law (these are light grey).

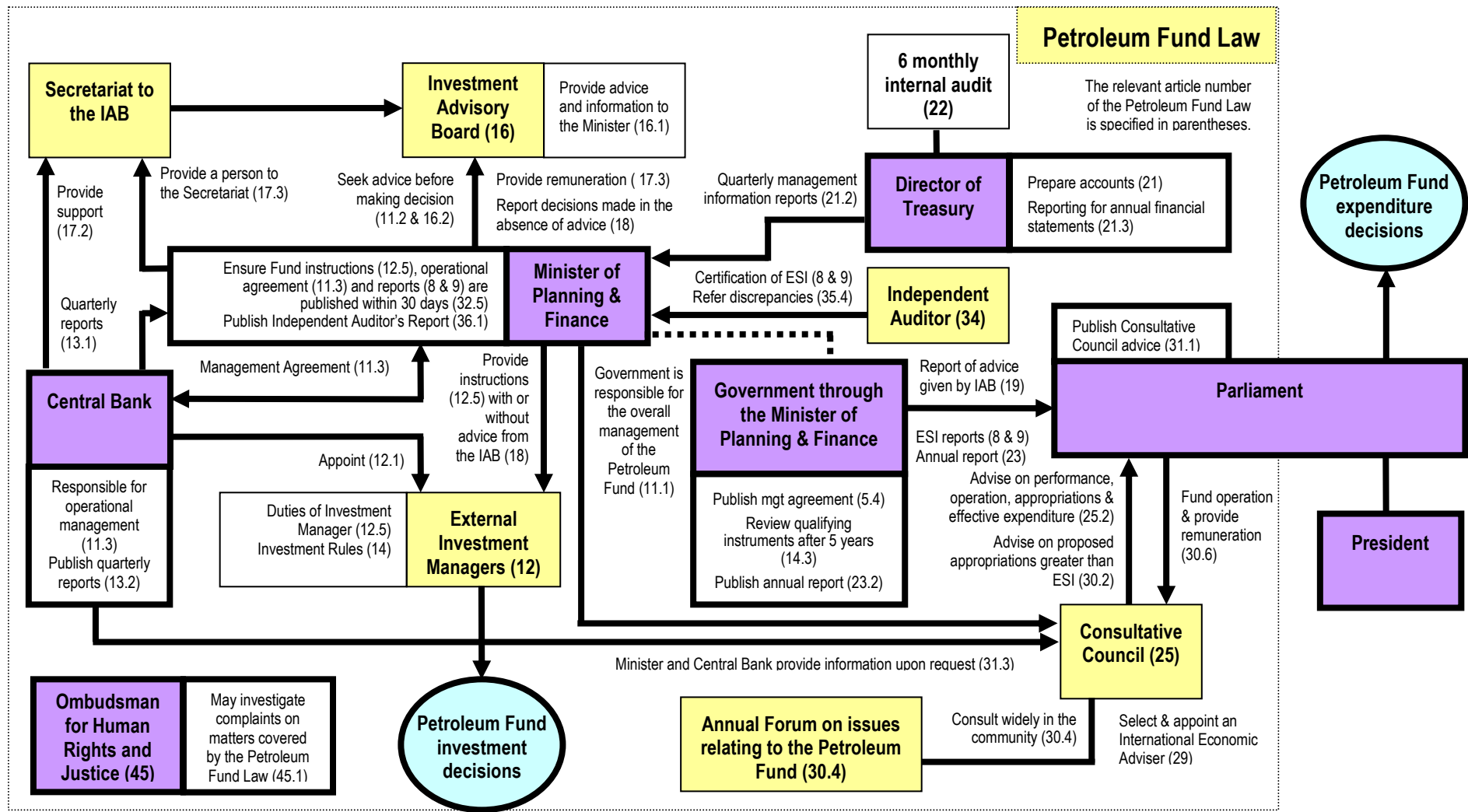


Figure 4.8 Linkages between actors and their responsibilities under the Petroleum Fund Law

The Figure illustrates that all of these institutions are ultimately bound by commitments to the Minister of Planning and Finance who is a central figure in the management of Timor-Leste's petroleum revenue. The majority of actions taken under the Petroleum Fund Law are by the Minister, or on the Minister's behalf. The Government departments responsible for actions under the Law are accountable to this Minister. The Minister also has enormous power in terms of the decisions that are made with regard to petroleum revenue management. For example, Article 11.2 states that the Minister shall not make any decisions in relation to the investment strategy or management of the Petroleum Fund without first seeking the advice of the IAB. However, Article 18 explains that in the absence of advice from the IAB, or if there is insufficient time to seek their advice, the Minister is able to proceed. If this were to happen, the Minister is required to report the making of the decision to the IAB. However, in another example which highlights the Minister's power, the need to report a decision which is contrary to the advice of the IAB (in a case where they did provide advice) is not required under the Law. With regard to the actual Petroleum Fund, the Central Bank remains responsible for the operational management of the Petroleum Fund, but under a management agreement with the Minister of Planning and Finance. The Minister, along with the Prime Minister, are both signatories to the Petroleum Fund account held in the Federal Reserve of the USA. In São Tomé e Príncipe the signatures of four separate officials (The President, the Prime Minister, the Director of the Treasury and Patrimony, and the Director of International Transactions at the Central Bank) are required to make transfers out of their Petroleum Fund. Despite the power of the Minister and the Prime Minister with respect to petroleum revenue, neither is specifically held accountable under the Petroleum Fund Law. In the draft Petroleum Fund Act the Minister of Planning and Finance had overall responsibility for the management of the Petroleum Fund and reported to the Prime Minister. The draft Petroleum Fund Act stated:

The Government is responsible for the overall management of the Petroleum Fund. In the exercise of any management functions and competences entrusted thereto, the Minister shall be accountable before the Prime Minister, and they both shall be accountable before the Council of Ministers and before Parliament (Ministry of Planning and Finance and Petroleum Fund Steering Group 2005 :8)

In the Petroleum Fund Law, only one sentence of this article remains: 'The Government is responsible for the overall management of the Petroleum Fund' (Article 11.1). The rest of the article that was drafted has been deleted. During consultation on the development of the Petroleum Fund Act, concerns were raised about this lack of accountability (by Clark 2005; Drysdale 2005a) but they were ignored. Whether the Minister of Planning and Finance would be held accountable in the event of a transgression against the Petroleum Fund Law would need to be tested in court.

There are institutions, other than the Petroleum Fund Law, designed to investigate corruption and hold Government officials to account. The Office of the Inspector General was established in July 2000. The Office of the Inspector General sits under the Office of the Prime Minister and conducts ‘independent’ reviews and examinations of maladministration and corruption within the Government<sup>111</sup>. The Inspector General has presented 78 investigative reports of maladministration to the Prime Minister of which ten have been referred to the Prosecutor General, in September 2006 (Office of the Inspector General 2006). The institution of the Office of the Inspector General remains weak; the Prime Minister cited ‘major hurdles’, the lack of an Organic Law, and a lack of office space as examples (Pereira 2006). The Office of the Ombudsman for Human Rights and Justice is another institution designed to enhance accountability, established pursuant to Section 27 (Figure 4.9) of the Constitution. The Statute of the Office of the Ombudsman for Human Rights and Justice (Democratic Republic of Timor-Leste 2004) was enacted in May 2004. The purpose of the Office of the Ombudsman (also known as the Provedor) is ‘to combat corruption and influence peddling, prevent maladministration and protect and promote human rights and fundamental freedoms of natural and legal persons throughout the national territory’ (Article 5.3).

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**The Constitution of the Democratic Republic of Timor-Leste - Section 27**

**Ombudsman**

- 1 The Ombudsman shall be an independent organ in charge to examine and seek to settle citizens' complaints against public bodies, certify the conformity of the acts with the law, prevent and initiate the whole process to remedy injustice.
  - 2 Citizens may present complaints concerning acts or omissions on the part of public bodies to the Ombudsman, who shall undertake a review, without power of decision, and shall forward recommendations to the competent organs as deemed necessary.
  - 3 The Ombudsman shall be appointed by the National Parliament through absolute majority votes of its members for a term of office of four years.
  - 4 The activity the Ombudsman shall be independent from any means of grace and legal remedies as laid down in the Constitution and the law.
  - 5 Administrative organs and public servants shall have the duty to collaborate with the Ombudsman.
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Figure 4.9 Section 27 of Timor-Leste’s Constitution (Constituent Assembly of East Timor 2002)

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The review of the Alkatiri Initiative (Cheema et al. 2006) noted the need for strong institutions to investigate and address the problems of corruption, and also that these two institutions (the Office of the Inspector General and the Ombudsman for Human Rights and Justice) overlapped in their responsibilities. When the new Prime Minister, Jose Ramos Horta, took office in June 2006 the Special Representative to the United Nations Secretary General, Sukehiro Hasegawa,

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<sup>111</sup> The extent an institution can be independent when it is based within the Office of the Prime Minister is debatable.

re-presented the review document to him and shortly thereafter the Prime Minister ordered the Inspector General to undertake an audit of all government services, conduct a verification of all inventories of all State assets, and initiate new investigations of government services (Santos 2006). The Prime Minister also ordered the 2004 draft of the Organic Law (of the Office of the Inspector General) to be sent to the Council of Ministers for immediate approval.

The Offices of the Inspector General and the Ombudsman are supposed to work closely together however there is no formal arrangement between them. The Ombudsman appears to have a more independent and wide-ranging role and the Inspector General to be more of an internal mechanism within the Government. One report (Pereira 2006) suggested the Inspector General's job was to monitor mismanagement of State revenue (e.g. the waste of electricity in government offices, as well as telephone bills). On this basis one would assume the Inspector General would be responsible for investigating the misuse of petroleum revenue. However, Article 45.1 of the Petroleum Fund Law states that it is the Ombudsman that should investigate complaints on matters covered by that Law. The lack of a distinction between the roles of these two institutions and the weaknesses in the judicial system do not inspire confidence that transgressions of the Petroleum Fund Law would be dealt with appropriately or in a timely manner.

Another institution that serves as a watchdog to ensure petroleum revenue is managed wisely is the Petroleum Fund Consultative Council (hereafter Consultative Council), established under Chapter V of the Petroleum Fund Law. In the Consultative Council, the Government again illustrated its intent to engage civil society in petroleum revenue management. When the Government raised the idea (MOPF 2004b) of establishing a body independent of Government to participate in petroleum revenue management debate, the submissions to the consultation on the draft Petroleum Fund Act overwhelming supported it. Membership of the Consultative Council includes representatives from civil society, business and religious organisations as well as ex-government or former state institution officials.

The role of the Consultative Council is to advise Parliament regarding the performance and operation of the Petroleum Fund. The Consultative Council must also advise the Parliament, in the context of the budgetary process, whether the appropriations are being used effectively to the benefit of current and future generations (Article 25.2c). The Consultative Council, in addition to the Parliament, provides input into decisions made about petroleum revenue management on behalf of civil society. To this end, the Consultative Council is instructed to 'consult widely in the community' and to 'hold an annual forum on issues relating to the Petroleum Fund' (Article 30.4). In terms of the Consultative Council's representation of the wider community, there is no requirement that any of the members of the Consultative Council be women or representative of a range of communities other than Dili, so they must consult widely in order to represent all the people of Timor-Leste. Despite its limitations, in the absence

of an educated and informed civil society to hold the Government accountable the role of the Consultative Council may be crucial to Timor-Leste's ability to avoid the resource curse. The Norwegian Petroleum Fund model does not have such a Consultative Council, but Chad and São Tomé e Príncipe do. Unfortunately the Chadian government interfered with their council's member selection and the President's brother in law stands as a member (Gary and Reisch 2005).

#### **4.4.3 Social and human capital**

Chapter Three explained some of the limitations created by a lack of human capital in the Government of Timor-Leste. The lack of institutional capacity, and the lack of capacity of individuals managing Timor-Leste's petroleum revenue, has affected the timeliness of reporting, and implementation of actions required under the Petroleum Fund Law, to date. For example, under Article 46 of the Petroleum Fund Law, appointments to the Consultative Council were to take place within six months of the Law coming into force (i.e. by 3 February 2006). However, the Consultative Council did not have its first meeting until November 2006. Further, under Article 23, the Law requires the Government to publish the Petroleum Fund's Annual Report within 15 days of its submission to Parliament, which should be at the same time as the annual financial statements of the Fiscal Year are submitted. The Petroleum Fund annual report for the 2005-2006 fiscal year was not submitted to Parliament at the same time as the annual financial statements for that year, and, as at June 2007, the first annual report of the Petroleum Fund has not been published. The way in which petroleum revenue is managed is also affected by the lack of capacity in the Government. As discussed in section 3.2.4, there are many foreign advisers needed to support East Timorese staff in managing Timor-Leste's petroleum resources. For example, as discussed in section 4.3.2, the lack of capacity in Timor-Leste's Central Bank affects the way in which petroleum revenue is invested.

The lack of capacity of civil society is also an issue for the wise management of Timor-Leste's petroleum revenue. In order for the mechanisms of transparency and accountability to work, the citizens of Timor-Leste must bring contraventions of the Petroleum Fund Law, and instances of petroleum revenue mismanagement, to the attention of the Office of the Ombudsman for Human Rights and Justice or the Office of the Inspector General. At this time, there are few individuals in civil society, or the media, who understand the mechanisms and institutions that Timor-Leste has established to manage its petroleum revenue, let alone interpret and analyse the information that the Government publishes.

The weak capacity of Timor-Leste's media is also concerning. Journalists sometimes report rumours without corroborating what they have been told. The media industry itself is very

under-developed (like all sectors) in Timor-Leste<sup>112</sup>. Community radio is the medium that reaches most of the population (television and newspapers are limited, primarily, to Dili), but 'Community radio in East Timor is still a work in progress' (Scambary 2004 :2). Scambary (2004) reports that community radio's needs, in terms of training and management, are many and varied. However, radio is well placed, particularly given the high rates of illiteracy in Timor-Leste and because a number of stations broadcast in several local languages, to debate crucial issues, particularly in relation to management of Timor-Leste's petroleum revenue.

Discussion of issues surrounding petroleum revenue management is necessary throughout the country, so that learning can occur and the East Timorese people can begin to hold the Government to account. As the capacity of Government and civil society grows, petroleum revenue management in Timor-Leste will benefit from sincere debate and engagement between these institutions. Now, the lack of trust between government and civil society (including the media) is problematic. Too often, the Government ignores, or criticises, feedback from civil society. The Petroleum Fund Law consultation was portrayed as a process in which participants could engage with the Government and provide input to the development of the Petroleum Fund Law. In practice, it was more an opportunity for civil society to learn about the Government's plans for petroleum revenue management (Drysdale 2007). Mindful of the big picture, the Petroleum Fund consultation process was useful in this regard, but it illustrated that there are few in civil society with the capacity to question the Government on petroleum revenue management, let alone hold them to account over the long term.

The Government has formalised its lack of trust in civil society and the media by drafting a Penal Code, which criminalises defamation. A mission visiting Timor-Leste to explore transparency and accountability declared the law 'problematic' (Mattiske 2006) and the JSMP reported:

Freedom of opinion and expression are important to the development of a democratic society. In JSMP's opinion, articles 172 – 177 of the draft Penal Code (which provide for one to two years imprisonment) place too strong a limit on individuals' and institutions' rights to freedom of expression. These articles could have the effect of stifling criticism of, and opposition to, the current and future Timor Leste governments. Criminal sanctions might dissuade journalists or individuals from reporting or discussing important issues for fear of prosecution and result in self-censorship by the media. (JSMP 2004 :5)

The development of a healthy and robust democracy relies on the opportunity for citizens to discuss and debate ideas and opinions, regardless of whether they are commensurate with the views of the Government. Similarly, how petroleum revenue is saved, spent and invested, must

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<sup>112</sup> The Timor-Leste Media Development Centre (2007) was established to support the East Timorese media, and recently developed a Documentary Training Program to train radio volunteers to write, edit and produce radio programs on topics such as the 'Timor Gap Treaty', and 'Vox Pops' to get people's perspectives about how petroleum revenue should be spent, and what the development priorities are.

be understood, and debated, if Timor-Leste's petroleum revenue is to be managed wisely. The Government has established many mechanisms that provide for civil society and the media to hold them to account. But, ultimately, transparency and accountability rely on the capacity of all of the stakeholders (government, civil society and the media) and the social capital of those stakeholders. In this way, petroleum revenue management in Timor-Leste is everybody's responsibility.

This chapter examined how the Government of Timor-Leste manages its petroleum revenue. Not enough time has passed to conclude whether Timor-Leste's Petroleum Fund Law will ensure that Timor-Leste can manage its petroleum revenue wisely. The Petroleum Fund Law incorporates some institutional features that give the impression that Timor-Leste's petroleum revenue will be managed wisely. However, the strength of these institutions is ultimately dependent on the intentions of the decision-makers, the good governance of institutions, and the strength of the rule of law. Civil society has a role in holding the Government to account in these respects. Norway provides a model of wise petroleum revenue management that Timor-Leste can aspire to, but Chad and São Tomé e Príncipe provide more appropriate examples of comparison because their institutional environment are weaker than Norway's, and possibly weaker than Timor-Leste's. Timor-Leste would be better served, now that they have established a Norwegian-based institutional framework, if they paid attention to the countries whose experience they wish to avoid.