Comments on RDTE draft Petroleum Fund Law

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This note presents some comments for the public consultation on the draft Petroleum Fund Law ("Law") prepared by the Government of the Democratic Republic of Timor-Leste ("RDTL"). It refers to the English translation of the draft Law, as presented by the Minister of Planning and Finance and the Petroleum Fund Steering Group in the document entitled "Timor-Leste Petroleum Fund Draft Act: Public Consultation."

My overall assessment of the draft law is that it provides a good legal framework for the stewardship of RDTE's oil revenues. Its focus on transparency, oversight, and good governance puts makes it the second recent example of a developing country attempting to turn a new page in the history of the "curse of natural resources" that has afflicted poor but resource-rich countries.[1] The people and government of RDTE, as well as the drafters of the Law, should be congratulated for this achievement.

My main concerns with the Law as drafted are threefold, and I state them in general terms before discussing specific articles in detail below:

A. While the Law and the executive summary both emphasise a commitment to transparency, some of the specific provisions fall short of that commitment. It is stated in general terms that transparency is a fundamental principle, yet on many occasions, the Law fails to establish full disclosure of information as the default mode of action, any departures from which have to strictly delimited by the Law itself and justified by the Government agency authorised to depart from it. Seeing as the Law governs not petroleum operations as such but merely the management of the country's revenues from the petroleum sector, it is hard to see why it is necessary to keep anything secret at all. Whatever exceptional cases the drafters have in mind, which may be legitimate, should be clearly spelled out and delimited in the text of the Law itself.
B. The Law only minimally incorporates a division of powers in the management of oil revenues. Almost all the power is vested in the executive in its various branches. (The Investment Committee, for example, is almost entirely made up of the Minister's appointees, and the Director of the Treasury and of the Central Bank might also not be independent of the Minister.) A Government intent on misusing the assets in the Petroleum Fund would not find this Law particularly obstructive to their actions (I mention examples below).

[1] The first is the West African country of São Tomé e Príncipe, another small former Portuguese colony, which passed its Oil Revenue Management Law in late 2004.

This may be a conscious choice, and may have to do with the constitutional structure of RDTL, which I ignore. Still, the drafters may want to consider (1) how the suggested institutional framework will constrain future Governments that may be less responsible than the present one (and when the reward for wrongdoing may have grown in proportion with the oil revenues); and (2) what incentives it will create in a situation where the political forces are more divided and competing for political support in the population—as will surely happen as the post-independence unity wanes—and therefore are under more pressure to engage in short-sighted spending of the oil wealth.

C. In many places, the Law relies on other parts of the RDTL legal régime for the functioning of the institutional structure it establishes. To the extent possible, these instances should explicitly cite the Laws that apply, in order to avoid ambiguity and unclarity.

I now proceed to detailed comments on specific articles.

§5: The Law does not specify where the account is held, nor who the account holder is, or who has the authority to sign for transfers. This relates to point B above: This account is potentially entirely controlled by the Minister.

§6: Whose responsibility is it to transfer oil revenues into the Fund? It looks like Government's, but this is not made clear. A different way to ask this question is: Who is to be sanctioned in the event that some portion of oil revenues do not make their way into the Fund? In the interest of transparency, the route from payment to receipt should be as short as possible: This argues for a requirement that the oil companies themselves (or other third parties) pay directly into the account. The Law can usefully provide that a financial obligation to RDTL covered by the Law is not considered fulfilled until it has been deposited in the earmarked account. This would give companies and other third parties an incentive to comply with the Law (rather than with pressure by potentially corrupt officials) and to make public all the payments they make.

§7.1: It would be desirable to mandate that all information regarding this State Budget account be public.

§7.2: It is not clear who exactly is responsible for this provision to be carried out, and who can be sanctioned for non-compliance. This depends on the degree of independence of the Central Bank, which I ignore. What is the Central Bank's responsibility if a Minister demands a transfer in excess of the appropriation amount? Does is simply take instructions from the Minister, or does it have legal and political independence that are sufficient to deny an illegal request?

§7.3: The same question applies. Does this article require the Central Bank to assess whether the auditor's report "certifies" the estimate? §7.2 suggests this ("subject to…"). Or does the Central Bank simply carry out instructions as per the budget law, if one is passed even without the requirements of §7.2 being met?

Does this article restrict the Parliament's authority to pass a budget law, in case the reports are not forthcoming?

Also, if the estimate for the preceding year differs from the preceding year's estimate of that year, should there not be a requirement to explain the discrepancy?

Finally, the first sentence of §7.3 seems misplaced. It is not clear that anything in §7.3 is subject to anything in §7.4.

§7.3 and 7.4: There should be a specific requirement that all these reports be made public and easily accessible, at the same (timely) moment that they are presented to Parliament. The underlying material and calculations used for the reports must also be made public. Otherwise, it is too easy for the Government to adjust the calculations of schedule I according to political interest.

§7.5: See point C above. This should refer to the legislation on tax payments and refunds. It should specify whether it includes interest payments on overpaid taxes.

§8.1: Accountability should be better defined, presumably with reference to the structure and nature of accountability set forth in the Constitution. What censoring, sanctioning or dismissal authority relies in these offices and institutions, in the case of mismanagement?

§8.2: This advice should be public.

§8.5: How and to whom does the Minister justify that he or she is "satisfied" that these requirements are met?

§8.6: See point C above. Refer to law on public tender.

§8.8: See point A above. The provision for confidentiality seems unnecessary. In the management of public wealth, there is no reason to keep anything secret. The only reason would have to be when this would jeopardise the value of the investments, but given that they should be restricted to low-risk, liquid instruments, RDTL's assets will never be large enough to create large market movements. The presumption must therefore be that everything should be published.

The article also seems to allow the Central Bank not to publish in full the report it sends to the Government. There is no reason for this. It should be required to provide a public report that is accessible to the lay public, but also the full report it submits to the Government.

§9: Since petroleum earnings ultimately have to finance imports, it seems more appropriate that the currency allocation of the investment instruments should correspond to the currency allocation of RDTL's imports. The restriction to US dollars inflicts currency risk on the real purchasing power value of the Petroleum Fund.

Some of the technical terms in this article should be defined in §2. Does “average interest rate duration” (§9.4) mean average maturity of the debt instruments? Is the average weighted by the instruments’ share in the portfolio? This should be specified.

§9.6: Does the “review” mean that the Minister can unilaterally decide a change in the portfolio, or does a change of investment policy (widening the range of permitted instruments) have to be changed by an Act of Parliament? See point B above.

§10: It is of crucial importance that this article include a ban on conflicts of interest by members of the Investment Committee. Also, the membership of the Investment Committee should be subject to Parliamentary approval. As currently stated, the Committee risks providing pure patronage positions for the Minister. This depends in part on who has the authority to appoint (and dismiss) the Director of the Treasury and the Central Banker. If this is the Minister, it is unclear how the Committee can provide any check on the Minister at all. This may not be the intention—the drafters may have in mind a pure advisory function (although §10.2-3 suggests a “check and balance” function). If so, the drafters should consider other mechanisms to provide countervailing power.

For the same reasons as stated in point A and the comments to §8.8 above, it is unclear why confidentiality should ever be necessary here. The presumption should be that all information be made public immediately. This should include Investment Committee meeting minutes. Similarly, there should be an obligation to report to Parliament (and to the public) without waiting for its request.

What is the justification for §10.2-3? What kind of decisions might these be? As stated in point A and in the comments to article 8.8 above, it is unclear what reasons there could ever be for managing public wealth in this fashion. In any case, the Law should explicitly delineate when this is permitted.

§10.8: Which law? See point C above.

§12: This article should require the Director of Treasury to make the accounts public.

§12.2: How do these reports relate to the Central Bank’s reports? These reports should also be made public.

§13: See point C above. State the law governing the audits.

§14: This article suggests that the list of reported information is exhaustive. A presumption of transparency would be better secured by stating that the report must include, but should not be limited to, the stated items. Moreover, it should be made clear that all the underlying information used to compile the report should also be publicly available. (If there are plausible extraordinary exceptions, this should be delineated explicitly; see point A above.)

§14.2(c): Is the Treasurer the same as the Director of Treasury?

§15: The powers of the Council seem very limited. It is not made clear whether the Council can issue opinions of its own motion, or is merely reactive to requests from the Parliament. I recommend the former. It is also not made clear that all the Council's opinions should be made public, which a presumption of transparency would require.

§16: It is unclear why only former Presidents are disqualified if they have been removed from office. If formal sanctions equivalent to impeachment also exist for the other offices that have *ex officio* membership on the Council, presumably such sanctions should disqualify the individuals concerned.

While the rules for governing the selection of civil society representatives can be left to secondary legislation, it is important here to state the principle the the civil society organisations must *themselves* choose their representatives. Otherwise, the rationale for having civil society members is undermined. The current language ("appointed to represent") suggests the opposite: That the Parliament is charged with picking representatives of the three civil society sectors listed.

Again, there is no provision against conflicts of interests. This could be incorporated into article 16.9.

§16.10: See point C above. This should refer to the specific law or "procedures" presently in force.

§17: Does the Committee have the authority to issue opinions of its own motion? Or to investigate potential wrongdoing? §17.2 suggests that activities are limited to assessing whether a withdrawal above the sustainable income is warranted. I recommend that the Council be free to engage in investigations and issue opinions of its own motion. One may also consider allowing the Council to refer cases of potential wrongdoing to the relevant court.

§17.3: See point A above. The Law again falls short of a presumption of publicity except in exceptional circumstances.

§18.1: As stated in point A above, this presumption, while stated in this article, is not implemented in the rest of the Law itself.

This article should clearly and explicitly delineate what would count as a reason for keeping something confidential. As stated above, there are no obvious reasons why public finances should ever be kept confidential. It is therefore particularly undesirable to leave an open-ended permission of confidentiality. Whatever exceptional cases the drafters have in mind should be clearly and exhaustively stated.

§19: As suggested above, this should be strengthened to saying that any petroleum-related revenue owed by companies or other parties is not considered paid until paid into

the Petroleum Fund earmarked receipts account, even if it has been paid to the Government. This would minimise the incentive for any future government to attempt to make payors circumvent this legislation.

§§20 and 23: Presumably the "independent" auditor should be independent of the Government, yet there is no provision for securing this independence. Indeed it is the Government that selects the auditor. The selection should be made subject to Parliamentary approval. Or the selection of the auditor could be vested in another branch of government, such as Parliament, the Council, or the judiciary.

§20.2 seems to limit the scope of §20.1. Why not require a complete list of individual payments in addition to aggregated by payer?

§20.5: Again, financial information should not be confidential, except in very special circumstances that should be clearly delineated in the law.

§21: It should be considered whether the Council can be given the power to refer cases of potential wrongdoing to the appropriate courts.

§22: Is it unclear why one should exempt the appointments to the first Investment Committee from the requirements of article 8. Perhaps this is for practical purposes, and the necessity of setting the Committee up without delay. Even so, there is no reason to protect these appointments for five years. I suggest replacing article 22 by a requirement to review the appointments made in the first six months within one year, according to the requirements of article 8.

Schedule 1: There are several components of the calculation that are left unspecified. This leaves the Government ample opportunities to adjust the calculation to suit its political priorities. This in turn undermines the function of the auditor, which is to "certify" the calculations. In particular:

- Which inflation rate is used to estimate the real return? The US inflation rate? The weighted inflation rates of the trading partners?
- The currency of the R's should be stated (presumably US dollars). Also, it should be made clear that they are nominal amounts (presumably, since they are deflated by the nominal interest rate). Since they are nominal amounts, which inflation rate should be assumed?
- Which oil price should be assumed in making the calculation?
- There should be some requirement on how the R's are estimated by the Government. Presumably it cannot just pick the numbers that suits its budget, but how is the auditor supposed to judge the projections? Is it? If not, who is overseeing the Government's calculations?
- Why use an averaged interest rate instead of applying the maturity-specific interest rate for each year of the projection?

While the general formula for oil revenue spending is sound and represents commendable foresight, the lack of specification leaves open the possibility of opportunistic adjustment

of the figure. This contrasts with the Oil Revenue Management Law of São Tomé e Príncipe, which also uses the sustainable income from oil wealth, but calculates it in a more rule-based manner, using, for example, the long-term moving average of the oil price. It also caps the real rate of return. The RDTL draft Law fixes the rate at a conservative 3% p.a., but the text of Schedule 1 does not in any way limit the Government's authority to change the rate at any time to what it wants. This in turn undermines the constraints put into the law to hinder spending in excess of the sustainable income.

-----Original Message-----
From: Martin E. Sandbu [mailto:sandbu@post.harvard.edu]
Sent: Tuesday, March 01, 2005 7:56 AM
To: Thomas Ekeli
Subject: Re: Public consultation - Draft Act on Petroleum Fund for Timor-Leste

Dear Thomas,

Thanks for your question, it is useful for me to have to clarify my points.

1. Article 22:

I may have misread who this applies to, and I share the concern for institutional capacity. I still think the intention is not as clear as it could be, and that the language could perhaps balance the trade-offs better. Does RDTL have a properly functioning regime of public tender? If it does, then that should be used, since this law would otherwise undermine the integrity of the legal system, and hint that oil revenue management is a somewhat separate jurisdiction. If it doesn't have satisfactory tender procedures, then that is fine, but then the six month-five years rule could perhaps be approved upon. Basically, as soon as there is a good public tender regime up and functioning, it should govern such appointments, but not before. If that happens in two years time, that's when it should start being applied to this appointment as well. If it still hasn't happened in five years, the special provisions in this Law should remain in force. This is an ideal view; it may well not be possible to codify this in a way that is not more open for abuse than the current text. So this is not a very strong concern of mine.

In any case, however, the Law should state more clearly how this investment manager should be selected when the exemption in article 22 applies. Basically, there should be a mechanism to provide reassurance to the public and the other branches of Government that the Minister is using his/her authority prudently. So the Law could include a review or confirmation of the Minister's decision by Parliament or some other appropriate body, perhaps the Council. As it stands, the lack of well-functioning tendering

procedures is causing the opposite extreme - the executive deciding everything unilaterally. Even if the executive acts wisely, there is the issue of being seen to exercise authority wisely, which is required for public confidence in the legal regime.

2. Schedule 1:

My interpretation of the Law was that the Minister is charged with estimating the sustainable income, and that the estimation is to be "certified" (I think this needs to be made more specific) by an independent auditor. In doing so, the Ministry is required to use the formula in schedule 1. The English text, however, seems to indicate that the law only fixes the real rate of return at 3% "at the commencement of this present Act", which sounds like it can in the future be changed as part of changed estimates. That is, 3% sounds like the benchmark or default value to be applied until the Minister changes it.

If the intention is that the real rate of return should be fixed at 3% until changed by an amendment to the law, it might be better to use a phrase like: "The real rate of return employed in the calculation of the estimated sustainable income shall be 3%" and not say that r is the estimated average real rate, since that implies that the Ministry in charge of the estimation has the authority to determine it.

Do please add these lines to my comments for the public record, and again many thanks for the opportunity to contribute in some small way to this admirable effort at creating a transparent and efficient revenue management regime.

Best regards,

Martin Sandbu