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## Review of the Legislation establishing the Sovereign Wealth Fund in Papua New Guinea<sup>1</sup>

### Abstract

The PNG Government published, in the National Gazette on 27 October 2014, a proposed law to abolish the Sovereign Wealth Fund (SWF) established by an organic law in 2012 and establish a new SWF with a Stabilisation Fund and a Savings Fund. The SWF purpose and objectives will be changed, the sources of revenue will be altered, and the governance arrangements amended.

PNG's resource dependency over the past two decades has been driven primarily by its reliance on minerals, specifically gold and copper. This is now changing. As LNG production and exports grow, the country's overall resource dependency will increase. Foreseeable flow-on effects will include continued adjustments to the structure of the PNG economy. There is increasing pressure upon the PNG Government to effectively transfer anticipated new 'national wealth' to PNG citizens. Part of the PNG Government's response has been to establish a SWF. An effective SWF, combined with strong political will, could assist as a platform for PNG's broader fiscal policy; it could provide something of a narrative describing the Government's response to the opportunities and challenges associated with the mining and petroleum sectors.

This paper highlights the main aspects of the SWF and concerns that need to be considered and addressed, particularly the need to simplify and clarify the withdrawal and deposit rules. While making improvements to the SWF structure is important, the success of PNG's SWF will be determined by the extent of ongoing political will to manage resource revenues well for current and future generations, and the degree of demand for better management of PNG's resource wealth.

Key recommendations in the paper include: the need for public consultations to build public confidence and engagement and potentially strengthening of political conviction; the need for Parliamentary oversight of the Investment Mandate; improvement in the conflict of interest provisions governing the Board; hard limits to compel the Government's holding companies to make appropriate disbursements; and the need for all mineral and petroleum receipts to be managed by the SWF, without exceptions.

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<sup>1</sup>The following analysis of Papua New Guinea (PNG)'s Sovereign Wealth Fund (SWF) was undertaken as part of the Australian National University's research partnership with the National Research Institute (NRI) in PNG. It expands upon the author's mid-2014 analysis of the SWF published in 2014, in NRI Issues Paper No. 09 titled, *An analysis of the Papua New Guinea Sovereign Wealth Fund's process of formulation and progress towards establishment*.

## Introduction

Since the publication of the October 2014 NRI Issues Paper (Osborne 2014), and as foreshadowed in that paper, the PNG Government published, in the National Gazette on 27 October 2014, a proposed law to amend the Organic Law on Sovereign Wealth Fund (*2014 Organic Law*). The main objective of the current analysis is to examine the proposed structure, and objectives, of the SWF outlined in the *2014 Organic Law*. The earlier NRI issues paper (Osborne 2014) detailed the process for the formulation of the SWF for PNG prior to the release of a new organic law. The current analysis will inform the ongoing discussion in PNG of the structure and objectives of PNG's SWF by:

- reviewing the Proposed Law to Amend the Organic Law on the Sovereign Wealth Fund (Organic Law on Sovereign Wealth Fund 2014) published in PNG's National Gazette in October 2014, and analysing the types and structures of the proposed funds (Stabilisation Fund and Savings Fund);
- highlighting the key features of the proposed SWF, its structure and operational mechanisms including its link with the Kumul Trust;
- comparing and contrasting the 2014 legislation with the 2012 Organic Law on the SWF; and
- analysing how money flows in and out of the proposed funds:
  - ◊ including highlighting how the funds may impact on PNG's existing fiscal framework, including the budget and consolidated revenue; and
  - ◊ outlining how the funds will work in practice, and providing an assessment of the likely size of the funds based on current PNG Government revenue forecasts.

Given the content of the previous paper (Osborne 2014), this paper can most relevantly focus on reviewing the new 2014 law, including comparing the component features of the 2012 and 2014 laws. This paper starts with an explanation of the rationale for PNG's SWF, discusses how a SWF can potentially assist in transferring wealth across the economy and PNG's need to set a new fiscal narrative. It outlines the key elements of the SWF's Stabilisation Fund and Savings Fund and the key governance features of the new SWF are discussed. Particular attention is paid to how the SWF's deposit and withdrawal rules will work in practice, including estimates of the Stabilisation Fund balance, under different scenarios. Finally, the paper proposes a range of key recommendations to the Government for the improvement of the SWF.

## Background

PNG is a resource dependent country, both for economic growth and government revenues. The rationale for a SWF in PNG is strong. The most persuasive is to assist macroeconomic stability through encouraging effective and sustainable management and use of anticipated mineral and petroleum export revenues, necessary to attain improved, sustained development outcomes. A SWF is also a useful fiscal policy tool in a context such as PNG's: the fund holds state owned funds; those funds are managed separately from other funds and with some legal protections; and there is generally a strong obligation (perceived or real) to use the funds for the public good. PNG's SWF needs to complement prevailing economic conditions, the fiscal environment, broader fiscal policy and political realities.

Over the past 40 years, PNG has made numerous, varied attempts to both stabilise and save government revenues using SWFs (Osborne 2014). The earlier attempts failed, primarily due to a combination of inadequate alignment with broader fiscal policies and insufficient political will.

The International Monetary Fund (IMF) noted in its 2014 Article IV report (IMF 2014), that PNG has made a number of attempts over the past decade to structure fiscal policy in a way that recognises the volatile nature of

natural resource related revenues. These attempts were largely contained in the Medium Term Fiscal Strategy (MTFS) 2002–2007 and the MTFS 2008–2012 (PNG Treasury 2002, 2008). In particular, the MTFS 2008–2012 created a rule for the treatment of natural resource revenues, requiring that only a portion be allocated to recurrent expenditure, with the remainder — amounts above that categorised as normal revenues — to be utilised for one-off expenditures only, including the repayment of public debt. The rule used in the MTFS 2008–2012 had both a stabilisation and a savings component<sup>2</sup>.

The PNG Government felt that it needed to go further than simply having a fiscal rule that is essentially only a guide, and lacks a legislative requirement for a minister or department to follow. The lack of rigour was highlighted when the 2015 and 2014 National Budgets breached the deficit and debt limits contained in the MTFS and PNG's debt strategy. The 2015 National Budget issued an amendment to the MTFS 2013-2017 that temporarily raised the deficit and debt limits, above 2.5 per cent of GDP and 30 per cent of GDP respectively<sup>3</sup>.

The IMF noted in its 2014 Article IV assessment of PNG that PNG's past record of fiscal sustainability and effective use of revenues from mineral and petroleum assets has been, at best, mixed. During the 1980s and 1990s these revenues were quickly exhausted with little to show in terms of broader economic development and poverty reduction<sup>4</sup>. The PNG Government has, since 2012, had an expansionary fiscal policy stance — a deficit of 8 per cent of GDP in 2013, well above the 2.5 per cent limit — driven by an expectation of large increases in revenues from the PNG LNG project. Due to the recent and potentially prolonged fall in oil and LNG prices, there is a possibility that PNG will need to revise down current revenue forecasts, and reconsider the issue of longer term debt sustainability and the appropriate budget stance. The design and operation of PNG's SWF model needs to be considered in this context.

### **Rationale for PNG's SWF**

Governments typically establish sovereign wealth funds to achieve a range of objectives including: increasing savings for future generations; reducing 'Dutch Disease' induced impacts; smoothing the revenue profile for national budgets; and also for setting aside funds for identified projects (for example, priority infrastructure projects) (Osborne 2014). It is not only resource dependent nations that establish SWFs, but it is in this category of countries that utilisation is growing, largely in response to the boom in commodity prices during the past decade.

PNG's economy is highly dependent on non-renewable natural resources. PNG is the tenth most resource-dependent country in the world (Howes 2014), with resource rents making up more than 30 per cent of PNG's GDP (the average value of resource rents for the 144 countries included in the World DataBank series is 7.1 per cent).

Resource dependency has created difficulties for management of PNG's economy, for example, the growth in the resource sector has negatively impacted the non-resource economy through causing volatility in the exchange rate (mainly appreciating), resulting in inflation and demand side effects (ACIL Tasman 2009). Over the past two decades PNG's budget revenues have been unpredictable, both on the upside and the downside. PNG's ostensibly impressive GDP growth rates over recent years, and forecast LNG related growth, disguise entrenched problems in the broader (non-resource) economy. There has been unsatisfactory improvement in PNG's human development indicators since 1980, with PNG still being placed in the low human development category, ranking at 156 out of 186 countries and territories (UNDP 2013).

PNG's resource dependency over the past two decades has been driven primarily by its reliance on minerals (gold and copper). This is now changing as LNG production and exports increase, further deepening PNG's overall resource dependency. Foreseeable flow on effects will include adjustments to the structure of the PNG economy. There has

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<sup>2</sup> The current MTFS (2013–2017) does not make an attempt to address the issue of volatility other than to place limits on the level of deficits and debt.

<sup>3</sup> The IMF has rated PNG's debt of 37 per cent to GDP as "appropriate under the circumstances" (IMF 2014).

<sup>4</sup> *ibid.*:2.

been pressure from a range of groups in PNG, including civil society, landowners and donors for the PNG Government to effectively transfer new 'national wealth' to PNG citizens<sup>5</sup>. Part of the PNG Government's response has been to progress the design of a SWF capable of reducing the harmful effects of a volatile economy, including stabilising revenue for the budget and to share the wealth with current and future generations of Papua New Guineans.

### **Transferring wealth 'across the economy'**

PNG has a dualistic economy bolstered by a small number of very large mines, the most recent addition being the US\$20 billion Liquefied Natural Gas (LNG) project. Mining projects typically create their own discrete economic enclaves in their localities, and economic benefits also tend to spill over into the broader economy over time. (The extent of the effect upon the broader economy depends upon the nature and size of the operation.)

As the production and export of PNG LNG increases, the relative impact on the PNG economy of the mining of minerals (gold and copper) will decrease. Although LNG projects typically require high levels of investment upfront — for example significant infrastructure investment — after this initial outlay there is a reduction, as LNG projects' ongoing operations usually only require the retention of hundreds, rather than thousands, of employees, and projects usually consume less goods and services in the production phase compared to the mining sector. Accordingly, LNG projects may be generally characterised as 'low impact projects' that result in comparatively limited spill over benefits for local economies. In the absence of highly effective revenue management and distribution, communities and local economies are unlikely to receive the long awaited LNG-related benefits anticipated by many<sup>6</sup>.

A key issue for the PNG Government and its policy makers is, as PNG evolves into a significant exporter of LNG, PNG's development will become more reliant upon effective Government management of the revenues and related expenditure — Government's choices made regarding investments in social and fixed infrastructure, health, education, roads and ports, and law and order.

PNG's growing resource dependency presents significant and potentially negative impacts upon the country's economy, Government revenue and the Government's ability to deliver services in a predictable, sustainable way. This needs to be increasingly factored into PNG's fiscal framework. Establishing an effective SWF can assist as a platform for broader fiscal policy and it can provide something of a narrative describing the Government's rationale and appropriate response to the challenges and opportunities presented by PNG's mining and petroleum sectors.

### **Setting a new fiscal narrative**

Past growth in the PNG Government's revenue and the related expansion in expenditure over the last decade was largely absorbed through the use of trust accounts. The economy was not able to expand in line with growing government expenditure, alongside demands placed on local capacity by the construction of the PNG LNG Project. The Government allocated funds, through the national budget and supplementary budgets, to expenditure programs, and held the funds in trust accounts. On the plus side, the trust accounts had a 'smoothing' effect, as they held funds until there was adequate capacity in the economy to implement the designated project or program. On the negative side, there have been allegations that funds went missing from many of the trust accounts, or were not used effectively or for their specifically intended purposes (Batten 2008). The transfer of money into trust accounts effectively takes the money 'off budget', such that there is no formal system for drawdowns nor reporting on fund utilisation. The trust accounts seem to lack appropriate systems of accountability and transparency.

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<sup>5</sup> PNG's 2015 National Budget has projected that GDP in 2015 will increase by 15.5 per cent, up from a projected increase of 8.4 per cent in 2014.

<sup>6</sup> It is recognised that more than an effective SWF is required to improve revenue management and distribution issues. Simultaneous reform of the tax system, budget management and service delivery is required; however this paper focuses on PNG's SWF.

PNG's fiscal framework needs to be well positioned to respond to economic events, including the foreseeable impacts of LNG related revenues. Hence, the use of ad-hoc structures, like trust accounts, should be reduced. Trust accounts should not be the default mechanisms. International and public confidence could be enhanced with changes that keep funds 'on-budget' and clearly within formal public financial management systems. The increase in global commodity prices may have passed for now, but history indicates it is likely to recur, either in the form of increased prices or expanded output.

The requisite elements of a good sovereign wealth fund need to be assessed on a country by country basis. Some key elements taken from international best practice include: integration with the existing fiscal framework, including the budget process; governance, transparency, disclosure, accountability and asset management rules based on international best practice and the SWF Generally Accepted Principles and Practices (Santiago Principles); and ensuring proper oversight by Parliament. The Santiago Principles (or 'Sovereign Wealth Funds Generally accepted Principles and Practices'), provide general guidance as to the design and establishment of an effective fund. In particular, the Santiago Principles outline that SWFs should: help maintain a stable global financial system and free flow of capital and investment; comply with all applicable regulatory and disclosure requirements in the countries in which they invest; invest on the basis of economic and financial risk and return-related considerations; and have in place a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability.

The ultimate challenge for the successful implementation of PNG's SWF is not just whether it aligns with the Santiago Principles. It is whether the SWF is able to meet its stated objective and purpose while demonstrating adherence to the good governance principles the Santiago Principles supports. Questions relating to the SWF's appropriateness for PNG's circumstances and whether it can be effectively implemented, are policy and politically related and are underpinned by deeper issues, such as the extent of political will for the SWF to succeed, the degree of implementation capability within institutions, and the degree of alignment with community expectations regarding how PNG's national wealth should be managed. These are not Santiago Principles issues as such.

### **The Organic Law on Sovereign Wealth Fund 2014**

The two sub-funds proposed in the 2014 Organic Law will have shared governance arrangements and linked funding flows, with moneys paid into or withdrawn from the funds being managed by the SWF's Board. The *2014 Organic Law* details the purpose, deposit and withdrawal rules for the two sub-funds, which are described below.

#### ***1. Stabilisation Fund***

The following section summarises the main elements of the Savings Fund deposit and withdrawal rules that are contained in the *2014 Organic Law*. The rules will be analysed throughout the paper.

The stated purpose of the Stabilisation Fund, as outlined in the *2014 Organic Law*, is *to manage the impact of fluctuations of mineral and petroleum receipts on the economy of Papua New Guinea so as to promote and support macroeconomic stability, and to ensure that large foreign currency movements do not affect the competitiveness of the economy*<sup>7</sup>.

The *2014 Organic Law* lists the following sources for deposits into the Stabilisation Fund, including:

- all earnings from investments of the Stabilisation Fund;
- 50 per cent of all mining and petroleum taxes. (It is not known what will happen to the other 50 per cent of taxes.);

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<sup>7</sup> Emphasis added by author.

- 60 per cent of the proceeds of sale from any interest, either directly or indirectly, the State holds in any mineral or petroleum asset (The portion remaining will be deposited into the Savings Fund.);
- all withdrawals from the Savings Fund;
- 75 per cent of all distributions from any interest, either directly or indirectly, the State holds in any mining or petroleum projects. (The portion remaining will be deposited into the Savings Fund.);
- an amount between 35 and 75 per cent, as determined by Parliament, of all dividends due to the State from non-holding companies holding interests in mining and petroleum projects. (The portion remaining will be deposited into the Savings Fund.) (It is not clear why there is not a fixed percentage.); and
- any other amount allocated under the National Budget. (This provides the Government the scope to deposit additional amounts into the Stabilisation Fund.)

The *2014 Organic Law* proposes the following rules for the withdrawal from the Stabilisation Fund:

- withdrawals (W) shall not exceed the 5 year moving average of mineral and petroleum receipts (X) as a share of non-mineral and non-petroleum receipts (Y). (The moving average means that each year the 5 year period will move forward by one year.); and
- must not exceed the product of:
  - ◇ the simple average of the yearly ratio of actual mineral and petroleum receipts to actual non-mineral and non-petroleum receipts for the last 5 years ending 2 years prior to the drawdown fiscal year; and
  - ◇ actual non-mineral and non-petroleum receipts in the National Budget 2 years prior to the drawdown fiscal year, determined by the following formula. (Note that the formula is used to show the relative importance of mineral receipts compared to non-mineral receipts.)

$$W_t = Y_{t-2} \left\{ \frac{1}{5} \left[ \sum_{s=2}^6 \left( \frac{X_{t-s}}{Y_{t-s}} \right) \right] \right\}$$

(W=withdrawals, Y=non-mineral and non-petroleum receipts, X=mineral and petroleum receipts, t=time (years), s=2 years.)

- Parliament may make further rules with respect to withdrawals. (This does provide scope for Parliament to change the rules in subordinate legislation, within the intent of the organic law.)

## 2. Savings Fund

The following section summarises the main elements of the Savings Fund deposit and withdrawal rules that are contained in the *2014 Organic Law*. The rules will be analysed throughout the paper.

The stated purpose of the Savings Fund, as outlined in the *2014 Organic Law*, is to provide a means of preserving the real [inflation adjusted] value of extracted mineral and petroleum resources through long-term investment for the benefit of current and future generations of citizens of Papua New Guinea<sup>8</sup>.

The *2014 Organic Law* proposes a range of sources for deposits into the Savings Fund, these include:

<sup>8</sup> Emphasis added by author.

- earnings of investments of the Savings Fund;
- any surplus of the Stabilisation Fund after its balance reaches US\$1 billion;
- 40 per cent of the proceeds of sale from any interest, either directly or indirectly, the State holds in any mining or petroleum asset;
- 25 per cent of all distributions from any of the State's holding companies holding interests in mining and petroleum projects;
- between 25 and 65 per cent, as determined by Parliament, of all dividends due to the State from non-holding companies holding interests in mining and petroleum projects. (The portion remaining will be deposited into the Stabilisation Fund. It is not clear why there is not a fixed percentage.)
- proceeds from the sale of any non-mineral or non-petroleum assets; and
- any other amount allocated under the National Budget. (This provides the Government the scope to deposit additional amounts into the Stabilisation Fund.)

The *2014 Organic Law* proposes the following rules for the withdrawal from the Savings Fund:

- the *real value*<sup>9</sup> of the Savings Fund is to be maintained;
- withdrawals can only be made from the *real income*<sup>10</sup>;
- withdrawals cannot be made before the tenth anniversary of the commencement of Part IV of the Organic Law (2014). (This means that withdrawals cannot be made until 10 years after the SWF starts operating.);
- withdrawals for each year must be at least equal to the *real income* of the Savings Fund earned two years prior to the withdrawal year. (That is, withdrawals cannot reduce the real [inflation adjusted] value of the fund.);
- all withdrawals shall be deposited into the Stabilisation Fund; and
- Parliament may make further rules with respect to withdrawals. (This does provide scope for Parliament to change the rules in subordinate legislation, within the intent of the organic law.)

### Consideration of key governance features of the proposed SWF

When analysing the *2014 Organic Law* it is appropriate to assess it against the Santiago Principles, which focus heavily on the governance aspects of SWFs, creating an internationally recognised good governance standard.

It was the view of some informants<sup>11</sup> during consultations for this analysis that the 2014 Organic Law generally adheres to the Santiago Principles, with only some minor exceptions noted and suggested adjustments proposed. For example, the Board's roles, responsibilities and obligations in regard to ethical standards are considered to be well articulated in the legislation. There were, however, concerns raised that as the Secretariat is required to implement Board decisions, the Secretariat's behaviour could be 'driven' by the Board. To mitigate against this possibility, a Code of Conduct could be developed and incorporated into employment contracts, increasing the obligation on the Secretariat to operate more clearly in accordance with Santiago Principle 13<sup>12</sup>. The Code of Conduct could specify behaviours or activities that have the potential to render Secretariat staff vulnerable to undue influences from Board

<sup>9</sup> Real value means the nominal Kina value adjusted for the annual inflation rate at the end of the fiscal year.

<sup>10</sup> Real income means an amount equal to the earnings for the Savings Fund adjusted by the real interest rate.

<sup>11</sup> There were only a small number of informants who were aware of the Santiago Principles and who could therefore express a view. All of these informants felt that the SWF generally adheres to the Santiago Principles.

<sup>12</sup> Principle 13: Professional and ethical standards should be clearly defined and made known to the members of the SWF's governing body(ies), management, and staff.

members. Specific aspects of the Code of Conduct could also be built into the employees' contracts in such a way as to ensure linkage with SWF objectives, and their effective implementation on the part of the employees.

One important governance issue of concern relates to the provision regarding Board members and conflicts of interest. According to the 2014 Organic Law, a Board member is required to inform the Board as soon as practicable after the member becomes aware of a conflict of interest. If this occurs, the Board can vote on whether the conflict should disqualify the member from voting. If this section is contravened, and the Board is not informed prior to a decision, it will have no effect on the validity of transactions or resolutions of the Board. Thus, there is no incentive for a Board member to declare a conflict of interest if doing so does not work in their favour. There may be a need for a Board Charter that would regulate the behaviour of members in some detail, including in conflict-of-interest situations.

Another area of focus during consultations has been the Investment Mandate<sup>13</sup>, and its applicability to the proposed objectives of the SWF. Importantly, the *2014 Organic Law* states investments shall only be made in foreign assets supporting the macroeconomic objectives of the Stabilisation Fund. Furthermore, it states the SWF shall not be used as collateral for a loan or otherwise encumbered and shall not be used as security or to support any guarantees — directly addressing an issue that has undermined previous PNG SWFs, particularly the Mineral Resource Stabilisation Fund (MRSF)<sup>14</sup>. It should be noted, however, the role of the Minister for Treasury (the Treasurer) has been boosted. The Minister issues the Investment Mandate to the Board, on advice from the Treasury. The Minister has much discretion over the Investment Mandate, with only limited high level direction provided by the *2014 Organic Law*. The Minister can make changes to the Investment Mandate without the need to seek approval from Parliament or the Executive (NEC). Changes only need to be tabled in Parliament after they take effect. This allows the Minister great scope to adjust the Investment Mandate without seeking NEC or Parliamentary approval, leaving open the possibility of acting at odds with the objectives of the SWF, and therefore, potentially, against the interests of Papua New Guineans. There is a need for Parliamentary oversight of this process.

How the SWF relates to other PNG Government entities is referred to in the deposit and withdrawal rules and the definitions section of the *2014 Organic Law*. Notably, there is no specific mention of the Kumul trust or Kumul holding companies in the *2014 Organic Law*<sup>15</sup>. There are references to holding and non-holding entities in the deposit rules for the Stabilisation Fund and the Savings Fund, which could include Kumul holding companies, depending on how they are established and the legal status they hold. Importantly, the legislation notes that holding companies will control the State's equity interests in mining and petroleum projects and will determine the size and timing of distributions to the SWF. There seems to be no legal requirement for holding companies to make disbursements to the SWF; they could conceivably decide to make no disbursements at all. (See below for further discussion on holding entities.)

### **Comparing the 2014 Organic Law with the 2012 Organic Law on the SWF**

The *2014 Organic Law* marks a new direction for the SWF. The changes cannot be cast as simple amendments, but rather need to be viewed as a redesign of the policy and the SWF model proposed. There have been changes to the sub-funds and their deposit and withdrawal rules, the governance arrangements, the Investment Mandate and the role of the responsible Minister. (Note that a table has been provided at Annexure B to assist in understanding the comparison between the two organic laws.)

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<sup>13</sup> The Investment Mandate is where the strategy for the investment of the funds is outlined and the related governance arrangements.

<sup>14</sup> Osborne, D., 2014, 'An analysis of the Papua New Guinea Sovereign Wealth Fund's process of formulation, and progress towards establishment', Issues Paper #09, Port Moresby, NRL.

<sup>15</sup> The PNG Government has been developing a new structure of holding entities to hold the State's equity interests in commercial assets. It has been proposed that the entities use the name Kumul.

The **Stabilisation Fund has been retained**, but with some significant changes. The previous policy was to capture 100 per cent of mining and petroleum taxes and dividends; this has been changed to 50 per cent of taxes and 75 per cent of dividends that are directly controlled by the State. (Other deposits are hard to forecast as they relate to assets in non-state holding entities and proceeds from asset sales that may or may not attract positive returns — the PNG National Budget has made some attempt to forecast receipts from asset sales but they are one-off sales and it is hard to determine the balance available for deposit to the SWF, after the repayment of related liabilities.) The basis of the model has also changed. Not only has the structure of deposits changed, but the withdrawal formula has gone from a 15, to a five-year moving average.

The biggest change to the SWF has been the **abolishment of the Development Fund**. This is a significant departure from the 2012 model. There were internal government criticisms of the Development Fund as established under the *2012 Organic Law*, as it potentially created a parallel budgeting system and implementing structure for a significant portion of development expenditure which could potentially undermine existing public financial management systems. That said, it did establish a dedicated source of much needed development spending, which is now lost under the *2014 Organic Law*. The PNG Government has not provided an explanation of the rationale for the abolishment of the Development Fund. An alternative to abolishing the Development Fund could have been to make amendments addressing the criticisms raised.

The *2014 Organic Law* has replaced the Development Fund with an intergenerational savings fund; that is, a **Savings Fund apparently established** to deal with previous issues around intergenerational equity. The earlier design process did not identify intergenerational equity as an important issue for the SWF to contend with. During the design of the SWF under the *2012 Organic Law* it was believed that PNG's immediate development needs were too great to lock money away for future generations, and current and ongoing investments in social and fixed infrastructure would pay a higher rate of returns than investing in long term financial assets could. The idea that PNG needed some type of intergenerational equity mechanism to contend with a limited number of one-off deposits that would be depleted, (i.e. akin to Norway and Alaska's circumstances), was not supported. Rather, policy makers were of the view that PNG had deposits that could be extracted over the very long term, amenable to establishment of a Development Fund. There is a strong possibility that intergenerational equity would be better achieved through investing now in PNG's development, compared to investing in long term financial assets.

Unlike the *2012 Organic Law*, under the *2014 Organic Law* the proceeds from the sale of assets are to be deposited into the SWF, **including non-mineral and non-petroleum assets**. The *2014 Organic Law* may overreach at this point as it goes further than the stated objective of the SWF of dealing with negative impacts from the volatility of the mineral and petroleum receipts, and locks away funds from non-mineral and non-petroleum asset sales. As PNG is capital constrained, and infrastructure is both limited and poor in quality, it is very likely that the returns from investing in infrastructure now will be much greater than the low returns achieved on financial assets. The *2012 Organic Law* only received funds related to mining and petroleum projects. Multiple informants questioned the significantly broadened approach as the SWF was originally designed to only manage receipts from resource projects due to their inherent volatility.

The *2014 Organic Law* **Investment Mandate** (discussed earlier in this paper) will be constrained to making investments in foreign currency assets. The 2012 legislation allowed investments in domestic, Kina denominated assets. The new approach under the *2014 Organic Law* will potentially assist the Stabilisation Fund in achieving its objective of macroeconomic stabilisation. The reduction of pressure on the Kina, relative to foreign currencies, allows for maintenance of international competitiveness for sectors outside of the mining and petroleum sectors.

Key aspects of the SWF **governance structures** have changed (as discussed earlier in this paper). In comparison to the *2014 Organic Law*, under the *2012 Organic Law* the Minister had only a limited role. The Government's role related to: receiving and reviewing SWF reports (issues raised were to be returned to the SWF Board to attend to); the passage of SWF legislation; issuing the Investment Mandate to the SWF Board; and the Ex-Officio had only a limited

role. Under the *2014 Organic Law* the Minister has deeper, ongoing involvement, from the process of passing legislation to implementation. The Minister has discretion over changes made to the Investment Mandate creating the potential for capture by political or self-interest.

As with the *2012 Organic Law*, many of the **operational mechanisms** have been left for the subordinate legislation and regulations to deal with. With operational mechanisms left to be addressed in future, there remains a risk of ‘trickle down’ political (or other) capture of key aspects of the operation of the SWF. The *2014 Organic Law* has been before the Subordinate Legislation Committee for deliberation prior to it being tabled for debate in Parliament. The Committee will play an important role ensuring the subordinate legislation aligns closely and effectively with the stated purposes and objectives of the SWF.

Under the *2014 Organic Law* the **withdrawal rules** are more complex, leaving the potential for confusion within government agencies regarding the treatment of withdrawals from the Savings Fund to the Stabilisation Fund. There is potential for a ‘circular flow’ of funds from the Savings Fund to the Stabilisation Fund, and back. Under the current draft legislation, this would seem to occur if the Stabilisation Fund accrues a balance of US\$1 billion at the time of a withdrawal from the Savings Fund, creating a transfer of funds, of the same amount, back to the Savings Fund. There is no immediately obvious reason why this circular flow would be desirable. An alternative arrangement would be to transfer the funds directly to consolidated revenue.

The **policy development process** for the *2012 Organic Law* was based on two years of extensive stakeholder and public consultations, plus it was informed by over 12 policy papers and draft legislative documents. By contrast, prior to being published in the National Gazette, the *2014 Organic Law*, did not go through a broad consultation process. If the amendments to the *2012 Organic Law* were minor, the lack of additional consultation may matter less. However, external stakeholders, and many government stakeholders, had no opportunity to review or comment on the proposed — and significantly changed — legislation. Multiple informants described concerns that apparently rushed changes to the *2014 Organic Law* will result in errors. If these concerns are correct and future rectification processes are required (processes which are convoluted with Organic Laws) this, plus the lack of consultation, may erode confidence in the SWF.

### **Deposits and withdrawals: how the 2014 Organic Law funds work**

Using the 2015 National Budget forecast period (2015 to 2019), there will be a zero balance maintained by the **Stabilisation Fund**. A positive balance is only possible if mineral and petroleum receipts are more than double the forecast amounts, or if receipts from asset sales exceed K730 million per year, on average, from 2016 to 2019. The Savings Fund will have a positive balance as it captures, without drawdowns, a portion of mining and petroleum dividends from day one. (See below for additional analysis of flows to the Savings Fund.)

The Stabilisation Fund only captures 50 per cent of mining and petroleum tax revenues and a maximum of 75 per cent of dividends (note that the Savings Fund captures the remainder of the dividends), if distributions are made from the State’s holding entities. There is no indication of how the remaining 50 per cent of tax revenues will be treated in the budget — an assumption is made that they will be reported in the budget as revenues and not transferred to the SWF account. (There is no indication from the PNG Government that the remaining 50 per cent of revenues will be diverted from consolidated revenues to other holding entities. If funds were diverted to other holding entities, such as the Kumul trusts, the budget process would be undermined due to reduced transparency and a reduction in the predictability of funds available to be allocated to social expenditure such as health and education programs.)

The Stabilisation Fund withdrawal rule has the effect of reducing the relative importance of mineral and petroleum receipts (see Figure 5 below). From 2016, the withdrawal rule switches from accounting for all mining and petroleum

taxes and dividends to only capturing 50 per cent of taxes and 75 per cent of dividends<sup>16</sup>. This has the immediate effect of increasing the amount that can be drawn from the Stabilisation Fund in its first seven years of operation (see Figure 1 below). For example, in 2016, if 100 per cent of tax revenues and dividends were captured by the withdrawal formula, the Stabilisation Fund would hold a positive balance of approximately K855 million, increasing to K1.03 billion in 2019 (and depending on the US to Kina exchange rate, a transfer to the Savings Fund may occur if the balance was above US\$1 billion). However, based on the current formula with the reduced tax and dividends used to measure the change in the mining to non-mining revenue base, there will be no balance maintained in the Stabilisation Fund, with all funds flowing back to consolidated revenue. Note that by reducing the period for calculating the moving average from 15 years to five years (with a two year lag), the Stabilisation Fund rule withdrawals will more closely reflect the actual volatility in receipts, reducing the revenue smoothing objective of the Stabilisation Fund. In order to achieve the smoothing (or stabilisation) objective, the use of a 10 to 15 year moving average would be advised.

### **Fund balance scenarios**

Analysis of potential future SWF balances is possible, with obvious limitations affecting the degree of accuracy of any predictions. Limitations include the ability to accurately forecast commodity prices, production levels and future investment decisions.

The following charts identify the minimum balances of the Stabilisation Fund under four different scenarios<sup>17</sup>. Each scenario looks at the impact of the section of the deposit rules that stipulates that in the year of establishment of the SWF, mineral and petroleum receipts will be calculated at 50 per cent from that year onwards and not 100 per cent as in each previous year. The analysis uses the revenue forecasts published in the 2015 National Budget and historical revenue data. In addition, for the period 2020 to 2030, trend revenue growth of 11.85 per cent has been used; calculated using the period 2005 to 2015. (The curve is upward sloping from 2021 due to the fixed (trend) rate of revenue growth. This is unlikely to occur but provides us with an indication of the balance if trend revenue growth is achieved over the next ten year period.) The analysis does not include receipts from asset sales or from the Savings Fund, therefore the balance could be higher in years that asset sales occur and above inflation returns are made on the Savings Fund (assuming, of course, that the holding entities make distributions).

The current MTF (2013–2017) does not make an attempt to address the issue of volatility other than to place limits on level of deficits and debt.

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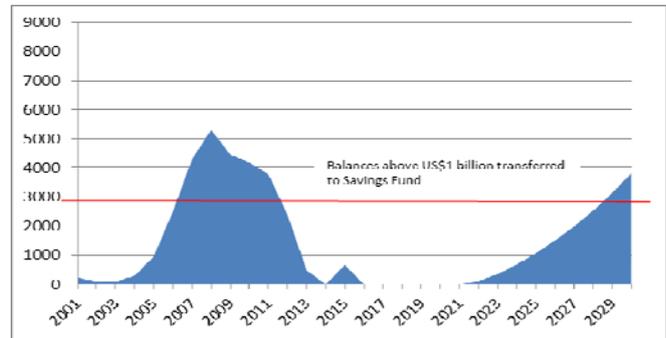
<sup>16</sup> The simple average of the yearly ratio of actual mineral and petroleum receipts to actual non-mineral and non-petroleum receipts for the last five (5) years ending two (2) years prior to the drawdown fiscal year. Note that for any year the SWF has been established (2016 onwards) the mining and petroleum receipts used to calculate the withdrawal amount will be almost halved (see Division 2, 12.(1), (a) and (b)).

<sup>17</sup> Note that the historical data covers the period 1994 to 2014. This is done to allow the scenario analysis to cover the period from 2001, i.e. five years plus a two year lag.

This chart applies the formula as outlined in the 2014 Organic Law with a definition of revenue at 100% prior to 2016, then 50% from 2002.

- SWF implemented from 2016.
- No balance available for stabilisation objective between 2016 and 2022.
- The reduction from 100% to 50% artificially reduces the importance of the mining and petroleum revenues relative to non-mining revenues.

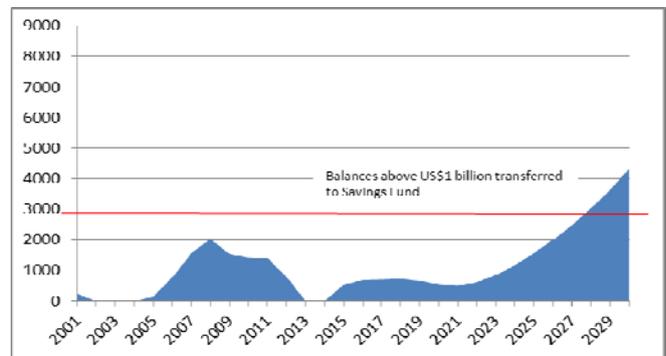
**Figure 1: Current rule with change of revenue definition in 2016 (see footnote 10 – 100% to 2016, then 50% onwards). (LHS = PGK)**



This chart applies the formula from 2002 with a definition of revenue at 100% prior to 2002 then 50% from 2002.

- Applying rules to historical data to identify the result from the boom over the past decade.
- Positive balance almost always available to perform stabilisation function.
- No transfer to Savings Fund, except in 2027, however stable revenue growth like this is very unlikely.
- Volatility reduces the balance as the fund performs its smoothing role.

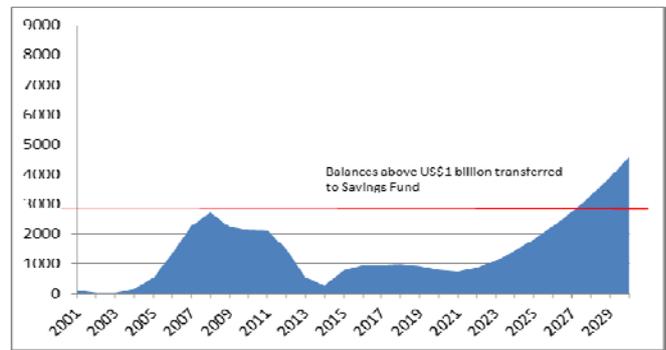
**Figure 2: Current rule with change of revenue definition in 2002 to 50%. (LHS = PGK)**



This chart applies the formula with a constant definition of revenue at 50% over the entire data range, 1996 to 2030.

- Positive balance always available to perform stabilisation function.
- No transfer to Savings Fund, except in 2027, however stable revenue growth is unlikely (as above).
- Does not artificially reduce importance of mining and petroleum revenues.

**Figure 3: Current rule with constant definition of revenue at 50%. (LHS = PGK)**

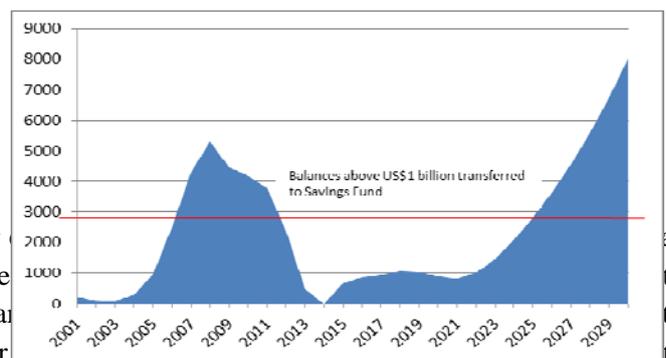


This chart applies the formula with a constant definition of revenue at 100% over the entire data range, 1996 to 2030.

- Stabilisation objective achieved.
- If SWF implemented prior to the last boom there would have been transfers to the Savings Fund during the peak of the boom in 2006 and 2007.

The current formula can only start to have a smoothing effect during the period of reduced tax and dividends only. Due to the transparent reporting of revenues, the Stabilisation Fund is not likely to hold a positive balance during this time and possibly later.

**Figure 4: Constant definition of revenue at 100%**



Under the current withdrawal rules and formula, mineral and petroleum receipts would need to more than double for a positive balance to start to accrue to the Stabilisation Fund and possibly triple for it to be ready and able to achieve its

objectives of stabilising the impact of fluctuating receipts on macroeconomic stability and the exchange rate. The PNG Government is able to allocate additional funds in the National Budget, however, this approach decreases predictability in the Government's fiscal management. So, the deposit of 100 per cent of mining and petroleum taxes would be required for the fund to achieve the stabilisation objective and for full transparency of revenue flows. The stabilisation role will only be required if there is volatility in revenues, and is not something that forecasts capture. (Interestingly, the 2015 National Budget accounted for 100 per cent of revenues flowing to the Stabilisation Fund.)

The above assessment does not factor in any receipts from the sale of mineral and petroleum assets, as information provided in the 2015 National Budget states the value of asset sales but does not determine the level of disbursements from holding entities. However, if assets are sold there is a chance that receipts will be used to retire debt held by the State and non-State holding entities or used for the purchase of new assets prior to any disbursements being made to consolidated revenue and the SWF.

The **Savings Fund** may have a balance of approximately K73 million in 2016, growing to approximately K260 million by 2019, using the 2015 National Budget forecasts. There is potential for a higher balance if assets are sold, including non-mineral and non-petroleum assets. However, these deposits are not likely to be large or frequent.

The deposit rules require further clarification. For example, the legislation does not specify over what period of time the Stabilisation Fund's US\$1 billion ceiling is calculated. The timing of calculation will have a material impact on the Savings Fund and ultimately consolidated revenue.

Again, the legislation does not mention the Kumul Holding entities, but it notes that holding companies will control the State's equity interests in mining and petroleum projects and will determine the size and timing of distributions to the Savings Fund. This also creates uncertainty as to the potential deposits to the Savings Fund. (Over the past decade dividends have averaged around K200 million per annum; this will significantly increase as LNG dividends are realised.)

Withdrawals from the Savings Fund will start after the 10th anniversary of the SWF being established; that is, in 2025 if the Organic Law passes through Parliament this year. All withdrawals from the Savings Fund flow to the Stabilisation Fund, and possibly back again if the balance of the Stabilisation Fund is US\$1 billion<sup>18</sup>. In addition, the adjustment for the real interest rate will reduce the amount withdrawn from the Savings Fund, accumulating more capital in the fund. The capital of the Savings Fund is to be held in perpetuity, with no provision in the legislation to withdraw it. (There may need to be a provision included for drawing down the capital as the rate of return on government expenditure increases.) Many informants raised concerns about the locking away of funds in the Savings Fund in perpetuity, as this could unnecessarily limit the growth of budget expenditures, and PNG's development needs are so great.

#### **Alignment required – SWF in the fiscal framework**

PNG's National Budget outlines the Government's fiscal policy for each year with forward estimates covering a four year period. The National Budget currently includes the MTFS and the debt strategy and any amendments. While fiscal policy is governed by the *Fiscal Responsibility Act* (2013), it is, of course, the budget that outlines the Government's actual approach to fiscal policy.

The MTFS 2013–2017 provides the following guiding principles, which are consistent with the purposes and objectives of the 2014 Organic Law. They are:

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<sup>18</sup>See the discussion on 'circular flow' between funds on page 10 above.

- ⇒ to maintain macroeconomic stability by providing stable and prudent fiscal arrangements, which are critical for sustained job creation and development;
- ⇒ to provide a framework to help address the development needs of Papua New Guinea through a better and more sustainable provision of services and strong broad based economic growth; and
- ⇒ to ensure that revenue collection is maintained to support development and macroeconomic stability objectives.

Looking forward, a key issue is whether the Government will operate within its own stated fiscal rules for deficits and debt levels. The proposed SWF may become a tool capable of: being used to reduce volatility, making expenditure more predictable, reducing the harm on the economy of external economic shocks and improving intergenerational equity. The SWF is not a tool capable of enforcing good budget management — that job falls upon the Government of PNG, using all available resources (and tools and guidelines etc.) and political strategy and will.

**Resource dependency and the fiscal impacts**

PNG’s dependence on revenues from mining and petroleum projects reduced from a percentage of 70 per cent in 2007 to 8 per cent in 2013, potentially rising to 25 per cent in 2015. Current budget forecasts will see this averaging at approximately 30 per cent between 2015 and 2019 as seen in Figure 5 below<sup>19</sup>.

**Figure 5: Stabilisation Fund withdrawal rule: mineral to non-mineral receipts (LHS = mineral/non-mineral receipts)**



Source: PNG 2015 et.

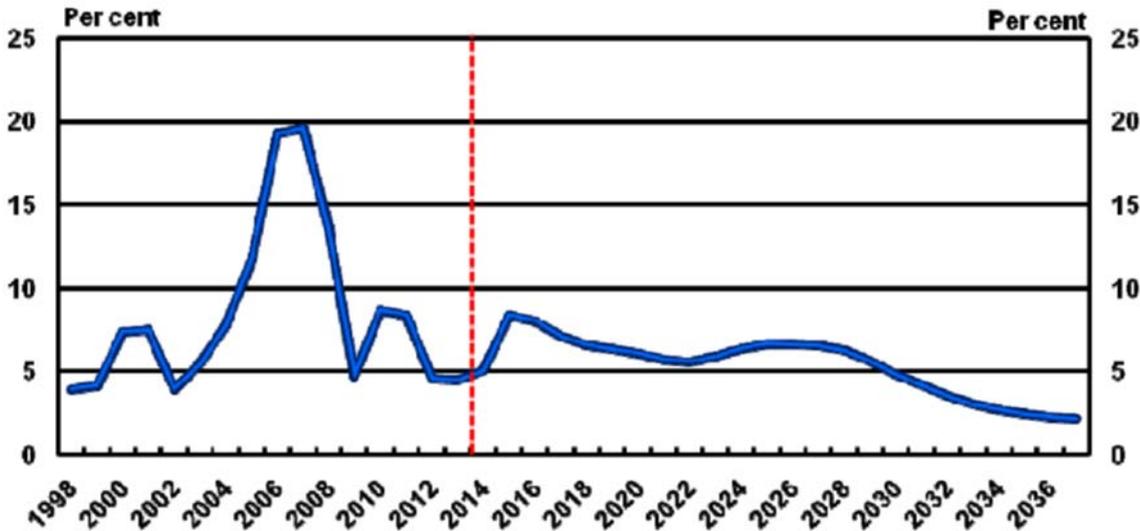
Data from the National Budget

The PNG Treasury has relied on a similar ratio to assess PNG resource dependency (as seen in Figure 6 below); resource revenue as a per cent of non-resource GDP. However, PNG’s actual reliance on the extractives sector is much greater than these ratios demonstrate, as they only capture the rents received from the exports of the resources,

<sup>19</sup> Figures used in calculating the ratio of PNG’s mining and petroleum to non-mining and non-petroleum rents came from the 2015 National Budget, Volume 1.

and not the second round effects on GDP and the fiscal balance. For example, it does not capture the US\$20 billion spent during the construction of the PNG LNG project, nor the taxes paid, nor the expansion of the Hidden Valley and Ok Tedi mines. While this analysis is not specifically of PNG’s resource dependency, it is a noteworthy factor when considering appropriate fiscal tools to reduce the impacts of volatility on both the PNG economy and government revenues.

**Figure 6: Resource revenue as a per cent of non-resource GDP**



Source: PNG 2013 National Budget, Volume 1, page 161.

ume 1, page 161.

Capital investment in mining and petroleum projects has boosted GDP, and with it, increased tax revenues from sectors that support construction activities. This, in effect, increases overall GDP, therefore decreasing the relative importance of revenues from the extractives sector. The actual level of resource dependency in the PNG economy is hidden. Such a measure would not include production, prices, capital formation, and dependant sectors. While Figure 6 demonstrates the volatility in rents from mining and petroleum projects, it does not represent the full scale of dependency. Arguably, the PNG Treasury would be better positioned to design appropriate fiscal policies and tools if it invested in developing a means of more accurately determining PNG’s actual level of resource dependency.

There have been attempts made to better capture the second round effects from the mining and petroleum sectors. For example, the 2009 ACIL Tasman analysis of the economic impact of the PNG LNG project was that 5 per cent of the capital cost would flow into PNG. PNG Treasury used this estimate in its revenue forecasting. However, given the very strong growth in personal and company income tax during the PNG LNG investment phase, the second round effects could have been much larger than five per cent. As the capital investment phases of mining and petroleum projects flow onto the rest of the economy, the challenge is how to best capture these impacts. Structurally, the assumption is that there will be a steady stream of new investments in the resource sector. The source of volatility is the movement in commodity prices, impacting both revenues from exports and revenues from capital investments.

## Conclusion

In conclusion, it is likely that a SWF will only work effectively if accompanied by genuine political will and institutional support to implement coherent and coordinated fiscal policy in PNG, that seeks to manage the negative effects that volatility has on the broader economy and government revenues. If the drive is not well informed and sustained, the SWF will have only limited impact on reducing external shocks to PNG's economy. *Hypothetically*, there is nothing structural in place to stop a government from setting pro-cyclical fiscal policy against the Stabilisation Fund's objectives, or continuing to increase debt while accumulating money in the Savings Fund, with the result of no improvements to intergenerational equity, in stark contrast to stated SWF objectives. Strong political will is a must for the SWF's (and PNG's) future success.

Aspects of the *2014 Organic Law* could certainly be improved, particularly via, for example, applying checks and balances on the powers to determine the Investment Mandate, improving the Board's conflict of interest provisions, and reconsideration of the level of tax receipts captured by the Stabilisation Fund formula, but ultimately it is the Government's willingness to set sustainable fiscal policy that is the most critical issue at play. The SWF does offer something of a window into decision making, requiring ongoing reporting of receipts from PNG's mineral and petroleum assets. This is a welcome element of transparency and an area to watch<sup>20</sup>.

This analysis has highlighted the main aspects of the SWF and some of the main concerns that need to be considered and addressed, such as the complexity of the withdrawal and deposit rules compared to the previous legislation. However, making improvements to the SWF structure should not distract from the most important issue that will determine the success or otherwise of PNG's SWF; that is, the need for ongoing political will, bolstered by community support and demand for significantly improved management of PNG's resource wealth.

## Recommendations

1. Public consultations should be undertaken as a matter of priority to develop **public confidence** in the SWF, which international experience illustrates is necessary to support the SWF's effectiveness and the political will required to protect the integrity of the SWF in the longer term.
2. The Minister's role in the **Investment Mandate** needs to be changed. Changes to the Investment Mandate should require the approval of NEC and Parliament. The Board should determine the SWF Investment Mandate.
3. **The Board conflict of interest provisions** should be improved to ensure adequate treatment, by the individual Board members and the Board as a whole, of conflict of interest situations. This could be dealt with through the establishment of a Board Charter.
4. A **Code of Conduct needs to be developed** for employees of the Secretariat and incorporated into Secretariat employees' employment contracts, specifically addressing issues such as conflicts of interest, and ensuring alignment with SWF objectives.
5. The Organic Law (or its subordinate legislation) needs to state the responsibilities of the **holding entities to distribute funds** to the SWF to ensure predictable and appropriate quantum and timing of holding companies' distributions to the SWF. Hard limits could be stated, to compel the holding companies to make appropriate disbursements.

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<sup>20</sup> On this point, note that transparency will be best served by improving the public reporting of all state and non-state holding entities that hold government assets, including the Independent Public Business Corporation (IPBC) and the proposed Kumul holding entities.

6. The requirement that proceeds from the sale of **non-mineral and non-petroleum assets** are to be deposited into the SWF should be amended or removed as extraneous to stated SWF objectives, and as potentially able to contribute to inappropriate management of capital.
7. The **subordinate legislation and regulations** that will describe and operationalise the SWF's operational mechanisms should completely and accurately reflect the intent of the Organic Law on Sovereign Wealth Fund and the objectives of the SWF, and, preferably capture the spirit of the Santiago Principles.
8. It should be specified when a **transfer from the Stabilisation Fund to the Savings Fund** will occur as the *2014 Organic Law* does not determine over what period of time the Stabilisation Fund's US\$1 billion ceiling is calculated; that is, at the end of the financial year or at any point that the balance reaches US\$1 billion.
9. The level of tax receipts captured by the **Stabilisation Fund formula should be reconsidered** from the perspective that the level should be set at 50 per cent in each year the formula covers (i.e. seven years prior to the starting year or 2016) or, at a minimum, applying the formula with a constant definition of revenue at 50 per cent over the entire data range, 1996 to 2030, helping to maintain the integrity of the stabilisation objective.
10. The *2014 Organic Law* should make it compulsory that **100 per cent of all mining and petroleum taxes and dividends are deposited in the SWF**, and the **ceiling of the Stabilisation Fund** should be simultaneously raised to maintain a flow of funds into consolidated revenue.
11. There needs to be a reconsideration of the **transfer of funds in and out of the Savings Fund**, as under the *2014 Organic Law* there is a risk of a circular transfer of funds in and out of the Savings Fund. This could include considering transferring withdrawals from the Savings Fund directly into consolidated revenue.
12. Fiscal tools utilised by the Government and Government departments need to **incorporate the impact of second round effects** from the mining and petroleum sector. PNG Treasury should lead discussions on the best approach to capturing all aspects of the mining and petroleum sector in forecasting, including capital investment and the related taxes, with an objective of identifying with more clarity the actual scale of effects of the mining and petroleum sectors on government revenues and economic activity, to enhance fiscal management and use of fiscal tools.
13. Government, business, civil society organisations and donors should support the sustained **political will and effort** required to support an effective SWF in PNG.

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**Annexure A***Consultations*

Research for this paper consisted of a desktop analysis of recent analyses and debates on the SWF in PNG, including drawing on work already undertaken by the NRI, PNG's Treasury Department, the Bank of PNG, the Department of Public Enterprises, and development partners. In addition, consultations occurred with key stakeholders in both PNG and Australia between 30 November and 7 December 2014, including with relevant government departments and development partners in PNG, as well as the Bank of PNG, PNG Treasury, the Australian Department of Foreign Affairs and Trade, the World Bank, the Asian Development Bank, and members of academia.

*List of Consultations*

- PNG Treasury, Port Moresby;
- Bank of PNG, Port Moresby;
- Department of National Planning and Monitoring, Port Moresby;
- SWF Secretariat, Port Moresby;
- PNG Institute of National Affairs, Port Moresby;
- Australian Department of Foreign Affairs and Trade, Port Moresby and Canberra;
- Previous and current Strongim Gavman Program officials from the Australian departments of Treasury and Finance;
- Australian Future Fund, Melbourne;
- Asian Development Bank, Port Moresby;
- World Bank, Port Moresby;
- Deloitte, Port Moresby;
- University of PNG, Port Moresby;
- ANU, Canberra; and
- PNG National Research Institute, Port Moresby.

Note that consultations were held on the basis of anonymity, with some views expressed not necessarily being the official views of the organisations represented.

Annexure B

<b>Table 1: Comparing the Key Elements of the 2012 and 2014 Organic Laws to Establish a SWF</b>			
	<b>2012 Organic Law</b>	<b>2014 Organic Law</b>	<b>Issues</b>
<b>SWF Objective</b>			
	To support macro-economic stabilisation; to support the development objectives of the government; and to support asset management in relation to assets accrued from natural resource revenue.	To support macro-economic stabilisation, intergenerational equity and asset management in relation to assets accrued from mineral and petroleum receipts.	<ul style="list-style-type: none"> <li>• The change in the objective reflects the removal of the Development Fund establishment of a Savings Fund.</li> <li>• The stabilisation and asset management objectives remain.</li> </ul>
<b>Funds</b>			
	Stabilisation Fund	<b>Stabilisation Fund</b>	<ul style="list-style-type: none"> <li>• Positive outcome, see below for comparison of the Stabilisation Fund.</li> </ul>
	Development Fund	Abolished	<ul style="list-style-type: none"> <li>• The Development Fund established a dedicated source of funding for investment in high priority infrastructure in PNG.</li> <li>• The fund potentially created a parallel budgeting, procurement and implementing structure, potentially undermining existing public financial management systems.</li> </ul>
	A savings fund was considered in the design phase but not included.	<b>Savings Fund</b> – established to deal with issues around intergenerational equity.	<ul style="list-style-type: none"> <li>• The earlier design process did not identify intergenerational equity as an important issue for the SWF to contend with.</li> <li>• PNG’s immediate development needs are too great to lock money away for future generations, and current and ongoing investments in social and fixed infrastructure would pay higher returns than financial investments could.</li> </ul>
<b>Design Process</b>			
	Two years of extensive stakeholder and public consultations, and informed by over 12 policy papers and draft legislative documents.	Did not go through a broad consultation process.	<ul style="list-style-type: none"> <li>• External stakeholders, and many government stakeholders, had no opportunity to review or comment on the proposed – and significantly changed – 2014 Organic Law.</li> <li>• This lack of consultation could erode confidence in the SWF.</li> </ul>

Operational mechanisms			
	Left to subordinate legislation.	Left to subordinate legislation.	<ul style="list-style-type: none"> <li>• The Subordinate Legislation Committee will play an important role ensuring the subordinate legislation aligns closely and effectively with the stated purposes and objectives of the SWF.</li> <li>• Subordinate legislation is easily changed and therefore key aspects should be dealt with in the Organic Law.</li> </ul>
Investment Mandate			
<i>Investments</i>	Investments in foreign currency assets, with a provision for investments in domestic assets.	Investments in foreign currency assets only.	<ul style="list-style-type: none"> <li>• The approach under the <i>2014 Organic Law</i> will potentially assist the Stabilisation Fund in achieving its objective of macro-economic stabilisation. The reduction of pressure on the Kina, relative to foreign currencies, allows for maintenance of international competitiveness for sectors outside of the mining and petroleum sectors.</li> </ul>
<i>Governance</i>	Issuing the Investment Mandate to the SWF Board; and the Ex-Officio had only a limited role.	The Minister has expanded discretion over changes made to the Investment Mandate.	<ul style="list-style-type: none"> <li>• The creating of the potential for capture by political or self-interest.</li> <li>• The requirement of the Minister to only report to Parliament on the Investment Mandate should be changed to needing the approval of NEC and Parliament.</li> <li>• The Board should determine the SWF Investment Mandate and then present it to NEC.</li> </ul>
Board			
<i>Conflict of interest</i>	Board members are required to inform the Board at a Board meeting as soon as practicable after the member becomes aware of a conflict of interest.	Board members are required to inform the Board as soon as practicable after the member becomes aware of a conflict of interest.	<ul style="list-style-type: none"> <li>• If this section is contravened, and the Board is not informed prior to a decision, it will have <u>no effect</u> on the validity of transactions or resolutions of the Board. (This is the same in both the 2012 and 2014 organic laws.)</li> <li>• There is no incentive for a Board member to declare a conflict of interest if doing so does not work in their favour.</li> </ul>

			<ul style="list-style-type: none"> <li>• There may be a need for a Board Charter that would regulate the behaviour of members in some detail, including in conflict-of-interest situations.</li> </ul>
<b>Secretariat</b>			
	Secretariat is required to implement Board decisions.	Secretariat is required to implement Board decisions.	<ul style="list-style-type: none"> <li>• Secretariat’s behaviour could be ‘driven’ by the Board. To mitigate against this possibility, a Code of Conduct could be developed and incorporated into employment contracts.</li> </ul>
<b>Stabilisation Fund</b>			
<i>Purpose</i>	Manage the impact of fluctuations in mineral and petroleum revenues on the PNG economy and on the National Budget.	Manage the impact of fluctuations of mineral and petroleum receipts on the economy of Papua New Guinea so as to promote and support macroeconomic stability, and to ensure that large foreign currency movements do not affect the competitiveness of the economy.	<ul style="list-style-type: none"> <li>• The purpose statement has been expanded and arguably improved in providing an explanation to why reducing volatility is important.</li> </ul>
<i>Deposit Rule</i>	100 per cent of all mineral and petroleum revenues; and, earnings from investment of the fund.	50 per cent of mining and petroleum tax revenues; 60 per cent of the proceeds of sale from any interest, either directly or indirectly, the State holds in any mineral or petroleum asset; all withdrawals from the Savings Fund; 75 per cent of all distributions from any interest, either directly or indirectly, the State holds in any mining or petroleum projects; an amount between 35 and 75 per cent, as determined by Parliament, of all dividends due to the State from non-holding companies holding interests in mining and petroleum projects; and earnings from investment of the fund.	<ul style="list-style-type: none"> <li>• The new deposit rules have greater complexity which could lead to implementation problems and makes the role of forecasting the balance of the fund much harder.</li> <li>• Deposits of the proceeds from the sale of assets, <b>including non-mining and non-petroleum assets</b>, is outside of the objective of the SWF, which is to “support macroeconomic stabilisation, inter-generational equity and asset management in relation to assets accrued from <b>mineral and petroleum receipts</b>.”</li> <li>• The <i>2012 Organic Law</i> only received funds related to mining and petroleum projects.</li> <li>• There is no legislative requirement for disbursements from holding entities, undermining deposits related to dividends.</li> </ul>

<p><i>Withdrawal rule</i></p>	<p>15 year moving average of mineral and petroleum revenues as a share of non-mining revenue. Parliament may make further rules with respect to withdrawals.</p>	<p>5 year moving average of mineral and petroleum revenues as a share of non-mineral and non-petroleum receipts; and must not exceed the product of the simple average of the yearly ratio of actual mineral and petroleum receipts to actual non-mineral and non-petroleum receipts for the last 5 years ending 2 years prior to the draw-down fiscal year and actual non-mineral and non-petroleum receipts in the National Budget 2 years prior to the draw-down fiscal year, determined by a formula (see main text). Parliament may make further rules with respect to withdrawals.</p>	<ul style="list-style-type: none"> <li>• Much more complex rule, leaving the potential for confusion within government agencies regarding the treatment of withdrawals.</li> <li>• There is a potential for a ‘circular flow’ of funds from the Savings Fund to the Stabilisation Fund.</li> <li>• By reducing the period for calculating the moving average from 15 years to five years (with a two year lag), the rule will more closely reflect the actual volatility in receipts, reducing the revenue ‘smoothing’ purpose of the Stabilisation Fund.</li> <li>• In order to achieve the ‘smoothing’ purpose, the use of a 10 to 15 year moving average would be advised.</li> <li>• The final aspect of the rule allows subordinate legislation to make changes to rules.</li> </ul>
<p><b>Holding entities</b></p>			
	<p>No reference to holding entities.</p>	<p>Holding companies will control the State’s equity interests in mining and petroleum projects and will determine the size and timing of distributions to the SWF.</p>	<ul style="list-style-type: none"> <li>• There seems to be no legal requirement for holding companies to make disbursements to the SWF, they could decide to make no disbursements.</li> <li>• The Organic Law (or its subordinate legislation) needs to state the responsibilities of the holding entities to distribute funds to the SWF to ensure predictable and appropriate quantum and timing of holding companies’ distributions to the SWF. Hard limits could be stated to compel the holding companies to make appropriate disbursements.</li> </ul>

### About the Author

David Osborne is a Visiting Fellow at the Australian National University's Development Policy Centre and is a Senior Economist with Adam Smith International. He has worked for the Australian Government (AusAID and DFAT) as a Senior Economist, including as Country Economist in PNG, and ran DFAT's Mining for Development initiative. He also worked for the PNG Sustainable Development Program in Port Moresby as an economist, and prior to that worked for government and NGOs in Indonesia. His work focuses on revenue management, the extractives sector and drivers of economic growth.

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*The views expressed in this paper are entirely the author's own and not those of the National Research Institute.*

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