ISSUES PAPER

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An analysis of the Papua New Guinea Sovereign Wealth Fund's process of formulation and progress towards establishment

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Abstract

The National Research Institute (NRI) commissioned this Issues Paper to review and analyse the process of the formulation of Papua New Guinea (PNG)'s sovereign wealth fund (SWF); its current status; and lessons and future prospects. After providing the background and PNG's historical attempts at creating SWFs, the paper then discusses the current SWF including its design, formulation process, structure, and the organic law. The paper then provides some key lessons emanating from the analysis, which include the need:

- to coordinate all fiscal policy tools utilised;
- to reduce PNG's resource dependency;
- for broad consultations;
- to prepare for possible future economic crises; and
- to go further than the Santiago Principles to ensure that the SWF genuinely contributes to PNG's development.

The paper concludes by emphasising that there is nothing evident in PNG's history, or current situation, precluding the PNG Government – if it wishes – from creating and implementing an effective SWF to assist PNG to meet its development objectives. However, history does show that considerable political will and stamina is required to do so.

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Introduction

The National Research Institute (NRI) commissioned this issues paper, reviewing and analysing the process of the formulation of Papua New Guinea's (PNG's) sovereign wealth fund (SWF), including some analysis of the implications of possible future plans for the SWF. The paper will discuss the formulation and establishment of PNG's SWF. It will describe past attempts to establish SWFs in PNG and will provide some lessons that can be drawn from PNG's past and current experiences. The paper will assist to develop understanding of the status of PNG's SWF and inform discussions on policy options for the SWF, ideally, demonstrating how an SWF may be established and operated in a way that will assist the Government of PNG to meet the needs of its people now and in the future.

This issues paper does not discuss in detail the structure of PNG's SWF as this was covered by NRI's Discussion Paper No.110: Creation of a Sovereign Wealth Fund.

Background

The PNG Government commenced design of a SWF in 2010. There were, and remain, many valid reasons for establishing a SWF in PNG. The most persuasive is to assist macroeconomic stability through encouraging effective and sustainable management and use of anticipated LNG export revenues, necessary to attain improved, sustained development outcomes for the country. There are multiple reasons why a SWF is 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 funds for the public good.

An Organic Law on the SWF (hereafter referred to as 'the Organic Law on the SWF') was developed in 2011 and was passed by PNG Parliament in 2012. The law's status has been questioned due to an alleged procedural error occurring during the final stages of the law being passed. Citing the procedural error, the Government has stated it expects it will table a new version of the Organic Law on the SWF in Parliament in November this year (2014), in order to finally establish a SWF for PNG. Given that PNG has exported its first shipment of LNG to Asian markets, and PNG is experiencing a large increase in LNG-related revenues, which commenced flowing in mid-2014, it is timely that an effective SWF is established to assist responsible management of both the macroeconomic impacts caused by the initial increases in revenue, and effective and sustainable management of long term revenue flows to assist improved development outcomes for Papua New Guineans.

Research for this issues paper consisted of a desktop analysis of recent analyses and debates on the SWF in PNG, including drawing on work already undertaken by the National Research Institute, 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 1 June and 2 July 2014, including with relevant government departments and development partners in PNG, including the Bank of PNG, PNG Treasury, the Australian Department of Foreign Affairs and Trade, the Asian Development Bank, the International Monetary Fund, and members of academia (see list of consultations at Annexure A).

Preliminary findings were presented at a public forum at the NRI in Port Moresby on 25 June 2014.

Rationale for PNG's SWF

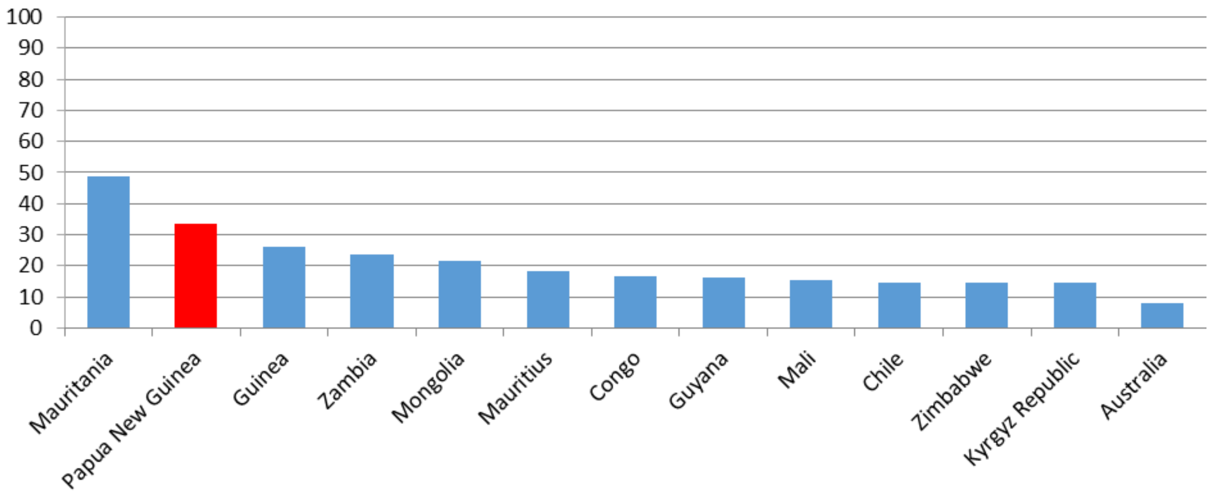
Governments typically establish sovereign wealth funds to achieve a range of objectives including: increasing savings for future generations; reducing 'Dutch Disease' induced impacts; smoothing the revenue profile for national budgets; and for setting aside funds for identified projects (for example, priority infrastructure projects). 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. Using World Databank, Howes (2014) demonstrated that PNG is the tenth most resource dependent country in the world, 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 many governments' management of their countries' economies, and this has been PNG's experience. 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 have disguised entrenched problems in the broader (non-resource) economy. There has been unsatisfactory improvement in PNG's human development indicators since 1980, with PNG still placing in the low human development category, ranking at 156 out of 186 countries and territories (UNDP 2013). The growth in PNG's resource sector has negatively impacted the non-resource economy through a volatile exchange rate (mainly appreciating), resulting in inflation and demand side effects – Dutch Disease style effects (ACIL Tasman 2009).

The degree of PNG's resource dependency is further demonstrated in Figure 1. This figure extracts oil and gas production values. On mineral rents alone, PNG is the second most resource dependent country out of 144 countries analysed. A key implication is when international commodity prices change, PNG's economy is susceptible to either 'booming or busting' to a greater degree than almost all the other countries examined.

Figure 1: Mineral rents as a percentage of GDP, 2010



Source: International Council on Mining and Metals (2012), UNCTADstat (2010)

PNG's resource dependency over the past two decades has been driven primarily by its reliance on minerals (gold and copper). This will change over the coming years as LNG production and exports increase, at which time PNG will likely move rapidly up in the 'overall resource dependency' rankings, conceivably ranking higher than countries such as Mongolia and Saudi Arabia in the near future. Foreseeable flow on effects will include adjustments to the structure of the PNG economy. There may be increased domestic pressure upon the PNG Government to effectively transfer new 'national wealth' to PNG citizens[1].

Transferring wealth 'across the economy'

PNG is a dualistic economy bolstered by a small number of very large mines, the most recent addition being the US$20 billion LNG project. Mining projects, like Ok Tedi and Lihir, have both direct and indirect employees (in the thousands and tens of thousands respectively) and consume large quantities of goods and services from domestic sources to support their operations; they are large impact projects. Although they create discrete economic enclaves, economic benefits also tend to spill over into the broader economy. This occurs, for example, through: the start-up and capitalisation of landowner companies and the investments and employment these create outside the enclaves; the remittances of wages and profits sent to communities outside the enclaves; the construction of mining-related infrastructure, such as roads and ports, that external businesses and small scale enterprises can rely upon for the transport of goods and services; and the dissemination of new skills and techniques across the economy. These are real and valuable benefits of mining projects, not all of which are typically evident in LNG projects.

As the production and export of LNG increases in PNG, 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, 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 minerals sector. Accordingly, they may be characterised as 'low impact projects' that demonstrate comparatively limited spill-over benefits for local economies. PNG citizens, who anticipate benefits will flow from PNG's LNG project, as they have from other mining projects, may be disappointed.

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 — the choices made regarding investments in social and fixed infrastructure, health, education, roads and ports and suchlike. In the absence of effective revenue management and distribution, communities and local economies will not receive the long awaited LNG-related benefits anticipated by many.

If, as has been the case in some other countries, PNG's resource dependency presents significant and potentially negative impacts upon PNG'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 PNG's broader fiscal policy; it can provide something of a narrative describing the Government's response to the opportunities and challenges of the project.

[1] PNG's 2014 National Budget has projected that GDP in 2015 will increase by 21.2 per cent, up from a projected increase of 6.2 per cent in 2014.

Setting a fiscal narrative

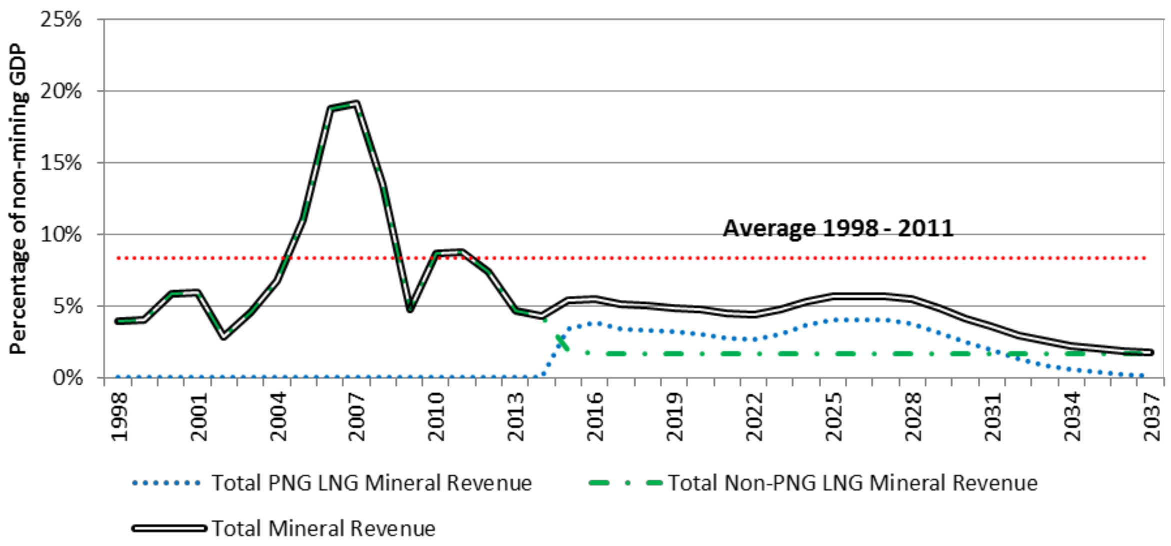
Past growth in the PNG Government's revenue and the related expansion in expenditure over the last decade has largely been absorbed through the use of trust accounts.

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 down 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. 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.

PNG's fiscal framework now needs to be positioned to respond to economic events, including the foreseeable impacts of LNG related revenues, and 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.

Figure 2 has been taken from the PNG Treasury's 2012 budget books. (The PNG Treasury used this chart to demonstrate that LNG revenues were not going to be as transformative as first thought, that the boom has passed, and that the time had come to rein in spending and balance the budget). The figure demonstrates the increase in mineral revenues, relative to non-mineral revenues, during the commodity price spike of the past decade.

Figure 2: Percentage of non-mineral GDP: PNG LNG Revenue replaces, but does not increase mineral revenues recently enjoyed in PNG (as a percentage of economy)



Source: PNG Treasury, 2012 Budget, Volume 1

PNG has a history of negative impacts from economic shocks, budget deficits and unsustainable government debt. It has a history of poor service delivery and poorly aligned fiscal policy. Emerging LNG -driven resource dependency requires highly effective Government expenditure to assist the Government's ability to effectively transfer LNG wealth and benefits to the broader economy and population.

Previous Efforts to Manage Revenues

PNG has a long history, going back some 60 years, of using sovereign wealth funds to manage windfall revenues from mining, oil and gas, and agriculture. There have been a range of models proposed (and some briefly used) but none lasting the test of time and effectively withstanding political interference. The first was the Mineral Resources Stabilisation Fund (MRSF), and subsequently the PNG Sustainable Development Program (PNGSDP) with its development and long term funds, and now the PNG Sovereign Wealth Fund (SWF).

The key reason sovereign wealth fund management has not 'taken' in PNG appears to be that previous PNG Governments have not successfully reconciled the divergent views of technocrats and politicians. Technocrats seem, by and large, to have considered SWFs based on the Santiago principles and aligned with existing public finance tools like the national budget process, the medium term debt strategy and the medium term fiscal strategy, appropriate for PNG. Politicians, on the other hand, do not seem consistently supportive of the restrictions the technocrats' proposed models would have imposed (such as the restrictive expenditure and investment rules). The following is a brief overview of the past funds up to the point of the current SWF.

Mineral Resource Stabilisation Fund (MRSF)

The MRSF was established by an Act of Parliament in 1974. Its purpose was to smooth the flow of resource revenues (including taxes and dividends) into consolidated revenue. However, amendments to the Act progressively undermined its stabilisation objective and in 1994 the Act was amended which allowed the PNG Government to secure a USD90 million loan from UBS against revenue flows to the MRSF. This was widely seen as a fatal blow to the MRSF from which it never recovered. In reality, the MRSF was flawed from a number of perspectives, and throughout much of the 1980s and 1990s the governments were simply borrowing domestically to build up the MRSF balances, and the full value of annual MRSF inflows was being spent through the national budget.

The MRSF could have been substantially improved had it been held as a foreign currency denominated account, and held offshore, thereby taking the pressure off the local currency and maintaining the global competitiveness of the agricultural sector. It was agreed at the time that the MRSF (or any other fund that is designed to serve a similar purpose) could only be effective if it was integrated into a coherent strategy for the overall conduct of fiscal policy.

Agricultural funds

PNG created a number of agricultural funds with the objective of stabilising the flow of foreign reserves and to regulate or 'smooth' the incomes of farmers through the use of price controls. For example, the Coffee Stabilization Fund, which was the largest of these funds, operated on the principle that cuts were made to growers' incomes during periods of good prices and were returned to them during low price periods. It was regulated under a mechanism which triggered a stabilisation levy deduction. A ten year moving average of prices was applied in some cases.

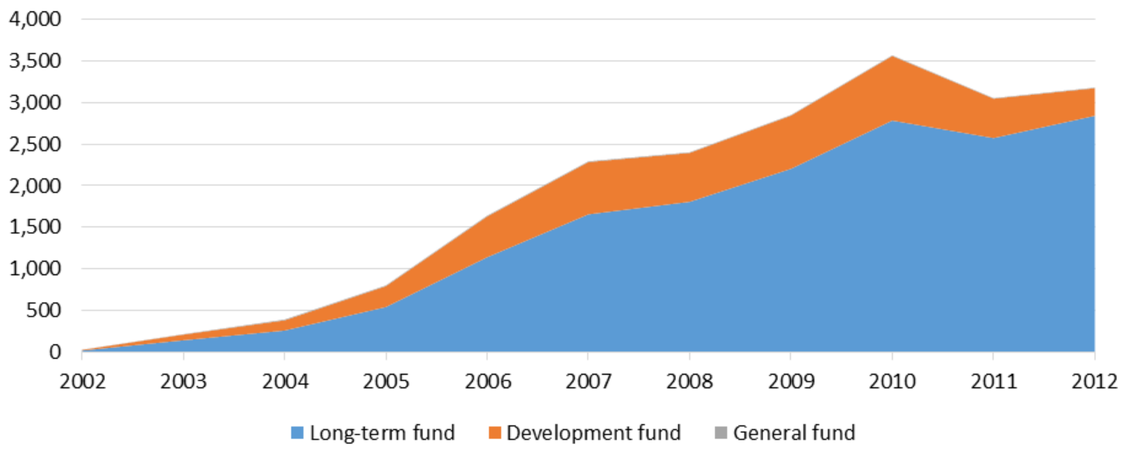
Other like funds include the Copra Stabilisation Fund, the Palm Oil Stabilisation Fund, and the Cocoa Stabilisation Fund. The funds' stabilisation objectives were rendered irrelevant as mineral and petroleum exploration and production dwarfed earnings from agriculture.

PNG Sustainable Development Program — long term and development funds

The PNGSDP (including its funds) was established in 2001 through an agreement between BHP and the PNG Government. The Development Fund received one third of the dividends from PNGSDP's equity in Ok Tedi Mining Limited and could be used for expenditure on development projects in the Western Province (one third) and the rest of PNG (the remaining two thirds). The Long-term Fund received two thirds of the dividends but was locked away until after mine closure, anticipated to occur in 2015.[2] Once the mine closes, 2.5 per cent of the capital plus any annual income can be drawn down for use in the Western Province (two thirds) and the rest of PNG (one third).[3] (Refer to the 2011 Review of PNGSDP by Howes and Kwa for further information on PNGSDP and its funds.)

PNGSDP's funds captured the increase in the prices for gold and copper over the past decade (see Figure 3). The funds were invested in predominantly off-shore investments, with a focus on preserving the capital base of the funds. The funds achieved a positive investment return in all but one year; 2009 saw a negative return of -2.62 per cent which was attributed to the Global Financial Crisis.

Figure 3: PNGSDP balance of funds, PGK millions



Source: PNGSDP's annual reports, 2002 to 2012.

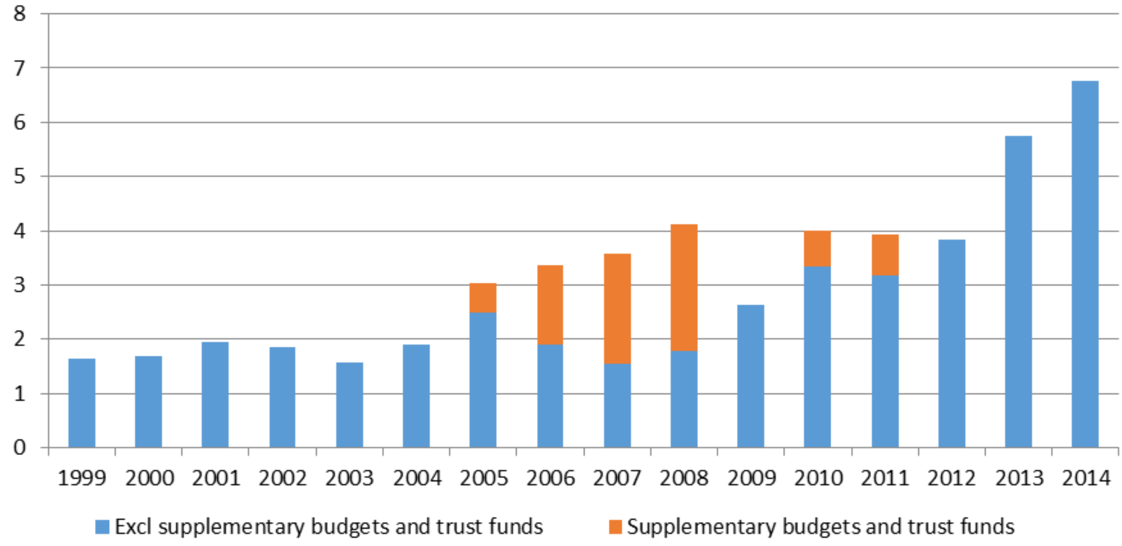
Trust accounts

As discussed earlier, the PNG Government's use of supplementary budgets and trust accounts during the boom period provided a mechanism that smoothed the expenditure, in that money was taken out of the economy at a time when capacity was constrained, holding money in trust until the capacity was available to implement earmarked projects. Accountability and mismanagement has long been a concern for these accounts and there remain unanswered questions around the status and quantum of the trust funds. It has been estimated that in the 1990s and early 2000s there were approximately 3000 separate trust accounts, reducing to an estimated 300 after a review in 2004 found many to be redundant (Batten 2010). There are some estimates that more than PGK5 billion has gone missing from trust accounts but without audited accounts it is impossible to confirm the status of all of the PNG Government's trust accounts. Figure 4 shows the size of the funds put in trust, relative to development expenditures.

[2] Mine closure date is now uncertain as there is a plan for mine life extension.

[3] Due to the nationalisation of Ok Tedi Mining Limited by the PNG Government in 2013 and the ceasing of PNGSDP's operations on 18 October 2013, the status of the long term and development funds is unknown.

Figure 4: Trust funds (supplementary budgets) PGK billions (2012 prices)



Source: PNG National Budgets, Volume 1, 2000 to 2013; and Howes (2014).

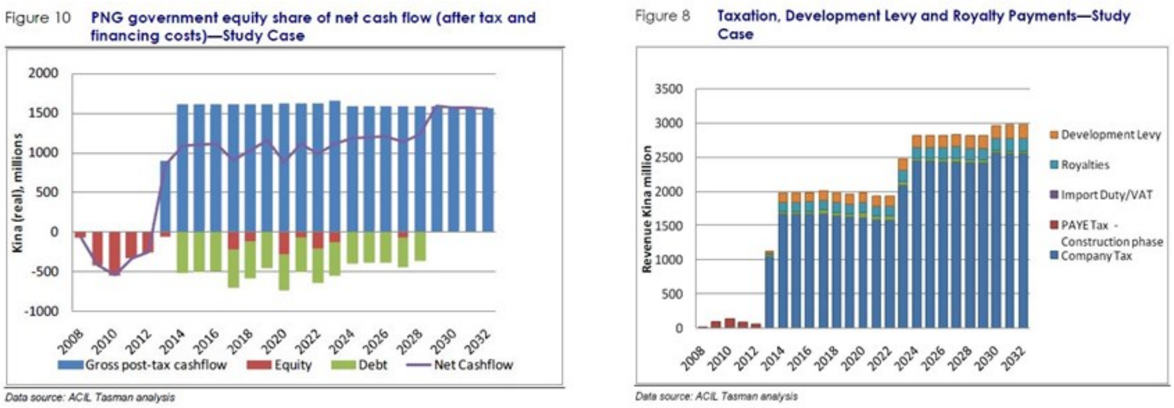
Despite the Government currently running large budget deficits, funds are still being placed into multi-year trust accounts (PNG Budget 2013).

The Current SWF

The catalyst for action

In February 2008 ACIL Tasman published the *PNG LNG Economic Impact Study for ExxonMobil* (revised in April 2009). The study provided an assessment of the direct and indirect impacts of the proposed PNG LNG Project on PNG's economy. The study had an impact on the PNG Government, community and other stakeholders as it highlighted, in great detail, the very significant benefits that would accrue to PNG if the project were to proceed. Faced with declining revenues due to the then planned closure at Ok Tedi, declining production levels from the oil fields and after a decade of little to no investment in exploration or new mines, the prospect of windfall revenues in excess of PGK3 billion annually (see Figure 5) proved too tempting for the Government to ignore.

Figure 5: ACIL Tasman study benefits – dividends and revenue



Source: ACIL Tasman (2009)

Along with the benefits, the study also gave an insight into the negative economic impacts that could come from the PNG LNG Project, noting that Dutch Disease style effects would be experienced. The following excerpt from the study provides an indication of the issues that would need to be addressed:

> *"… the modelling indicates that growth in demand in the oil and gas sector and high rates of public and private expenditure will put upward pressure on the exchange rate, causing it to appreciate. A stronger kina, together with a tendency for the gas development to draw capital and labour away from the primary production sectors such as agriculture and forestry, has the potential to reduce the export competitiveness of those sectors." (ACIL Tasman (2008), p.8.)*

The study went on to predict that, at the sectoral level, the inflationary effects of increased government spending and a positive trade balance (or an appreciation of the real exchange rate) could produce a contraction in agricultural activity. Smallholder cash crop production was likely to be the hardest hit by the growth in the resources sector, with a prediction that smallholder palm oil production could decline by 138 per cent and smallholder cocoa production could decline by 15 per cent. ACIL Tasman also provided estimates of rural employment falling by between 32 to 35 per cent.

It was this assessment that gave rise to the need to look at ways to manage the economy differently, including the idea of a SWF to manage the benefits in a way that led to the long term and sustainable economic development of PNG; a way for the 'winners' (Government revenue) to compensate the 'losers' (the non-resource economy, especially rural and agricultural workers as they would be the least likely to benefit from the increased incomes in the urban centres).

In addition to being used as the technical basis for much of the early work for the design of the SWF, the ACIL Tasman study underpinned PNG LNG Project negotiations between the PNG Government and Exxon Mobil.

Early days in the SWF design process

In October 2009, at the Australia-Papua New Guinea Ministerial Forum, the idea of the establishment of a SWF to manage the PNG LNG Project revenues and dividends was formally discussed. SWF establishment was seen as a condition for directing Australian support towards the PNG Government's role in developing the LNG project; support which was viewed as critical to getting the project past the point of Final Investment Decision (FID) stage. (Financial and technical support was provided and the project progressed.)

In March 2010, Sir Michael Somare announced to Parliament that a number of SWFs would be established to maximise the development impacts from the PNG LNG Project. Sir Michael announced there would be three funds: a Stabilisation Fund to reduce the impact on the domestic economy of an internal or external shock; a Future Fund to create a pool of diversified pool of assets and to reduce the impact of Dutch Disease style effects; and an Infrastructure Fund to provide the capital for national infrastructure projects. This announcement formed the basis for the SWF design work and related consultations through 2010 and 2011.

The SWF Secretaries Committee was formed with membership comprising the Department of PM & NEC, Department of Treasury, Bank of PNG, Department of Public Enterprises, Department of National Planning and Monitoring, and Department of Justice and Attorney General, chaired by the Secretary of the Treasury. An Inter-departmental Sovereign Wealth Fund Working Group was established to support the Secretaries Committee, with membership comprising the Department of Treasury, Bank of Papua New Guinea, Department of National Planning and Monitoring and Department of Public Enterprises, chaired by the Department of Treasury. The Working Group was assigned the task of assessing the current framework, seeking advice and assistance from international institutions and interested governments, and recommending possible fund options to take to government, and undertaking stakeholder consultations.

Consultation and Design: 2010–2011

The PNG Government led extensive consultations with a wide range of stakeholders, including internationally recognized experts experienced in the design and implementation of SWFs. Consultations started with a number of domestic and international stakeholder forums held in May 2010. Genuine community consultations didn't start until mid-November 2011, after the Organic Law on the SWF was published in the National Gazette.

Members of the SWF Secretaries Committee and the Working Group engaged with numerous foreign governments which had established SWFs to manage non-renewable resource revenues. Included in these consultations were Norway, Timor Leste, Chile, Australia and others at the International Forum of Sovereign Wealth Funds meeting in Sydney during May 2010.

In addition to the many stakeholder forums, meetings and study tours, the SWF Working Group produced a number of policy papers and invited submissions from interested stakeholders. The papers submitted to the SWF Working Group included the following[4]:

- 'Discussion paper: possible creation of a Sovereign Wealth Fund', Department of Treasury and Bank of PNG 2010;
- 'The Establishment and Management of an Infrastructure Fund for Papua New Guinea', Department of Public Enterprises 2010;
- 'Creation of a Sovereign Wealth Fund', National Research Institute 2010;
- 'Papua New Guinea – Considerations in Establishing A Sovereign Wealth Fund', IMF 2010;
- 'Managing Resource - Induced Volatility in Papua New Guinea: Some Issues for Discussion', The World Bank 2010;
- 'Effects on the PNG Economy of a Major LNG Project', Dixon, Kauzi, Rimmer 2010;
- 'PNG's Sovereign Wealth Funds - drawdown rules and economic purpose', Department of Treasury 2011;
- 'Concept Note: Economic Guidance for Legislation Regulating Draw-downs from the PNG LNG Project Sovereign Wealth Funds', McGillivray 2011;
- 'Macroeconomic modelling in Papua New Guinea', Narayan 2011; and
- 'Draft Independent Infrastructure Authority Act', Port Moresby, 2012.

In addition to the consultations, donors and international organisations provided specific technical and policy support. The International Monetary Fund provided support with macroeconomic modelling and with the design of the investment mandate, the World Bank provided support with policy and economic analysis and the Australian Government, through the 'Joint Understanding between Papua New Guinea and Australia on further cooperation on the PNG LNG Project', provided support across a wide range of issues, including economic policy, modelling, design and implementation. This support provided PNG with access to experts from the Department of Finance and Deregulation and the Future Fund, Australia's largest SWF. It included many interactions between the Secretaries Committee and Mr David Murray, the then Chairman of Australia's Future Fund and of the International Forum of Sovereign Wealth Funds.

[4] Note that this list does not include all the international technical and policy papers used by the SWF Working Group.

SWF approval

The SWF Working Group submitted its final report to NEC in October 2011 which recommended for the establishment of an offshore SWF. It contended that this structure was the most appropriate mechanism to manage all future mineral and petroleum revenues, including revenues from the PNG LNG Project.

The 2011 National Budget, passed in late 2010, outlined the main objectives and structure of the SWF. The budget outlined that a joint NEC submission reflected both the Working Group's work and work separately undertaken by the Department of Public Enterprises. The submission recommended for the establishment of three integrated offshore funds, a stabilisation fund, infrastructure fund and a future (or savings) fund. This was identical to what had been announced by Prime Minister Somare earlier in the year.

The budget papers outlined the objectives of the SWF, which included:

- Macroeconomic stabilization – to deal with the volatile and unpredictable resource revenues;
- Improve economic and social development – through appropriate investment of the LNG dividends;
- Fiscal transparency and oversight – to improve accountability, transparency and governance;
- Mitigation of Dutch Disease – to reduce the negative impacts on the competitiveness of the non-resource tradable sectors;
- Asset management – to improve the management and the returns of the Government's financial assets;
- Savings – to save for future generations and achieve long-term fiscal sustainability.

There were no particulars provided on how revenues and dividends would flow into the funds, the drawdown rules or the investment mandate (it being proposed that this would follow as the details of the design were agreed, and then drafted into legislation).

The Organic Law on the SWF

The 2012 National Budget announced that the SWF would be established through an Organic Law. It was proposed that the Organic Law would provide the requisite high level structure, governance arrangements, and policy guidance. It was proposed that all other aspects of the SWF would be dealt with in subordinate legislation.

The structure and number of funds had altered since Sir Michael Somare's announcement. Specifically, the Organic Law on the Sovereign Wealth Fund outlined the establishment of two consolidated funds, a stabilisation fund and a development fund. The Future Fund had been dropped and the Infrastructure Fund had been renamed as the Development Fund. These changes coincided with the 2011 political crisis and subsequent changes to the PNG Government. Peter O'Neill had become Prime Minister and Arthur Somare had lost his ministerial position, and with it control of the proposed Infrastructure Fund. With the change of Government in August 2011, the structure of the SWF changed.

The budget documents explained the specific purposes of the two funds as follows:

- Stabilisation Fund – to manage the impact of fluctuating mineral and petroleum revenues on the PNG economy and on the National Budget; and
- Development Fund – to provide a definite and ongoing funding source for the provision of development in key economic and social priorities in accordance with the development plans as determined by the Government.

And the stated objective of the SWF was described as follows:

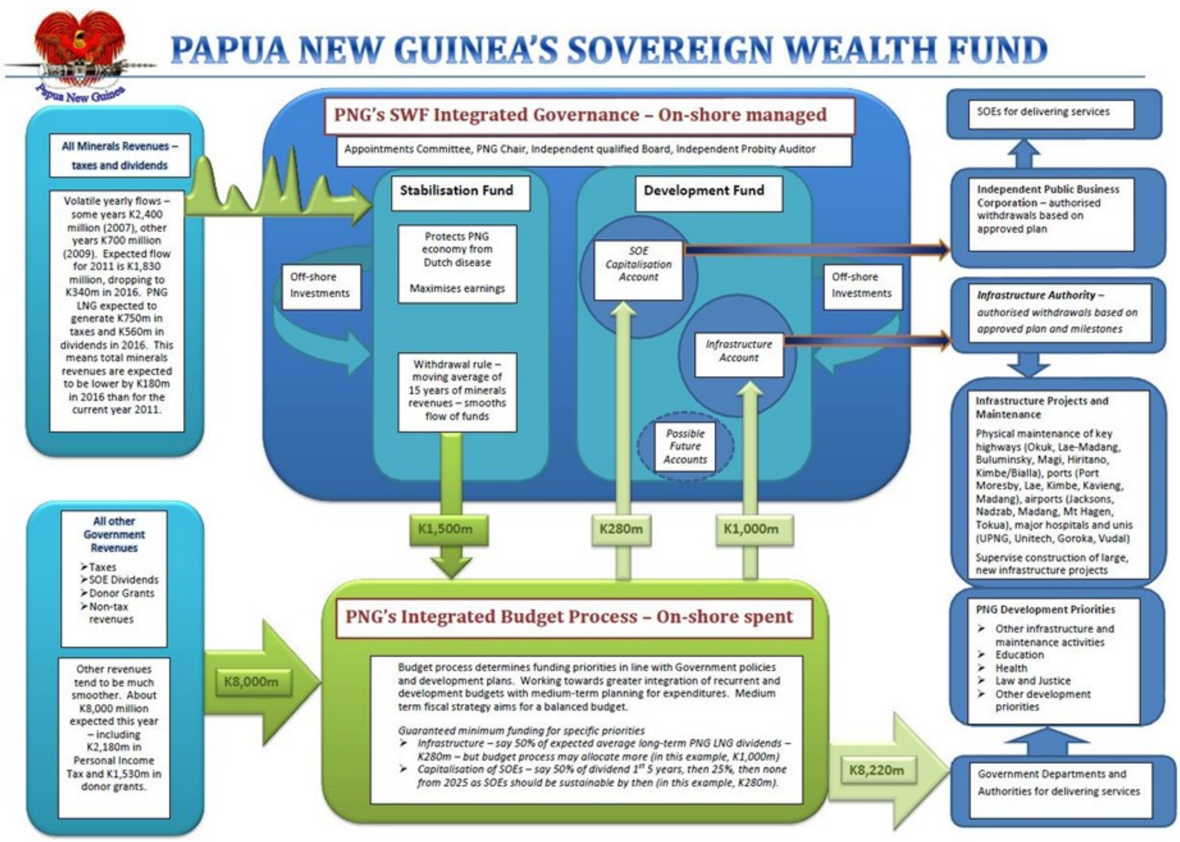
- Support macroeconomic stabilisation;
- Support the development objectives of the Government, including long-term economic and social development; and
- Support asset management in relation to assets accrued from natural resource revenue.

Some key elements taken from international best practice remained. These included: 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.

In October 2011, the SWF policy and legislative framework was endorsed by the Government. On 21 October 2011, a Constitutional amendment to create a head of power provision for the proposed Organic Law was published in the National Gazette. Then, on 2 November 2011, the SWF Organic Law was published in the National Gazette. It was tabled in Parliament in December 2011, the first of two times. The Organic Law was then passed after it was tabled in Parliament for the second time in February 2012. It was certified on 21 March 2012.

It appeared that the Organic Law had gone through all the required steps and would then move to implementation, in time for the first export of LNG. Figure 6 demonstrates the flow of funds and the relationship with existing fiscal frameworks and development objectives.

Figure 6: How PNG's SWF was proposed to operate in practice



Source: PNG National Budget, Volume 1, 2012

Stabilization Fund

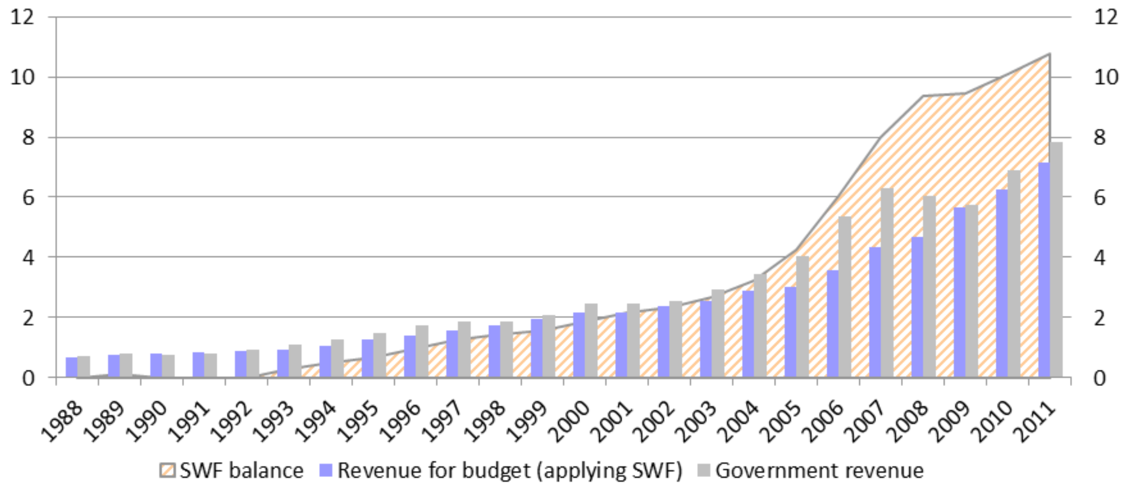
The Organic Law on the SWF states that the purpose of the Stabilisation Fund was to manage the impact of fluctuations in mineral and petroleum revenues on the PNG economy and on the National Budget.

The Stabilisation Fund was designed to support the non-resource budget deficit. The Stabilisation Fund, with its rigid drawdown rule, would minimize the impact that volatile resource revenues would have on the national budget. The rule would also reduce policy discretion which would further stabilise government expenditure. The rule would ensure that resources held in PNG's Stabilisation Fund were withdrawn in a disciplined manner in accordance with the National Budget process, and integrated within the broader fiscal framework. However, it is important to remember that such rules are only as effective as a government wishes them to be, as on their own they cannot control government spending or deficits, and may actually encourage an increase in the debt level.

All mineral and petroleum revenues (taxes and dividends) were to be deposited into the Stabilisation Fund. Withdrawals from the fund were to not exceed the 15 year long-term moving average of mineral and petroleum revenues as a share of non-mining revenue.

Figure 7 attempts to simulate the impact of this rule if the SWF had been in place since 1988, capturing the most recent commodity price boom. This is a hypothetical exercise to demonstrate the impact on the revenue available for the budget.

Figure 7: Simulated stabilization fund accumulation (PGK, billions)



Source: PNG Treasury data, PNG National Budget 1988 to 2012

Development Fund

The Organic Law on the SWF states that the purpose of the Development Fund was to provide definite and ongoing funding for economic and social development in accordance with the development plans of Government.

The Development Fund was to receive a minimum allocation of no less than the expected average of the dividends accruing as a result of the equity interest of the State in the PNG LNG Project (see Figure 5 for an estimate of the dividends). The Organic Law did not place restrictions on the withdrawals from the Development Fund, other than to say that moneys would be made available to support the development plans of Government in accordance with an Act of Parliament.

The question of validity of the Organic Law

There is not a consensus regarding the status of the Organic Law on the SWF, and specifically, whether it is valid or not. It appears there was a procedural issue or mistake that has raised real questions regarding the law's legitimacy. The prevailing view is that it was incorrectly certified the same day that it was tabled and passed by Parliament. To avoid any future ambiguity, the SWF Secretaries Committee agrees that the Organic Law on the SWF should be tabled in Parliament again.

The Secretaries Committee, on advice from the SWF Working Group, also saw this as an opportunity to amend the Organic Law to fix a number of mistakes. It was at this point that other stakeholders, including PNG's Attorney General's Department, appear to have considered it an opportunity to influence the structure of the SWF.

The redrafted Organic Law: the new model

On 9 September 2013 the Governor of the Bank of PNG, Loi Bakani, outlined in a speech to the PNG Advantage Summit that an amendment would be made to the existing Organic Law due to the procedural issue placing doubt around the law's validity. The presented amendments seemed to go further than simply correcting the procedural issue; the amendments contained new funds with changed arrangements for how revenues and/or dividends would flow into the SWF and how drawdowns would be treated. A new SWF model emerged.

The Government has since confirmed that the amended Organic Law (the new model), has been approved by NEC and is now waiting to be published in the National Gazette prior to being tabled in Parliament. While the finer details have not yet been published, it is understood that the SWF will initially constitute two funds, a future fund and a stabilisation fund, and with a provision for the creation of additional funds.

It is understood that the new SWF will only receive up to a maximum of 30 per cent of the dividends from the Government's equity in resource projects that are held by the Kumul trusts (Kumul Petroleum Holdings Limited and Kumul Mining Holdings Limited). The actual amount flowing to the SWF will be determined by the related Kumul holding companies on the basis of the dividends they declare in favour of the Government. In addition to only receiving 30 per cent of the dividends, it seems that no resource tax revenues will flow through the SWF.

The proposed flow of funds and drawdown rules for each fund are as follows:

- Future fund – 9 per cent of mining, oil and gas dividends, no drawdown before 2035;
- Stabilisation fund – 21 per cent of mining, oil and gas dividends, full drawdown on 1 January of each year, starting 2018.

If we were to simulate the fund balance under this model, in a like fashion as outlined above for the first Organic Law (Figure 7), there would be a zero balance. This is because the new model's drawdown rule seems to permit a full drawdown at the beginning of each budget year, therefore potentially having no impact on the amount available to the budget. It is difficult to see how the full drawdown at the beginning of each budget year (thereby rendering a zero balance) assists to achieve the stabilisation objective or does anything to reduce the macroeconomic impacts from volatile resource revenues.

Minister Marape announces model

On 12 June 2014, Minister Marape used his speech at the PNG Update Dinner to announce that the NEC had approved a new SWF. The Minister outlined the following details for the related funds (note that the Minister's statement has not been confirmed through the issuing of a written statement):

- Savings Fund – 25 per cent of all LNG and mineral revenues locked away to 2035;
- Stabilisation Fund – 25 per cent of all LNG and mineral revenues;
- Current development use – 50 per cent of all LNG and mineral revenues.

Without further information it is hard to analyse the implications, however the model announced by Minister Marape appears to be a sensible approach and reflective of the work done to date. Further analyses will not be possible until the detailed model is provided, including governance arrangements, drawdown rules and the investment mandate.

Some lessons from SWFs in PNG

While it was not this paper's primary purpose to present findings as such, some lessons can be extracted from a brief analysis of PNG's history with SWFs.

- All fiscal policy tools utilised need to be coordinated. Many experts, including Garton (2012), argue that a key element of an effective SWF is the need for it to be integrated within a country's broader fiscal policy and coordinated with all related fiscal policy tools. For example, a savings fund would only be effective if there was a genuine increase in government saving, (not offset by increased borrowing in the budget). PNG's SWF will need to be closely integrated with the policies established under the Kumul Trust as it seems likely that the Kumul Trust will control resource dividends for the state. Logically, the SWF will need to not contradict the objectives of PNG's current and future Medium Term Fiscal Strategy, Medium Term Debt Strategy and the annual National Budget, and vice versa.

- There is a need to reduce PNG's resource dependency. Investing government funds that have come from the resource sector, back into the resources sector, will further increase PNG's resource dependency and in doing so increase the exposure to the risks the sector poses to the budget and broader economy. For example, Government purchases of Oil Search Ltd shares increases PNG's exposure. There is a strong case for using funds from the resources sector in alternative investments, either in international financial products (that don't present exposure to risks) or in social and fixed infrastructure in PNG, such as health, education, roads, ports, and the like.

- Broad consultation will increase the likelihood that PNG's SWF will succeed in meeting its objectives. While consultation was an important part of the first two versions of PNG's SWF, since 2013 there has been little to no consultation with stakeholders, and limited detailed information is being provided to the public. It seems that government officials and SWF experts were not widely consulted during the drafting of the most recent SWF model. An important aspect of a SWF's success is the sense of ownership by all relevant stakeholders, including by the general public.

- There is a need to prepare for possible future economic crises. Based on historical experience, it is highly likely that PNG will face an economic crisis of some nature in future years. Such a crisis could be caused by a relatively minor global event, but which could have a large impact upon PNG's economy. For example, there could be a significant fall in the price of LNG, gold or copper; or a disruption to the new LNG pipeline; or an inability on the part of PNG to refinance its short term debt. It would therefore be prudent for PNG to place some money in a SWF which can effectively act as a savings fund, especially during a period of increasing revenues and rapidly increasing expenditure.

- Finally, there is a need to go further than the Generally Accepted Principles and Practices (the Santiago Principles) to ensure the SWF genuinely contributes to PNG's development. Of the 24 Santiago principles, none actually cover the need for the fund to be designed in a way that benefits the 'owners' (i.e. the citizens of the country). The principles don't explicitly cover the need for a fund to achieve positive outcomes for the economy. (They are primarily focused on the governance and accountability structures.)

Conclusion

There appears to be nothing evident in PNG's history or current situation, precluding the PNG Government – if it wishes – from creating and implementing an effective SWF to assist PNG to meet its development objectives. History does show that considerable political will and stamina is required to do so.

At this stage the status of the current SWF, and details as to its structure and objectives are unclear. There seems to be agreement that there will be a savings fund and a stabilisation fund, but the payments into the funds and the proposed drawdown rules are, as yet, unknown, even as we approach the end of 2014.

Treasurer Pruaitch announced on 22 June 2014 that a new legislation for the establishment of the SWF would be tabled in the June session of Parliament; however, this was rendered redundant when on 24 June 2014 Parliament was adjourned to August 2014. It is generally assumed that the details of PNG's SWF will not emerge before the end of October 2014, when Parliament next sits. It is a pity that more information regarding PNG's proposed SWF is unavailable. However, the potential of the establishment of an effective SWF remains.

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Annexure A

Consultations

- PNG Treasury officials
- Bank of PNG
- PNG Institute of National Affairs
- Australian Department of Foreign Affairs and Trade
- Previous and current Strongim Gavman Program officials from the Australian departments of Treasury and Finance
- Asian Development Bank official
- International Monetary Fund official
- World Bank official
- University of PNG academics
- ANU academics
- PNG National Research Institute

Note that attempts were made to consult with the Department of Attorney General, Gadens Lawyers, and the PNG Chamber of Commerce.

Annexure B

Terms of reference

The terms of reference for the study are as follows.

The researcher will:

i. review and update the discussion to-date in PNG on the processes of developing a SWF for PNG;

ii. highlight the current status of the SWF, including the key features of the proposed SWF, Legislation (including its Organic Law), its structure, and operational mechanisms;

iii. analyse the prospects of the SWF;

iv. draw policy lessons to inform SWF policy debate;

v. inform the public and generate public debate on SWF;

vi. work closely with the Economic Policy Research Program Leader; and

vii. seek background information from:

   a. relevant government agencies; and

   b. other key stakeholders.

About the Author

David Osborne is a Visiting Fellow at the Development Policy Centre and is a Senior Economist with Adam Smith International. He has worked for AusAID and DFAT as a Senior Economist, including as Country Economist in PNG and ran DFAT's Mining for Development initiative. He worked for the PNG Sustainable Development Program in Port Moresby as an economist for two years, 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.

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

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