



## The Heritage and Stabilization Fund (HSF)

### Great Expectations or False Promises?

After a significant hiatus, the government of Trinidad and Tobago is bringing to life the Heritage and Stabilization Fund (HSF) in the midst of another major energy boom. Substantial energy revenues are already flowing into the government's coffers and even more inflows are anticipated over the next few years. The proposed legislation will see the demise of the Interim Revenue Stabilization Fund and the transfer of some US\$1.2 billion to the HSF. Subsequently, a minimum of 60% of excess oil and gas revenues will be deposited to the Fund in each financial year. Not surprisingly, the HSF embodies great expectations as the instrument to manage the country's energy wealth. However, the sobering experience with commodity stabilization funds across the world has shown that few have worked well and many have failed. Sound design principles are therefore critical to helping avoid any false promises.

In this context, two fundamental design parameters of the proposed HSF are flawed:

- **Setting two distinct but often conflicting goals.** The HSF is one investment portfolio with twin objectives. Firstly, the HSF seeks to use surplus resources to stabilize government spending in the face of volatile energy prices; and secondly it aims to invest surplus funds (heritage) to support public expenditure capacity for the rainy day when our non-renewable energy reserves are depleted. What goal will prevail during an uncertain period of falling oil prices? Would it be stabilization, which may be politically beneficial and tempting? Or would it be heritage, which may be politically unacceptable but prudent? Who will determine the relative importance of these goals?
- **Calculation of benchmark energy prices using a moving average rule.** The rule for accumulating deposits into the HSF would be determined on the basis of the long term prices of crude oil and natural gas. Energy prices would be calculated on the basis of an eleven (11) year moving average comprising prices in the current financial year, in five (5) years immediately prior to the current year and in the five (5) years immediately following the current financial year. Who will carry out these price projections? Would it be the Central Bank or the Ministry of Finance? Would these institutions open their energy

price projections to public scrutiny?

These are all very relevant questions that one must ask in relation to the discipline, transparency and intergenerational fairness necessary for such a critical vehicle as the HSF. As a student of economics, I am reminded of the Tinbergen Principle, which states that there must be ONE policy instrument for each objective. In other words, you cannot serve two masters at the same time. Or in Trini parlance, “two beau rat cannot live in the same hole”. (Quite interestingly, Jan Tinbergen was awarded the first Nobel Prize in Economics (1969) partly for developing this concept). The HSF in its current incarnation violates the Tinbergen Principle – one instrument exists but with dual objectives.

There are many difficulties in projecting energy prices. The use of a moving average rule in particular assumes that energy prices will quickly return to their average or “normal” level. This assumption certainly does not hold true in the real world where oil is black gold – the fountainhead of geopolitical power and drama. Oil prices are highly volatile and ONLY very slowly revert to a mean level over several years. Oil prices usually follow a random walk process – similar to a drunkard staggering down the street. In Trinidad & Tobago, oil revenue projections are also complicated by the provisions of the tax regime, production sharing contracts, and the intermediary role of the National Gas Company (NGC).

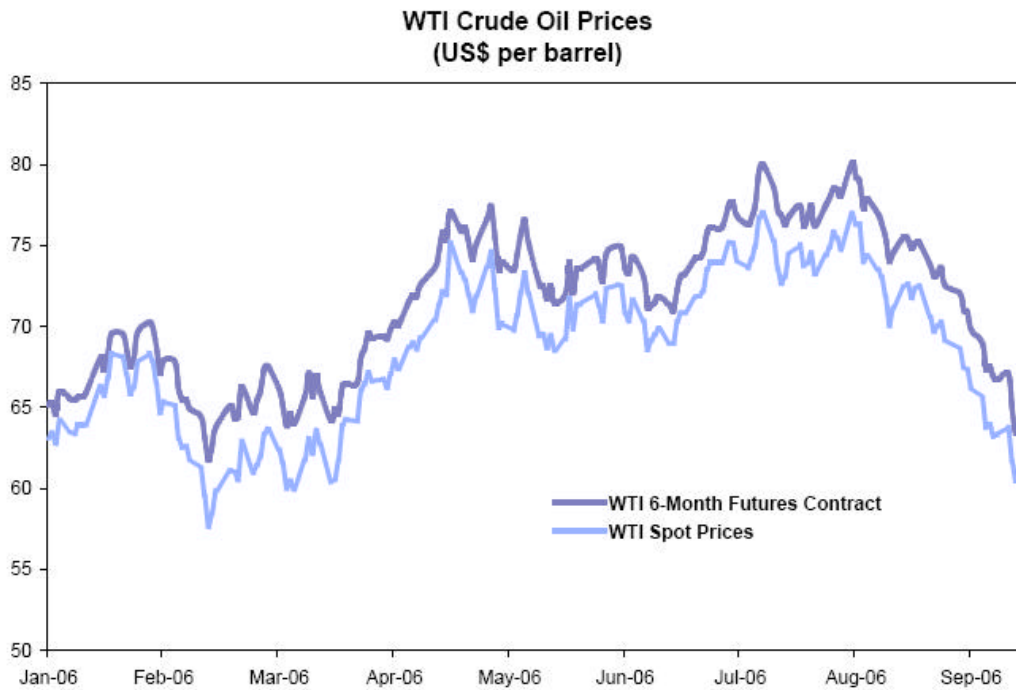
On balance, there is little convincing evidence to suggest that the HSF, as proposed, is likely to achieve its desired results. We therefore make the following recommendations:

1. Create a true Heritage Fund into which ALL excess energy revenues would be placed. The principal from this Heritage Fund must be invested permanently and cannot be spent without a national referendum. Some portion of the investment income must be distributed each year as a dividend payment to eligible nationals, thereby giving them a personal vested interest in protecting the Heritage Fund.
  2. Accumulate deposits into the Heritage Fund based on forward looking prices set in the futures and other oil-derivative markets. On the New York Mercantile Exchange (NYMEX), futures prices for West Texas Intermediate (WTI), a proxy for BPTT crude, are readily available all the way from October 2006 to December 2012. (See figure 1)
  3. Stabilize the impact of oil price volatility on the budget by hedging oil price exposures on the international financial markets. Crude oil is the world’s most actively traded commodity. More crude oil is traded daily on the NYMEX than the total world production of crude oil (about 65-80 million barrels in futures versus 83 million barrels of physical). Oil futures, options and swap offer the best possibility for risk management.
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Much of Trinidad & Tobago's economic management has focused on accommodating gyrations in the global oil market. The ensuing policy responses and institutional practices over the previous boom-bust cycle resulted in mismanagement of oil resources with dire consequences.

History and our children's children will not absolve us if, once again, we mismanage our energy wealth. The government must go back to the HSF drawing board.

**Figure 1: WTI Crude Oil Spot Prices and 6-Month Futures Contract**



Source: Bloomberg

## FINANCIAL & ECONOMIC INDICATORS

As at 21<sup>st</sup> September 2006

| <u>Exchange Rate/US\$</u> | <u>Closing Value</u> | <u>Previous Week</u> |
|---------------------------|----------------------|----------------------|
| Yen                       | 116.38               | 117.59               |
| Euro                      | 1.28                 | 1.27                 |
| Jamaica                   | 65.94                | 65.96                |
| Guyana                    | 200.70               | 200.70               |

| <u>Commodity Prices</u>  | <u>Closing Value</u> | <u>Previous Week</u> |
|--------------------------|----------------------|----------------------|
| Crude oil (US\$/bbl)     | 61.59                | 63.22                |
| Natural Gas (US\$/mmbtu) | 4.65                 | 5.07                 |
| Gold (US\$/Troy Ounce)   | 584.20               | 575.25               |

### Eurobond Indices (Returns, % YTD as of 21- Sept- 06)

|  |        |
|--|--------|
| Lehman Brothers Global Aggregate Index | 2.40   |
| JP Morgan EMBI+                        | -11.30 |
| CMMB Eurobond Index                    | -0.30  |

| <u>Policy Interest Rates (%)</u> | <u>Closing Value</u> | <u>Previous Month</u> |
|----------------------------------|----------------------|-----------------------|
| United States                    | 5.25                 | 5.25                  |
| Euro Zone                        | 3.00                 | 3.00                  |
| Japan                            | 0.25                 | 0.25                  |
| Brazil                           | 14.25                | 14.25                 |
| Trinidad                         | 7.75                 | 7.75                  |
| Jamaica                          | 12.15                | 12.15                 |
| Barbados                         | 4.75                 | 4.75                  |

| <u>Market Interest Rates (%)</u> | <u>Closing Value</u> | <u>Previous Week</u> |
|----------------------------------|----------------------|----------------------|
| US 90-day T-Bill                 | 4.79                 | 4.81                 |
| US 10-Yr Treasury                | 4.64                 | 4.77                 |
| 3-month UK Libor                 | 5.06                 | 4.99                 |
| Japan 90-day T-Bill              | 0.28                 | 0.28                 |
| Brazil 90-day T-Bill             | 13.86                | 13.91                |
| TT 90-day T-Bill                 | 6.60                 | 6.47                 |
| Jamaica 90-day T-Bill            | 12.06                | 12.29                |
| Barbados 90-day T-Bill           | 5.91                 | 5.91                 |

Sources: Bloomberg, CMMB Research Centre, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, [www.lehman.com](http://www.lehman.com)

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