REPÚBLICA DEMOCRÁTICA DE TIMOR-LESTE

State Budget

2012

Budget Overview

Book 1

"Goodbye Conflict, Welcome Development "

Book 1 Budget Overview

Preface

The Organic Law of the Ministry of Finance specifies the responsibility of the National Directorate of Budget to collect and manage financial information relating to the public sector and publish the statistical results.

In accordance with this provision and to raise the transparency of the public finances, the Ministry of Finance is publishing the final version of the documents relating to the General Budget of the State 2012, promulgated by His Excellency Dr. Jose Ramos-Horta, President of the Republic, following the debate in the plenary session of the National Parliament.

The documentation for the General Budget of the State 2012 consists of the Budget Law, which is published in the Journal of the Republic, plus six supporting budget books:

Book 1 Budget Overview

Book 2 Annual Action Plans

Book 3 Districts

Book 4a and 4b Budget Line Items

Book 5 Development Partners

Book 6 Special Funds

Book 1 Budget Overview describes the overall budget strategy of the Government. It provides information on the international and domestic economic outlook; expected domestic and oil-based revenue including expected sustainable income, and overall expenditure in the medium term and the main new initiatives in the coming year.

Budget documentation is available on the website of the Ministry of Finance, www.mof.gov.tl. Inquiries relating to the publication should be directed to the National Director of Budget, Mr. Agostinho Castro on email: acastro@mof.gov.tl or telephone +670 333 9520.

As Timor-Leste farewells conflict and welcomes development, I believe that this document will increase awareness and understanding of the Government's finances by providing the people of Timor-Leste, civil society and our development partners with relevant information on the 2012 State Budget.

Emília Pires
Ministra das Finanças

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Part 2: Executive Summary

Introduction

The Strategic Development Plan (SDP) outlines policies to transform Timor-Leste into an upper middle income country with a healthy, educated and secure population by 2030. The 2012 State Budget appropriates expenditures to implement these policies and achieve the SDP's goals. The Combined Sources Budget for Timor-Leste in 2012 is $1.95 billion. This comprises Government expenditure of $1.76 billion and commitments from Development Partners of $188.9 million.

Table 2.1 Combined Sources Budget 2010-2016 $ million

	2010 actual	2011 budget	2012 budget	2013 budget	2014 budget	2015 budget	2016 budget
Combined Sources Budget	**1,022.6**	**1,578.8**	**1,952.3**	**1,932.2**	**1,926.8**	**1,569.3**	**1,564.1**
Government Expenditures by Fund	*758.7*	*1,306.0*	*1,763.4*	*1,803.4*	*1,854.8*	*1,505.7*	*1,564.1*
CFTL	758.7	681.7	954.1	784.2	815.6	848.2	882.2
HCDF	0.0	25.0	30.0	35.0	40.0	45.0	45.0
Infrastructure Fund	0.0	599.3	746.2	904.0	918.2	509.6	457.0
Infrastructure Expenditures by Loans	0.0	0.0	33.1	80.2	81.1	102.8	180.0
Development Partner Commitments	*263.9*	*272.8*	*188.9*	*128.8*	*72.0*	*63.7*	*0.0*

Source: National Directorate of Budget, Ministry of Finance, 2011

Table 2.2 shows expenditure, revenue, and financing for the State Budget and key economic indicators.

Table 2.2 Fiscal Table

($millions)	2008 actual	2009 actual	2010 actual	2011 budget	2012 budget	2013 budget	2014 budget	2015 budget	2016 budget
Total Expenditure by Appropriation Category	**483.9**	**603.6**	**758.7**	**1,306.0**	**1,763.4**	**1,803.4**	**1,854.8**	**1,505.7**	**1,564.1**
Recurrent	*356.0*	*394.3*	*505.0*	*588.4*	*679.0*	*709.9*	*741.9*	*775.0*	*804.2*
Salary and Wages	50.3	87.3	91.5	116.8	140.1	145.7	151.5	157.6	163.9
Goods and Services (including HCDF)	221.4	212.8	245.1	294.1	344.7	362.3	380.4	399.0	413.2
Public Transfers	84.3	94.2	168.4	177.5	194.2	202.0	210.0	218.4	227.2
Capital	*127.9*	*209.3*	*253.7*	*717.6*	*1,084.4*	*1,093.5*	*1,112.9*	*730.7*	*759.9*
Minor Capital	41.4	38.5	38.1	29.3	30.0	31.2	32.4	33.7	35.1
Capital and Development (including Infrastructure Fund)	86.5	170.8	215.6	688.3	1,054.4	1,062.3	1,080.5	696.9	724.8
Financing	**483.9**	**603.6**	**758.7**	**1,306.0**	**1,763.4**	**1,803.4**	**1,854.8**	**1,505.7**	**1,564.1**
Domestic Revenue	*69.4*	*90.8*	*96.4*	*110.7*	*136.1*	*158.7*	*185.5*	*217.8*	*256.3*
Estimated Sustainable Income (ESI)	*396.0*	*408.4*	*502.0*	*734.0*	*665.3*	*641.2*	*617.1*	*591.4*	*577.1*
Excess Withdrawals from the PF	*0*	*103.6*	*309.0*	*321.0*	*928.9*	*923.3*	*971.2*	*593.6*	*550.7*
Use of Cash Balance	*18.5*	*0.8*	*-148.7*	*140.3*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Borrowing	*0.0*	*0.0*	*0.0*	*0.0*	*33.1*	*80.2*	*81.1*	*102.8*	*180.0*
Selected Economic Indicators									
Non-Oil Fiscal Balance	*-414.5*	*-512.8*	*-662.3*	*-1,195.3*	*-1,627.3*	*-1,644.7*	*-1,669.4*	*-1,287.9*	*-1,307.8*
Nominal Non-Oil GDP Excl UN ($m)	*459.7*	*578.5*	*653.8*	*788.3*	*929.7*	*1,097.1*	*1,282.3*	*1,500.4*	*1,767.8*
Non-Oil Fiscal Deficit / Non-Oil GDP	*90%*	*89%*	*101%*	*152%*	*175%*	*150%*	*130%*	*86%*	*74%*

Source: Ministry of Finance, 2011.

Economy

The preliminary estimate of Timor-Leste's economic growth for 2010 is 8.5%. Government contracts to build infrastructure in 2010 spurred strong growth in the construction sector. Rice and coffee production were below expectations in 2010 mainly due to unseasonal rains. Bullish economic growth is expected to continue in the medium term, underpinned by high public expenditures.

Domestic inflation had increased to 12.4% by June 2011, compared to June 2010 prices. High inflation in 2011 was driven by an increase in international food prices, depreciation of the US dollar and increasing recurrent expenditure. International food prices and the value of the dollar are outside of the Government's control and the onus, therefore, lies with the Government's fiscal policy to control inflation. The Government is committed to prudent growth in recurrent expenditure in the medium term, which is in line with the SDP and consistent with stable inflation. In 2012, however, a significant increase in recurrent expenditure is required to pay for the essential expenditures described in the next section.

Expenditure

The budget for recurrent expenditure in 2012 is $679 million; representing a 15% increase compared to 2011. This increase in expenditure is necessary to pay for increased spending on fuel for generators, spending related to the teachers' and paramedics' career regime and an expansion of the Human Capital Development Fund.

The budget for capital expenditure (including minor capital) in 2012 is $1.1 billion, reflecting a higher Infrastructure Fund budget than 2011 and including funds to the Timor-Leste Investment Corporation (TLIC). Over 70% of this expenditure will occur through large, multi-year projects in the Infrastructure Fund. These projects will contribute to the construction of the core infrastructure necessary to develop and support a modern and productive economy.

The 2012 State Budget also includes over $52 million dollars of expenditure for the PDD1 and PDD2 programs. These programs aim to construct small scale infrastructure according to local needs and boost the development of local construction companies.

Revenue

Domestic revenue collections are forecast at $136.1 million in 2012. This represents a 22.9% increase compared to the 2011 forecast of $110.7 million. This increase is being driven by sales tax, excise tax and import duties. Withholding tax is also increasing mainly due to the forecasted increase in the value of construction contracts related to public expenditure.

In 2012 domestic non-oil revenue collections are forecast to finance 7.7% of total Government expenditure. However, high rates of economic growth and increased efficiency in tax collections mean that by 2016 domestic non-oil revenues should rise to $256.3 million, financing 16.4% of total expenditure.

The Estimated Sustainable Income (ESI) is calculated at $665.3 million for 2012, which is a decrease of $69 million from the 2012 ESI estimate in last year's budget. The main reasons for the decrease are a significant downward revision of production forecast and a significant upward revision of costs at Bayu-Undan. There are no material changes of methodology of the ESI calculation.

Petroleum revenues are expected to peak in 2011 at $2.5 billion before starting to steadily decline from 2012 onwards. Notwithstanding a reduction in inflows and increased withdrawals compared with last year's budget calculations, the Petroleum Fund balance is set to increase from $6.9 billion by the end of 2010 to $8.7 billion by the end of 2011, $9.2 billion by the end of 2012 and $11.3 billion by the end of 2016.

The amended Petroleum Fund Law was passed by Parliament on August 23, 2011. The amended Petroleum Fund Law strengthens the already internationally acclaimed governance framework embedded in the original 2005 law. A key change in the amended law is the investment policy of diversification that allows for other investment instruments than US Government bonds and increasing the share of equities in the portfolio. Being a long-term investor, Timor-Leste can endure the higher short-term swings in returns that will follow the new investment policy. The increased expected return will better align the investment policy to the fiscal policy and Timor-Leste's nation building program.

Financing

The non-oil deficit is equal to domestic revenue minus total expenditure. The non-oil deficit in 2012 will be $1.6 billion. This deficit will be financed by the Estimated Sustainable Income (ESI), excess withdrawals from the Petroleum Fund and a relatively small amount of borrowing.

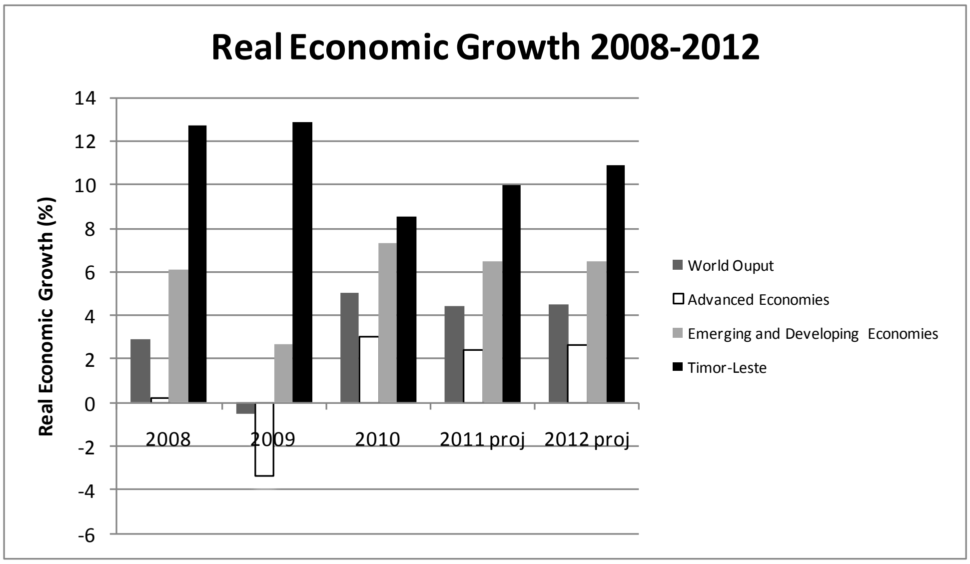
Over the next five years significant excess withdrawals from the Petroleum Fund will be required to fund the construction of core infrastructure; leading to the ESI falling to $577 million by 2016. These excess withdrawals are in line with the Government's policy, outlined in the SDP, of frontloading withdrawals from the Petroleum Fund. The Government believes that in the long term strong economic growth will drive significant growth in domestic revenue allowing excess withdrawals from the Petroleum Fund to fall back towards zero.

Part 3: Economic Outlook

International Economy

The international economy is still recovering from the financial crisis that plunged major advanced economies into recession and adversely impacted many emerging and developing countries. The credit crisis in the USA that propelled the world into economic chaos took place in mid-2007 and only by mid-2009 did the economy show signs of stabilising. In 2010, the global economy grew by about 5% and in the first quarter of 2011, it grew by 4.3% despite negative events such as the earthquake in Japan and the greater weakness of US activity than was expected. Projections for 2011 and 2012 are 4.3% and 4.5% respectively. Figure 3.1 displays world output figures and forecasts between 2008 and 2012 and illustrates the impact of the global recession and the subsequent recovery. Timor-Leste has been relatively sheltered from the crisis, and its economic growth has remained strong throughout.

Figure 3.1 Real Economic Growth 2008 to 2012



Sources: Macroeconomic Directorate, Ministry of Finance and IMF World Economic Outlook Update, June 2011. 2010 estimate is preliminary and 2011 and 2012 are targets.

Global inflation increased from 3.5% in the last quarter of 2010 to 4% in the first quarter of 2011, which is 0.25% higher than projected in the April 2011 IMF World Economic Outlook. Inflation is expected to remain constant or decrease over the next couple of years. It is suspected that inflation accelerated primarily because of higher than anticipated commodity prices. Unemployment remains above pre-crisis levels, which poses further economic and social challenges. World unemployment is expected to be 6% this year with youth unemployment increasing significantly. Financial markets started to return to their pre-crisis state in 2010 followed by improved financial conditions in the first part of 2011. However, global financial conditions have become more volatile since late May 2011, which primarily reflects issues throughout advanced economies in the Euro area and the US. The extent of the economic recovery is still varying across regions; Asia and Latin America are rebounding the fastest while the advanced economies are more sluggish.

Advanced Economies

Growth in advanced economies is expected to average roughly 2.2% and 2.6% in 2011 and 2012 respectively, which is weaker than the 3% growth observed in 2010. Additionally, growth is expected to be weaker than previously projected in the US and Japan. Unemployment remains a large concern throughout the advanced world and currently remains at about 10% throughout the Euro area and the US. Advanced economies were hit hardest by the spread of unemployment in 2010. Financial volatility has picked up since late May, reflecting market concerns regarding sovereign debt risks in the Euro area and the US as well as a consistent decline in the US real estate market. Additionally, the debt crisis along with the downgrading of US credit rating to AA+ has lead to stock market fluctuations worldwide in August, as investors fear the uncertainty of the global economy and the potential for a double dip recession. Further efforts need to be made by policy makers in the US and the Euro area to reduce debt levels and repair the financial sectors. This needs to be a priority for securing growth and job creation over the medium term.

Asia

Growth in Asia has continued to outpace other regions and is projected to rise by more than 6% in 2011 and 2012. The region has experienced strong export performance and private domestic demand as well as an increase in credit growth and capital flows. In most Asian countries the transition from public sector-driven growth to private sector-driven growth is making good progress. The post-crisis era is a good time for Timor-Leste to take advantage of strong regional demand by developing and implementing policies to boost its exports. Growth within the ASEAN-5 (Indonesia, Malaysia, Singapore, Thailand, and the Philippines) economies is expected to be 5.4% in 2011 and 5.7% in 2012 behind strong consumption and increased investment within Indonesia. After rapid growth of 8.4% in 2010, growth projections in the newly industrialised economies of Singapore, Hong Kong, South Korea, and Taiwan are expected to decrease to a more sustainable growth rate of 5% in 2011 and 2012. Table 3.1 shows GDP growth rates as well as projections for selected Asian economies.

Table 3.1 Real GDP growth rates (%)

Countries	Actual			Projection	
	2008	2009	2010	2011	2012
China	9.6	9.2	10.3	9.6	9.5
Australia	2.6	1.3	2.7	3.0	3.5
Singapore	1.5	-0.8	14.5	5.2	4.4
ASEAN-5	4.6	1.7	6.9	5.4	5.7
Indonesia	6.0	4.6	6.1	6.2	6.5
Vietnam	6.3	5.3	6.8	6.3	6.8
Philippines	3.7	1.1	7.3	5.0	5.0
Thailand	2.5	-2.3	7.8	4.0	4.5
Malaysia	4.7	-1.7	7.2	5.5	5.2
Timor-Leste	12.7	12.9	8.5	10.0	10.9

Sources: IMF, World Economic Outlook April 2011, World Economic Outlook Update June 2011, and Macroeconomic Directorate, Ministry of Finance (For Timor-Leste, 2010 estimate is preliminary and 2011 and 2012 are targets).

Inflation is also on the rise within Asia and overheating is becoming a concern, which usually happens when aggregate demand exceeds production capabilities. As a result, the tightening of macroeconomic policies has become a serious topic within Asia. Inflation remains a concern for Timor-Leste as their major trading partners/suppliers are primarily in the Asia region, where inflationary pressures are strong.

Emerging and Developing Countries

Output growth in emerging and developing economies is expected to be 6.5% during 2011-12, and in many emerging economies outside Central and Eastern Europe, unemployment is below pre-crisis levels. Overheating has been a concern as inflationary pressures are high. Headline inflation is exceeding 6%, which is nearly 1% higher than January 2010. With food and energy prices on the rise, the risks of an inflationary spiral are greater in the emerging world, because they spend a larger share of their income on food and energy. During the same period core inflation has jumped from 2% to about 4%. Credit growth is also expanding rapidly in emerging markets. Brazil, Colombia, India, Indonesia, and Turkey have experienced credit growth between 10% and 20%. The IMF has raised the importance of guarding against potential credit booms and inflationary pressures.

World Prices

The main impact of world economic activity on Timor-Leste is through changing prices for oil impacting on oil revenues. However, through saving the majority of oil revenues and spending via the mechanism of the Estimated Sustainable Income (ESI), the domestic economy is protected to a large degree from short run oil price fluctuations. Changing oil prices, therefore, have no short-term impact on the domestic economy, via the mechanism of the State Budget, but prices do impact the size of the nation's oil wealth. In 2008, the world price of oil collapsed from over $140 per barrel mid-year to just $40 by the end of 2008, but by 2010, oil prices rose and stabilised at around $70-80 per barrel. In the first half of 2011, oil prices jumped and remain high compared to 2010. In April oil prices surged to nearly $120 per barrel, but currently appears to have stabilised between $90-100 per barrel. Factors likely influencing the rise in prices are unrest in the Middle East and North Africa since January of 2011 and greater than anticipated demand for oil in the 2nd half of 2010. A more detailed description of the impact of oil prices on Timor-Leste's oil wealth and projected oil revenue streams can be found in the Petroleum Revenues section.

Besides oil, other commodity prices have been on the rise. The IMF Food and Beverage Index started to experience large increases from June of 2010 and continued until prices hit their peak in April of 2011. Currently, prices are decreasing, but they remain much higher than a year ago. Hopefully, this downward trend will continue as the global food market continues to recover from the weather related supply shocks in 2010. As an importer country, the impact of rising global food prices is a concern and the effects can be seen in Timor-Leste, mostly in Dili (see the inflation section below). This is no surprise as Food and Beverages hold the largest weight in Timor-Leste's CPI calculation[1].

[1] *All information in the World Economic Overview section was taken from the IMF World Economic Outlook April 2011, IMF World Economic Outlook Update June 2011, and BBC article, "Policymakers must act to avoid recession."*

Domestic Economy: Non-oil GDP

Tables 3.2 to 3.4 show that following 2006, when unrest destroyed parts of the economy, growth in output rebounded, averaging double digit rates between 2007 and 2010. Growth has been driven primarily by public sector spending, which stimulates both demand and supply in the economy, contributing to impressive growth rates in the private sector. Private sector industry and services now account for $201 million of total nominal GDP however their share in real GDP remains fairly constant at 33%. The public sector has the highest share in real non-oil GDP and this share has been expanding continually since 2002.

Table 3.2 Sector Shares in Real non-oil GDP

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Real Non-oil GDP, excl. UN	100%	100%	100%	100%	100%	100%	100%	100%	100%
Including UN	123%	115%	110%	106%	109%	118%	117%	113%	111%
Agriculture	35%	34%	35%	35%	37%	32%	32%	32%	28%
Industry and Services	35%	35%	34%	33%	30%	32%	32%	31%	33%
Public Sector, excl. UN	30%	31%	31%	32%	33%	36%	36%	37%	39%
United Nations	23%	15%	10%	6%	9%	18%	17%	13%	11%

Source: Macroeconomic Directorate, Ministry of Finance. 2010 data are preliminary

Real GDP growth in 2010 is estimated at a preliminary rate of 8.5%. While this is an internationally high rate of economic growth it is below the 2009 growth rate, primarily due to a contraction in the agriculture sector, especially the food sub-sector, caused by unseasonal rains damaging crops. Rice production suffered particularly badly and this shortage probably contributed to the higher prices for locally produced rice. High hopes for 2010 coffee production were dashed due to the rains and although growth on 2009 was reported in this sector, it was not as high as anticipated.

Expansion of private sector industry and services in 2010 continued at similar rates to the previous 3 years (12.3%) with private construction, communications and services boasting the strongest growth rates. Growth in private construction activity appears to be phenomenal, with the number of active companies in 2010 almost five times higher than in 2009. Much of this activity is thought to be spurred by public sector construction contracts. Although the data in manufacturing are historically not especially reliable, it is assumed that the boom in construction will have led to increased demand (and therefore production) of construction materials in the manufacturing sector, particularly non-traded materials that cannot be replaced by imports.

Table 3.3 Nominal non-oil GDP, excluding UN, Millions of USD

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Non-oil GDP, excl. UN	267.6	276.6	290.9	312.4	307.5	362.6	459.7	578.5	653.8
Agriculture	95.9	97.7	104.0	111.8	116.7	105.9	126.9	153.1	151.1
Industry and Services	92.1	96.6	98.2	101.6	90.5	113.7	146.0	174.0	200.7
Public Sector, excl. UN	79.6	82.4	88.7	99.0	100.2	143.0	186.9	251.3	302.1

Source: Macroeconomic Directorate, Ministry of Finance. 2010 data are preliminary

Table 3.4 Real GDP Growth Rates (%)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Real Non-oil GDP, excl. UN	2.1	-0.1	4.4	6.5	-5.9	8.8	12.7	12.9	8.5
Agriculture	3.1	-2.5	6.2	6.4	-0.1	-5.4	13.4	12.6	-4.7
Industry and Services	1.6	0.0	2.1	2.6	-14.6	15.5	13.0	11.0	12.3
Public Sector, excl. UN	1.7	2.3	5.0	10.8	-3.1	18.5	11.7	15.0	16.8

Source: Macroeconomic Directorate, Ministry of Finance. 2010 data are preliminary. Growth rates in Industry and Services and overall growth rates for 2007-2009 differ from previous estimates because new historical data on the transport sector became available.

Looking to the 2011 forecast, the food sector is expected to rebound strongly in 2011. However coffee trees, which have a good year every other year, are not expected to produce high yields of coffee cherries in 2011. Growth in private sector industry and service activity should remain strong, with the hope that investors will be forward-looking and increase investments in anticipation of the substantial improvements in infrastructure that are underway. Revenue collections in 2011 to date indicate high levels of construction activity in 2011 and increased imports, which in part will be materials to fuel a fast growing economy.

Government Expenditures

Government expenditure in 2010 reached a record $758.7 million with a budget execution rate of 91%, exceeding previous years. Recurrent spending represented 66.6% of 2010 expenditures and capital expenditures 33.4%. This spending structure closely followed the 2009 structure. In 2011, due to the introduction of the Infrastructure Fund, capital and development spending accounted for a higher proportion of Government expenditures, with planned capital expenditures representing 55% of the 2011 budget. Until the end of July 2011, preliminary execution rates were 41.5%, based on data that have not been audited.

Table 3.5 Whole of Government Expenditures ($ millions), including Autonomous Agencies

	2003/04	**2004/05**	**2005/06**	**2006/07**	**2007**	**2008**	**2009**	**2010**	**Execution 2011 to July 31st**	**Budget 2011**
Total Expenditures	70.4	70.3	93.7	170.5	97.2	483.9	603.6	758.7	542.2	1306.0
Recurrent Expenditures	59.1	60.0	71.2	139.5	63.1	356.0	394.3	505.0	230.6	588.4
Wages and Salaries	23.1	24.8	26.1	33.8	17.4	50.3	87.3	91.5	54.4	116.8
Goods and Services	36.0	35.2	45.1	93.9	37.1	221.4	212.8	245.1	108.9	294.1
Public Transfers	0.0	0.0	0.0	11.8	8.6	84.3	94.2	168.4	67.2	177.5
Capital Expenditures	11.3	10.3	22.5	31.0	34.1	127.9	209.3	253.7	311.6	717.6
Minor Capital	Distribution Unknown			9.3	0.7	41.4	38.5	38.1	2.7	29.3
Development & Major Capital				11.7	0.7	86.5	170.8	215.6	308.9	688.3
Capital Transfers	0.4	0.0	10.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unallocated Capital Carryovers	7.3	8.4	8.3	10.0	32.7	0.0	0.0	0.0	0.0	0.0

Source: Treasury Department, Ministry of Finance. 2011 execution data are preliminary, not yet audited and therefore subject to change. They should be considered as a guide only.

Domestic Revenues

Overall, revised domestic revenues are estimated to reach $110.7 million in 2011, up from $96.4 million in 2010. These figures show a growth rate of 14.8%, significantly higher than the 6.2% achieved last year. It is also important to note that both these growth rates have been constrained by falls in revenue stemming from the rice subsidy program which, as a temporary measure, has been scaled back.

In terms of the individual revenue categories, direct taxes are estimated to show strong growth into 2011, mainly due to increased withholding tax receipts which should stem from increased capital expenditures by Government. Indirect Taxes should also show strong growth, mainly on the back of improvements in administration in the customs area and increases in imports and price levels. These customs improvements have also seen the Port Authority's revenues, which show strong growth within the Autonomous Agencies category where with continued procedural improvements and the first full year at the revised rates, EDTL has continued to lead the way in terms of revenues.

Table 3.6 Domestic Revenues, 2002-2011($'m)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 Est.
Domestic Revenues	**24.6**	**29.6**	**39.9**	**43.0**	**44.3**	**27.0**	**69.4**	**90.8**	**96.4**	**110.7**
Direct Taxes	5.3	6.0	8.7	9.8	10.1	6.6	19.1	13.3	18.2	22.3
Indirect Taxes	12.2	14.9	18.6	17.5	17.7	14.1	19.3	30.3	31.9	42.6
User fees and charges	2.2	3.2	4.4	4.2	4.3	2.6	5.0	16.4	19.7	16.5
Autonomous Agencies	4.7	5.3	6.8	7.6	7.0	3.9	7.7	10.2	13.7	19.2
Interest	0.2	0.2	1.4	3.9	5.2	3.1	1.6	0.3	0.1	0.1
Rice Sales	0.0	0.0	0.0	0.0	0.0	0.0	16.8	20.4	12.6	10.0

Source: Macroeconomic Directorate, Ministry of Finance, 2011. Calendar year actuals were calculated by using the average of two fiscal years where required.

Petroleum Revenues

The main factors driving the inflow of petroleum revenues are prices, production and costs. In 2011, the *oil price* is estimated at $88 per barrel, which is $20 per barrel higher than anticipated in last year's budget. The revised 2011 estimate takes into account the actual development in the seven months to July and forecast information from EIA for the remainder of the year. The revised forecasts for 2012 and 2013 are also slightly higher than previous forecasts but thereafter revert to basically the same as the average as used for Budget 2011. The price changes increased the 2012 ESI by $21 million, mainly from the increase in 2011, 2012 and 2013 prices.

The Bayu-Undan liquids *production* (condensate and LPG) forecast is revised significantly downward compared to last year's ESI calculations taking into account recent operational experience and the now fully assimilated results of 2010 Phase II drilling. This reduces 2012 ESI by $69 million. The LNG forecast is also revised downwards resulting in a decrease in 2012 ESI of $20 million.

There is a significant increase in the estimate of the *costs* at Bayu-Undan; both upstream and downstream. Total costs are around 40% higher than in last year's forecast. The change in the cost forecast reduces 2012 ESI by $36 million.

On these assumptions the petroleum revenues are expected to peak in 2011 at $2.5 billion before starting to steadily decline in 2012 and onwards. Notwithstanding a reduction in inflows and increased withdrawals compared with last year's budget calculations, the Petroleum Fund balance is set to increase from $6.9 billion by the end of 2010 to $8.7 billion by the end of 2011, $9.2 billion by the end of 2012 and $11.3 billion by the end of 2016.

The Petroleum Fund Law amendment was passed by Parliament on August 23, 2011. The amended law is based on two central principles, namely good governance and diversification. With regards to *governance*, the Timor-Leste Petroleum Fund is internationally recognised for its high standards of transparency and accountability. The amended Petroleum Fund Law further strengthens this already strong governance framework by improving reporting requirements, strengthening checks and balances, and strengthening the requirements for technical skills in the management of the Fund.

The amended Petroleum Fund Law states that the objective of the investment policy is to maximise the risk-adjusted return. A necessary condition to achieve this objective is to employ the principle of *diversification*. Diversification is about mitigating risk and volatility by investing in a number of different asset classes rather than being concentrated in any one of these. So far the real return of the Fund's investments (mostly bonds) has only been some 2%. At the same time, the fiscal policy is based on a long-term Estimated Sustainable Income (ESI) from the petroleum wealth of 3%. Allowing for a maximum of 50% of the Fund's assets to be invested in equities should give a reasonable probability of achieving 3% real return over time, thus better aligning the Petroleum Fund investment policy with the ESI budget spending guideline.

Domestic Inflation

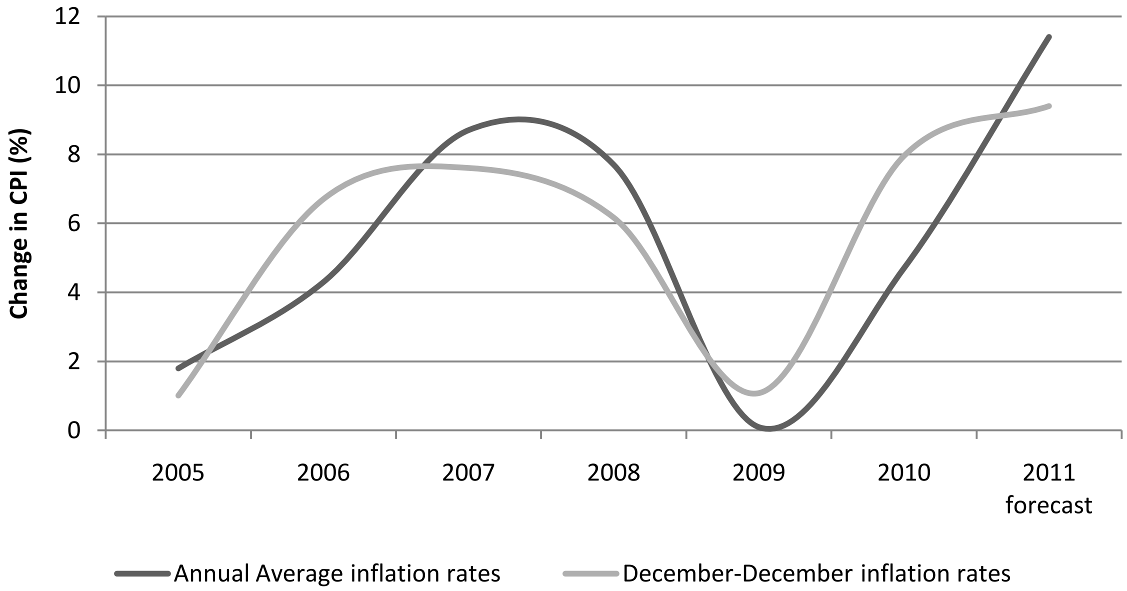
Headline inflation in Timor-Leste was 8% (December to December) in 2010, compared to 9.2% in Dili. The latter part of 2010, through into 2011, saw domestic inflation leaping into double digits, with prices in June 2011 12.4% higher than they were in June 2010, as measured by the change in Consumer Price Index[2] (CPI). The main items driving the price rises in Timor-Leste are food and beverages, clothing and footwear and transport, with house building costs also showing significant increases over the period. International price rises, particularly in food and fuel, explain much of the inflation, and compounding the impact is the depreciation of the dollar against Timor-Leste's major trading partners' currencies, especially the Australian dollar; this has made imports relatively more expensive in dollar terms.

[2] *The CPI is measured by the National Directorate of Statistics.*

Data show the price of locally produced rice rose in recent months, which will have a relatively large impact on the CPI because rice is weighted relatively strongly in the CPI. The price spike is partly due to the unseasonal rains damaging rice production in 2010, together with the scaling back of the Government subsidised imported rice. This is beneficial to rice producers and farmers who can take advantage of the higher rice prices, expanding production, increasing their profits and reducing reliance on imports. Therefore as domestic rice production increases this high rice price spike could be temporary.

Expansionary fiscal policy is likely to have increased domestic demand and played a role in price rises of some items. Analysis shows that historically, correlation is stronger between the Timor-Leste CPI and recurrent expenditure (in particular wages and salaries) than between the CPI and total expenditure. This makes sense intuitively as a higher proportion of recurrent expenditure (compared to capital expenditure) is likely to directly enter the domestic economy. However, the recent boom in both public and private construction activity probably put upward pressure on the prices of building materials; the price index for house building materials in Dili was 11.2% higher in June 2011 than June 2010. Closer inspection of these prices shows that between 2006 and 2010, the average price of domestically sourced materials grew by 60%, compared with an (unweighted) average of 36% growth in imported materials.

Figure 3.2 Percentage Changes in Consumer Price Index 2005-2011

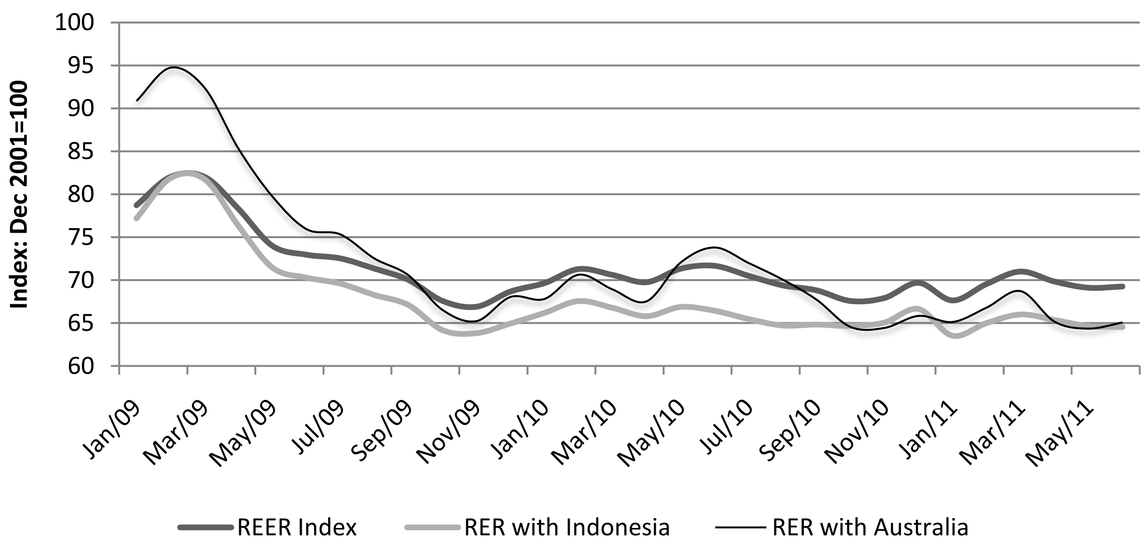


Sources: Statistics Directorate and Macroeconomic Directorate, 2011

Since April 2011, monthly price rises have slowed or become negative, suggesting fast paced inflation may have come to an end. Year-on-year inflation rates will remain high until at least October 2011 (because they will include the increases in prices seen in recent months) and from then are expected to fall to single digit rates. The Strategic Development Plan (SDP) is targeting single digit inflation rates with long term inflation in the range of 4-6%. The Government is analysing the recent high rates of inflation in detail and while international commodity price rises and monetary policy are not within the control of the Government, the SDP pledges to focus Government expenditures (recurrent and capital) on boosting the supply side capacity of the economy, to reduce inflationary pressure. Spending on productive infrastructure and development of human resources will help reduce industry and trade bottlenecks and lead to an increase in supply of goods and services, keeping the prices down. In the short run, the Government's focus on agriculture, through the SDP, should involve implementing initiatives to spur local rice production in order to increase supply and bring down rice prices.

Figure 3.3 shows the evolution of the real effective exchange rate (REER) between the US dollar and the currencies of Timor-Leste's major trading partners. The real exchange rate between the US dollar and the currencies of Australia and Indonesia are also displayed. Over 2009 a real depreciation was observed, meaning Timor-Leste's exports became more competitive in foreign markets but imports became more expensive. From 2010 until mid-2011 the REER remains fairly stable. This is because the US dollar depreciated further, but at the same time Timor-Leste experienced high inflation relative to other countries. These two factors are used to measure the REER and acted in different directions; depreciation making exports relatively cheap in foreign markets but domestic inflation increasing the relative price of exports (exports are predominantly coffee in Timor-Leste at present).

Figure 3.3 Real Effective Exchange Rate, Timor-Leste



Source: Banking & Payments Authority of Timor-Leste, 2011

Employment

Publication by the National Directorate of Statistics and SEFOPE of the Labour Force Survey has provided policy makers with a snapshot of employment structures in Timor-Leste. Results show Dili is the leading district in terms of economic activity; incomes are higher and formal wage employment is more widespread. More useful than the unemployment rate is the number of people classified as vulnerably employed, who are unlikely to have formal work arrangements and have no guaranteed salary or job security. Seventy per cent of the labour

force is estimated to be vulnerably employed, with 42% of the urban population falling into this category compared with 80% of the rural labour force.
As a short term solution to a lack of formal sector jobs, the Government of Timor-Leste has strived to generate jobs for unskilled labour through infrastructure projects, with an estimated 66,485 'full-time equivalent'[3] jobs created in 2010. Many of these projects are small scale infrastructure projects in rural areas that will have spurred economic growth and employment in the districts. Addressing the issue of employment over the medium and longer term, the Government launched the Human Capital Development Fund to provide training and scholarships to talented Timorese people. This should qualify Timorese people to replace foreigners in existing positions and take up newly created roles as the economy expands.

Almost all rural farmers are classed as vulnerably employed. Agriculture and fishing are by far the main source of income for the population of Timor-Leste. To improve employment conditions for agricultural workers, Government policy, as stated in the SDP, is focussing on development of the commercial agriculture sector to improve the incomes and working conditions for the relatively large rural population. Policy also aims to promote expansion of strategic sectors in industry and services in rural areas and will encourage the growth of small and micro businesses. Support will be provided in upgrading licensed training centres across Timor-Leste, with curricula geared to industry needs.

Poverty and MDGs

A household is said to be poor if per capita consumption falls below the 'basic needs' poverty line. Those living below the poverty line are therefore unable to afford 2,100 calories per day while also meeting basic non-food needs. In a 2007 survey[4], 49.9% of the population were estimated to live below the poverty line. However, in 2010, the World Bank reported that in 2009, 41% of the population lived below the poverty line[5]. The fall of almost 9 percentage points is partly because of higher rate of real economic growth since 2007 and social transfer programs such as pensions for elderly and veterans and cash for work programs that contributed to increase of private consumption. There is no comparable estimate for 2010 but it is likely that continued high rates of economic growth have lifted more people out of poverty. However, high inflation rates will have made it relatively harder for poor people to afford enough food while also meeting basic non-food needs.

Short to Medium-Term Prospects (2012-2016)

As the Government begins to implement the SDP, Timor-Leste is set to see a fast-paced improvement in physical infrastructure, with a new power plant, large scale efforts to improve roads and upgraded airports and seaports. While these could take a few years to show substantial benefits in terms of increased private investment and economic output, the foundations will begin to be laid in the very short term. Investment in physical capital, human

[3] *Full-time-equivalent (FTE) jobs are based on 249 calendar days a year constituting a full-time job. In reality, most unskilled labourers do not work for a full year; therefore significantly more people will have found shorter term employment (less than a year) through infrastructure job creation projects than the number of FTE jobs estimated.*
[4] *Timor-Leste, Poverty in a Young Nation, 2008, National Directorate of Statistics.*
[5] *World Bank methods ensure compatibility between the 2007 and 2009 estimates. Details from World Bank Poverty Report, 2010*

capital and Government's strategic reforms will focus on the agriculture, tourism, and petroleum sectors, which are targeted as key areas for driving sustainable growth in the future.

Agriculture is expected to experience structural change, beginning to move away from subsistence farming with more emphasis on developing commercial, smallholder agriculture. Additionally, there are plans to support research, development, and extension programs for all of Timor-Leste's agricultural production, as well as upgrading and expanding irrigation systems. Following these policy actions and reforms, by 2015, Timor-Leste should see large increases in rice and maize production, with a Timor-Leste Research and Development Institute planning additional investment into research and extension programs. An irrigation scheme will have been created, and there will be increased capital investment into cash crops.

Petroleum is the backbone of the economy and development of this strategic sector is considered to be key for further development of the country. An immediate priority is to establish a National Petroleum Company, which should aid in the transparency of revenues as well as encourage the inclusion of the local population in exploiting this sector. Additionally, the development of three industrial clusters will take place on the south coast from Suai to Beaco through the implementation of the Tasi Mane Project. By 2015, the SDP aims to have construction of the Suai Port completed, the Suai airport rehabilitated, and the refinery and other parts of the Tasi Mane project well underway.

Tourism could be set to experience rapid expansion over the medium term following structural reforms and the priority afforded to it through the SDP. Moreover the Tourism and Services sector saw the largest rise in credit to the private sector in the year to March 2011[6]. The SDP highlights 3 key zones of Timor-Leste (in the East, Centre and West) to receive special attention in developing the tourism industry. By 2015, the SDP explains that critical tourist infrastructure will have been built or upgraded (including the Dili airport, regional airports and key roads), a tourism-training centre will have been established, tourist packages will have been created for each zone, and tourist information centres will have been established in Dili, Lospalos, and Baucau.

[6] *Data from BPA, cited in Quarterly Statistical Indicators 1st Quarter 2011, National Directorate of Statistics.*

Part 4: Expenditure

Table 4.1 shows the combined state budget for 2010 to 2016. Infrastructure Fund spending is budgeted to increase to $746.2 million in 2012. This spending is in line with the Government's commitment, as stated in the SDP, to build core infrastructure and should contribute to sustained economic development. Planned Infrastructure Fund spending and infrastructure spending through loans are shown until 2015, with a 4% increase in the total assumed in 2016. Expenditure on the HCDF is budgeted to increase to $30 million in 2012. This expenditure will pay for training and capacity building in public sector management, education and other strategic sectors which are essential for the promotion of economic growth and international competiveness. CFTL fund spending is increasing in 2012, due mainly to funds for the Timor-Leste Investment Corporation (TLIC). Costs of the new teacher career regime and a higher budget for fuel for generators also contribute to higher CFTL spending. Development partners' commitments are currently estimated at $188.9 million in 2012.

Table 4.1 The Combined Sources Budget in $ millions

	2010 actual	2011 budget	2012 budget	2013 budget	2014 budget	2015 budget	2016 budget
Combined Sources Budget	**1,022.6**	**1,578.8**	**1,952.3**	**1,932.2**	**1,926.8**	**1,569.3**	**1,564.1**
Government Expenditures by Fund	*758.7*	*1,306.0*	*1,763.4*	*1,803.4*	*1,854.8*	*1,505.7*	*1,564.1*
CFTL	758.7	681.7	954.1	784.2	815.6	848.2	882.2
HCDF	0.0	25.0	30.0	35.0	40.0	45.0	45.0
Infrastructure Fund	0.0	599.3	746.2	904.0	918.2	509.6	457.0
Infrastructure Expenditures by Loans	0.0	0.0	33.1	80.2	81.1	102.8	180.0
Development Partner Commitments	*263.9*	*272.8*	*188.9*	*128.8*	*72.0*	*63.7*	*0.0*

Source: National Directorate of Budget and National Directorate of Aid Effectiveness, 2011

Table 4.2 shows a consolidated fiscal table for the Government across all funds. Recurrent expenditure increases by 15% to $679 million in 2012 (including the HCDF). This is mainly due to an increase in the Goods and Services budget caused by higher budgeted expenditure in the HCDF and on Goods and Services in the CFTL fund. The capital expenditure budget has increased from $717.6 million in 2011 to $1.1 billion in 2012. From 2012 onwards a prudent 4% increase in CFTL recurrent and capital expenditures is budgeted (excluding the TLIC funds).

Table 4.2 Consolidated Fiscal Table in $ millions

	2010 actual	2011 budget	2012 budget	2013 budget	2014 budget	2015 budget	2016 budget
Total Expenditure	**758.7**	**1,306.0**	**1,763.4**	**1,803.4**	**1,854.8**	**1,505.7**	**1,564.1**
Recurrent Expenditure	505.0	588.4	679.0	709.9	741.9	775.0	804.2
Capital Expenditure	253.7	717.6	1,084.4	1,093.5	1,112.9	730.7	759.9
Financing	**758.7**	**1,306.0**	**1,763.4**	**1,803.4**	**1,854.8**	**1,505.7**	**1,564.1**
Domestic Revenue	96.4	110.7	136.1	158.7	185.5	217.8	256.3
Est. Sustainable Income (ESI)	502.0	734.0	665.3	641.2	617.1	591.4	577.1
Excess Withdrawals from PF	309.0	321.0	928.9	923.3	971.2	593.6	550.7
Use of Cash Balance	-148.7	140.3	0.0	0.0	0.0	0.0	0.0
Borrowing	0.0	0.0	33.1	80.2	81.1	102.8	180.0
Non-oil Fiscal Balance	-662.3	-1,195.3	-1,627.3	-1,644.7	-1,669.4	-1,287.9	-1,307.8

Source: Ministry of Finance, 201. Note: Non-oil fiscal balance is domestic revenue minus total expenditure.

In 2012 domestic revenues of $136.1 million will pay for approximately 7.7% of total expenditure. Strong growth in domestic revenue is forecast over the next five years due to strong economic growth and increases in the efficacy of tax collection. By 2016 approximately 16.4% of total expenditure will be financed by $256.3 million in domestic revenues.

The non-oil fiscal deficit is equal to domestic revenue minus total expenditure. This non-oil deficit can be interpreted as showing the increase in the money supply and aggregate demand caused by spending which is financed by withdrawals from the Petroleum Fund. Large non-oil deficits can potentially cause inflation and thus reduce the international competiveness of Timorese firms and reduce citizens' living standards. The Government, however, considers that this is unlikely to be the case in Timor-Leste as much of the increase in spending and the non-oil fiscal deficit is driven by large scale infrastructure projects such as the Central Electric Power Plant and roads. Such projects will not significantly increase aggregate demand but are likely to increase the productive potential of the economy. As such they are likely to increase economic growth and not inflation. Increases in recurrent expenditure financed by withdrawals from the Petroleum Fund may have a larger impact on inflation, but the Government is already committed to prudent growth in recurrent expenditure in the medium term. Current increases are due to the implementation of SDP in the first five years. So the increases are temporary which will return to sustainable levels after the implementation of the SDP.

Table 4.2 shows that the 2012 non-oil deficit (expenditures not covered by non-oil domestic revenues) is financed through excess withdrawals from the Petroleum Fund, the Estimated Sustainable Income and a small amount of borrowing. Excess withdrawals are required every year until 2016 to pay for investments in infrastructure and human capital development. These investments will contribute to strong economic growth and improved domestic revenue collections. In the long term the Government believes increases in domestic revenue will allow the excess withdrawals from the Petroleum Fund to fall to zero.

Table 4.3 shows key economic forecasts (and economic growth targets) until 2016. The Government's believes that its policy of investing in infrastructure and human capital development will contribute to double digit economic growth and moderate inflation in the medium term.

Table 4.3 Economic Targets and Forecasts 2011-2016

Description	2011	2012	2013	2014	2015	2016
Real Economic Growth Targets (%)	10.0	10.9	10.4	9.9	10.8	11.5
Domestic Revenues ($ mil)	110.7	136.1	158.7	185.5	217.8	256.3
Petroleum Revenues ($ mil)	2,546.9	1,765.8	1,564.6	1,410.4	1,556.6	1,596.6
Pet. Fund Balance ($ mil)	8,678.9	9,174.8	9,514.5	9,685.3	10,422.1	11,285.2
Inflation (rolling year, %)	9.4	8.0	8.0	8.0	7.0	7.0

Sources: Macroeconomic Directorate and Petroleum Fund Directorate, Ministry of Finance, 2011.

Expenditure Review

In 2011 the Ministry of Finance drafted detailed expenditure reviews for the 2010 financial year and the first five months of 2011. The conclusions from these reviews fed into a Budget Execution Review Workshop in August 2011, chaired by the Prime Minister, which was broadcasted live on national television. The focus of this workshop was to identify areas where savings could be made and to improve the efficacy, efficiency and distribution of Government expenditure.

The workshop and expenditure reviews noted that capital expenditure has sharply increased between 2008 and 2011 driven by increased spending on infrastructure; particularly the Central Electric Power Plant project. Infrastructure spending, especially on electricity, is needed to stimulate economic growth in line with the SDP. The Government plans, as reflected in the 2012 budget, to continue a high rate of infrastructure spending over the medium term with large funds for the power project winding down in 2013.

Recurrent expenditure also increased between 2008 and 2011. The Government is committed to prudent increases in recurrent expenditure in the medium term consistent with moderate inflation and financial sustainability. There will, however, have to be some increases in recurrent expenditure in the medium term to maintain newly constructed infrastructure and to pay for the fuel needed for generators as the supply of, and demand for, electricity increases.

A Review of Major Reform Initiatives in 2011 and 2012

The Government is committed to improving public financial management. Through improved public financial management the Government will improve the efficiency and distribution of expenditure and reduce fiduciary risk. The Government has tailored its public financial management reform program in light of the conclusions of the expenditure review reports and Budget Execution Review Workshop.

In early 2011 the Government launched the Transparency Portal. This portal allows citizens to view and analyse Government expenditures. Citizens can use this portal to hold the Government to account and improve the efficiency of expenditure. In the month of August the Government launched the e-Procurement Portal, another initiative to ensure value for money and competitiveness. In 2012 the Government will continue with the implementation of a comprehensive integrated financial management information system including contract management and E-procurement modules. These modules should improve public financial management and restrict the ability of line ministries to sign contracts for off-budget projects. The implementation of these modules should also allow cash management to be improved.

Institutions were also established during 2011 to monitor, manage and implement the HCDF and Infrastructure Fund. The Secretariat of Major Projects was given responsibility for undertaking a detailed review of submissions made to the Infrastructure Fund. CAFI (Board of the Infrastructure Fund) was established to decide which projects should be included in the Infrastructure Fund based on its reading of the review undertaken by the Secretariat of Major Projects and the SDP. In addition, the National Development Agency was established to supervise the implementation of the projects, validate the progress of projects and undertake quality control. The Procurement Commission was, meanwhile, established to assist in the procurement of selected large scale projects included in the Infrastructure Fund. The Government is committed to further strengthening these institutions and processes in the long term.

Institutional Arrangements for the Formulation, Procurement and Monitoring of Projects

The Government established institutions in 2011 to appraise, procure, and monitor projects in the Infrastructure Fund. These institutions should ensure that the Government receives value for money from private contractors, the fiduciary risk that funds are subjected to is minimised and that all projects contribute to goals and visions of the SDP.

Line ministries are responsible for submitting Infrastructure Fund projects to the Secretariat of Major projects, which is responsible for undertaking a detailed review of these submissions. This Secretariat also advises the Board of the Infrastructure Fund (CAFI) on whether specific projects should be approved and financed by the Infrastructure Fund or rejected.

CAFI was also established in 2011. It reviews the report on projects drafted by the Secretariat of Major Projects and decides whether or not a particular project should be financed by the Infrastructure Fund.

The Budget Review Committee is responsible for deciding the overall budget for the Infrastructure Fund. Parliament is responsible for reviewing and enacting the entire State Budget including the Infrastructure Fund.

Once a project is approved and included under the Infrastructure Fund in the enacted State Budget the Procurement Commission is responsible for procuring large projects. This includes issuing a procurement notice, evaluating proposals from different companies and recommending which company should be awarded the contract. The ADN is then responsible for quality control and supervision of the implementation of the contracts.

CAFI is responsible for the final approval of contracts on projects with a value of less than $5 million. For contracts with a value of above $5 million the CoM is responsible for approval. On completion the relevant line ministry is responsible for operating and maintaining the infrastructure projects.

For some projects there maybe two or more interlinked project approval and procurement processes. A line ministry may propose a detailed budget for a design and feasibility study of a road and an approximate budget for its construction. This project maybe approved and included in Infrastructure Fund in the State Budget. After the detailed design study has been undertaken the project will be reappraised and its budget amended in the next year’s State Budget if required.

CFTL Expenditures

Table 4.4 shows the budget for the CFTL by appropriation category. Recurrent expenditure in the CFTL increases from $563.4 million to $649.0 million from 2011 to 2012 driven mainly by an increase in expenditure on Goods and Services. There is then moderate growth in recurrent expenditure of 4% each year from 2012 to 2016. This is in line with the SDP's commitment to prudent increases in recurrent expenditure. CFTL capital expenditure increases from $118.3 million to $305.1 million from 2011 to 2012, due to $200 million to capitalise the TLIC in the 2012 budget.

Table 4.4 CFTL Expenditure by Appropriation Category in $ millions

	2010 Actual	2011 Budget	2012 Budget	2013 Budget	2014 Budget	2015 Budget	2016 Budget
Total Expenditure	**758.7**	**681.7**	**954.1**	**784.2**	**815.6**	**848.2**	**882.2**
Recurrent	*505.0*	*563.4*	*649.0*	*674.9*	*701.9*	*730.0*	*759.2*
Salary and Wages	91.5	116.8	140.1	145.7	151.5	157.6	163.9
Goods and Services	245.1	269.1	314.7	327.3	340.4	354.0	368.2
Public Transfers	168.4	177.5	194.2	202.0	210.0	218.4	227.2
Capital	*253.7*	*118.3*	*305.1*	*109.3*	*113.7*	*118.2*	*123.0*
Minor Capital	38.1	29.3	30.0	31.2	32.4	33.7	35.1
Capital and Development	215.6	89.0	275.1	78.1	81.2	84.5	87.9

Source: Budget Directorate, Ministry of Finance, 2011.

Salaries and Wages

Key policy decisions in the Salaries and Wages appropriation category include:

- Increasing the salary and wages budget of the Ministry of Education by $2.6 million to account for the teachers' career regime. This regime increases the pay of teachers who have gained appropriate qualifications, motivating them to gain better qualifications. Better qualified teachers will contribute to better educational outcomes in Timor-Leste.

- In order to strengthen higher education UNTL has been appropriated a separate budget from the Ministry of Education. The increase for Salaries and Wages for UNTL is $3.5 million.

- The Government has granted permanent contracts to temporary staff in the Public Service causing its Salaries and Wages budget to increase from $17.7 million in 2011 to $23.2 million in 2012 including for special career regime, allowances for attaches, and new recruitments.

Goods and Services

The total budget for this category is $314.7 million. This represents a significant increase compared to the $269.1 million included in the 2011 budget. The main measures in this area include:

- $87.0 million in 2012 for fuel for generators in the Ministry of Infrastructure including EDTL. This represents a sharp increase in the fuel for generators budget, but this increase is justified in light of the current international oil price and the Government's commitment to increase the supply of electricity.

- $2.4 million is budgeted in 2012 for the professional training of teachers. This training will increase the competency and professionalism of teachers, raising teacher standards and leading to students receiving a better standard of education in the medium and long term.

- An increase in the operational services item in the Ministry of Education from $2.8 million in 2011 to $5.2 million in 2012 mainly to account for increases in the budget for the school feeding program. This increase is necessary due to the increase in food prices seen during the first 6 months of 2011.

- Expenditures for celebrations of the centenary of Dom Boaventura and other important days in the amount of $4 million.

- Expenditures for elections in the total amount of $14.5 million in which $8 million for STAE, $1.5 million for CNE, $4 million for PNTL, $0.5 million for F-FDTL, and $0.5 million for RTTL.

Public Transfers

Public Transfers are budgeted to increase by 9.4% in 2012 compared to 2011. The total budget for Public Transfers in 2012 is $194.2 million. The main transfer programs budgeted for in 2012 are:

- $69.9 million in the Ministry of Social Solidarity to pay personal benefits for war veterans. The payment of these benefits is justified in light of the brave service of war veterans during Timor-Leste's struggle for independence and their current needs.

- $32.1 million in the Ministry of Social Solidarity to pay personal benefits of $30 per month to those over 60 years of age with a proven inability to work. Approximately 89 thousand people directly benefit from this scheme, which has helped to reduce poverty.

- $6.3 million in the Ministry of State Administration and Territorial Organisations to pay for the PDL program. This program provides small scale grants in districts for the construction and rehabilitation of infrastructure. It also encourages the growth of small companies in districts and boosts economic growth.

- $20 million for the Secretary of State for Professional Training and Employment (SEFOPE) for labour intensive capital works to create jobs in the rural areas.

Minor Capital

The Government has increased the budget for Minor Capital from $29.3 million in 2011 to $30.0 million in 2012. The main expenditures in this category for 2012:

- $1.4 million in the Ministry of Health to purchase ambulances and $0.5 million for medical equipment for hospitals.

CFTL Capital and Development

Table 4.5 shows CFTL Capital and Development expenditure. The Government has budgeted for overall CFTL Capital and Development Expenditure to increase by 209% in 2012 compared to 2011, driven by new funds directed to the Timor-Leste Investment Corporation (TLIC).

Table 4.5 CFTL Capital and Development Expenditure in $ millions

Capital and Development	2011 Budget	2012 Budget	2013 Budget	2014 Budget	2015 Budget	2016 Budget
PDD1 Sub-district, Suco and Aldeia	15.5	33.8	35.1	36.5	38.0	39.5
PDD2 District	28.8	18.7	19.4	20.2	21.0	21.9
Ministries / Agencies	44.7	222.6	23.5	24.5	25.5	26.5
Total	**89.0**	**275.1**	**78.1**	**81.2**	**84.5**	**87.9**

Source: Budget Directorate, Ministry of Finance, 2011

The PDD1 and PDD2 programs finance the development of small scale infrastructure. Roads, education facilities, health facilities, water supply and sanitation and irrigation will all be constructed through these programs in 2012. These programs are also intended to encourage the growth of construction companies to build and maintain this infrastructure and contribute to the long term development of Timor-Leste.

The Government is committed to a fair, needs based distribution of PDD1 and PDD2 projects throughout Timor-Leste. The Ministry of State Administration and Territorial Organisation arranged a series of meetings with Suco chiefs, citizens and community leaders in 2010 to identify their demand for different types of PDD1 and PDD2 projects. These requests then developed into more detailed project proposals for consideration by the Budget Review Committee. This committee also considered indicators of service delivery in each Suco from the 2010 census when deciding which PDD1 and PDD2 projects to finance. Sucos where a low proportion of people have access to clean drinking water are more likely to have funding for drinking water through PDD1 or PDD2 projects included in the 2012 state budget. Budget Book 3 discusses the PDD1 and PDD2 programs in more detail.

Infrastructure Fund

Core infrastructure is necessary to develop and support a modern and productive economy. Timor-Leste currently lacks this infrastructure. The Government is committed to rectifying this situation by developing electricity, transport and education infrastructure. It is also committed to improving infrastructure on the South Coast to attract investment in the downstream petroleum sector.

Large scale infrastructure projects often require financing for more than one year. The Government established the Infrastructure Fund in 2011 to finance the development of large (over a $1 million) and multi-year projects. In recognition of their importance projects which contribute to the development of the MDGs are also financed through the Infrastructure Fund.

Human Capital Development Fund

For Timor-Leste to become a successful, healthy, educated and safe nation it must invest in its citizens. The building of human resources is a priority for the Government. The multi-year Human Capital Development Fund (HCDF) was established in 2011 to finance activities to improve human capital development. Table 4.6 shows the budget for the HCDF.

Table 4.6 Human Capital Development Fund in $ millions

	2010act	2011bud	2012bud	2013bud	2014bud	2015bud	2016bud
HCDF	0.0	25.0	30.0	35.0	40.0	45.0	45.0

The objectives of the fund are to:

- finance training and human resource development;
- provide a whole, across Government coordinated approach;
- provide certainty in the negotiation and execution of contracts that extend beyond one year; and
- promote transparency and accountability through improved systems of reporting.

Specific initiatives in the fund for 2012 include:

- $8.3 million for the Ministry of Education;
- $2.6 million for the Ministry of Health; and
- $4.9 million for the Ministry of Justice.

Timor-Leste Investment Corporation

Timor-Leste Investment Corporation (TLIC) will assist with the development of investment opportunities and growth of national wealth, delivering major strategic projects that have a commercial focus. TLIC is a joint stock company established by decree law, and the Government of Timor-Leste is the sole shareholder. Additionally, TLIC may be involved in commercial activities that are not contemplated in the SDP as well as a catalyst in investing in sectors that are not attractive to other investors. TLIC also will invest in strategic sectors of the country, such as internet undersea cable and other strategic projects.

The creation of TLIC will help the state of Timor-Leste achieve the objective of developing a sustainable diversified economy by transferring the Petroleum Fund wealth into the non-oil economy, through economic growth and diversification of the economy from one dependent on oil and gas to non-oil and gas.

TLIC is a state owned enterprise with profit seeking objectives similar to that of Temasek in Singapore. It is owned by the Government but functions on a commercial imperative basis.

Therefore, TLIC needs capitalisation to start its work. TLIC capitalisation is seed capital for future investments. As all investments required by the nation on the commercial page cannot be anticipated in advance, it is important that when they do arise that decisive action is taken immediately. The potential investments foreseen for TLIC in 2012 may consist of the following projects:

(1) Undersea cable project internet connectivity to the rest of the world using the best technology in 2012, which could make Timor-Leste a world leader in internet access.

(2) Benchmarking quality of tourism projects (hotels etc.) to commence the beginning of tourism (a pillar of SDP) either in joint venture or outright.

(3) Office tower of high quality to ensure other commercial operators are not taking advantage of oligopolistic position via high market rents to private sector including Government instrumentalities.

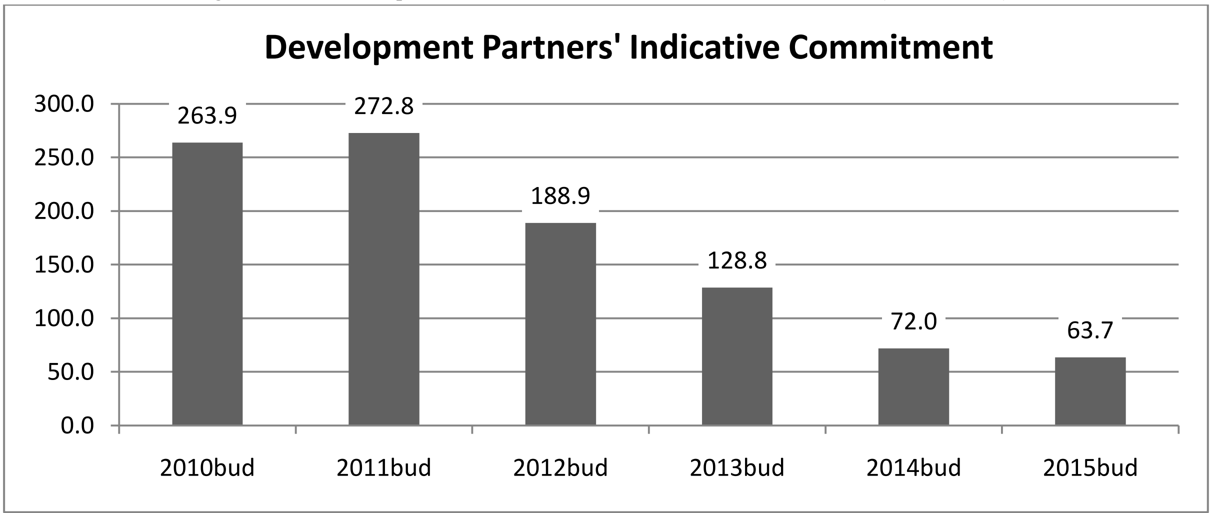
(4) Other strategic investments such as passenger and freight access at fair prices.

(5) Shopping complex of high quality to stimulate tourist potential. Timor-Leste's low tariffs making it nearly duty free, will allow lowest cost prices in the region, which will compete with any market for tourists seeking high quality products.

Development Partners

Development partners will provide a total of $188.9 million to Timor-Leste in 2012; representing 9.7% of the total combined sources budget. Book five outlines and discusses the details of these commitments.

Figure 4.1 Development Partners' Indicative Commitments ($ millions)



Note: 2011 and 2010 figures for development partners' commitments represent the latest available data.
Source: National Directorate of Aid Effectiveness, 2011

Part 5: Revenues

Introduction

Total Revenues in 2012 is estimated to be $1.90 billion, with the bulk of it ($1.77 billion) flowing from Petroleum Revenues and the remaining $136.1 million being Domestic Revenues.

Going forward, despite this continued dominance of Petroleum Revenues, as the economy expands and administration is improved Domestic Revenues will show robust growth and reach $256.3 million by 2016. As a percentage of Total Revenue, these changes will see Domestic Revenues rise from 7.2% of the total in 2012, to an estimated 13.8% in 2016, and continued growth, will become all the more important as Petroleum Revenues begin to decline.

Table 5.1 Total Revenues Projections, 2010 - 2016 ($'m)

	2010	2011	2012	2013	2014	2015	2016
	Actual	Estimate			Projection		
Total Revenues	2,213.7	2,657.6	**1,901.9**	1,723.3	1,595.9	1,774.4	1,852.9
Domestic Revenues	96.4	110.7	**136.1**	158.7	185.5	217.8	256.3
Petroleum Revenues	2,117.3	2,546.9	**1,765.8**	1,564.6	1,410.4	1,556.6	1,596.6

Source: Macroeconomic Directorate, Ministry of Finance, 2011

Domestic Revenues

Domestic Revenues are comprised primarily of Taxes (Direct and Indirect), User Fees and Charges, Interest, and revenues from Autonomous Agencies. Additionally, revenues also come from the sale of subsidised rice and other products, following on from a temporary measure introduced by Government to ease the hardship caused by the spike of world food prices in 2008.

Table 5.2 shows that taxes, fees and charges, and autonomous agencies continue to increase from 2010 through 2016. The rolling back of the subsidy program means that revenue from rice sales have fallen considerably and projected to remain at these lower levels.

Table 5.2 Revenue projections 2010 - 2016 ($'m)

	2010	2011	2012	2013	2014	2015	2016
	Actual	Estimate			Projection		
Direct Taxes	18.2	22.3	**40.6**	43.2	46.4	50.4	53.7
Indirect Tax	31.9	42.6	**54.5**	64.4	74.6	85.0	95.8
Fees and Charges	19.7	16.2	**19.0**	24.0	30.9	40.8	55.3
Rice Sales	12.6	10.0	**0.8**	0.9	1.1	1.2	1.3
Interest	0.1	0.1	**0.1**	0.1	0.1	0.1	0.1
Auto Agencies	13.7	19.2	**20.9**	25.9	32.2	40.0	49.9
Social Game Receipt	0.0	0.3	**0.2**	0.2	0.2	0.2	0.2
Total	**96.4**	**110.7**	**136.1**	**158.7**	**185.5**	**217.8**	**256.3**

Source: Macroeconomic Directorate, Ministry of Finance, 2011

Taxes

Table 5.3 shows revenue projections by category and tax type. Direct Taxes are estimated to increase in 2011, reaching $40.6 million in 2012 and with growth stabilising thereafter. These changes are largely due to the increased Government investment in the economy, through capital expenditures. They are projected to have increased on Withholding Tax, as building and construction contracts are subject to this tax type.

The projection for Indirect Taxes for 2012 is $54.5 million, increasing to $95.8 million in 2016. These projections are largely based on the continued requirement of imports to facilitate domestic growth and consumption on the one hand, and the continued ability of domestic infrastructure to accommodate these increases on the other. As such, changes in the port infrastructure or significant increases in domestic production to satisfy consumer and industrial demand could significantly alter these figures in the medium term.

Table 5.3 Total Tax Revenue Projections 2010 - 2016 ($'m)

	2010	2011	2012	2013	2014	2015	2016
	Actual	Estimate			Projections		
Direct Taxes	**18.23**	**22.30**	**40.56**	**43.21**	**46.44**	**50.45**	**53.73**
Income Tax	5.53	7.10	**7.82**	8.13	8.46	8.79	9.15
Individual Income	0.68	*1.29*	***1.95***	*2.03*	*2.11*	*2.20*	*2.28*
Individual Inc Other	4.85	*5.81*	***5.87***	*6.10*	*6.34*	*6.60*	*6.86*
Corporate Tax	4.49	5.70	**5.59**	6.23	6.96	7.76	8.67
Witholding Tax	8.22	9.50	**27.15**	28.84	31.03	33.89	35.92
Indirect Taxes	**31.94**	**42.60**	**54.50**	**64.40**	**74.59**	**85.05**	**95.83**
Service Tax	3.49	4.00	**5.11**	6.15	7.43	8.98	10.86
Sales Tax	6.08	11.40	**13.34**	15.72	18.13	20.53	22.94
Excise Tax	16.88	17.70	**24.65**	29.08	33.53	37.97	42.42
Import Duties	5.48	9.50	**11.40**	13.44	15.50	17.55	19.61

Source: Macroeconomic Directorate, Ministry of Finance, 2011

User Fees and Charges

Table 5.4 contains the projected income from User Fees and Charges, which are expected to increase from $16.2 million in 2011 to reach $19.0 million in 2012. The fall in 2011 is due to exceptionally high receipts in the Other Non-Tax Revenue in 2010, and the underlying growth trend in this category will return going forward, seeing Fees and Charges receipts reach $55.3 million in 2016.

Table 5.4 User Fees and Charges Projections 2010 - 2016 ($'m)

	2010	2011	2012	2013	2014	2015	2016
	Actual	Estimate			Projection		
Fees and Charges	**19.73**	**16.18**	**19.00**	**23.98**	**30.93**	**40.84**	**55.29**
Business Reg. Fees	0.44	0.74	1.31	2.27	3.93	6.80	11.77
Postage Fees	0.07	0.06	0.02	0.02	0.02	0.03	0.03
Property Rentals	2.23	2.39	4.01	5.38	7.21	9.67	12.96
Water Fees	0.05	0.07	0.06	0.06	0.07	0.07	0.08
National University	0.39	0.47	0.48	0.54	0.60	0.67	0.74
Vehicle Registration	0.95	0.94	1.33	2.09	3.21	4.93	7.48
Vehicle Inspection Fees	0.00	0.24	0.26	0.38	0.57	0.86	1.29
Drivers Licence Fees	0.00	0.34	0.36	0.54	0.81	1.22	1.83
Other Transport Fees	0.00	0.00	0.00	0.00	0.00	0.00	0.00
ID & Passport	0.53	0.81	0.96	1.31	1.77	2.40	3.25
Visa Fees	1.03	1.48	1.30	1.46	1.64	1.84	2.06
Hospital & Medical Fees	0.08	0.07	0.07	0.08	0.09	0.10	0.11
Court Fees	0.00	0.00	0.17	0.19	0.22	0.24	0.27
Dividends, Profits & Gains	3.72	7.26	5.23	5.84	6.52	7.27	8.12
Mining & Quarrying	0.09	0.10	0.07	0.08	0.09	0.10	0.11
Radio & Television Fees	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bid Doc Receipts	0.05	0.05	0.03	0.02	0.02	0.01	0.01
Auctions	0.17	0.05	0.01	0.02	0.02	0.02	0.02
Other Non-Tax Rev	9.95	1.11	3.32	3.70	4.13	4.61	5.15

Source: Macroeconomic Directorate, Ministry of Finance, 2011

Rice Sales and Interest

Rice subsidies were introduced to buffer the Timorese people from spikes in world food prices in 2008. The need for the Government to intervene in this market has now been deemed to have subsided. As Government intervention reduces, revenues from this sector are projected to fall to $0.8 million in 2012, and as further intervention is not envisaged, revenue increases will remain stable.

Interest, being monies received on Government bank account balances, represents only a small portion of Domestic Revenues. Interest receipts are projected to be $0.1 million in 2012 and then increase modestly in the medium term.

Autonomous Agencies

Revenues from Autonomous Agencies (Equipment Management, Aviation, Port, and EDTL) are shown in Table 5.5.

EDTL, the most significant contributor to this category, is expected to see its revenues expand from $14.52 million in 2011, to $16.08 million in 2012. This strong growth is projected to continue into the future with the continued expansion of economic growth and demand for electricity, and continued efforts to increase pay for use among electricity consumers. It is also possible that the rates charged, which were revised in August of 2011, may be further modified as better-off clients could be asked to accept less of a subsidy for their electricity, and such changes could boost these revenues further.

Growth in Aviation revenue is projected to be steady, reaching $1.35 million in 2012, though increased flight and passenger numbers, perhaps facilitated in the future by improved infrastructure, could see these figures rise significantly.

The Port revenues, estimated to be $3.39 million in 2012, have shown robust growth which is projected to continue in the medium term, reaching $6.46 million by 2016. Again, these increases are dependent on the continued increase of demand for imports, as well as increases in their price levels and the ability of the port facilities to accommodate these increases.

Table 5.5 Autonomous Agencies Projections 2010 - 2016 ($'m)

	2010	2011	2012	2013	2014	2015	2016
	Actual	Estimate			Projection		
Equipment Mgt	0.03	0.00	0.11	0.12	0.13	0.15	0.16
Aviation	1.23	1.32	1.35	1.42	1.48	1.55	1.63
Port	2.46	3.10	3.39	3.99	4.68	5.50	6.46
EDTL	10.00	14.52	16.08	20.40	25.88	32.83	41.64
SAMES	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total	**13.72**	**18.94**	**20.94**	**25.92**	**32.18**	**40.03**	**49.89**

Source: Macroeconomic Directorate, Ministry of Finance, 2011

Petroleum Revenues

The main factors driving the inflow of petroleum revenues are prices, production and costs. Compared with the petroleum revenue forecasts in last year's budget, prices are somewhat higher, production is significantly lower and costs are significantly higher. Based on these assumptions, the petroleum revenues are expected to peak in 2011 at $2.5 billion before starting to steadily decline to $1.8 billion in 2012 and onwards to $1.6 billion in 2015 (see Tables 5.6 and 5.7). The revisions reduce the accumulated revenues over the life of Bayu-Undan by about 20% compared with last year's forecasts.

Table 5.6 Estimated Petroleum Revenues 2011-2016 ($millions)

	2010 Actual*	2011 Estimate	2012 Budget	2013 Projection	2014 Projection	2015 Projection	2016 Projection
Total Petroleum Revenue	**2,339**	**2,830**	**2,090**	**1,904**	**1,759**	**1,922**	**1,991**
BU** FTP/Royalties	159	165.66	119.28	114.40	108.26	117.37	115.08
BU Profit oil	1,031	1,275.18	930.97	780.30	676.69	767.06	843.39
BU Income Tax	458	420.00	251.58	264.29	280.21	323.41	277.02
BU Additional Profit Tax	374	472.74	300.86	291.99	236.89	293.26	320.20
BU Value Added Tax	35	8.48	13.43	13.64	13.00	9.79	10.40
BU Wages Tax	16	15.00	10.00	8.49	8.66	8.83	9.01
BU Pipeline Payments	7	8.56	8.56	8.56	8.56	8.56	8.56
BU Other Payments	19	136.60	25.00	20.00	-	-	-
BU Withholding Tax	18	10.57	16.73	16.99	16.20	12.20	12.95
Kitan		33.74	89.44	45.98	61.86	16.10	-
Petroleum Fund Interest Received	221	283	324	339	349	365	394

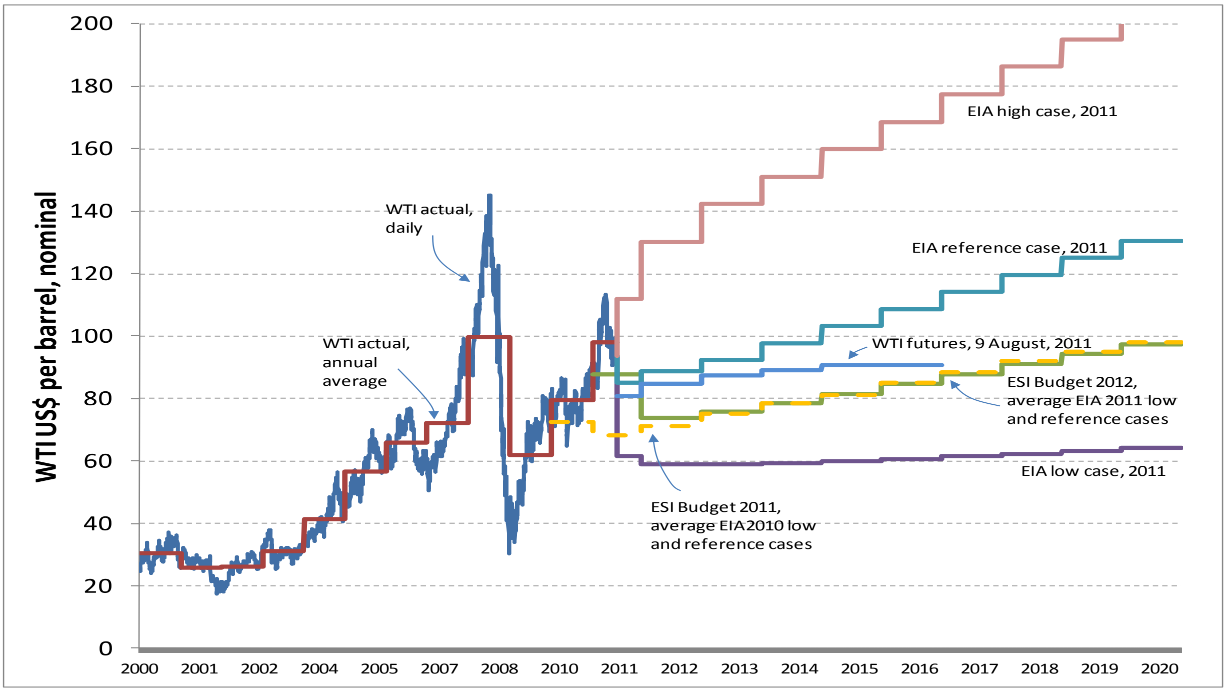
*) Actual Cash flow for 2010 **) BU: Bayu Undan

Source: Petroleum Fund Directorate, Ministry of Finance, 2011

Oil Prices

The oil price for 2011 is estimated at $88 per barrel, taking into account the actual development until July. This estimated oil price is about $20 per barrel higher than anticipated in last year's budget. Oil prices are estimated at $74 and $76 per barrel for 2012 and 2013 respectively, slightly higher than previously expected. Figure 5.1 shows the oil price assumptions used in the petroleum revenue forecast. In particular, the figure shows two things: Firstly, the oil price assumptions, which is an average of the EIA reference and low case, has not changed materially from last year's forecast. Secondly, the oil price assumption is prudent, being lower than EIA's "most likely case" or reference case and WTI futures[7], and significantly lower than EIA's high case. The oil price assumption methodology (as well as all the other key assumptions) was thoroughly discussed in Budget 2011.

Figure 5.1 Historical Changes and Future Projections in the WTI Oil Price ($ per barrel)



Source: Energy Information Energy (EIA), Annual Energy Outlook 2011

Oil Production

The condensate and LPG (liquids) production forecast for Bayu-Undan is revised significantly downward compared to last year's ESI calculations, taking into account recent operational experience and the now fully assimilated results of 2010 Phase II drilling. As shown in Table 5.7, the total petroleum production on Bayu-Undan (also including LNG) has already peaked and is now set to ebb off before ceasing in 2024.

The Field Development Plan for the Kitan field was approved in 2010 and production expects to commence in the 4th quarter of 2011. The total production is modest compared to the Bayu-Undan field. Kitan's Low and Base Production Case are 26.8 and 35.5 million barrels of oil respectively over the life time of the project. The total revenue stream based on the Low Production Case is equivalent to $247.1 million, or some 1% of Bayu Undan.

[7] *WTI Futures reflects the parties (seller and buyer) in the oil market expectations regarding the future oil price and quantity to be delivered.*

Costs

The estimated costs for the Bayu-Undan project, both upstream and downstream, have increased significantly. Total costs (capital and operating, at the upstream facility, on the pipeline, and at the downstream LNG plant) are around 40% higher than in last year's forecast. The change in the cost forecast derives primarily from the strengthened Australian dollar, in which a significant proportion of costs are incurred, and corrosion and other operational issues that require remedial action over the next few years. Table 5.7 shows the oil price, production volumes and undiscounted and discounted petroleum revenues for Timor-Leste over the life time of the two projects.[8]

Table 5.7 Sustainable Income Calculations – Oil Price Assumptions, Production and Revenue Forecasts 2002-2025

Timor-Leste Petroleum sector				
	Average WTI oil price	Production	Total Discounted Petroleum Revenues (Factor of 3.7%)	Total Undiscounted Petroleum Revenues
	$/Barrel	million barrels oil equivalent	$ million	$ million
Total		**892**		**27,266**
Total from 1 January 2012		**548**	**13,496**	**18,864**
to 2002				
2003				10
2004	44	17	0	174
2005	54	29	0	336
2006	65	57	0	609
2007	72	58	0	1,288
2008	100	64	0	2,272
2009	62	62	0	1,653
2010	79	57	0	2,060
2011	88	59	0	2,547
2012	74	50	1,734	1,766
2013	76	52	1,482	1,565
2014	79	47	1,288	1,410
2015	82	50	1,371	1,557
2016	85	47	1,356	1,597
2017	88	44	1,245	1,521
2018	91	37	953	1,207
2019	94	38	986	1,295
2020	97	36	949	1,292
2021	101	36	918	1,297
2022	104	33	741	1,085
2023	106	18	376	572
2024	109	0	60	94
2025	112	0	37	61

Source: Petroleum Fund Directorate, Ministry of Finance, 2011

[8] *Includes revenue streams from Bayu Undan and Kitan fields*.

Investment Return

The net investment return on the investments in the Petroleum Fund was $221 million or 3.8% nominal in 2010. During 2010 inflation in the USA was 1.5%, hence the real return was 2.3%. From 2011 and onwards it is assumed a return on investments of 3.7%, which translate into $283 million in 2011 and $324 million in 2012 (nominal). Going forward, the assumed return on investments will reflect the expected return on the Fund as the asset allocations develop in line with the amended Petroleum Fund Law investment policy.

As of the second quarter of 2011, the net investment return of the Petroleum Fund is 1.7%. The annual return for the 12 months to June 2011 is 3% nominal. The annual return on the investments since the inception of the Fund is 4.2% nominal.

Petroleum Fund

According to the Petroleum Fund Quarterly Report published by Banking and Payments Authority (BPA), the Fund's balance was $8.3 billion as of second quarter 2011. This is an increase of $1.4 billion from the start of the year. The Fund balance is expected to be $8.7 billion by the end of 2011 after deducting the estimated withdrawal of $1.1 billion in 2011 adopted by Parliament.

Notwithstanding lower production, higher costs and higher withdrawals than earlier anticipated, the value of the Petroleum Fund is set to increase to $9.2 billion by the end of 2012, $9.5 billion by the end of 2013 and $11.3 billion by the end of 2016.

The forecasts of the future Petroleum Fund balance is shown in table 5.8.

Table 5.8 Estimated Petroleum Fund Savings 2011 - 2016 ($millions)

	2010 Actual	2011 Estimate	2012 Budget	2013 Projection	2014 Projection	2015 Projection	2016 Projection
Opening Balance	**5,377**	**6,904**	**8,679**	**9,175**	**9,515**	**9,685**	**10,422**
Petroleum Revenue excluding PF Interest	2,117	2,547	1,766	1,565	1,410	1,557	1,597
Petroleum Fund Interest, Net*	221	283	324	339	349	365	394
Withdraw al	-811	-1,055	-1,594	-1,564	-1,588	-1,185	-1,128
Closing Balance	**6,904**	**8,679**	**9,175**	**9,515**	**9,685**	**10,422**	**11,285**

*) net of management and market revaluation

Petroleum Wealth and ESI calculation

According to the Petroleum Fund Law the Estimated Sustainable Income (ESI) shall be 3% of the Petroleum Wealth. The Petroleum Wealth, which comprises the balance of the Fund plus the net present value of future petroleum revenue, is estimated to be $22.2 billion as of 1 January 2012. The estimated Petroleum Wealth has decreased by $2.2 billion compared to the calculations provided in the Budget 2011, mainly as a consequence of the changes to production and cost assumptions discussed above. The key assumptions underlying the ESI calculations are listed in Table 5.9.

The Estimated Sustainable Income (ESI) is estimated at $665.3 million for 2012. This is a decrease of $69 million from the 2012 ESI estimate in last year's budget.

Table 5.9 Key assumption behind ESI

Asset recognition	Forecast petroleum revenues are included only for projects with approved development plans. This includes Bayu-Undan and Kitan.
Petroleum Reserves and Production Forecasts	Production estimates are provided by project operators. Low case production is used, consistent with a 90% probability that actual will exceed the forecast. For Bayu-Undan the difference between the low (P10) and central (P50) case is only around 7-12%.
Oil price forecast	ESI for Budget 2012 as for 2011 is prepared using the average of Energy Information Agency (EIA) low case and reference case for light sweet crude oil (WTI[9]).
Prices for specific petroleum products	Bayu Undan produces condensate, Liquefied Petroleum Gas (LPG) and Liquefied Natural Gas (LNG) while Kitan is planned to produce only condensate. Forecast assumptions for each product are derived from historic differentials observed with WTI. LNG prices are forecast using contractual pricing formulae for the short term and an assumed relationship with oil prices for the longer term using advice from market experts.
Production costs	Central estimate of future capital and operating costs as provided by project operators.
Discount rate	A specific discount rate is calculated for each year of the petroleum revenue forecast using the ten year average of US bond rate for each respective maturity date. For descriptive purposes a single implicit discount rate is then calculated that results in the same net present value as arrived at with the specific discount rate.

Source: National Directorate of the Petroleum Fund, Ministry of Finance, 2011

Table 5.10 shows the ESI calculation for 2012 and Figure 5.2 the ESI together with the petroleum revenue forecast.

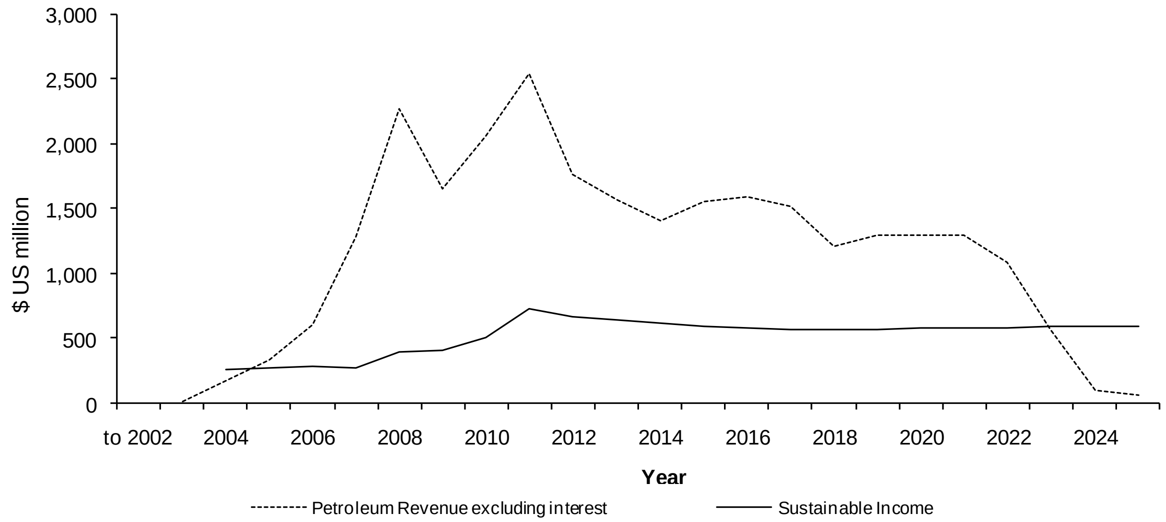
Table 5.10 ESI as of 1 January 2011 compared to figures in Budget 2010

US$ million	2011 Budget	2012 Budget	2013 Budget	2014 Budget	2015 Budget	2016 Budget
Petroleum Fund balance	6,617	8,679	9,175	9,515	9,685	10,422
+ Net Present Value of future revenues	17,847	13,496	12,197	11,055	10,028	8,814
Total Petroleum Wealth (PW)	24,465	22,175	21,372	20,570	19,713	19,236
Estimated Sustainable Income (PWx3%)	734	665.3	641.2	617.1	591.4	577.1

Source: Petroleum Fund Directorate, Ministry of Finance, 2011

[9] *The EIA "Low Sulfur Light Oil" is stated in EIA documentation to be the same as WTI.*

Figure 5.2 Timor-Leste Petroleum Revenues and Estimated Sustainable Income 2002-2024



Source: Petroleum Fund Directorate, Ministry of Finance, 2011

Changes in the ESI from 2011 to 2012

Figure 5.3 shows the key incremental changes in 2012 ESI since the 2011 Budget. Main driving factors include oil price, petroleum production and costs. Refer to Table 5.9 for a general introduction to the key ESI assumptions.

Oil prices

The 2011 low and reference case from EIA are essentially unchanged. The 2011 price of $88 per barrel used for Budget 2012 ESI is the weighted average of actual $98 per barrel for the 7 months to July 2011[10], and the average of the EIA AEO 2011 low and reference cases of $73 per barrel. This is significantly higher than the Budget 2011 forecast of $68 per barrel. The revised forecasts for 2012 and 2013 are also slightly higher than previous forecasts but thereafter revert to basically the same as the average of EIA low and reference cases used for Budget 2011. The change in the WTI forecast increases 2012 ESI by $21 million, mainly from the increase in 2011, 2012 and 2013 prices.

Liquids price differentials

The assumed values of Bayu-Undan (BU) condensate and LPG relative to WTI in the future have been slightly revised as discussed above. The change in liquids differential increases 2012 ESI by $4 million.

LNG price differentials

There is a modest effect from reflecting specific spot-sale differentials as forecast by Poten&Partners for 2012-2013. The Japan Crude Cocktail (JCC) differential has been revised to WTI minus 3.5% (Budget 2011 WTI minus 5%). These changes increase ESI by $5 million.

[10] *Source EIA http://www.eia.gov/dnav/pet/pet_pri_spt_s1_d.htm; average of monthly prices series until July 2011.*

Liquids production

ConocoPhilips (COP) has revised the production forecast for Bayu-Undan significantly downwards taking into account recent operational experience and the now fully assimilated results of 2010 Phase II drilling. This reduces 2012 ESI by $69 million. Explanations by ConocoPhilips on the revision include:

- In late 2010 liquids production started deviating from the base case forecast which had previously been a highly accurate predictor of production.

- After investigation, COP is now undertaking a bottom up rework of its reservoir modeling and fully incorporated the results from Phase II drilling program carried out in 2010. This will be completed towards the end of 2011.

- Work completed so far has resulted in a reduction of the Gas Initially In Place (GIIP) estimate from 8.0 Tcf to 7.6 Tcf, and a reduction particularly in the GIIP for the high liquids content Plover formation, reducing liquids forecast overall.

- Reservoir pressure has declined faster than expected resulting in some potential for condensate and LPG to drop out in the reservoir, and therefore not be produced.

- There is increased water production, and some evidence of lean gas breakthrough (re-injected gas migrating to producing wells and being preferentially produced ahead of liquids)

- The design of the field with only 12 producing wells provides limited operational flexibility.

LNG production

The LNG forecast is the COP P50 case, modified to end in 2023 when low case liquids production ceases. This still reflects a reduction from the 2011 low case resulting in a decrease in ESI of $20 million. If the low case as presented by COP is used without adjustment, ESI would decrease by a further $20 million, however the Ministry of Finance believes this would be excessively prudent.

Cost

ConocoPhilips has significantly increased its estimate of base case costs for the Bayu Undan project, both upstream and downstream. Total costs (capital and operating, at the upstream facility, on the pipeline and at the downstream LNG plant) are around 40% higher than in last year's forecast, resulting in a decrease in ESI of $36 million. The change in the cost forecast derives primarily from the strengthened Australian dollar, in which a significant proportion of costs are incurred, and corrosion and other operational issues that require remedial action over the next few years.

Sixty-three per cent of Bayu-Undan costs are incurred in Australian dollars, as are 85% of Darwin LNG costs. The current forecasts assume an exchange rate of 1.07 US$ = 1 AUS$ for the life of the project, which is roughly a 38% increase in US$ based costs relative to last year. The Government takes the view that although there is a possibility that the $AUS could moderate in relative strength over time, it remains prudent to use the COP costs reflecting the 1.07 US$ assumption.

Kitan

The development plan for Kitan was approved by the ANP during 2010 and forecast revenues from Kitan are therefore included in the ESI calculation. The $3 million ESI increase reflects the Kitan low production case.

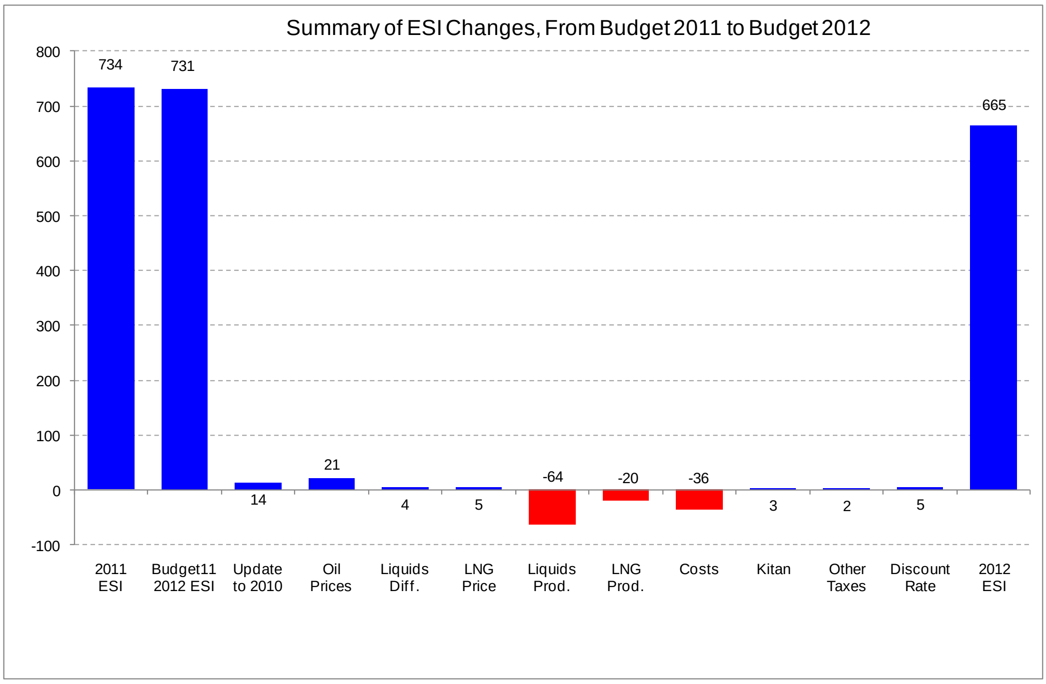
Taxes on exploration

Recognising their relative immateriality, 2011 ESI included a very simple forecast of wages and other taxes related to the non-Bayu-Undan exploration activity. This turned out to have understated these revenues. Tax collections from subcontractors and exploration drilling are forecast for Budget 2012 consistent with recent collections and taking into account exploration work commitments as advised by ANP. The change in the forecast of other taxes increases 2012 ESI by $2 million. There are no firm exploration work commitments beyond 2013 therefore no revenues are assumed past this date.

Discount rate

The discount rate used is the 10-year rolling average of U.S. Treasury bond rates, which has continued to fall. The discount rate has been reduced from 4.0% to 3.7%. A lower discount rate increases the present value of future petroleum revenues, and has increased ESI by $5 million.

Figure 5.3 Changes in the 2012 ESI (from Budget 2011 to Budget 2012)



Source: Petroleum Fund Directorate, Ministry of Finance, 2011

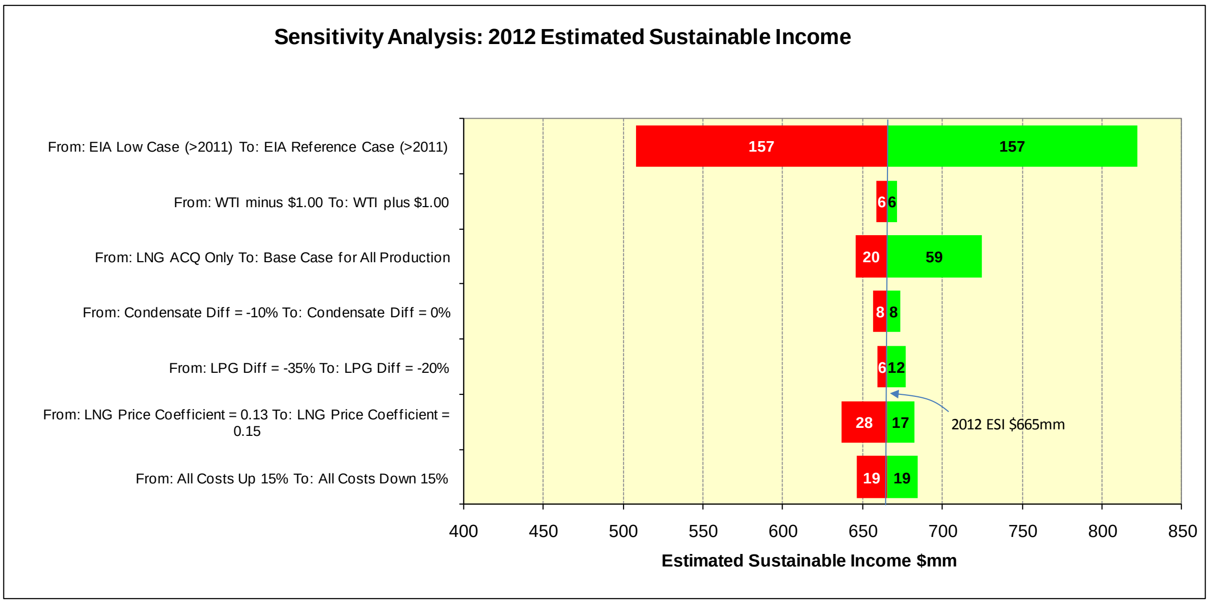
Sensitivity analysis

The Government's objective is to prepare an estimate of ESI that is prudent overall. Assumptions for each key input into the forecast of future petroleum revenues have been developed taking into account the best information available and advice from experts.

However, each input is subject to uncertainty. Figure 5.4 shows how 2012 ESI changes when key assumptions are changed individually. The sensitivity analysis starts with the 2012 ESI of $665.3 million and shows by how much ESI would change if a different assumption for each key variable was used. For sensitivity to oil prices, the forecast used in the 2012 estimate is compared to the EIA low case and reference case forecasts (in both cases starting in 2012). For other key assumptions, the parameters used in the sensitivity analysis reflect a judgmentally determined range from key base assumptions.

This analysis shows that the oil price and production forecasts are by far the most important assumptions with others of secondary importance. Accordingly ESI is prepared with prudent assumptions for oil prices and production, and with assumptions generally consistent with (P50, expected outcome) for others, being conscious that prudence in each input would result in excessive prudence overall.

Figure 5.4 Sensitivity Analysis – Estimated Sustainable Income ($ Millions)



Source: Petroleum Fund Directorate, Ministry of Finance, 2011

Review of methodology

Schedule 1 of the Petroleum Fund law requires the ESI to be estimated using prudent assumptions reflecting international best practice and based upon recognised international standards. The Ministry of Finance undertook a comprehensive review of the methodology for the ESI prepared for Budget 2011 with technical assistance from the Fiscal Affairs Department of the International Monetary Fund. No material changes in methodology have been implemented for Budget 2012.

As in previous years, for liquids production (condensate and LPG) low case production forecasts are used for ESI. For LNG a modified base case is used as a consequence of a change in the methodology of ConocoPhilips.

The Petroleum Fund Law Amendments

The Petroleum Fund Law amendments were passed by Parliament on 23 August 2011. Two principles are especially reflected in the legislation: good governance and diversification. These principles are explained below, along with a discussion of key changes in the amended legislation.

The Petroleum Fund Annual Report 2010 also discusses in length the application of these principles in the law, with specific emphasis on the governance framework and the risk-return trade-off embedded in the new investment policy.

Good Governance

Based on the "Santiago principles[11]", the Petroleum Fund governance model is based on a high degree of transparency and disclosure of information. This helps build public support for wise management of petroleum revenues and reduces the risk of bad governance. Transparency ensures that information can be used to measure the authorities' performance and also guards against any possible misuse of powers. Transparency serves to enable accountability, which means authorities and whoever handles public money can be held responsible for their actions.

As the Executive, the Government through the Ministry of Finance is responsible for the overall management of the Petroleum Fund, on behalf of the people of Timor-Leste. The Petroleum Fund Law makes the Government accountable to Parliament through various reporting requirements. The operational management is currently carried out by the BPA (Central Bank), which invests the Fund's capital according to guidelines established by the Ministry of Finance and mandates developed by the Investment Advisory Board (IAB). The Ministry of Finance is required to seek advice from the IAB before making decisions on any matter relating to the investment strategy or management of the Petroleum Fund.

The amended Petroleum Fund Law further strengthens this internationally recognised governance framework by improving reporting requirements, strengthening checks and balances and strengthening the requirements for technical skills in the management of the Fund.

Diversification

Obtaining financial returns involves taking risk. Where capital is systematically allocated to assets other than those that deliver a risk-free rate of return, investors expect a higher return as a reward for the additional risk they are taking. That is, risk and expected return are related. This relationship is discussed and quantified in the Petroleum Fund Annual Report 2010.

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[11] *International Working Group's "Sovereign Wealth Funds: Generally Accepted Principles and Practices", otherwise known as the Santiago Principles. The Principles identify a framework of generally accepted principles and practices that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by Sovereign Wealth Funds (SWFs) on a prudent and sound basis.*

The amended Petroleum Fund Law states that the objective of the investment policy is to maximise the risk-adjusted return. A necessary condition to achieve this objective is to employ the principle of diversification. Diversification is the process of exposing an investment portfolio to a number of different asset classes, risk factors, and individual financial assets, rather than being concentrated in any one of these. Diversification is the antidote to many avoidable risks. The key to the diversification process is that different asset classes and other portfolio risk factors will usually not move in unison. Combining assets with returns that are less than perfectly correlated reduces risk and volatility.

The cornerstone of the fiscal policy is the Estimated Sustainable Income (ESI). The ESI is the guiding rule for withdrawals from the Petroleum Fund on sustainable basis and is at 3% of the petroleum wealth.

A necessary condition for the ESI to actually be sustainable is that the Fund's investments earn a real return of 3%. The real return of the portfolio from inception of the Fund in September 2005 to June 2011 has been 2.2%. Economic models predict that the narrow investment universe regulated in the previous Petroleum Fund Law will earn 2% real return over time. This investment policy is therefore not aligned with the fiscal policy. The amended law allows for a maximum of 50% of the Fund to be invested in equities. Modelling predicts this will give a reasonable probability of achieving a 3% real return over time with a risk level the Government is willing to accept, thus aligning the Petroleum Fund investment policy with the ESI budget spending guideline.

Part 6: Financing

The SDP calls for significant investment in infrastructure. To achieve this successfully, the Government is considering a number of financing and implementation options. These include borrowing at a concessional level where the cost of borrowing is lower than the economic returns of the project in the medium term.

Public-Private Partnerships

The Government with donor support has completed the development of the Public-Private partnership (PPP) policy and legal framework, and is in the process of developing internal operational guidelines and procedures, which will allow the adoption of Public-Private Partnerships (PPP). To be successful a proposal will need to demonstrate an overall community benefit and be consistent with the Government's plans and priorities. Early planning and studies are vital to ensure that the Government is receiving value for the rights that are granted. This is important as PPP are complex arrangements and are often prepared and negotiated over an extended period of time.

The PPP concept is a good policy option because it shares risks and can overcome capacity bottlenecks in delivering the required services. Within the SDP there are several projects that may be suitable for consideration for using PPP arrangements. The Government is currently exploring the following projects: port and airport among others. Most importantly, PPP arrangements can also be used to deliver social infrastructure. However, the PPP process is complex and there is an initial high cost for planning, negotiation and establishment. Accordingly, the Government expects at the outset that PPP will be used sparingly for very high economic return projects that will attract the appropriate private sector expertise. This will also allow lessons learned and international experience to grow organic capacity to deliver PPP.

Loans

Under Articles 20 and 21 of the Budget and Financial Management Law the Government has a legal basis to borrow. Further, on the 24 August 2011 Parliament approved the Public Debt Regime, which intends to establish a basis for facilitating the contracting of foreign loans between the Government, multilateral and bilateral funding institutions to supplement the financing needs of the SDP. The primary goal of external borrowing is to bring forward the implementation of strategic capital projects as identified in the SDP 2011-2015 Project Implementation Plan (PIP).

The loans available from multilateral agencies, and on a bilateral basis, will be undertaken over the longer period of time and at rates below the economic returns of the funded projects. It is envisaged the loans will be utilised for national priority projects such as roads and bridges. Table 6.1 shows the size of loans for different segments of roads across the country and for drainage in Dili. For 2012, it is expected the loans will be about $33.1 million. The size will increase in the next five years as indicated in Table 6.1. The funds from co-financing from the Government come from the Infrastructure Fund. Table 6.1 does not show repayment because most of the loans have a ten year grace period. Until then, the Government will report the repayments through the State Budget.

Table 6.1. Financing needs and Co-financing from the Government, 2012 - 2016

Roads	**2012**	**2013**	**2014**	**2015**	**2016**	**Total**
Dili-Liquica, Tibar-Ermera	5,260	10,700	10,700			26,660
Manatuto-Natarbora	2,840	2,880	2,280	5,340	30,000	43,340
Dili-Manatutu-Baucau	5,000	6,600	8,100	27,500	50,000	97,200
Maubise-Ainaro/Same		10,000	20,000	20,000		50,000
South Coast Highway		30,000	40,000	50,000	100,000	220,000
Dili Sanitation/drainage	20,000	20,000				40,000
Loans	**33,100**	**80,180**	**81,080**	**102,840**	**180,000**	**477,200**
Government Co-Financing	9,930	24,054	24,324	30,852	54,000	143,160
	43,030	**104,234**	**105,404**	**133,692**	**234,000**	**620,360**

Source: Major Project Secretariat, Ministry of Finance, 2011

Prepared for the
Government of the Democratic Republic of Timor-Leste
by the

MINISTRY OF FINANCE

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