REPÚBLICA DEMOCRÁTICA DE TIMOR-LESTE

State Budget

2011

Budget Overview

Book 1

Goodbye Conflict, Welcome Development

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The Combined Source Budget for Timor-Leste in 2011 is $1.18 billion comprising the General State Budget in the amount of $985 million, and $195 million from Development Partners, as shown in Table 2.1.

Table 2.1. Combined Source Budget, 2011 – 2015 ($ million, prelim)

Budget	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
CFTL	**837.9**	**642.7**	**653.4**	**679.6**	**706.7**	**734.9**
Infrastructure Fund	-	317.3	597	620.9	645.8	671.6
HCDF	-	25.0	30	35	40	45
General State Budget	**837.9**	**985.0**	**1,280.4**	**1,335.5**	**1,392.5**	**1,451.5**
Development Partners	256.8	195.0	112.7	75.2	32.7	0
Combined State Budget	**1,094.7**	**1,180**	**1,393.1**	**1,410.7**	**1,425.2**	**1,451.5**

Source: Budget and Aid Effectiveness directorates, Ministry of Finance, 2010

Table 2.2 shows Consolidated Fund of Timor-Leste (CFTL) by categories of expense, divided between recurrent and capital.

Table 2.2. CFTL by Category, 2011 – 2015 ($ million, prelim)

Budget	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Recurrent						
Salary and Wages	99.3	115.9	120.6	125.4	130.4	135.6
Goods and Services	260.6	245.5	255.3	265.5	276.1	287.1
Public Transfers	184.4	164.5	171.0	177.9	184.9	192.4
Capital						
Minor Capital	39.9	28.2	29.3	30.6	31.8	33.0
Capital & Development	253.7	88.6	77.2	80.2	83.5	86.8
CFTL Total	**837.9**	**642.7**	**653.4**	**679.6**	**706.7**	**734.9**

Source: Budget Directorate, Ministry of Finance, 2010.

Economy

The international economy has begun to recover from the financial crisis that plunged major advanced economies into recession and impacted adversely on the majority of emerging and developing countries. Timor-Leste was relatively sheltered from the crisis and its economic growth remained strong throughout, as result of limited exposure to international trade and no financial industry. Overall real economic growth in Timor-Leste in 2009 is estimated at 13%, with Public Sector contributing 5.6% of this growth, Agriculture contributing 3.9% of growth and

Industry and Services contributing the remaining 3.5%. Going forward, it is projected that the economy will continue its double digit economic trajectory from 2011 through 2015 driven primarily by public expenditures.

Since the 2008 financial crisis, oil prices have risen and stabilized at around $70-$80 per barrel. Oil demand has risen in the first half of 2010, particularly in China, on the back of a rebound in global activity. Timor-Leste's petroleum revenues, including interest, were $1.84 billion in 2009. It is estimated that the petroleum revenues will reach $2.02 billion in 2010, primarily due to an increase in the average oil price from $62 per barrel in 2009 to an estimated average of $76 per barrel in 2010.

Headline inflation year-on-year in 2009 in Timor-Leste and Dili was 0.1% and 0.7% respectively.[1] This represents a drop in inflation rates from 2007 and 2008. Global food prices are expected to rise as a result of bad weather leading to poor harvests, and consequently inflation is projected to increase to 4%.

Expenditure

For 2011, the Government has determined the following expenditure priorities:

- **PN1: Infrastructure:** electricity, roads and bridges, water and sanitation.
- **PN2: Rural development:** agricultural productivity, livestock, access to microcredit and environmental protection.
- **PN3: Accelerated development of human resources:**
  - Professional and technical training;
  - Justice, health and teachers training;
  - Specialist training in the finance, management and administration areas.
- **PN4: Access to justice.**
- **PN5: Delivery of Public Services:**
  - Assistance to Vulnerable groups, health and education;
  - Improve public service and access.
- **PN6: Good Governance**
  - Focus in the transparency, accountability, coordination between ministries and user services and training of inspectors and auditors.
- **PN7: Public Security and Stability**

[1] National Directorate of Statistics (DNE), Ministry of Finance

This year's Budget Review Committee, led by the Prime Minister reviewed the budget submissions based on a careful assessment of prior years budgets, and redirected savings to national priorities identified in the Strategic Development Plan process.

Expenditure in the Budget is constructed on the framework of the Strategic Development Plan. The SDP has two main objectives; to transform Timor-Leste:

- from a low-income country to an upper-middle income country by 2030, and
- by reducing its dependence on oil.

Public investment will constitute a major driver of growth in the immediate phase of this plan and provide a catalyst for private investment to supplant government expenditure. Two Special Funds, the Infrastructure Fund (FI) and the Human Capital Development Fund (HCDF), will be established to manage the SDP expenditure under the stewardship of the Prime Minister and relevant line ministers. The Ministries/Agencies will implement the projects under the Special Funds.

The Government will create the National Development Agency (ADN) in 2011 to provide technical assistance for the implementation of the SDP. In addition, a Procurement Commission will manage procurement.

The centralization of decision making of the projects within the Special Funds will ensure projects are better coordinated between line ministries and integrated within the SDP.

Revenues

In 2010, Domestic Revenues are expected to achieve a milestone when in excess of $100 million is expected to be received, despite a reduction in revenues from rice. Domestic Revenues will continue its growth trajectory and reach $163.3 million by 2015. These are conservative estimates as further regulatory reforms, improved tax administration, and increased compliance may result in additional revenues.

The Petroleum Revenues are expected to remain high in 2011 and 2012 due to stable production and higher average oil prices. The estimated Petroleum Revenues for 2011 and 2012 are $2.23 billion and $2.4 billion respectively. The Petroleum Fund balance is expected to be $6.62 billion at the beginning of 2011 representing an increase of $1.24 billion from year on year.

The Estimated Sustainable Income (ESI) for 2011 is calculated at $734 million. This is an increase of $232 million from ESI 2010, and results basically from a change of methodology for the oil price forecast.

The Government in the last three years has fully implemented its investment strategy, and fully utilized the scope of the Petroleum Fund Law. The Petroleum Fund now invests not only in US bonds but also in other foreign Government bonds, and Supranational Organizations. An equity mandate has been added to its portfolio in October 2010.

The Government's strategy to further diversify the Petroleum Fund portfolio will necessitate amendments to the Petroleum Fund Law and will require approval by Parliament. Diversification will manifest in an increase exposure to equities.

Development partners will contribute $194.8 million in 2011 to the Combined Source Budget of Timor-Leste. Development partner's contribution will reduce disproportionately from 2010 onwards. This reduction is based on actual information to date and therefore does not reflect an absence of future international support and commitment.

Financing

Aside from traditional funding sources, a deficit will arise between desired development and domestic available resources over the medium and long term. Accordingly, the Government is exploring alternative funding options to finance strategic public investment.

A Debt Management Unit (DMU) has been established within the Ministry of Finance to ensure effective and efficient management of public debt should it arise. The Government is assessing the benefits of borrowing as opposed to relying exclusively on the Petroleum Funds revenue, including the financing options of Private Public Partnerships (PPP).

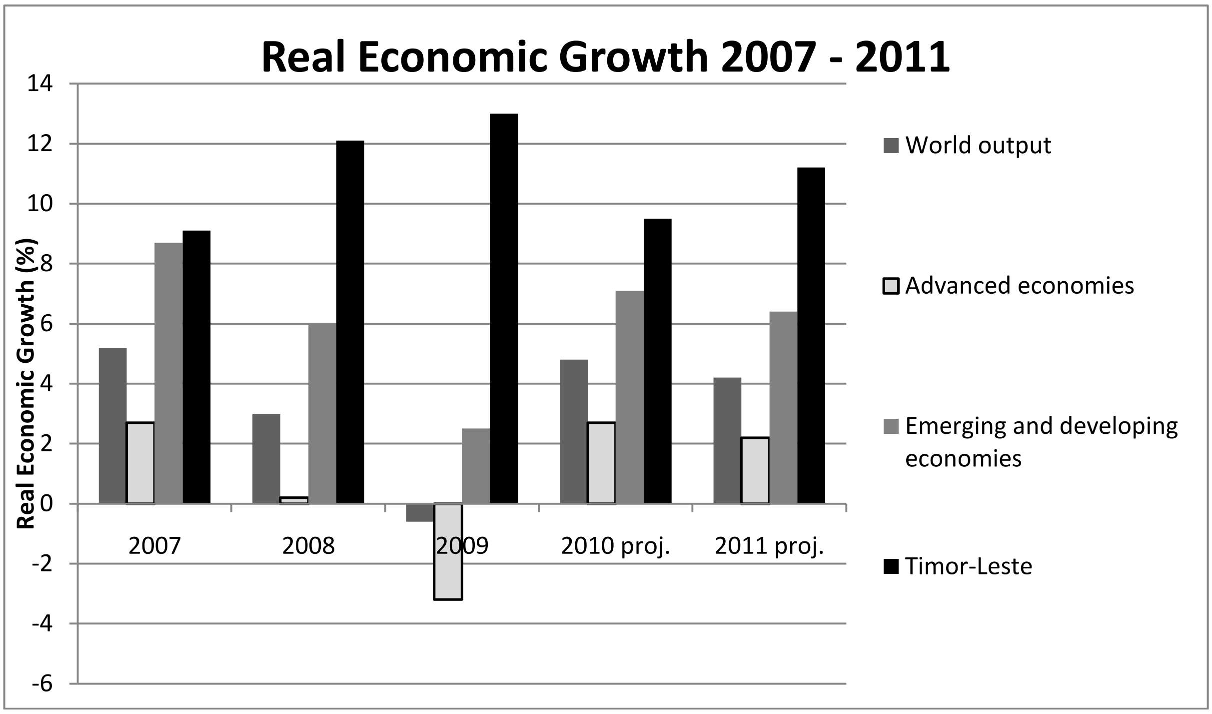
PART 3. ECONOMIC OUTLOOK

1. International Economy

The international economy has begun to recover from the financial crisis that plunged major advanced economies into recession and impacted adversely on the majority of emerging and developing countries. Over the first half of 2010 the world economy expanded at just over 5%, on an annual basis, according to the October 2010 IMF World Economic Outlook (WEO). Global output is now expected to rise by 4.8% in 2010 and 4.1% in 2011 and IMF's assessment is that the risk of a strong global downturn in economic activity is low. *Figure 3.1* shows world output between 2007 and 2011 and the impact of the recession and subsequent recovery. Timor-Leste was relatively sheltered from the crisis and its economic growth remained strong throughout.

Overall, inflation rates around the world are forecast to stay low due to excess capacity and high levels of unemployment. Financial markets have begun to return to their pre-crisis level, although in early 2010 financial market volatility increased and investor confidence dropped. This highlights the fragility of the recovery process. However, the extent of recovery varies substantially across regions; Asia and Latin America are the fastest rebounding regions.

Figure 3.1: World, Regional and Timor-Leste's Output Growth, 2007-2011 (%).



Source: IMF, *World Economic Outlook*, October 2010.

Advanced Economies

Growth has accelerated in Europe in 2010, but elsewhere in the USA and Japan economic activity slowed in the second quarter of 2010. Advanced economies are battling with the need to reduce high levels of public and private debt, while consumption remains low due to a lack of consumer confidence and reduced household incomes. Advanced economies were hit hardest by the spread of global unemployment and in 2010 unemployment rates in advanced economies have dipped modestly from peak rates. There is also a pressing need to reform financial sectors, which are still vulnerable to shocks. Growth rates are reportedly slowing as public sector stimulus eases and IMF projects only 2.7% and 2.2% in output growth for 2010 and 2011 respectively in advanced economies.

Asia

Economies of advanced Asia (apart from Japan) experienced a strong rebound, with output already exceeding pre-crisis levels. Large manufacturing sectors in these countries have benefited from renewed levels of international trade. A strong demand-driven recovery is underway in Asia's newly industrialized economies (NIEs[2]) and the ASEAN economies[3], with strong domestic activity coupled with healthy regional demand, particularly from China. Demand for commodities and electronics in particular is benefiting exporting countries and private investment activity is strong (although in Malaysia investment is not in full swing as in other countries).

Emerging Asia has also seen capital inflows return after the international crisis; inflows have increased by more than four times over the four quarters to October 2010. Many of these economies have already adopted prudent macroeconomic policies to protect against adverse effects from potential volatility of capital flows. Demand from Asian economies, particularly China, India and Indonesia has spurred growth in emerging Asia as well, with economic growth averaging 9.5% over the first half of 2010. 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 increasing exports. *Table 3.1* shows the extent and timing of the economic recovery in selected Asian countries.

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[2] NIEs include Hong Kong SAR, South Korea, Singapore and Taiwan Province of China.
[3] Indonesia, Philippines, Malaysia and Thailand

Table 3.1: **Real Economic Growth in Asian Economies, 2007 – 2011 (%)**

	Actual			**Projection**	
	2007	2008	2009	2010	2011
China	14.2	9.6	9.1	10.5	9.6
Australia	4.8	2.2	1.2	3.0	3.5
Singapore	8.5	1.8	-1.3	15.0	4.5
ASEAN-5	6.7	4.6	1.4	6.5	5.3
Indonesia	6.3	6.0	4.5	6.0	6.2
Vietnam	8.5	6.2	5.3	6.5	6.8
Philippines	7.1	3.7	1.1	6.0	4.0
Thailand	4.9	2.5	-2.2	7.5	4.0
Malaysia	6.5	4.7	-1.7	6.7	5.3
Timor-Leste	9.1	12.1	13.0	9.5	11.2

Sources: IMF, *World Economic Outlook* October 2010; Macroeconomic Directorate, Ministry of Finance (for Timor-Leste data).

Emerging and Developing Countries

Emerging and Developing countries' prudent policies have led the IMF to project significantly improved medium-term growth compared to previous post-global recession periods; 7.1% growth in 2010 and 6.4% in 2011. As with all regions, recovery has been heterogeneous, with developing and emerging countries growing significantly faster; Timor-Leste is an example of such a country. Countries that were hit hard by the recession are straining to sustain economic growth after the crisis; these include many regions in emerging Europe and the Commonwealth of Independent States.

Noting that developing countries have begun to benefit from the higher post-crisis levels of global trade, which is contributing to their strong growth, IMF recommends measures to improve developing countries' market access, for example, 100% duty-free and quota-free market access for the least developed countries, complemented by liberal rules of origin. This should be implemented alongside programs aimed at strengthening low income countries' capacity to trade. Trade facilitation is especially important at a time when capital is scarcer than before the global recession and developing countries must rely more heavily on domestic revenues. Policy to supplement traditional forms of financing could include public-private partnerships (PPP) and South-South investment initiatives.

World Prices

The main impact of world economic activity on Timor-Leste is on oil revenues, through changing prices in oil. However, through saving the majority of oil revenues and spending via the mechanism of the Estimated Sustainable Income, Government spending in the domestic economy is protected from oil price fluctuations. Changing oil prices have no short-term impact on economic growth. In 2008 the world price of oil collapsed from over \$140 per barrel mid-year to just \$40 by the end of 2008. Since then, oil prices have risen and stabilized at around \$70-80 a barrel and oil demand became stronger in the first half of 2010, particularly in China, on the back of strong global activity. Oil demand is projected to rise with economic recovery but advanced economies' slow-paced recovery will counteract much of the expected rise in demand for oil from emerging and developing countries. Oil prices are projected to rise gently but not exceed \$90 per barrel by 2013. 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 Sector section below.

Commodities are real assets as well as goods, and accordingly their prices can be affected by changing expectations over the global economic forecast. The IMF report that rapidly changing expectations in May and June 2010 resulted in broader financial market volatility spilling over into commodity markets, observed by a decline in commodity prices, after peaking in early May 2010. Since the decline, most commodity prices are on the rise again but only food, beverage and agricultural commodity prices have exceeded their peak in May. Rising food prices are a result of recent supply shocks from bad weather leading to poor harvests. Specifically, drought and wildfire in Russia and in other major exporters resulted in low wheat harvests with consequent surges in wheat prices in July and August 2010. The impact of rising global food prices can be seen in markets in Timor-Leste, mostly in Dili (see the Inflation section below).

Wheat markets are more vulnerable to shocks over this harvest period and the IMF assessment is that any further shocks to this harvest would probably spill over and impact on other major crop prices. Over the medium-term commodity prices are forecast to remain relatively high, accompanied by upside risks.

2. Domestic Economy

Non-oil GDP

Table 3.2 shows the evolution of the structure of Non-Oil Domestic Product (GDP) over seven years in Timor-Leste. The public sector's share in economic output increased from 31.6% to 38.4% between 2002 and 2009 while the United Nations' share decreased across this period by 61%. This is true despite the increased role of the United Nations since 2005, which has only partly offset the decline in UN presence in the four years leading up to the 2006 crisis. After 2003 the economy moved into recovery, driven by moderate growth in agriculture and public sector production. However, social unrest in 2006 destroyed parts of the economy, reducing the size of the economy by almost 6% in real terms.

Table 3.2: **Sectoral share of real non-oil GDP, 2002 - 2009 (%)**

	2002	2003	2004	2005	2006	2007	2008	2009
Real Non-oil GDP, excl. UN	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Including UN	119.0	113.0	109.4	105.6	108.1	115.2	114.7	111.7
Agriculture	33.5	32.7	33.3	33.2	35.3	30.6	30.9	30.8
Industry and Services	34.9	34.9	34.2	32.9	29.9	31.6	31.3	30.8
Public Sector, excl. UN	31.6	32.4	32.5	33.9	34.9	37.8	37.8	38.4
United Nations	19.0	13.0	9.4	5.6	8.1	15.2	14.7	11.7

Source: Macroeconomic Directorate, Ministry of Finance, 2010.

Table 3.4 illustrates that over the years since 2007, the Timor-Leste non-oil economy has continued to expand rapidly, driven primarily by public sector spending. Government spending has stimulated both the demand and supply sides of the domestic economy, contributing to impressive growth rates in many areas of the private sector. On the demand side, government funds have been allocated to social transfer schemes as well as creating tens of, thousands of jobs for unskilled labourers through infrastructure spending. Infrastructure developments and improvements in public services and public utilities have boosted the production capacity of private businesses. Overall real economic growth in Timor-Leste in 2009 is estimated at 13.0%, with public sector production contributing 5.6 of the 13 growth percentage points, agriculture contributing 3.9 of the points and industry and services contributing 3.5 of the percentage points to growth in Non-Oil GDP of Timor-Leste.

Table 3.3: **Nominal GDP by sector**

	2002	2003	2004	2005	2006	2007	2008	2009
Non-oil GDP, excl. UN	257.7	266.9	280.8	301.9	297.1	357.8	444.6	557.8
Agriculture	86.1	87.7	93.4	100.4	104.8	102.1	122.4	146.3
Industry and Services	90.2	94.4	96.0	99.2	88.8	111.3	135.1	161.7
Public Sector, excl. UN	81.4	84.8	91.4	102.3	103.6	144.4	187.1	249.8

Source: Macroeconomic Directorate, Ministry of Finance, 2010.

Table 3.4: **Real GDP Growth Rate (%)**

	2002	2003	2004	2005	2006	2007	2008	2009
Real Non-oil GDP, excl. UN	2.1	-0.1	4.4	6.5	-5.9	9.1	12.1	13.0
Agriculture	3.1	-2.5	6.2	6.4	-0.1	-5.4	13.4	12.6
Industry and Services	1.6	0.0	2.1	2.6	-14.6	15.3	11.2	11.2
Public Sector, excl. UN	1.7	2.3	5.0	10.8	-3.1	18.5	11.7	15.0

Source: Macroeconomic Directorate, Ministry of Finance, 2010.

Due to poor weather conditions in 2007, the agriculture sector suffered badly, with negative growth reported. However, the sector recovered in 2008 and stronger growth in the food sector is reported through into 2009. Ministry of Agriculture and Fisheries (MAF) report that productivity of land, particularly for rice and maize, rose sharply in 2009 following distribution of seeds, fertilizer and hand tractors. A poor year for coffee production was reported in 2009, with minimal or negligible growth levels experienced by many farmers. High hopes for 2010 coffee production were dashed, largely due to persistent unseasonal rains, and only slight growth on 2009 is anticipated overall for 2010.

In the industry and service sector, wholesale and retail trade grew most rapidly in 2009 with substantial real growth also observed in transport and communications, manufacturing and private construction sectors. Overall, the private sector has seen double-digit growth since 2007.

Government Expenditures

Expenditure in 2009 reached a record $603.6 million, increasing on 2008 expenditure levels by 25%. In 2009, 35% of the executed budget was spent on Capital and 65% on recurrent expenditure. This represents an increase in the proportion of spending afforded to capital, relative to recurrent items. In 2008, the split was 26% and 74% respectively. The budgeted divide in 2010 is 34% for capital spending and 66% for recurrent spending, maintaining 2009 allocations between these two broad categories. Total budget execution (including obligations) until 12 November 2010 was 75.6% of the $838 million approved by the National Parliament in the Rectified 2010 Budget. In cash the budget execution until 12 November 2010 was 52.1%, which is very similar to 2009 execution rates at the same time of year.

During 2008, 2009, and 2010, the Government has placed public financial management on firm foundations. The direction and progress of the Government was confirmed by a number of independent reviews undertaken by leading international financial institutions. This included a

Public Expenditure and Financial Accountability (PEFA) assessment and a Report on the Observance of Standards and Codes (ROSC) carried out by the IMF.

Improved service delivery by decentralisation remains a focus of Government. This related particularly to increased financial capacity and autonomy in line ministries and decentralisation of procurement. As a result of visits to the districts by the Prime Minister, local management of smaller projects were envisaged. To achieve the Government's priorities while maintaining fiscal responsibility has required reduced expenditure in areas of lower priority.

Table 3.5: **Whole of Government Expenditures ($ million), including Auto Agencies.**

	02/03	03/04	04/05	05/06	06/07	2007	2008	2009	12 Nov 2010	Budget 2010
Total expenditures	**60.7**	**70.5**	**70.2**	**93.7**	**170.5**	**97.2**	**483.9**	**603.6**	**436.6**	**838.0**
Recurrent expenditures	49.9	59.2	59.9	71.2	139.5	63.1	356.0	394.3	342.2	550.7
Wages and Salaries	20.5	23.1	24.8	26.1	33.8	17.4	50.3	87.3	65.8	99.1
Goods and Services	29.4	36.0	35.2	45.1	93.9	37.1	221.4	212.8	182.7	267.0
Transfers	0.0	0.0	0.0	0.0	11.8	8.6	84.3	94.2	93.7	184.6
Capital expenditures	10.9	11.3	10.3	22.5	31.0	34.1	127.9	209.3	94.40	287.3
Minor Capital	Unknown distribution				9.3	0.7	41.4	38.5	11.6	34.5
Development & Major Capital					11.7	0.7	86.5	170.8	82.8	252.8
Capital Transfers	0.5	0.4	0.0	10.9	0.0	0.0	0	0		0.0
Unallocated Capital Carryovers	5.7	7.3	8.4	8.3	10.0	32.7	--	--		--

Source: Timor-Leste Ministry of Finance, Treasury Department and 2009 Budget for actual values; Macroeconomic Directorate for 2010 projections.
Note: The amounts in the highlighted column in Table 3.5 are the cash execution as at 12 November 2010.

Domestic Revenues

Overall, domestic revenues are estimated to reach $94.7 million in 2010, up from $90.8 million in 2009. Although this growth rate of 4.3% is significantly slower than the 30.3% achieved last year, it was to be expected that strong growth would be achieved from the lows of the crisis period. The fall in growth rates also is accounted for by reductions in rice revenues (subsidy) intended only as a temporary measure.

Government tax revenues increased by 16.7% in 2009 to $43.6 million or up from $37.3 million in 2008. Tax revenues will continue to increase in 2010 reaching $47.5 million (*Table 3.6).* Direct Tax revenues performed better than expected in 2009 in light of the tax reforms of 2008. But the resuming growth in 2010 will bring revenues from Direct Taxes back to the levels of 2008 ($18 million). It is projected further growth in Direct Taxes in the coming years as the economy continues to expand. Indirect Tax revenues grew strongly from $19.3 million in 2008 to $30.3

million in 2009 despite Tax Reforms in 2008. It is estimated that Indirect Taxes will be $31.5 million in 2010 and continue to grow in the years to come.

User Fees and Charges is another area that showed increased growth from 2008 to 2009. The significant increase from $6.2 million in 2008 to $16.4 million in 2009 is attributable to an extraordinary refund. It is projected to be $14.1 million in 2010 and $16.2 million in 2011.

Autonomous Agency revenues grew from $7.9 million in 2008 to $10.4 million in 2009. It is estimated at $13.0 million in 2010. This is driven largely by increased revenue performance by EDTL, as their efforts to increase pay for use and higher tariffs take effect. Rice subsidies were introduced in 2008 to protect the Timorese people from spikes in international food prices. Revenues flowing from these measures increased from $16.8 million in 2008 to $20.4 million in 2009. It is expected to be $20 million in 2010. However, as world food prices stabilize and the need for government subsidy is reduced, revenues in this area are estimated to fall to $10.0 million in 2011.

Table 3.6: **Domestic Revenues, 2002-2010 ($ million)**

	2002	2003	2004	2005	2006	2007	2008	2009	2010 Estimate
Total Domestic Revenu	**24.8**	**29.9**	**36.8**	**45.2**	**40.9**	**48.9**	**69.7**	**90.8**	**94.7**
Direct taxes	5.8	5.9	6.6	10.6	10.1	12.6	18.0	13.3	**16.0**
Indirect taxes	12.9	14.8	18.6	17.5	16.6	18.8	19.3	30.3	**31.5**
User fees and charges	1.4	3.3	4.5	4.3	3.1	4.3	6.2	16.4	**14.1**
Autonomous Agencies	4.6	5.8	7	7.9	6.8	6.9	7.9	10.4	**13.0**
Interest	0.1	0.1	0.1	4.9	4.3	6.3	1.5	0.0	**0.1**
Rice sales	0	0	0	0	0	0	16.8	20.4	**20.0**

Source: Timor-Leste Ministry of Finance, Directorate of Treasury 2002 -2009 for actual values; Macroeconomic Directorate for 2010 Estimate.

Petroleum Revenues

Timor-Leste's Petroleum Revenues, inclusive of Petroleum Fund interest, were $1.84 billion in 2009 with oil price of $62 per barrel and an estimated $2.02 billion in 2010 with expected oil price per barrel to be $76. However, lower commodity prices over the near term bring with them lower crude oil prices. Using the projections by the US Energy Information Administration (EIA) for crude oil,[4] petroleum receipts will significantly exceed the 2009 Budget projections for both

[4] *Annual Energy Outlook: 2009 – Official US Government Energy Statistics*, Energy Information Administration, March 31, 2009.

2009 and 2010 because of higher production levels than the conservative production estimates required and new negotiated contracts favorable to Timor-Leste.

The Petroleum Revenues are expected to remain high in 2011 and 2012 due to relatively stable production and oil price forecasts such that petroleum revenues are estimated at $2.29 billion and $2.40 billion in 2011 and 2012 respectively.

The Petroleum Fund balance is expected to be $6.62 billion by end of 2010, which is up from $5.38 billion by end of 2009. The Petroleum Fund balance is estimated at $8.17 billion by the end of 2011, $9.82 billion by the end of 2012 and $14.60 billion by end of 2015.

The Estimated Sustainable Income (ESI) is calculated at $734 million for 2011, which is an increase of $232 million from 2010. The main reason for the increase is a change of methodology of the ESI calculation. While Energy Information Administration's (EIA) Low Case has been used as the West Texas Intermediate (WTI) oil price forecast in the past, the average of EIA's Low and Reference Case is now used as the long term oil price forecast in the ESI calculation for 2011. The WTI oil price forecast for 2011 and 2012 is $68 and $71 per barrel respectively and increases to $110 in 2024.

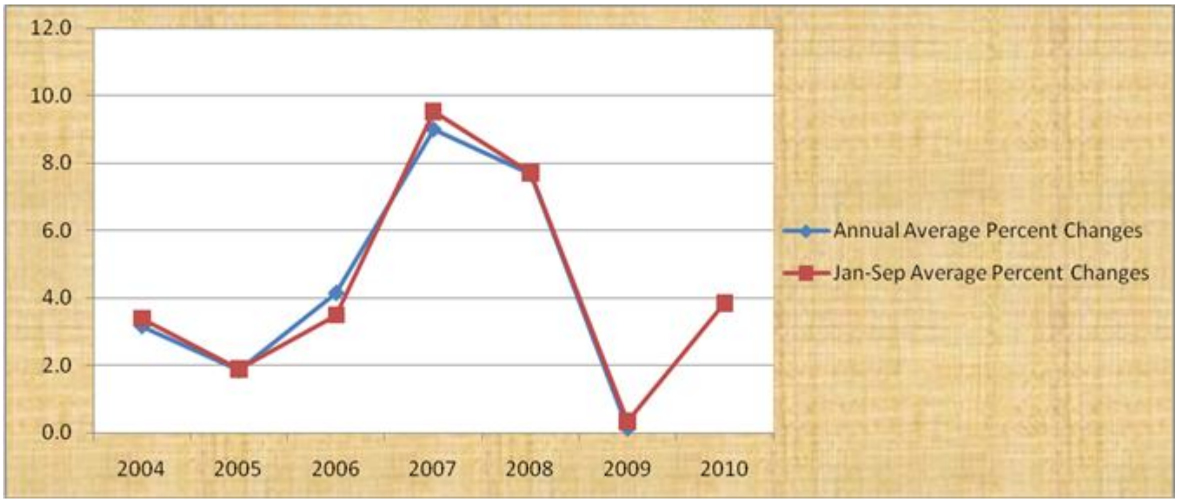
The Government has over the last three years gradually developed the investment strategy of the Petroleum Fund. The objective is to diversify the portfolio into a range of asset classes, regions and currencies in order to reduce risks and increase expected return. A range of foreign Government bonds and bonds issued by Supranational Organizations have been added to the portfolio since 2009 and in October 2010 the Fund commenced investing in global equities.

Further diversification requires changes in the Petroleum Fund Law. The investment strategy will be further developed once the amendments to the Petroleum Fund Law are approved by Parliament.

Inflation

Headline inflation year-on-year in 2009 in Timor-Leste and Dili was 0.1% and 0.7% (DNE, 2009) respectively. These figures represent a drop in inflation rates from 2007 and 2008, when prices rose sharply, putting pressure on consumers' purchasing power. *Figure 3.2* shows annual trends in inflation in Timor-Leste.

Figure 3.2: **Percentage Changes in Consumer Price Index, 2004 – 2010 (%).**



Source: National Directorate of Statistics, Ministry of Finance, 2010

Relatively low levels of inflation in 2009 and continuing through to 2010, reflect lower inflation of all categories of goods, but primarily food, which peaked in 2007 and 2008 following the "global food price crisis". The second and third quarters of 2009 prices actually fell; or year-on-year deflation over these two quarters were -2.8% and -1.7% respectively. By the fourth quarter of 2009 prices started to pick up and in 2010 this trend continues; 2010 inflation to date exceeds 2009 inflation but remains well below 2007 and 2008 levels. Year-on-year inflation in the second quarter of 2010 was 2.5%. Headline Inflation in Dili has steadily increased in the first half of 2010, showing higher rates of inflation than those in Timor-Leste overall. June 2010 price levels in Dili are 6.6% higher than June 2009. Part of this inflationary pressure, in Timor-Leste especially Dili comes from price rises for food, in particular cereals, following sharp international price rises for cereals (see International Economy Section). The year-on-year inflation rate for 'cereals, roots and their products[5]' in Dili in June 2010 was 14.1%.

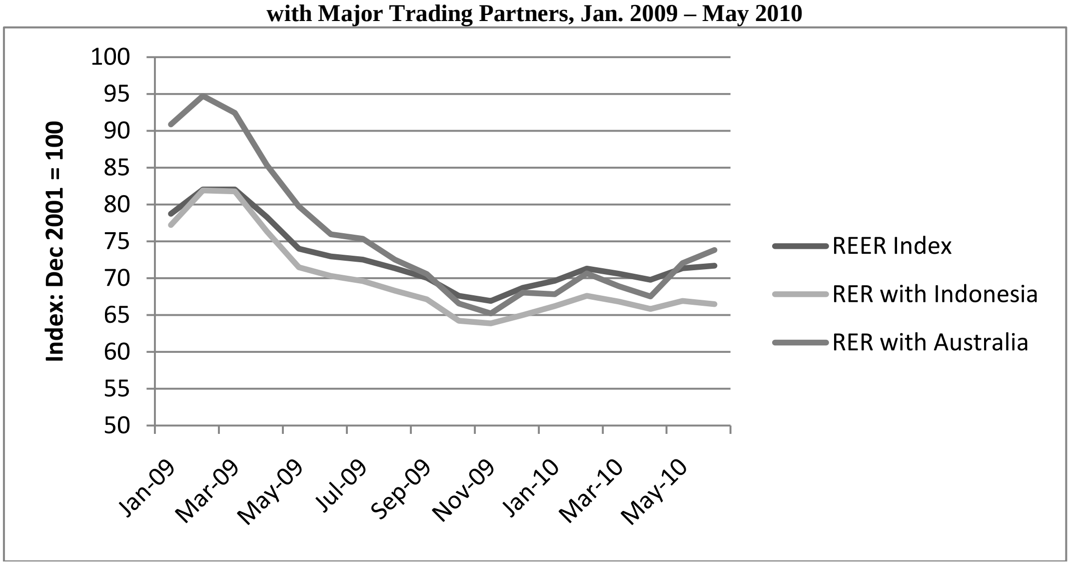
The potential for high inflation remains a concern particularly in the short-term with increased public spending and rising food prices. However, public spending on core infrastructure, advancement of the business environment and improving the capacity of the port should improve the efficiency and capacity of the supply side of Timor-Leste, putting downward pressure on inflation over the medium term. Subsidized rice protected Timor-Leste from steep rises in the world price of rice in 2008. However, since the price of rice has declined sharply in international markets after its peak in mid-2008, the need for subsidies has greatly diminished. Despite signs in

[5] This category includes local rice, imported rice, cassava, wheat flour and instant noodles.

mid-2010 of an increased world price of rice the September 2010 Thai rice price remains at half its peak value of 2008.

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. In the first half of 2010 the REER has started to appreciate, coincidentally with rising inflation.

Figure 3.3: **Real Effective Exchange Rate and Real Exchange Rate Changes with Major Trading Partners, Jan. 2009 – May 2010**



Source: Bank and Payments Authority, Timor-Leste.

Employment

Timor-Leste has a rapidly expanding labour force together with high levels of unemployment and underemployment. The size of the labour force (15 – 64 year olds in work, or unemployed but actively seeking work) in 2010 is approximately 375,000, with an estimated 10,000 - 15,000 newcomers each year. The private sector employs less than 10% of the labour force, as does the public sector, so the vast majority have no choice but to participate in low-productivity subsistence agriculture. Unemployment is largely an urban phenomenon and can pose a threat to social stability. Spending on infrastructure projects has the potential to absorb some of this labour in the short-term through well-targeted infrastructure projects that employ relatively more labour than capital. Timor-Leste potentially has a competitive advantage in such labour-based infrastructure projects, but quality of the projects' outcomes must be ensured.

The Government of Timor-Leste has strived to create short-term jobs for unskilled labour, with an estimated 33,020 'full-time-equivalent[6]', unskilled jobs created from public infrastructure spending in 2008 and 61,174 'full-time-equivalent' jobs generated for unskilled labourers from infrastructure spending in 2009. The infrastructure content in the 2010 Rectified Budget is larger still, leading to an estimated 64,921 unskilled full-time-equivalent jobs that could potentially be created for unskilled labourers[7]. Secretary of State for Professional Training and Employment (SEFOPE) contributed an additional 4,363 'full-time equivalent' jobs, over 2008 and 2009, through their targeted labour-intensive infrastructure projects.

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[8], 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[9]. 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, veterans, housing subsidy for IDPs, and cash for work programs that contributed to increase of private consumption. Low inflation rates since mid-2008 also increased private consumption levels because of increase in purchasing power.

The UN 2010 Human Development Report recently released, positions Timor-Leste at 120 out of 169 counties, which is an improvement of 14 places. From 2005 to 2010, Timor-Leste's HDI value increased from 0.428 to 0.502, an increase of 17%.

Besides consumption, preliminary analysis of the Demographic Health Survey 2009-2010 (DHS 2009-2010) compared to DHS 2003 and TL-SLS 2007 suggest improvements in living conditions in recent years. For example, 45% of children are underweight in Timor-Leste, which represents a drop from 48.6% estimated for 2007 in the TL-SLS. Further, the incidence of wasting fell from 24.5% in 2007 to 19% in 2009. Wasting occurs when children become severely underweight for

[6] Full-time-equivalent (FTE) jobs are based on 249 calendar days a year constituting a full-time job.
[7] Macroeconomic Directorate, Ministry of Finance. 2010 estimate uses 2009 budget execution rate.

[8] Timor-Leste: Poverty in a Young Nation, 2008, National Directorate of Statistics (DNE), Ministry of Finance.

[9] World Bank methods ensure comparability between this prediction and the 2007 estimates produced by DNE. Details taken from World Bank Poverty Note, 2010.

their height, due to very low energy intake in the short term, which is closely linked to changes in the level of poverty[10].

In the education sector, the net enrolment rate in primary education has increased from 65.6% in 2007 to 82.7% in 2009. Additionally, the completion rate increased from 47% in 2004 to 56.9% in 2009. This is in the context of increasing school enrolments, which rose from 65% in 2007 to 83% in 2009/2010.

Timor-Leste has surpassed the MDG target for 2015 for both under-five mortality rate and infant mortality rate based on targets set in 2004 and also the detection and cure of Tuberculosis with new target being set. In 2009, the National TB program has achieved the two key global targets for TB control namely, a New Smear Positive (NSP) case detection rate of 70% (global target 70%) and treatment success rate of 85% among NSP cases registered in previous year (global target is 85%).

In addressing the need to fast track achievement towards the MDGs, the government has created an innovative program to be launched in 2011, the MDG Sucos program. This program will provide 11,140 houses in 2,228 aldeias to the most vulnerable families together with power, water, and sanitation, enabling their participation in the development process.

Medium-Term Prospects (2011-2015)

The Government of Timor-Leste is designing a 20-year Strategic Development Plan (SDP) targeting double-digit growth over the period of SDP. Timor-Leste will be an upper-middle income country no later than 2030, with the gap closed with today's richer neighbors, such as Indonesia, Thailand, and Malaysia. The SDP sets out a plan to increase government capital and development spending over the short-term in a bid to fast-track critical infrastructure development in Timor-Leste. The government will strive towards this target predominantly through capital and development spending plans on critical infrastructure such as roads, electricity, housing, water and sanitation that boosts the productive capacity of the private sector.

In the medium-term (2011 – 2015), besides infrastructure, public spending also will be directed to agriculture, tourism, and hydrocarbon sectors to maintain the double digit growth through 2015

[10] World Bank Poverty Note, 2010

and sustain it beyond that period en route to middle income country by 2030. Human resources development also is an integral part of the medium to long-term strategy.

In addition, the government also aims to undertake aggressive policies to improve business environment so that Timor-Leste can attract foreign direct investment. In a recent international conference organized by the Ministry of Finance, participants discussed several policy choices that Timor-Leste need to explore to attract investment both domestic and international. Firstly, improve the conditions of doing business in Timor-Leste, which includes creating an investment package that allows:

- Clear, fast, and ready to go procedures to curtail the current lengthy business registration process.
- For land laws and titling processes to provide collateral.
- The rule of law.
- Timely bankruptcy procedures.
- Access to credit.
- Clear mechanism for investors to follow including a one-stop shop.

Secondly, explore ways to finance large-projects with the private sector such as Private-Public-Partnership (PPP) that can contribute to additional investment, efficiency/productivity gains, and improvement in quality of service. Project financing of large projects is another option within the PPP framework.
Thirdly, revisit Timor-Leste's tax regime and possibility of shifting to Value Added-Tax (VAT) to further attract private investment. Fourthly, invest in infrastructure such as roads, power, telecommunications, and water and sanitation, which can also be the subject of PPPs.

Finally, special attention must be given to structural bottlenecks that add higher transaction costs to the economy.

If the renewed post-crisis growth in Asia is maintained and advanced economies continue their recovery, Timor-Leste could be in a good position to attract foreign investment over the medium term. This will rely on continued social and political stability in the country as well as realization of infrastructure development plans and improvements in the business environment. Policy to extend this impressive growth through private sector participation could include the following:

- Address the skills deficit through Vocational Educational Training (VET) and on-the-job training, in both the agriculture and industry and service sectors.
- Update agro-processing machinery along with improved road networks from rural farming areas to the port and border crossing with Indonesia, in order to boost export earning potential in agriculture.
- Continue efforts in reducing Customs delays and modernizing their procedures.

In short, Timor-Leste requires policies and actions to reduce the skills deficit, secure access to land, improve the business environment (through institutions that improve service delivery), develop road links (particularly important trade corridors) and increase the port capacity.

PART 4. EXPENDITURE

1. Introduction

This part covers expenditures from all funds controlled by the Government, the Consolidated Fund of Timor-Leste (CFTL) and the new Special Funds. It also covers expenditures from the Government's own source of revenues as well as development partners in the combined source budget. In addition, key expenditure objectives are outlined in this budget.

Table 4.1 provides Combined Source Budget of $1.18 billion for 2011 with General State Budget at $985 million and $195 million from Development Partners.

Table 4.1: **Combined Source Budget, 2011 – 2015 ($ million, preliminary)**

Budget	2010	2011	2012	2013	2014	2015
CFTL	**837.9**	**642.7**	**653.4**	**679.6**	**706.7**	**734.9**
Infrastructure Fund	-	317.3	597.0	620.9	645.8	671.6
HCDF	-	25.0	30	35	40	45
General State Budget	**837.9**	**985.0**	**1,280.4**	**1,335.5**	**1,392.5**	**1,451.5**
Development Partners	256.8	195.0	112.7	75.2	32.7	0
Combined State Budget	**1,094.7**	**1,180**	**1,393.1**	**1,410.7**	**1,425.2**	**1,451.5**

Source: Budget Directorate, Ministry of Finance, 2010.

Table 4.2 outlines the medium term fiscal envelope.

Table 4.2: **Expenditures and Fiscal Envelope, 2010 – 2015 ($ million)**

No	Description	2010	2011	2012	2013	2014	2015
1	Expenditures	838	985	1,280.4	1,335.5	1,392.5	1,451.5
2	Fiscal Envelope	597	844	862.4	881.7	903.5	925.4
3	1. Domestic Revenues	95	110	121.4	133.7	148.5	163.4
	2. ESI	502	734	741	748	755	762
	3. Excess withdrawal of PF	309	0	418	453.8	489	526.1

Note: Domestic Revenues, projected as of November 2010

Source: Budget and Macroeconomic directorates, Ministry of Finance, 2010.

Table 4.3 outlines the economic targets from 2011 to 2015.

Table 4.3: Economic Targets, 2011 – 2015

No	Description	2010	2011	2012	2013	2014	2015
1	Real Economic Growth (%)	9.5	11.2	11.7	13.0	12.3	10.6
2	Domestic Revenues ($ mil)	95	110	119	134	148	163
3	Petroleum Revenues ($ bil)	2.0	2.3	2.4	2.2	2.5	2.4
4	Pet. Fund Balance ($ bil)	6.6	8.2	9.8	11.2	12.9	14.6
5	Inflation (y-o-y, %)	4	4	4	4	4	4

Source: Budget, Macroeconomic, and Petroleum Fund directorates, Ministry of Finance, 2010.

2. Expenditure reviews

This year's Budget Review Committee, led by the Prime Minister reviewed the budget submissions based on a careful assessment of prior years budgets and redirected savings to national priorities identified in the Strategic Development Plan process.

The focus of the review was to improve quality of expenditure and reduce inefficiencies in planning and execution. The outcome of this review resulted in the creation of Special Funds targeted to improving basic infrastructure and human capital as a catalyst to attract private investment.

Budget estimates for 2011 were drawn based on the following criteria:

1. Increases due to inflation rate of 4%,
2. 1 to 10% normal increases of the ongoing budget, and
3. Greater weighting (between 1 to 50%) to programs of identified national priorities.

As part of the Strategic Development Plan (SDP) formulation the Prime Minister held wide ranging consultations with the People of Timor-Leste over five months visiting all 65 sub-districts. The SDP is in the stage of finalisation, however inputs from these extensive consultations are incorporated in Budget 2011.

3. Major initiatives proposed for 2011

To finance the above plans, the Government will establish two Special Funds in accordance with the Budget and Financial Management Law. This is described in detail in Part 6 of this Book. The purposes of the funds are to finance large-scale (more than one million dollars), multi-year capital investments in infrastructure and human development projects respectively.

The special funds will be known as:

1. Infrastructure Fund (FI) - This fund will be used to finance wide range infrastructure projects above $1 million.
2. Human Capital Development Fund (HCDF) - This fund will be used to finance training programs to increase skills and knowledge of Timor-Leste people.

The Special Funds are not included in the Consolidated Fund of Timor-Leste (CFTL) and hence will be reported on in accordance with Budget and Financial Management Law.

Aside from Special Funds, the Government will launch the MDG-Suco Program to target poverty reduction with provision of housing including solar energy, water, and sanitation. The program envisages the building of 5 houses in each of the 2,228 aldeias; the equivalent of 11,140 houses in 2011, or 55,700 houses over five years.

To implement these programs, the Government will create the National Development Agency (ADN) in 2011, with competence to evaluate, monitor, and supervise projects, validate progress reports, and undertake quality control. The ADN will report to the Council of Ministers and the National Parliament.

ADN is the precursor of the Economic Planning and Investment Agency (EPIA) to be created in 2012. It is anticipated that EPIA will have broader powers than ADN in planning, implementation, and evaluation.

The ADN oversees implementation of projects financed by the Special Funds, whilst the Ministries/Agencies will manage the recurrent expenditures, as well as the annual Capital and Development and Minor Capital expenditures. In addition, a Procurement Commission will manage the procurement process.

CFTL Expenditures

The annual budget is operated from the Consolidated Fund of Timor-Leste (CFTL) comprising five categories as indicated in Table 4.4.

Table 4.4: **CFTL by Category, 2011 – 2015 ($ million)**

Budget	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Recurrent						
Salary and Wages	99.3	115.9	120.6	125.4	130.4	135.6
Goods and Services	260.6	245.5	255.3	265.5	276.1	287.1
Public Transfers	184.4	164.5	171.0	177.9	184.9	192.4
Capital						
Minor Capital	39.9	28.2	29.3	30.6	31.8	33.0
Capital & Development	253.7	88.6	77.2	80.2	83.5	86.8
CFLT	**837.9**	**642.7**	**653.4**	**679.6**	**706.7**	**734.9**

Source: Budget Directorate, Ministry of Finance, 2010.

Salaries and Wages

Key policy decisions in Salaries and Wages include:

- Transforming temporary civil servants to permanent staff in 2011.
- Freezing new recruitment across all Ministries/Agencies except Civil Service Commission, PNTL (Police) and F-FDTL (Armed Forces) according to their needs.
- $9 million of allowances reallocate from Goods and Services to Salary and Wages.
- $7 million for the provision of Career Regime for teachers in Ministry of Education.

Goods and Services

The total budget for this category is $270.5 million including $25 million for the Human Capital Development Fund. The main expenditures in this category include (amounts are rounded):

- $1.2 million to support F-FDTL in Material and Operational Provisions in Ministry of Defence and Security.
- $3.4 million for F-FDTL Operational Readiness Package and maintenance of patrol boats.
- $0.5 million for LDC – g7+ in Ministry of Finance.
- $2.0 million to target MDG 5 (Maternal Mortality) and support of Specialist in Referral Hospitals of Baucau and Suai.
- $1.6 million for the provision of textbooks in Ministry of Education.
- $1.5 million for Merenda Escolar in Ministry of Education.
- $0.15 million for National Institute of Linguistics in the National University of Timor Lorosae (UNTL).
- $30 million to $48 million for fuel including EDTL in the Ministry of Infrastructure.
- $32 Million for professionals service and technical assistance in the areas of Petroleum, Justice, Education, Health, Management Banking and Financing, Foreign Affairs, Tourism, Conflict prevention, and quality control.
- $1.0 million dollars for peace initiative in Sudan.

Despite new initiatives in this category the budget for 2011 is lower than 2010 as a result of the expenditure review.

Public Transfers

Public Transfers expenditures will also decrease in 2011 compared to 2010. The government aims to properly target public transfers to vulnerable groups and deliver it more efficiently. The government will scale up payments to elderly, veterans, and scholarships. This will also include programs of conditional cash transfers and cash for work. Major initiatives in this category include:

- $1.1 million for contribution to: Western Sahara ($0.8 million), and Guinea-Bissau Office in New York ($0.3 million), in Ministry of Foreign Affairs.
- $3.5 million for capacity building in local administration.
- $1 million for the Land Compensation in Ministry of Justice.
- $3.0 million for overseas medical treatment in Ministry of Health.
- $1.5 million for returning of Medical students from Cuba in Ministry of Health.
- $6 million for capital transfers in Ministry of State Administration and Territorial Planning.
- $3.4 million for further capitalisation of IMFTL in the Ministry of Economy and Development.
- $7.5 million for demobilizing ex-FALINTIL from 1975 – 2000 (Aileu).
- $0.8 million for Mortuary (Restus Mortais).
- $1.1 million for the Council of Veterans (Concelho Veteranus).
- $1.0 million for natural disaster response in Ministry of Social Solidarity.
- $11 million allocated to Local Development Programs (PDD1) for retention ($3 million) and re-budgeting ($8 million).

Minor Capital

Minor Capital expenditures also reduced in 2011 to $28.3 million compared to $39.9 million in 2010. The principle expenditures in this category are:

- $12 million for the purchase of multi-purpose vehicles for Ministry of Health, mobile banking, education monitoring, and preparation and monitoring of local and national elections, and patrol boats in Ministry of Defense and Security.
- $0.7 million for the handover Package of UNMIT to Timor-Leste of equipments.
- $1.1 million for equipment for the Techno-Professional Schools and laboratory in Ministry of Education.

CFTL Capital and Development

The Government continued to improve service delivery to the people by increased delivery at district, subdistrict, and suco level, by use of public transfers with specific purposes, together with accountability mechanisms. This reflects increased confidence in regional delivery mechanisms.

Table 4.5 shows Capital and Development expenditures of CFTL. The government will continue to develop successful programs, such as Local Development Programs (PDD1) and Decentralized Development Programs (PDD2). The Government will improve the quality and execution of these programs. CFTL Capital and Development expenditures comprise:

- PDD1 - that will be diversified into:
    - Aldeias (with project values up to $15,000),
    - Sucos (up to $75,000), and
    - Sub-Districts (up to $150,000).
- PDD2 - with projects with value from $150,001 to $500,000.
- Ministries/Agencies - with annual Capital and Development expenditures below $1 million.

Table 4.5: **CFTL Capital and Development, 2011 – 2015 ($ million)**

Capital and Development	**2011**	**2012**	**2013**	**2014**	**2015**
PDD1 - Aldeia, Suco, & Sub-District	15.5	16.2	16.8	17.5	18.2
PDD2 - District	28.8	30.0	31.2	32.4	33.7
Ministries/Agencies	44.3	31	32.2	33.6	34.9
Total	**88.6**	**77.2**	**80.2**	**83.5**	**86.8**

Source: Budget Directorate, Ministry of Finance, 2010.

4. Infrastructure Fund

The Infrastructure Fund covers Multi-annual and Large Projects above $1 million, and MDG. These projects will span a timeline that may be more than one year depending on size and timeframe of implementation.

The single major expenditure item for the Infrastructure Fund is Central Electric, to establish a National electricity generation and transmission grid. This project is costed at $166 million and will provide reliable access to electricity across the country, with capacity to support industry, particularly in the northern coast from Batugade to Tutuala.

The Government will increase its investment in roads and bridges, and buildings, offices, hospital, and schools. The Government continues its investment in integrated financial systems by a further $7.7 million in developing procurement and financial monitoring software and hardware capacity.

Table 4.6: **Special Funds, 2011– 2015 ($ million)**

Capital & Development	2011	2012	2013	2014	2015
Multi-Annual Projects	212.3	348	294.9	264.8	230.6
Large Projects	40	184	261	316	376
MDGs	65	65	65	65	65
Sub-Total	**317.3**	**597**	**620.9**	**645.8**	**671.6**
Human Capital Dev. Fund	25.0	30	35	40	45
Total	**342.3**	**627**	**655.9**	**685.8**	**716.6**

Source: Budget Directorate, Ministry of Finance, 2010.

Large Projects will start with Tasi Mane projects that will cost approximately $36 million, mostly for the development of the Southern Coast, including the following projects:

- Development package of Suai, which includes multi-purpose port ($2.5 million), Supply Base ($10 million), and Rehabilitation of Airport ($5 million),
- Detail site survey, design, and supervision of southern cost development of Beaco ($5.8 million),
- Southern coast infrastructure development for pipeline route analysis ($3.5 million), environmental studies ($2.8 million), and
- Design and studies on Seaport Development in Dili ($2.0 million)

5. Human Capital Development Fund

This multi-annual Special Fund of $25 million is aimed at developing human capital by up-scaling Timorese skills through:

- Professional Training,
- Scholarships,
- Technical Training, and
- Other Training.

Initiatives will include:

- $7.7 million for the Ministry of Education,
- $2.1 million for the Ministry of Finance,
- $2.5 million for Secretary of State for Natural Resources (SERN),
- $2.6 million for Secretary of State of Professional Training and Employment (SEFOPE),
- $2.4 million for training for health personnel for Ministry of Health,
- $1.9 million for Ministry of Justice,
- $0.6 million for scholarships and training in the Institute of Public Administration, and

- Training abroad for F-FDTL Officers in Japan, Australia, Philippines, and Malaysia.

6. Development Partners

Development Partners will provide a total of $194.8 million to the Timor-Leste in 2011 to the total Combined Sources Budget of $1.18 billion. The details of the expenditure these contributions are contained in Book 5.

PART 5. REVENUES

1. Introduction

Major revenues of Timor-Leste comes from oil and gas, while Domestic Revenues (taxes, user fees and charges, autonomous agencies, and others) are a small component of the total revenues (Table 5.1). Total Revenues in 2011 is estimated to be $2.4 billion with the bulk of it ($2.29 billion) being Petroleum Revenues and the remaining $110 million Domestic Revenues. Going forward, Petroleum Revenues will continue to dominate for the next five years and beyond. Domestic Revenues show an increasing trend in collections. In 2010, the projection is for Domestic Revenue of $94.7 million, and in 2011 it is projected to be $110 million. By 2015, Domestic Revenues are projected to reach $163.3 million. The Government's objective is to achieve $200 million before 2015 but this will be dependent on the introduction of significant reforms.

Table 5.1: **Total Revenue Projections, 2009-2015 ($ million)**

	2009	2010	2011	2012	2013	2014	2015
	Actual	Estimate			Projection		
Total Revenues	1,918.4	2,111.0	2,398.1	2,520.0	2,293.5	2,609.4	2,606.4
Domestic Revenues	90.8	94.7	110.1	121.4	133.7	148.5	163.4
Petroleum Revenues	1,827.6	2,016.3	2,288.0	2,398.6	2,159.8	2,460.9	2,443.0

2. Domestic Revenues

Domestic Revenues are comprised of Taxes (Direct and Indirect), User Fees and Charges, and revenues from autonomous agencies. Additionally, revenues also come from the sale of subsidized rice, a 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 2009 through 2015. These increases off-set the reduction of revenues from rice sales, which will continue to decrease as world food prices stabilize.

Table 5.2: **Domestic Revenues, 2009-2015 ($ million)**

	2009	2010	2011	2012	2013	2014	2015
	Actual	Estimate		Projection			
Direct Taxes	13.3	**16.0**	**22.3**	26.9	31.4	35.9	40.4
Indirect Tax	30.3	**31.5**	**42.6**	44.5	46.3	50.3	54.4
Fees and Charges	16.4	**14.1**	**16.2**	17.5	19.6	21.9	24.2
Rice Sales	20.4	**20.0**	**10.0**	9.6	9.6	9.6	9.6
Interest	0.0	**0.1**	**0.1**	0.1	0.1	0.1	0.1
Autonomous Agencies	10.4	**13.0**	**18.9**	22.8	26.7	30.7	34.6
Total	**90.8**	**94.7**	**110.1**	**121.4**	**133.7**	**148.5**	**163.3**

Source: Macroeconomic Directorate, Ministry of Finance, 2010

Taxes

Table 5.3 shows revenue projections by category and type of taxes. Direct taxes, adversely affected by the Tax Reforms of 2008, have recovered and show an upward trend.

Direct taxes are projected to be $22.3 million in 2011. This is due to stronger prospects for economic growth and the efforts of increasing compliance and improved tax administration. The projection for Indirect Taxes is $42.6 million in 2011, and expected to increase to $54.4 million in 2015.

Table 5.3: **Total Tax Revenue Projections, 2009-2015 ($ million)**

	2009	2010	2011	2012	2013	2014	2015
	Actual	Estimate			Projections		
Direct Taxes	**13.4**	**16.0**	**22.3**	**26.9**	**31.4**	**35.9**	**40.4**
Income Tax	5.1	6.0	**7.1**	8.8	10.5	12.2	13.9
Corporate Tax	2.0	2.4	**5.7**	6.9	8.1	9.3	10.5
Witholding Tax	6.3	7.6	**9.5**	11.2	12.8	14.4	16.0
Indirect Tax	**30.3**	**31.5**	**42.6**	**44.5**	**46.3**	**50.3**	**54.4**
Service tax	2.9	3.4	**4.0**	4.9	5.3	5.9	6.6
Sales Tax	7.3	7.5	**11.4**	10.7	11.2	12.2	13.1
Excise Tax	13.8	14.2	**17.7**	20.7	21.6	23.5	25.5
Import Duties	6.3	6.4	**9.5**	8.2	8.2	8.7	9.2

Source: Macroeconomic Directorate, Ministry of Finance, 2010

User Fees and Charges

Table 5.4 contains the projected income from User Fees and Charges, which are expected to increase to $16.2 million in 2011 from $14.1 million in 2010. There is a core upward trend of growth in User Fees and Charges which is projected to continue in 2011 and beyond.

Table 5.4: User Fees and Charges, 2009-2015 ($ million)

	2009	2010	2011	2012	2013	2014	2015
	Actual	Estimate			Projection		
Fees and Charges	**16.4**	**14.1**	**16.2**	**17.5**	**19.6**	**21.9**	**24.2**
Business Registration Fees	0.2	0.5	0.7	0.9	1.1	1.3	1.5
Postage Fees	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Property Rentals	1.9	2.8	2.4	2.6	2.8	3.1	3.3
Water Fees	0.1	0.1	0.1	0.1	0.1	0.1	0.1
National University Fees	0.4	0.7	0.5	0.5	0.5	0.5	0.6
Vehicle Registration Fees	1.0	0.9	0.9	0.9	1.1	1.1	1.3
Vehicle Inspection Fees	0.0	0.2	0.2	0.0	0.0	0.0	0.0
Drivers Licence Fees	0.0	0.3	0.3	0.0	0.0	0.0	0.0
Other Transport Fees	0.0	0.0	0.0	0.0	0.0	0.0	0.0
ID and Passport	0.4	0.6	0.8	1.0	1.1	1.4	1.6
Visa Fees	1.2	1.8	1.5	1.7	1.9	2.1	2.3
Hospital and Medical Fees	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Dividents, Profits, and Gains	4.6	4.8	7.3	8.1	9.1	10.1	11.2
Mining and Quarrying	0.1	0.0	0.1	0.1	0.1	0.2	0.2
Radio and Television Fees	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bid Document Receipts	0.1	0.1	0.0	0.1	0.1	0.1	0.1
Auctions	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Other Non-Tax Revenue	6.4	1.2	1.1	1.2	1.4	1.6	1.7

Source: Macroeconomic Directorate, Ministry of Finance, 2010

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 subsided with the stabilization of world food prices. As government intervention reduces, revenues in this area are projected to fall to $10 million in 2011, and stabilize at $9.6 million.

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 2011 and then increase modestly in the medium term.

Autonomous Agencies

Revenues from Autonomous Agencies (Equipment Management, Aviation, Port, and EDTL) have improved in recent times as shown in Table 5.5. The share of total revenues is expected to increase from 12% in 2009 to 14% for 2010. For 2011, the share of this category of revenue is projected to increase to 17%, being $18.9 million.

The most significant revenue item is EDTL. It outperformed expectations for 2009 ($7million) by 16%. This growth trend is likely to increase further with continued efforts to increase pay for use among electricity consumers. This will be complemented by increased tariffs. The current projection for EDTL revenues for 2011 is $14.5 million. It is anticipated that the customer base will increase and result in additional revenue.

Aviation and Port performance has been strong relative to the 2010 Budget projections, and sustained growth in revenues is likely to continue.

Table 5.5: **Revenues from Autonomous Agencies, 2009-2015 ($ million)**

	2009 Actual	2010 Estimate	2011	2012	2013 Projection	2014	2015
Institute of Equipment Management	0.0	0.0	**0.0**	0.0	0.0	0.0	0.0
Aviation	0.9	1.1	**1.3**	1.6	1.7	2.0	2.2
Port	1.4	2.5	**3.1**	3.5	4.0	4.5	5.0
EDTL	8.1	9.4	**14.5**	17.7	21.0	24.2	27.4
Total	**10.4**	**13.0**	**18.9**	**22.8**	**26.7**	**30.7**	**34.6**

Source: Macroeconomic Directorate, Ministry of Finance, 2010

3. Petroleum Revenues

The Petroleum Revenues are expected to remain high in 2011 and 2012 due to relatively stable production and oil price forecasts during this period. This Revenue is estimated at $2.29 billion and $2.4 billion in 2011 and 2012 respectively. This is an increase from $1.84 billion in 2009 and the forecast for 2010 of $2.02 billion, mainly due to higher expected oil prices. Table 5.6 shows actual revenues in 2009, estimates of 2010 and the Petroleum Revenue forecast through 2015.

Table 5.6: **Estimated Petroleum Revenues, 2009-2015 ($ million)**

	2009 Actual	2010 Estimate	2011 Budget	2012 Projection	2013 Projection	2014 Projection	2015 Projection
Total Petroleum Revenue	**1,828**	**2,016**	**2,288**	**2,399**	**2,160**	**2,461**	**2,443**
Royalties	122	136	147	162	137	149	143
Profit oil	871	916	1,057	1,075	946	1,055	1,009
Income Tax	283	368	355	393	296	362	381
Additional Profit Tax	343	341	395	381	327	385	333
Value Added Tax	15	9	6	6	9	7	7
Wages Tax	10	8	8	8	8	9	9
Pipeline Payments	5	6	6	6	6	6	6
Other Payments	1	20	10				
Withholding Tax	9	12	8	9	12	9	10
Petroleum Fund Interest Received*	167	200	296	359	419	479	546

*) Actual Cash flow for 2009

Source: Petroleum Fund Directorate, Ministry of Finance, 2010

After the oil price skyrocketed in the first part of 2008, and the West Texas Intermediate (WTI) oil price peaked at $145 per barrel in June 2008, it dropped to $30 per barrel six months later. Since then the WTI oil price has recovered and averaged $62 per barrel in 2009. The average oil price by end of August 2010 was $78 per barrel, which is $16 per barrel higher than the oil price projection used in the Budget 2010, and the average price for 2010 is estimated at $76 per barrel. The Petroleum Revenue forecast for 2011 and 2012 is based on an oil price of $68 and $71 per barrel respectively. Chart 5.1 shows the historical WTI oil price and oil price forecast used in Budget 2011.

A scheduled shut down at Bayu Undan in 2010 has resulted in lower production and revenues from the field in 2010 than otherwise would have been the case. The production in 2010 is estimated at 57 million barrels of oil equivalents, which is down from 62 million barrels of oil equivalents in 2009. The production at Bayu Undan in 2011 and 2012 is expected to increase to 62 and 60 million of oil equivalents respectively, before it declines gradually until the production is expected to cease in 2024.

Development Plan for the Kitan field has been approved in 2010 and the production will commence in 2011. The total production is modest compared to the Bayu Undan field. Kitan's Low and Base Production Cases are 23 and 35 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 $145 million.

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

Source: Petroleum Fund Directorate, Ministry of Finance, 2010

The total production from the two fields is estimated at 65 and 68 million of oil equivalents for 2011 and 2012 respectively. Table 5.7 shows the oil price, total production volumes, undiscounted and discounted Petroleum Revenues for Timor-Leste over the life time of the two projects[11].

Table 5.7: **Oil Price Assumptions, Total Production and Timor-Leste Revenue Forecasts 2002-2024**

Timor-Leste Petroleum sector				
	Average WTI oil price	Production	Total Discounted Petroleum Revenues (Factor of 4%)	Total Undiscounted Petroleum Revenues
	$/Barrel	million barrels oil equivalent	$ million	$ million
Total		**991**		**30,613**
Total from 1 January 11		**647**	**17,847**	**22,461**
to 2002				
2003				10
2004	44	17		175
2005	54	29		336
2006	65	57		612
2007	72	58		1,258
2008	103	64		2,284
2009	62	62		1,660
2010	76	57		1,816
2011	68	65	1,954	1,992
2012	71	68	1,923	2,040
2013	75	57	1,579	1,741
2014	79	61	1,727	1,981
2015	81	57	1,590	1,897
2016	85	49	1,341	1,664
2017	88	51	1,462	1,887
2018	92	45	1,308	1,755
2019	95	38	1,025	1,431
2020	98	41	1,104	1,602
2021	101	39	1,032	1,558
2022	104	32	765	1,202
2023	107	33	793	1,295
2024	110	9	215	365
2025	114	0	28	50

Source: Petroleum Fund Directorate, Ministry of Finance, 2010

[11] Includes revenue streams from Bayu Undan and Kitan fields

Investment Return

Gross investment return for 2011, before management fee, is estimated at $296 million. The similar investment return forecast for 2010, including both Petroleum Fund interest and change of value of the Petroleum Fund, is $241 million. These estimates are significantly higher than the investment return in 2009 of $34 million. The reason is that US interest rates have declined during the period, with a corresponding increase the market value of the Fund.

So far in 2010, from January to July, the gross return has been $188 million. The Petroleum Fund interest has been $117 million during this period and change in value of the Fund (market revaluation) equivalent to $71 million. Net investment return, gross return less management fee, is estimated at $235 million for 2010, of which Petroleum Fund interest is estimated at $200 million, change in the Fund's value estimated at $41 million and management fee of $6 million. The investment return forecast is included in Table 5.8.

The nominal investment return from January to July 2010 has been equivalent to 3.2% of the Petroleum Fund. The annual return for the 12 months to July 2010 was 4.2 %, while the annual return on the investments since inception of the Fund is now 4.6 %.

Table 5.8: **Estimated Petroleum Fund Savings 2009-2015 ($m)**

	2009 Actual	2010 Estimate	2011 Budget	2012 Projection	2013 Projection	2014 Projection	2015 Projection
Opening Balance	**4,197**	**5,377**	**6,617**	**8,165**	**9,817**	**11,223**	**12,923**
Petroleum Revenue excluding PF Interest	1,660	1,816	1,992	2,040	1,741	1,981	1,897
Petroleum Fund Interest*	177	200	296	359	419	479	546
Change in Value of the Fund	-143	41	0	0	0	0	0
BPA Management fee	-3	-6	-6	-6	-6	-6	-6
Withdraw al	-512	-811	-734	-741	-748	-755	-762
Closing Balance	**5,377**	**6,617**	**8,165**	**9,817**	**11,223**	**12,923**	**14,598**

*) includes accrued interest

Source: Petroleum Fund Directorate, Ministry of Finance, 2010

Petroleum Fund

The balance of the Petroleum Fund as of 31 July 2010 was $6.45 billion. This is an increase of $1.07 billion during the financial year. The balance is expected to increase only modestly for the rest of the year as the major part of the withdrawals in 2010 will take place in the second part of 2010. By the end of 2010, the balance of Petroleum Fund is expected to be $6.62 billion.

The current forecast shows the total value of the Fund to be $8.17 billion by the end of 2011, $9.82 billion by the end of 2012 and $14.6 billion by end of 2015. The forecasts of the future Petroleum Fund balance are shown in Table 5.8.

The Government has over the last three years gradually implemented the investment strategy of the Petroleum Fund. The objective is to diversify the portfolio into a range of asset classes, regions and currencies in order to reduce risks and increase expected return, within the limitations of the Petroleum Fund Law. The first step was taken in 2009 when the Bank for International Settlements (BIS) was appointed as the Fund's first external manager. The BIS is responsible for investing 20 per cent of the portfolio. Now the portfolio includes Government bonds issued by Australia, Japan, EU and UK as well as bonds issued by Supranational Organizations, such as the European Investment Bank and the World Bank.

In 2010, the Government appointed the External Manager, Schroeder Investment Management Ltd as the first Equity Manager and 4% of the portfolio is now allocated to global equities. With the latest allocation to equities, the flexibility in the current Petroleum Fund Law to diversify the portfolio is now fully exploited. Further diversification of the portfolio requires changes to the Petroleum Fund Law.

The fund is currently overweighted to bonds and this represents an exposure to financial risk associated with potential US interest rate increases. The Government will continue diversifying the portfolio away from US Government bonds once the amendments to the Petroleum Fund Law are approved by the National Parliament. This will include an increased exposure to equities.

Petroleum Wealth and ESI calculation

Total Petroleum Wealth, which comprises the balance of the Fund plus the net present value (NPV) of future Petroleum Revenues, is estimated to be $24.47 billion as of 1 January 2011. The estimated Petroleum Wealth has increased by $7.82 billion compared to the calculations provided in the Budget 2010.

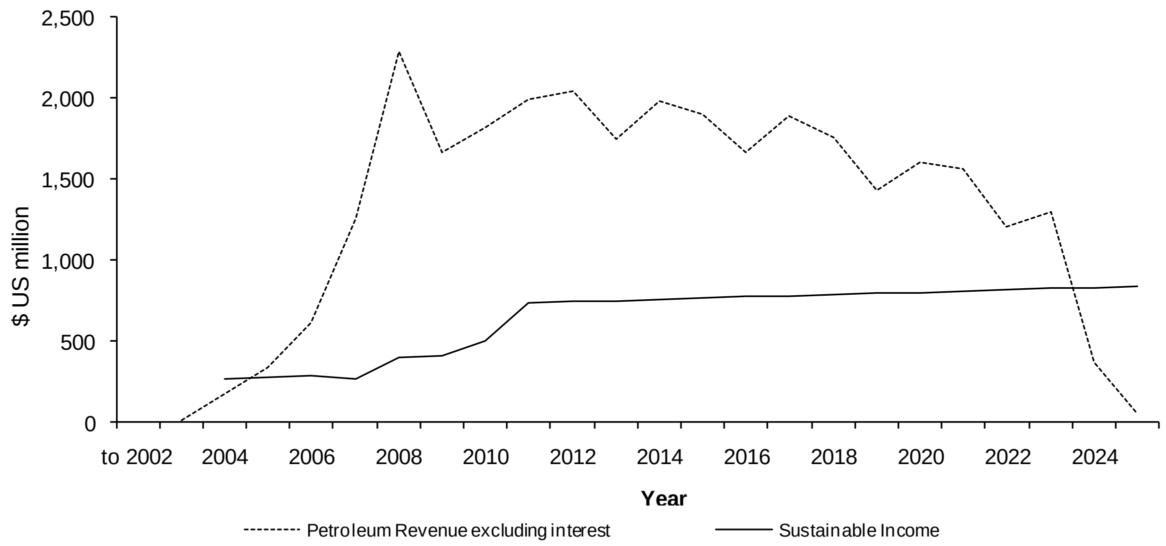
According to the Petroleum Fund Law, the Estimated Sustainable Income (ESI) shall be 3% of the Petroleum Wealth. Correspondingly, the ESI for the Financial Year 2010 is estimated at $734 million. This is an increase of $232 million compared to the ESI for 2010. Table 5.9 shows the ESI calculation for 2011 up to 2015 and Chart 5.2 the ESI together with the petroleum revenue forecast.

Table 5.9: **ESI as of 1 January 2011 Onward Compared to Figures in Budget 2010**

US$ million	2010 Budget	2011 Budget	2012 Budget	2013 Budget	2014 Budget	2015 Budget
Petroleum Fund balance	5,272	6,617	8,165	9,817	11,223	12,923
+ Net Present Value of future revenues	11,446	17,847	16,529	15,110	13,939	12,476
Total Petroleum Wealth (PW)	16,718	24,465	24,695	24,927	25,162	25,399
Estimated Sustainable Income (PWx3%)	502	734	741	748	755	762

Source: Petroleum Fund Directorate, Ministry of Finance, 2010

Figure 5.2: **Timor-Leste Petroleum Revenues and ESI, 2002-2024**



Source: Petroleum Fund Directorate, Ministry of Finance, 2010

Change of Methodology

The Ministry of Finance together with the IMF have reviewed the methodology used for calculating the Petroleum Wealth and ESI in 2010 prior to the ESI calculation for 2011. Although most of the methodology remains unchanged, two major changes have been made:

Oil price forecast

ESI Petroleum Revenue forecasts use West Texas Intermediate (WTI) as the benchmark oil price. For ESI calculations between 2007 and 2010, WTI has been forecasting deterministically using the Energy Information Administration (EIA) low case oil price forecast provided in its annual report, Annual Energy Outlook[12]. EIA is an independent organization that applies a consistent and rigorous methodology, and the only such organization to provide both a low and reference case forecast for WTI oil prices.

[12] Annual Energy Outlook 2010: http://www.eia.doe.gov/oiaf/aeo/index.html

Oil prices are inherently difficult to forecast, and there is much academic debate as to their underlying properties, including whether the market upheaval in 2008 and 2009 signals a permanent shift to a higher oil price world. The EIA low and reference case forecasts have been reviewed against current futures prices and other sources to evaluate whether these ESI cases serve as a reasonably prudent guideline for sustainable consumption of Timor-Leste’s petroleum wealth. Based on this assessment, the EIA low case forecast is felt to be overly prudent and the 2011 ESI calculation will instead use the average of EIA low and reference case forecasts.

Discount rate

Previous ESI used a single observation of the US government bond yields close to the date of the ESI calculation, weighted simply according to the proportion of forecast petroleum revenues occurring against each maturity period. The further liberalisation of US monetary policy following the global financial crisis has resulted in unusually low bond yields, as reflected in a discount rate of 2.6% for 2010 ESI.

The methodology has been revised to use (1) the 10 year historic average of bond yields for each maturity date; and (2) a refined calculation of the average discount rate. This results in a discount rate of 4.0 percent for 2011 ESI.

Changes in the ESI from 2010 to 2011

Several factors have affected the outcome of the ESI calculation for 2011 compared to the calculation in the previous year:

Oil prices

The forecast WTI oil price for 2010 has increased from $62 to $76 per barrel reflecting the average of actual oil prices to August 2010 and the EIA forecast for 2010 for the remainder of the year. For years after 2010, the move from EIA low case to the average of EIA low and reference case forecasts involves moving from long term real prices that converge to $50 per barrel to real prices that increase by around 2 percent per year between 2012 and 2025.

Liquids price differentials

The assumed value of Bayu Undan (BU) condensate and LPG relative to WTI have been slightly revised consistent with actual average differentials since the start of the project, leading to a modest further increase in ESI.

Production

The Bayu Undan low case production forecasts provided by Conoco Philips increased for all three product types. The range of uncertainty around future production volumes has narrowed reflecting revised reservoir estimates taking into account further production history and data gathered during recent development drilling. The higher production forecast, when valued using the average of EIA low and reference case oil prices, adds $61 million to ESI.

LNG prices

LNG contract prices until end of 2009 are now settled and these were largely reflected in 2010 ESI. Prices for 2010 to 2012 are close to being finalized and have resulted in a modest increase relative to prudent assumptions made for the 2010 ESI forecast. The forecast differential between JCC and WTI has been refined slightly consistent with historical actual average since the start of LNG shipments.

Petroleum fund withdrawals

Withdrawal of $512 million in 2009 (compared to Budget 2010 assumed withdrawal equalling ESI of $408 million) and $811 million now planned in 2010 (against ESI of $502 million) reduce the projected opening Petroleum Fund balance on 1 January 2011.

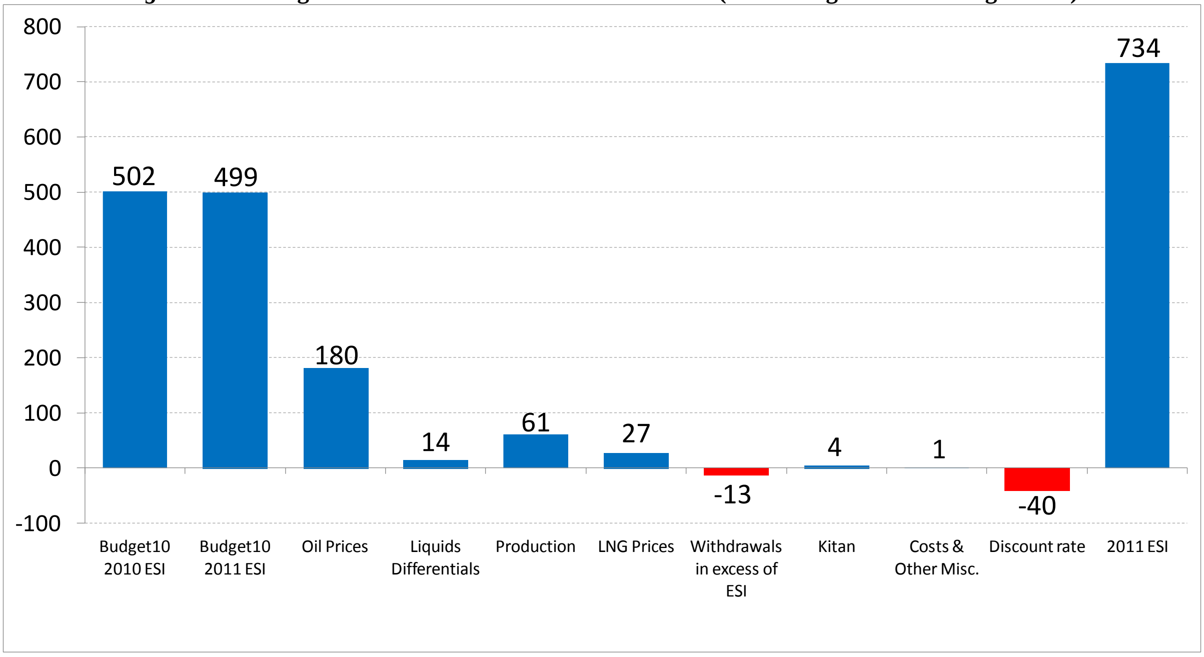
Kitan

The development plan for Kitan was approved by the Autoridade Nacional de Petroleo (ANP) or National Petroleum Agency (regulator) during 2010 and forecast revenues from Kitan are therefore included in the ESI calculation. The $4 million ESI increase reflects the Kitan low production case.

Discount rate

The discount rate has increased from 2.6% to 4.0% due to a change in methodology. A higher discount rate reduces the present value of future petroleum revenues. The magnitude of various factors affecting the ESI is illustrated in Chart 5.3.

Figure 5.3: **Changes in the Estimated Sustainable Income (from Budget 2010 to Budget 2011)**

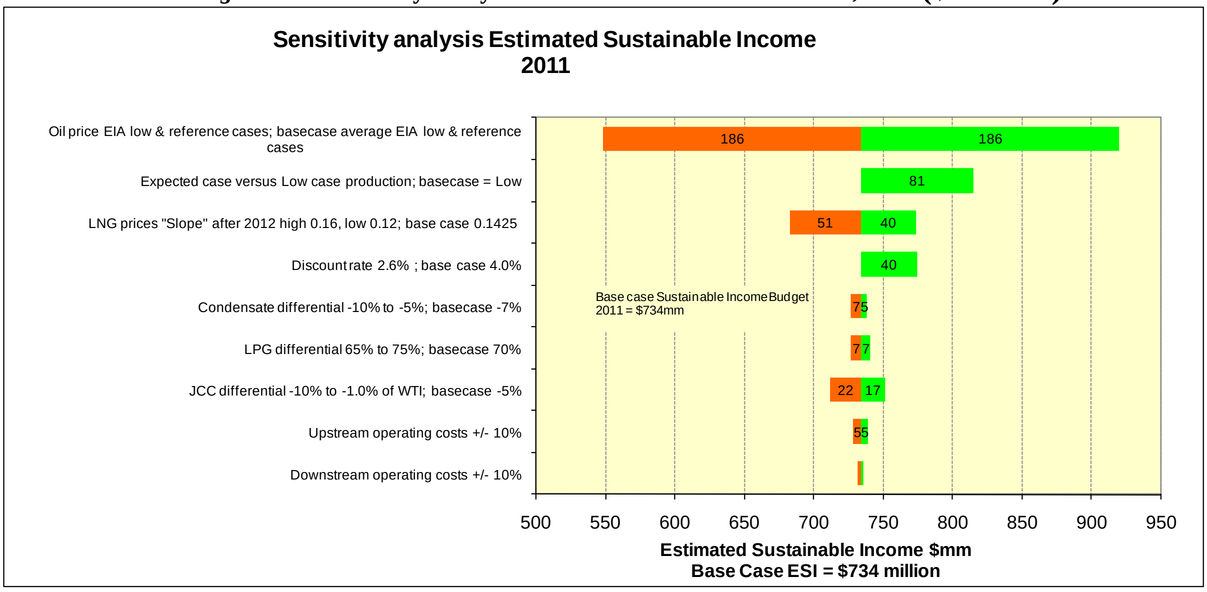


Source: Petroleum Fund Directorate, Ministry of Finance, 2010

Sensitivity analysis

There are a range of risks and uncertainties in any forecast of petroleum revenue. The most sensitive assumption is the oil price, as the forecast of petroleum revenues changes substantially for even a relatively small change in assumed oil prices. Chart 5.4 shows the sensitivity of ESI to changes in the most relevant variables.

***Figure 5.4*: Sensitivity Analysis – Estimated Sustainable Income, 2011 ($ million)**



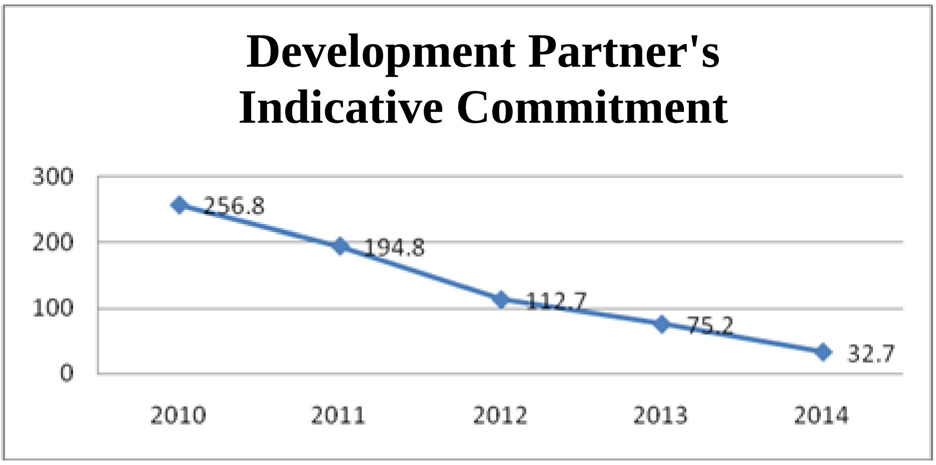
Source: Petroleum Fund Directorate, Ministry of Finance, 2010.

4. Development Partners

Timor-Leste's Development Partners will provide a total of $194.8 million to the Timor-Leste in 2011. This represents 17% of the total Combined Sources Budget of $1.18 billion.

Development partner funding is expected to reduce significantly from 2012 onwards. Current projections are that contributions will reduce by $82.2 million (42.2%) between 2011 and 2012, $47.4 million (42.0%) between 2012 and 2013, and $42.5 million (56.5%) between 2013 and 2014. These figures reflect actual information to date and accordingly do not reflect an absence of future international support and commitment.

Graph 5.4: **Development Partners' Indicative Commitment, 2010 - 2015 ($ million)**



Source: Aid Effectiveness Directorate, Ministry of Finance, 2010

PART 6. FINANCING

Timor-Leste is a developing economy with a nominal non-oil per-capita income of $594.50. 41% of the population live below the poverty line, down from 49.9% in 2007. The number of people entering the work force continues to increase at a faster rate than employment creation in public and private sectors. The challenges of building a sustainable economy, absorbing the increased workforce participation rate, and reducing poverty, are enormous. The Timor-Leste economy is primarily driven by public investment but for long term growth and sustainability private investment is critical. The prerequisites for private investment include security and political stability, basic infrastructure, skilled labour force, attractive tax rate, land laws, rule of law, and legal framework. Public investment and regulatory reform are essential to deliver these prerequisites.

The Government is finalising the Strategic Development Plan (SDP) 2011-2030, which calls for substantial investment in two fundamental pillars to create the basic conditions to attract private investment for growth and sustainability. These two pillars are basic infrastructure and human capital.

This budget year marks the beginning of the SDP with an immediate need for funding to operationalise the SDP.

The main source of revenue for Timor-Leste is Petroleum Revenues, which is derived mainly from Bayu Undan in the Timor Sea. These revenues are deposited in the Petroleum Fund, from which withdrawals are made to finance the State Budget guided by the Estimated Sustainable Income (ESI) benchmark of 3% of the Petroleum Wealth.

Domestic Revenues and donor funding constitute a small component of the Budget revenues.

Beyond what can be spent from traditional funding sources (ESI and Domestic Revenues), additional amounts are envisaged to be required in the first five years of the SPD. The Government is, therefore, exploring other options towards funding strategic public investments. These financing options range from judicious withdrawals from the Petroleum Fund ensuring long term sustainability, access to concessional and non-concessional borrowings, and Public Private Partnerships (PPP).

Starting 2011, the Government will establish two Special Funds in accordance with section 32 of Law No. 13/2009 on Budget and Financial Management. The purposes of the funds are to finance large-scale, multi-year capital investments in infrastructure and human development. The special funds will be known as:

1. Infrastructure Fund (FI), and
2. Human Capital Development Fund (HCDF).

The creation of Special Funds is provided for in section 32 of the Budget and Financial Management Law. These funds will be financed through the budget and provide a more transparent and effective governance and reporting mechanism on the use of the money. The Government in accordance with article 115(1)(e) of the Constitution has the competency to establish the rules and regulations for the Special Funds. Parliamentary authorisation is required pursuant to article 32 of the Budget and Financial Management Law.

The use of Special Funds will fast track the implementation of the SDP. The Special Funds will be governed by a board consisting of the Prime Minister and relevant line ministers. One of the benefits of the Special Funds is the centralisation of decision making, which will ensure projects are coordinated between line ministries and integrated within the SDP. The board will prioritise and sequence projects, with the scope to realign projects to accommodate changes arising from factors outside its control. Another benefit of the Special Funds is that it will provide an avenue to allow donors to participate in the SDP.

A National Development Agency (ADN) will be established under the Prime Minister staffed with technical expertise to quality control project submissions to ensure specifications and costings are appropriate. The ADN will also provide supervision and monitoring of the projects including quarterly reporting to the National Parliament through the Council of Ministers.

The Minister of Finance is responsible for the management and control of the Special Funds in accordance with the Budget and Financial Management Law. The purposes of the Special Funds are included in Article 9 of the State Budget 2011.

Under articles 20 and 21 of the Budget and Financial Management Law the Government has a legal basis to borrow. The primary goal of external borrowing is to fill the deficit between desired development needs and domestically available resources over the medium and long-term. A Debt Management Unit (DMU) has been established within the Ministry of Finance to ensure efficient and effective management of public debt should it arise. The Government is assessing the benefits of borrowing as opposed to relying exclusively on the Petroleum Funds revenue.

The Government is considering the financing option of Private Public Partnerships (PPP), which will enable more infrastructure investments whilst sharing associated risks with other parties.

ANNEX 1 - Estimated Sustainable Income Calculation 2011

Introduction

According to the Petroleum Fund Law the Estimated Sustainable Income (ESI) the maximum amount that can be appropriated from the Petroleum Fund in a financial year while leaving sufficient resources to appropriate an amount of equal real value in subsequent years. This means that the ESI is a benchmark indicating the sustainable level of withdrawal from the Petroleum Fund that does not reduce the real value of Timor-Leste's total petroleum wealth in the long-term.

The Petroleum Fund Law requires that all assumptions underlying the calculation of the ESI be prudent, reflecting international best practice and be based upon internationally recognized standards. Currently approximately 2/3 of Timor-Leste's Petroleum Wealth included in the ESI calculation is still under the seabed in Timor Sea, while 1/3 is already in the Petroleum Fund. The future revenues are highly uncertain and subject to production and oil prices in the future.

Moreover, currently only one field, Bayu Undan, is in operation. The risk, however small, is that an event on the Bayu Undan field will cause a deferral of the revenue stream to the State of Timor-Leste. Such a deferral may last for months, years or even indefinitely, depending on the event. Furthermore, oil prices are very volatile, and it should not be ruled out that oil prices fall to or below the price assumptions used in the calculations of the Petroleum Fund.

Review of methodology

The Ministry of Finance (MoF) has reviewed the methodology used for the ESI calculation and has broadly re-confirmed the approach used previously with the exceptions noted below.

Asset recognition policy

The forecast of future petroleum revenues used for ESI includes projects with approved development plans and firm investment commitment from the oil company. This has been re-confirmed as an appropriate basis for ESI and revenues from Bayu Undan (BU) and the recently approved small Kitan project are included in the forecast. Because of significant uncertainty and potential for material delay no revenues are included for the Sunrise project. Though exploration continues, at this time there have been no other significant petroleum discoveries in the Joint Petroleum Development area or Timor-Leste exclusive areas.

Petroleum Reserves and Production Forecasts

The operators, ConocoPhillips and Eni, have provided three production scenarios, “high”, “expected” and “low” production, based on different assumptions of the total petroleum resources available at Bayu Undan and Kitan fields respectively.

The State Budget estimates production on the basis of the Operators’ “Low” estimate, which reflects a 90% likelihood that predicted production levels will be achieved. This is considered to be in accordance with the prudent requirements in the Petroleum Fund Law.

ConocoPhillips update production forecasts annually, taking into account new production data, including results from 2009 development drilling. There were no major revisions in underlying production plans, but as the Bayu Undan field matures, the low, base and high case production forecasts are converging, reflecting the reducing level of uncertainty. The key difference between the three production cases now lies in the estimated size of the total producible reserves, as reflected in differing cut off points and production volumes in the final years of the field.

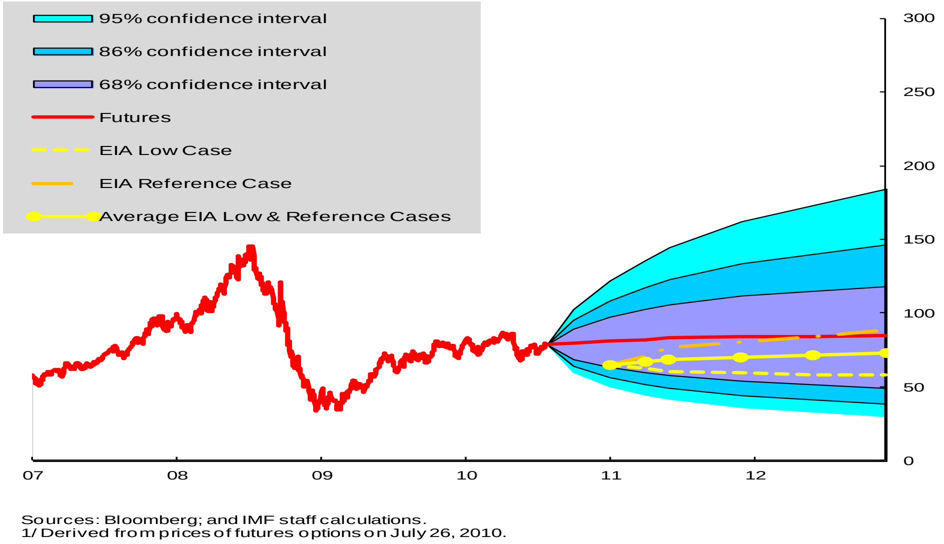
Oil prices

ESI petroleum revenue forecasts use West Texas Intermediate (WTI) as the benchmark oil price. For ESI calculations between 2007 and 2010, WTI has been forecast deterministically using the Energy Information Administration (EIA) low case oil price forecast provided in its annual report, Annual Energy Outlook13. EIA is an independent organization that applies a consistent and rigorous methodology, and the only such organization to provide both a low and reference case forecast for WTI oil prices.

The 2011 ESI calculation uses the average of the EIA low case and reference case forecasts as the WTI oil price benchmark for the ESI calculation. The average of the two EIA cases lies well within the 68 percent confidence interval around average futures prices, and significantly below the average of futures prices, as shown in Chart A1.

[13] Annual Energy Outlook 2010: http://www.eia.doe.gov/oiaf/aeo/index.html

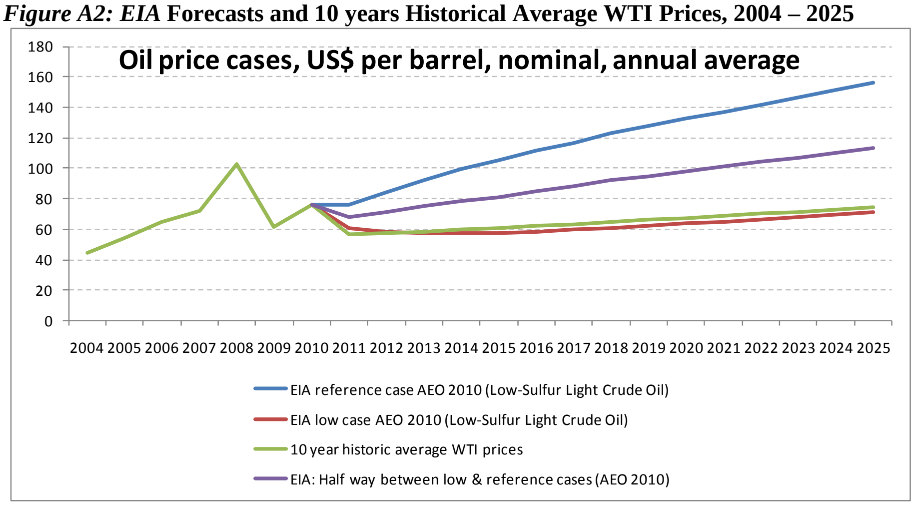
Figure A1: **Comparing EIA Oil Price Forecasts to Market Futures Prices (WTI prices, $ per barrel)**



Source:Petroleum Fund Directorate, Ministry of Finance, 2010

Moreover, the average of the EIA low case and reference case is significantly lower than the EIA's Reference Case, and the difference between the two projections increases with the time horizon. The EIA's Low, Reference and average of Low and Reference Case are shown in Chart A2 together with the historical average WTI prices.

Figure A2: EIA **Forecasts and 10 years Historical Average WTI Prices, 2004 – 2025**



Source: Petroleum Fund Directorate, Ministry of Finance, 2010.

There are many institutions providing oil price forecasts. Nonetheless, the EIA is the only one, as the Ministry of Finance is aware, that provides both Low and Reference Price Cases. As shown in Table A1, the oil price projection used in the ESI calculation is significantly lower than most other oil price forecasts made by other institutions.

Table A1: **World Oil Price Forecasts, 2015 - 2025**

World Oil price forecasts, USD/barrel, real 2008 USD	**2015**	**2020**	**2025**
INFORUM	92.5	108.0	109.7
DB	93.2	105.5	114.7
IHSGI	85.1	81.9	74.9
IEA		100.0	115.0
EVA	80.4	84.5	91.0
SEER (Business-as-usual)	79.2	74.3	69.7
SEER (Multi-Dimensional)	99.0	101.5	105.8
EIA Reference Case	94.5	108.3	115.1
EIA: Half way between low & reference	73.6	80.4	84.4
EIA Low Price Case	51.6	51.9	51.7

Source: AEO 2010, EIA

Budget 2010 forecast a WTI oil price of $62 in 2010. For the seven months to the end of July 2010, WTI spot prices averaged $78.1[14]. For the remaining five months of 2010, prices are assumed to average the most recent EIA forecast for WTI in 2010 of $72.4. The weighted average 2010 price is therefore $75.7. Oil price forecasts for 2011 and 2012 are US$68 and US$71 per barrel.

Discount rate

The Petroleum Fund Law stipulates that the discount rate used for calculating the present value of the future cash flow from the petroleum sector be the nominal yield on a US Government security averaged over the years, in which the Petroleum Fund receipts are expected.

Previous ESI used a single observation of the US government bond yields close to the date of the ESI calculation, weighted simply according to the proportion of forecast petroleum revenues occurring against each maturity period. The unprecedented loosening of US monetary policy following the global financial crisis has resulted in unusually low bond yields, as reflected in a discount rate of 2.6% for 2010 ESI. The methodology has been revised to use (1) the 10 year historic average of bond yields for each maturity date; and (2) a refined calculation of the average discount rate. This results in a discount rate of 4.0 percent for 2011 ESI.

[14] Source: Daily WTI spot prices from Energy Information Administration (EIA) (http://tonto.eia.doe.gov/dnav/pet/pet_pri_spt_s1_d.htm)

Other assumptions

Actual realized prices for condensate and liquefied petroleum gas (LPG) relative to WTI have been reviewed and the forecast differential set consistent with average actual percentage differentials since the start of shipments in 2004.

Liquefied Natural Gas (LNG) prices for 2010-2012 are forecast using the provisional price formula negotiated between Darwin LNG and Japanese LNG buyers. For 2013 onwards, a prudent assumption has been made for long term LNG prices relative to oil prices, taking into account advice from Poten & Partners (LNG consultants advising the ANP). The percentage differential between WTI and the JCC[15] is forecast consistent with the historic actual average.

Operating and capital costs are the operator's forecast consistent with base case production. Advice from the operators is that costs would not be materially different for the low production case, therefore base case costs are used without adjustment as a prudent estimate of low case production costs.

Certification of the ESI calculation

According to the Petroleum Fund Law Art. 8 no transfer shall be made from the Petroleum Fund in the Fiscal Year unless the Government has first provided Parliament with reports:

(a) specifying the Estimated Sustainable Income for the Fiscal Year for which the transfer is made;

(b) specifying the Estimated Sustainable Income for the preceding Fiscal Year; and

(c) from the Independent Auditor certifying the amount of the Estimated Sustainable Income in paragraphs (a) and (b) above.

The reports are attached as Annex 3 and 4.

[15] Japanese Crude Cocktail, price index of all oil imported into Japan, reported by Japanese Ministry of Finance

ANNEX 2 - 2011 General State Budget Law

ANNEX 3 – Transfer from Petroleum Fund

Kay Rala Xanana Gusmao
Prime Minister
Democratic Republic of Timor-Leste

Dear Prime Minister,

SUBJECT: REQUIREMENT FOR TRANSFERS FROM PETROLEUM FUND

This report is provided in accordance with Article 8 (a) and (b) of the Petroleum Fund Law.

The Estimated Sustainable Income is calculated in accordance with provisions outlined in Schedule 1 of the Petroleum Fund Law.

Estimated Sustainable Income For Financial Year: 2011	**Amount (USD)** $734 million
Estimated Sustainable Income For preceding Financial Year: 2010	**Amount (USD)** $502 million

A review of the methodology which the ESI-calculations are based on is included as an attachment to the Budget 2011.

According to Art. 8 (c) of the Petroleum Fund Law, the Independent Auditor, shall certify the amount of the Estimated Sustainable Income. The certification report is attached.

Yours sincerely,

Emilia Pires
Minister of Finance

ANNEX 4 – Deloitte Report

Deloitte.

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AUDITOR'S REPORT TO THE MINISTRY OF FINANCE, DEMOCRATIC REPUBLIC OF TIMOR-LESTE

We have audited the Estimated Sustainable Income calculation for the Petroleum Fund of Timor-Leste for the fiscal year ending 31 December 2011 for purposes of the Fiscal Year 2011 Budget ("the Calculation"). The preparation of the Calculation is the responsibility of the Government of Timor-Leste. Our responsibility is to express an opinion on whether the Calculation has been prepared in compliance with Article 8 and Schedule 1 of the Petroleum Fund Law of the Democratic Republic of Timor-Leste ("the Law").

We conducted our audit in accordance with International Standards on Auditing applicable to compliance auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the Calculation has been prepared in compliance with the Law. An audit includes examining appropriate evidence on a test basis. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Estimated Sustainable Income Calculation for the Petroleum Fund of Timor-Leste for the fiscal year ending 31 December 2011 for purposes of the Fiscal Year 2011 Budget which has been calculated by the Government of Timor-Leste as 734 million United States Dollars, has been prepared, in all material respects, in compliance with Article 8 and Schedule 1 of the Petroleum Fund Law of the Democratic Republic of Timor-Leste.

Deloitte Touche Tohmatsu

DELOITTE TOUCHE TOHMATSU
Chartered Accountants
Darwin, 20 October 2010