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Submission[1] to Commission C National Parliament of Timor-Leste

regarding the

Timor-Leste General State Budget for 2009

from

La'o Hamutuk

Timor-Leste Institute for Development Monitoring and Analysis

24 December 2008[*]

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Introduction

La'o Hamutuk, as a civil society organization in Timor-Leste, has closely followed issues relating to national development and petroleum resource management for more than eight years. We are a member of the Core Group on Transparency (CGT) and of the Timor-Leste NGO Forum (FONGTIL), and offer this submission in coordination with and in support of other submissions made by these coalitions and their member organizations.

There are many thousands of proposals, plans and allocations in the State Budget for 2009,[2] and we are concerned that neither Government nor Parliament has enough time to consider them all

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[1] Bele hetan submisaun ida ne'e iha lian Tetum iha http://www.laohamutuk.org/econ/OGE09/sub/LHSubOGE24Dec08Te.pdf

[*] This translation of this submission was edited slightly on 5 January 2009.

[2] The complete 2009 State Budget Book 1, in both English and Portuguese, is on La'o Hamutuk's web site at www.laohamutuk.org/econ/OGE09/08OJE2009.htm with commentary and analysis.

thoroughly. It is unfortunate that the annual or semi-annual budget processes are the only venues to discuss major issues of policy and direction for Timor-Leste's future, which should get more deliberative consideration.

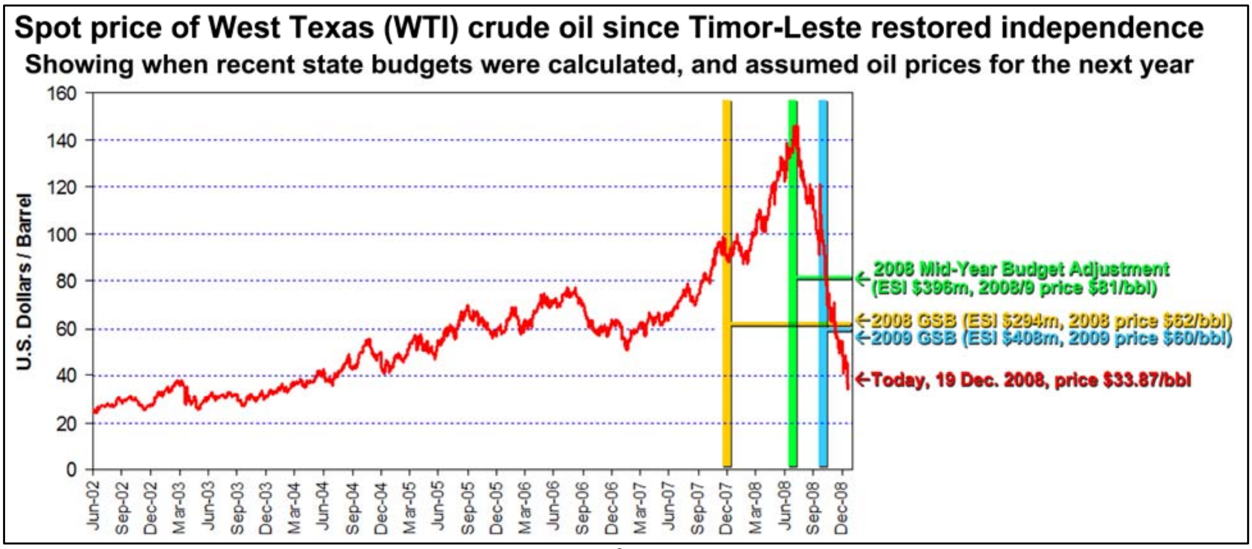
Sadly, we in civil society also do not have the time or expertise to thoroughly assess and evaluate everything in the budget documents. However, what we have examined raises serious concerns that this budget pushes Timor-Leste down the path of the "resource curse" which afflicts most impoverished, oil-dependent countries. More specifically, the pattern of overspending when oil revenues are high, resulting in expenditure commitments which force indebtedness and unsustainability when revenues fall, seems to be gaining momentum.

A wise person once said "if we do not change our direction, we are likely to end up where we are headed." La'o Hamutuk believes that it is not too late to change policy, and we would like to suggest a few main concerns and topics which we believe Parliament should scrutinize closely.

Overspending the non-sustainable "Estimated Sustainable Income"

The Ministry of Finance has estimated the Petroleum Fund's Sustainable Income (ESI) for 2009 at $407.8 million, and the Government proposes to spend all of that, plus an additional $181.2 million, in 2009. La'o Hamutuk believes that there are so many uncertainties and unknowns regarding petroleum revenues and Petroleum Fund earnings that this is a serious mistake which poses long-term dangers for Timor-Leste's future.

The ESI calculation, done last October, uses ConocoPhillips production forecasts from February 2008 and U.S. Energy Information Administration (EIA) price projections made in March 2008. When the calculations were done two months ago, the West Texas Intermediate Crude (WTI) oil price was around $65 per barrel; this week it has fallen below $34 and continues to drop.



Source: Historical oil prices from EIA website[3], to 19 Dec 2008. ESI and assumed prices from budget documents.

[3] http://www.eia.doe.gov/emeu/international/crude1.html

The jagged red line in the graph above shows the world market price of crude oil from when Timor-Leste achieved independence until this week. The colored vertical bars indicate when the ESI was calculated for the last three General State Budgets, and the horizontal lines show what was assumed as the oil price for the year following the calculation. Bayu-Undan production peaked in 2008 and has begun to decline, so the price during 2008-2009 will have the greatest effect on current revenues, the valuation of the oil reserve remaining in the ground, and the estimate of the Sustainable Income.

Last October, the Ministry of Finance attempted to adapt the outdated ConocoPhillips and EIA projections to the situation at that time, but there are so many unknowns and assumptions that their estimates are very uncertain. The Ministry thought it was being conservative by predicting that oil prices from 2009-2013 would be $60/barrel, but the current price is less than 57% of that and continues to fall. In addition, the petroleum industry is rapidly changing, as capital and operating costs begin to decline (although more slowly than the price of oil). This will affect profits and revenues from both current and future projects.

During the last few months, the developed world has been engulfed by a financial and credit crisis which will have major effects on both oil prices and the earnings of the Petroleum Fund. Already, world demand for petroleum has dropped significantly, as factories close and industry cuts back on production. In addition, the Federal Reserve Bank of New York recently reduced its prime rate to under 0.25%, although how this will impact interest paid on U.S. Treasury bonds is still unclear.

All these uncertainties make it imprudent to rely on an increased ESI, and foolhardy to enact a budget that spends all of it and more. Families and governments around the world are tightening their belts and waiting to see what happens to the world economy, as well as the effect of the change of administration in Washington. It would be wise for Timor-Leste to do the same.

We suggest that before Parliament approves the budget in January 2009, you ask the Ministry of Finance to make another estimate of the Sustainable Income, and ask Deloitte to verify the estimate. An even more accurate estimate will be possible by March, with new production forecasts from ConocoPhillips and a new U.S. Energy Information Administration *Annual Energy Outlook*.[4] It would be prudent to review the revenue side of the budget at that time, making appropriate adjustments to planned expenditures if necessary.

Last year, oil revenues were higher than expected and the Government was eager to spend rapidly. Timor-Leste is lucky that this cash outflow has been curtailed by constitutional and legal constraints, as well as by falling prices in regional and global markets. But even if only $380 million of the $788 million rectified budget for 2008 is spent, it still represents three times the spending rate of only one year ago. We doubt that the Government has the capacity to wisely manage so many new projects, so rapidly.

The largest increases in the proposed 2009 budget are for salaries and capital infrastructure. These set a dangerous precedent for the future, and will be difficult to reverse. Once salary

[4] A preliminary version of the 2009 *Outlook* was released by the U.S. Energy Information Administration on 17 December 2008 and is available from http://www.eia.doe.gov/oiaf/aeo/index.html. The final report will be available early in 2009.

increases are paid, they are likely to stay in place even when money is not available to pay for them, taking funds from essential services. We discuss this in more detail below. The infrastructure component of this budget, also discussed below, is dominated by the "bellwether" project of the national electric generation and distribution system, budgeted at $87 million in 2009 (42% of all capital expenditures next year) but $162 million in 2010, which it will be 69% of the entire capital budget. This creates huge obligations in future years, even though nobody knows how much revenue will be available at that time.

We caution Parliament to avoid being infected with the unrealistic optimism which characterizes the Government's description of future petroleum revenues. "Optimism" may seem an odd description for a projected 50% decline in Timor-Leste's oil revenues between 2008 and 2009, but the actual drop could be much more. More troubling is budgeting based on wishes – the budget document envisions bright future prospects for oil discoveries, highlighting the Kitan field which may begin development in a year or two. But Kitan is small – at best, it will increase the ESI by less than $20 million per year. Even Greater Sunrise, still commercial under the current petroleum industry economics, may add only $300 million/year to the ESI.

The cost of living in Timor-Leste, according to the Banking and Payment Authority's (BPA) Consumer Price Index,[5] rises about 12% every year. To date, the investment earnings on the Petroleum Fund have averaged around 6%, far less than Timor-Leste's inflation rate, and only about 3% above worldwide inflation. In other words, the 3% withdrawn each year as the "sustainable" income is not sustainable in inflation-adjusted dollars.

Furthermore, Timor-Leste's population grows by 3.5% every year. By 2020, when Kitan and Sunrise will probably be generating revenues, we will have about 1.7 million people, and prices will be nearly four times current levels. Maintaining today's level of services will cost more than six times what it does now, about $3 billion dollars per year. But the ESI will be less than one billion, and annual petroleum revenues could be lower. In other words, the "sustainable" income from the Petroleum Fund will not be sufficient to provide "sustainable" services for our people.

La'o Hamutuk is happy that the Government has tried to comply with the decision of the Court of Appeals that it is illegal to transfer more than the ESI from the Petroleum Fund without a detailed explanation of long-term impacts. The Prime Minister's letter[6] explains why he believes Timor-Leste's should spend $181 million more than the ESI in 2009, primarily for infrastructure. Although we do not find his letter convincing and hope that Parliament will not accept his argument, we appreciate the effort to comply with the Petroleum Fund Law.

A second common cause of the "resource curse," in addition to spending sprees with windfall revenues, is that dependence on petroleum revenues leads to the neglect of other sectors of the economy and income sources. Sadly, this is becoming the pattern in Timor-Leste. One need only look at the declining share of domestic revenues in the budget (in 2009, 79% of the $31.5 million in "user fees" revenues are from Government sales of subsidized rice, while most of the $49.2 million in direct and indirect taxes also results directly from Government activities) to understand the undeveloped condition of Timor-Leste's non-oil economy.

[5] http://www.bancocentral.tl/en/inflation.asp

[6] Annex 9 to the Budget Document.

Unaffordable, unreliable, and polluting heavy oil power plants

As in the 2008 rectification budget, the proposed 2009 budget contains a huge commitment for a massive, heavy oil-powered electric generation and distribution system. We agree that better electricity supply, reaching more people, is an essential step toward this country's economic and social development. However, we do not believe that this project can achieve those goals, no matter how much money is thrown at it.

Last July, Parliament voted down this project, on the understanding that hydroelectric and other clean energy sources already under development can meet Timor-Leste's electricity needs for the next several decades. We urge you to do so again – the project looks even worse as more information comes out.

The following table shows how the power plant project fits into the overall capital budget of the Ministry of Infrastructure. Over the four years from 2008 through 2011, this project will cost $381 million, which will be 78% of the government's total capital expenditure on infrastructure. The cost of this project dwarfs everything else; in fact, it will cost more than all 2008 governmental expenditures added together.

Budget	Project (million USD)	2008	2009	2010	2011	Total 2008-11
OR2008	Electricity Generation	5	35	35	30	105
OR2008	Electricity Distribution	5	95	95	90	285
OR2008	**Total**	**10**	**130**	**130**	**120**	**390**
OGE2009	Generation & Distribution	10	85	160	120	375
OGE2009	Supervision of the Power Project	-	2	2	2	6
OGE2009	**Total**	**10**	**87**	**162**	**122**	**381**
OGE2009	Total of all infrastructure capital projects	53	117	179	136	486
	Percentage for power project	19%	74%	90%	90%	78%

As the table shows, the $10 million expenditure this year is increased nearly nine-fold in 2009, to be nearly doubled again in 2010. Considering the expected decline in petroleum revenues and ESI discussed above, it seems imprudent to make such a huge commitment of future funds. Can Parliament and Government be sure that $162 million will be available for this project in 2010? Can Chinese Nuclear Industry 22nd Construction Company be sure that they will be paid?

The Government claims that this is its "bellwether" project, setting the direction of the "year of infrastructure". Yet it is not discussed in the narrative text or the Action Plans of the Ministry of Infrastructure (which is responsible for having it built) or EDTL (which will be responsible for running it after it has been constructed). The Action Plan of the Department of Environmental Services in the Ministry of Economy and Development does not mention this project, although conducting a meaningful environmental impact assessment for it should be one of the major tasks of this Department in 2009.

These heavy oil power plants, larger than any project ever imagined in Timor-Leste, will emit large amounts of particulate and acid pollution, fly ash, sulfur and other dangerous chemicals. They will cause acidic rain both in Timor-Leste and downwind, damaging agriculture, forests, fisheries and water supplies. They will produce large amounts of carbon dioxide, undercutting Timor-Leste's efforts to prevent climate change and our commitment to the Kyoto Protocol, as well as possibly endangering international funding sources for carbon offsets or climate change adaptation.

They are second-hand, 20-year old generators which use technology long discarded by developed countries. Keeping them running will demand operating and maintenance skills far beyond what is available here in this sector. This centralized power system, based on unreliable and hard-to-manage difficult technology, may end up generating no electricity at all.

Dili is currently home to several large Chinese construction projects, and anyone can see that virtually no local workers or subcontractors are involved. Chinese Nuclear Industry 22nd Construction Company will operate the plant for five years after it is built (although this does not appear in the 2009 budget), and must train 150 Timorese to keep it operating afterwards. But there does not appear to be any local content requirement for the construction process; \$375 million of Timor-Leste's money may not create employment or capacity-building for a single Timorese construction worker or civil engineer.

According to State Secretary Agio Pereira, the power plant project "is a recognized dream led by the Prime Minister himself, Xanana Gusmão." Parliament must see that the dream has a foundation in reality before allowing it to soak up nearly a year's worth of Timor-Leste's Gross Domestic Product.

Unrealistic and dangerous future expenditure projections

When La'o Hamutuk analyzed the 2008 Rectified Budget, we concluded that many of the Government's projected expenditures for the years 2009-2011 were inconsistent with the assumptions in that budget for 2008, grossly underestimating future outlays. The current proposed budget for 2009 is close to La'o Hamutuk's projections, proving our analysis correct.

Sadly, we see similar problems with the 2010-2012 estimates in the draft State Budget for 2009, and we urge Parliament to closely examine these predictions and to consider whether the path laid down in 2009 can be followed in future years.

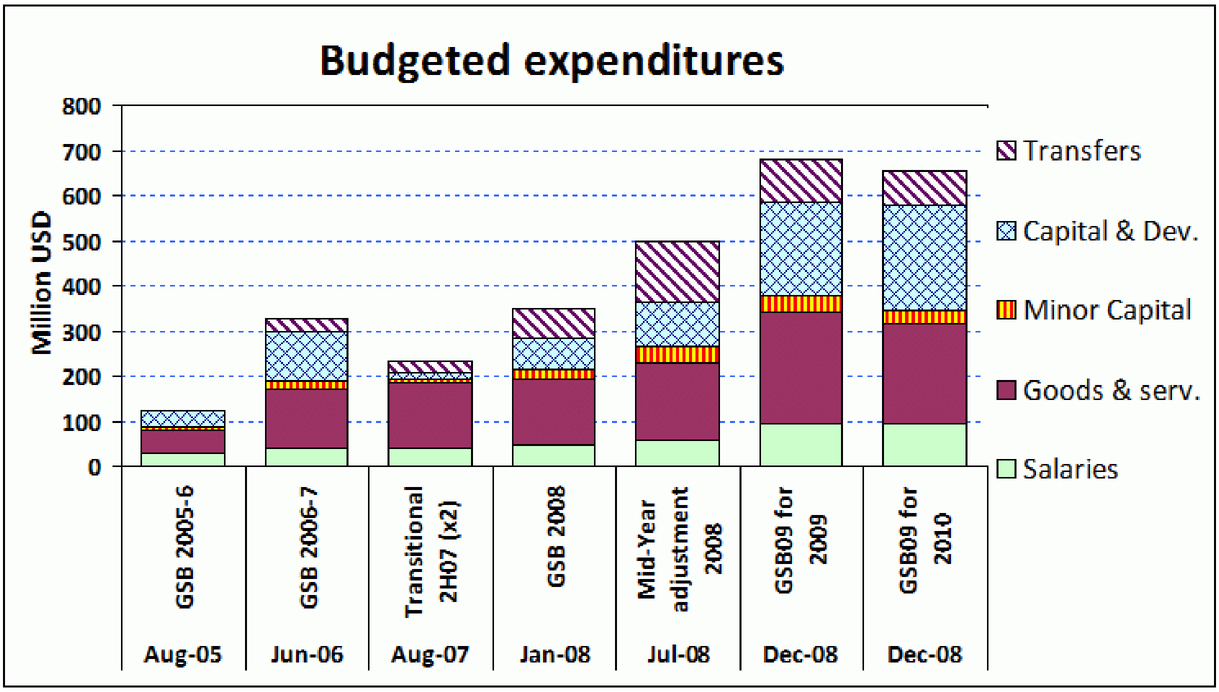
Over the past year, the Ministry of Finance has envisioned the following expenditures relating to current year appropriations for the next few years. The bottom row indicates the amount of money needed beyond the ESI from the Petroleum Fund and domestic revenues. It is clear that the 2009 budgeted expenditure, \$681 million, is closer to La'o Hamutuk's projection of \$665 million than to the estimate of \$517 million in the mid-year rectified budget.

Future spending projections in recent RDTL budgets (million USD)

Budget	2008	2009	2010	2011	2012
Original 2008 budget (1/08)	348	280	269	274	-
Rectified 2008 budget (without Economic Stabilization Fund) (7/08)	533	**517**	438	430	-
La'o Hamutuk projection from rectified 2008 budget (without ESF, with shift of payment schedule for power plants)	533	**665**	787	828	-
OGE2009 (11/08)	380	**681**	656	585	468
OGE2009 deficit filled from PF or "unconfirmed financing sources"		181	261	134	

The Government's figures assume sharp drops in Minor Capital, Goods and Services, and public transfers between 2009 and 2010. They also assume that non-power-plant capital spending drops markedly every year after 2009, and that salaries will grow only 2.5% per year, far less than the inflation rate. Although power plant capital spending will be $75 million higher in 2010 than 2009, the Government projects the total budget to decrease by $18 million. As a final test of credibility, the Government plans to cut spending by 20% when it submits itself to the voters in 2012! These projections are erroneous at best and misleading at worst, and Parliament should make its own estimates of what the commitments made in the 2009 budget are likely to cost in future years. La'o Hamutuk has not yet made such projections, but we are ready to work with Commission C if you would like our help.

The following graph shows the budgeted expenditures in each State Budget from fiscal year 2005-6 to the present. Between 2007 and 2009, they have increased greatly, especially in salaries, goods & services, and Capital & Development. The right-most bar shows the projections for 2010 contained in the proposed 2009 budget, which we believe are unrealistic.



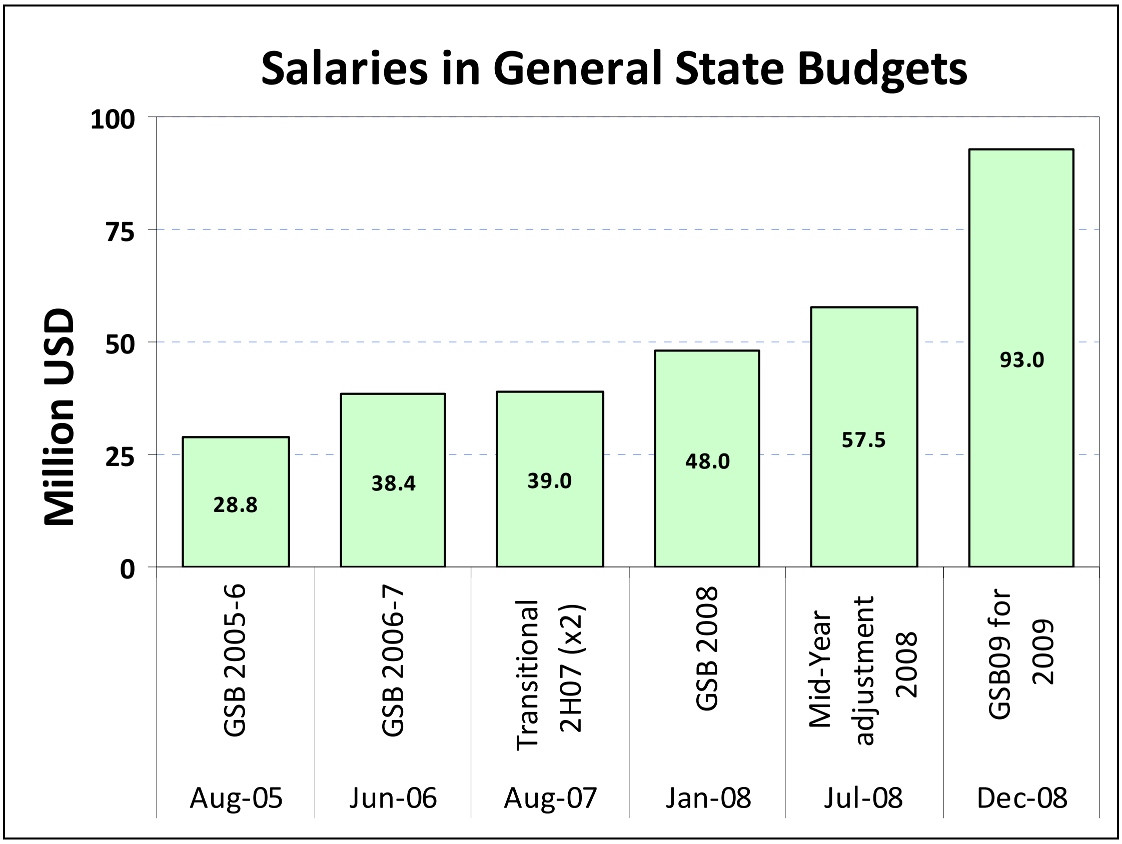
Source: Government Budget Documents for each year.
The 2008 Mid-Year Budget does not include the unconstitutional Economic Stabilization Fund

As discussed above, petroleum revenues and petroleum fund earnings will probably decline over the next few years, and the ESI could drop as well. The Government, however, promises not to take more than the ESI from the Petroleum Fund after 2009. (The same promise regarding 2009 in the 2008 mid-year budget has already been broken.) But the ESI is not sufficient to pay for even the grossly understated future expenses discussed in the previous paragraph, and the Government relies on "unconfirmed financing sources" to make up the deficit, which is (under-) estimated at $208 million in 2010 and $126 million in 2011.[7] These could be further raids on the Petroleum Fund, taking out loans (although future budget projections do not include debt service payments), winning the lottery or receiving manna from heaven.

[7] Table 2.8, OGE 2009 Book 1, Portuguese version. There are some inconsistencies between this and other tables in the budget document, and with the English version.

Unwise and unsustainable salary increases

The proposed 2009 budget increases the expenditure for salaries in the entire Government by 94% over the original 2008 budget, to 138% higher than they were in 2007. As the following graph shows, salaries have increased significantly in every budget during the past three years. Since salary expenditures have the highest percentage execution, actual expenditures are nearly the same as budgeted amounts. Furthermore, salary increases are very difficult to roll back, so the raises which the Government has given to its own leaders and workers are likely to be irreversible, persisting as pensions even after employees retire.



The largest salary increase is for the National Parliament, where the Salaries category has gone up 329% since the rectified budget passed five months ago. Although some of this is for much-needed expansion of Parliament's professional staff, the largest part of it is to increase the remuneration of each Member of Parliament.

The Ministry of Education budget includes $32 million for salaries, the largest in the budget. This is a 54% increase over the rectified budget, reasonable considering the growing number of children in this country and the importance of preparing them for the future. Dividing the total 2009 salary allocation for this Ministry by the 13,555 people who work there gives an average salary and benefits of $198/month. By comparison, the 128 people on the Parliamentary payroll will receive an average of $1,990 every month, almost ten times as much.

Last month, the World Bank's report *Timor-Leste: Poverty in a Young Nation* found that the number of poor people in Timor-Leste has increased significantly over the past five years. At the end of 2007, the report says, "About half of the Timorese population lives below the basic needs poverty line of $0.88 per person per day, [and] one-third of the population is afflicted by extreme poverty." Poverty is worst in the western and central rural areas of Timor-Leste – the areas where most voters supported the current government.

We hope the Deputados are listening to what people are saying: "For Parliamentarians, 2008 was the year of cars, and 2009 will be the year of money. In 2010, they'll get airplanes."

Hidden funding for the National Petroleum Authority

Last 10 June, the Council of Ministers enacted Decree-Law No. 20/2008, establishing the National Petroleum Authority (NPA) to manage Timor-Leste's petroleum resources in the Joint Petroleum Development Area in the Timor Sea, as well as in Timor-Leste's territory. The NPA began operating on 1 July 2008.

While the draft legislation was being discussed, La'o Hamutuk raised concerns[8] that the NPA law violates both the Constitution and the Petroleum Fund Act. In particular, we thought that it should have been established by a Parliamentary Law, and that its budget should have been part of the State Budget. In addition, as the Petroleum Fund Act requires that all petroleum-related revenues be deposited into the Petroleum Fund, La'o Hamutuk recommended that all revenues for operating the NPA be paid out of an appropriation from the State Budget, rather than taken directly from oil company payments. Unfortunately, the State Secretariat for Natural Resources (SSRN) and the Council of Ministers did not accept our suggestions.

The Constitution gives Parliament the responsibility to oversee government budgets, as well as to approve them. However, the NPA is not mentioned in the State Budget for 2009, neither within the State Secretariat for Natural Resources budget nor as an autonomous agency. We encourage Parliament to carry out your Constitutional responsibilities and to ask the Government to include the NPA budget for 2009 as part of the General Budget of the State.

Although revenues from petroleum activities in the Joint Petroleum Development Area bypass the Petroleum Fund Act and pay for NPA operations relating to that area, the NPA does not yet receive any income from petroleum activities in Timor-Leste's sovereign territory, even though it is responsible to regulate such activities.

La'o Hamutuk asked SSRN and the Ministry of Finance to explain how the NPA will pay for its operations relating to Timor-Leste's territory, and were told that one million dollars is allocated for the NPA buried in the SSRN budget, under the title "Assistencia Tecnica/Professional Services"[9] in the appropriation for the National Directorate for Natural Resources Policy. This NPA subsidy takes up nearly half of the total Goods and Services appropriation for SSRN, although it is not mentioned in Budget Book 1, nor in SSRN's action plan.

[8] La'o Hamutuk submission to the State Secretariat for Natural Resources regarding the Draft Decree-law to establish a National Petroleum Authority, 10 June 2008. Available at http://www.laohamutuk.org/Oil/PetRegime/NPAlaw/08RestructIndex.htm.

[9] OGE 2009, *Documento Orcamental No. 2,* page 62

No legislative consultation planned

La'o Hamutuk has not read the Action Plans of every Government Ministry and organ. We have reviewed some, and are concerned about what they leave out. The Ministry of Education Action Plan is missing from Budget Book 1 submitted to Parliament (although it is included in the English version[10] provided to La'o Hamutuk by the Ministry of Finance).

During 2009, the Government plans to promulgate several laws and decree-laws relating to La'o Hamutuk's areas of work. The Action Plans for the State Secretariat for Natural Resources (SSRN) include legal creation of a National Oil Company and an Institute of Petroleum and Geology, as well as laws on Petroleum Optimization, Petroleum Draining (Depletion), and Minerals. The State Secretariat for Energy Policy plans to enact a National Energy Law. The Ministry of Economy and Development Directorate of Environment plans to implement laws on environmental impact evaluation and pollution control (even though these laws have not yet been passed).

All of these proposed laws cover complex, technical areas which can have both positive and negative consequences for Timor-Leste's citizens. All of them are areas where other countries without effective legislation, strictly enforced, have had disastrous experiences. All of them cover areas where powerful vested interests, including foreign companies, have incentives to pressure for weak laws that they can easily circumvent.

However, none of the Action Plans include any socialization of policy papers or public consultation on draft laws before they are passed. It is also unclear which will be decree-laws enacted secretly by the Council of Ministers, and which will be submitted to Parliament. We encourage Parliament, as representatives of the people responsible to oversee and establish fundamental policies of the nation, to ensure that these laws are carefully considered, with inputs from as wide a range of experts and interested parties as possible. Please ask the relevant organs to perform adequate public consultations before approving these laws. We would be happy to work with you to develop guidelines for a meaningful public consultation process.

Last year, the SSRN Action Plan included public consultation on the NPA Law. When such consultation didn't happen on schedule, La'o Hamutuk wrote an open letter[11] reminding the Secretary of his commitment; a brief public consultation soon followed. We are concerned that the Government has reacted by removing consultation from its Action Plans, and Parliament should not accept this undermining of democratic participatory processes.

To avoid such problems in the future, we encourage Parliament to enact a law on public consultation which would spell out necessary steps prior to enactment of decree-laws and laws, including socialization of drafts, opportunity for public input, publication of all submissions received, and careful deliberation on all points raised before the legislation is approved.

Thank you very much for your consideration of our submission, and La'o Hamutuk is always ready to assist Parliament in any ways you find helpful to enact the best State Budget possible.

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[10] See http://www.laohamutuk.org/econ/OGE09/OGE09Book1En9Dec08LHs.pdf, pages 270-283.

[11] The letter is available at http://www.laohamutuk.org/Oil/PetRegime/NPAlaw/LH-SSRN-NPA23May08En.pdf