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24 February 2015

To: His Excellency Dr. Rui Maria Araujo, Prime Minister of RDTL

Cc: Minister of Finance Santina Cardoso
Minister of Planning Xanana Gusmão
Members of RDTL National Parliament
President Taur Matan Ruak
Media and public

Please review revenue projections and total expenditures as you revise the 2015 state budget.

Dear Excellencies,

Like everyone in Timor-Leste, we look forward to great things from the Sixth Constitutional Government that was sworn into office last week. The new Prime Minister faces tremendous challenges, and we hope that he and all of us will be able to move this beloved country in a more sustainable, equitable and democratic direction. We are ready and willing to help in this process.

One of the consequences of restructuring the Government is that the 2015 General State Budget, promulgated less than two months ago, needs to be revised. Certainly, the Rectification Budget will have to shift money from agencies which no longer exist and add lines for new institutions. However, we hope that Government and Parliament will conduct a broader review and make more fundamental changes. As this letter explains, we believe the that revised 2015 State Budget should be based on an Estimated Sustainable Income (ESI) from the Petroleum Fund of $450 million,[1] with total expenditures of $1,135 million or less.

Oil prices and revenues have dropped markedly since the budget was prepared.

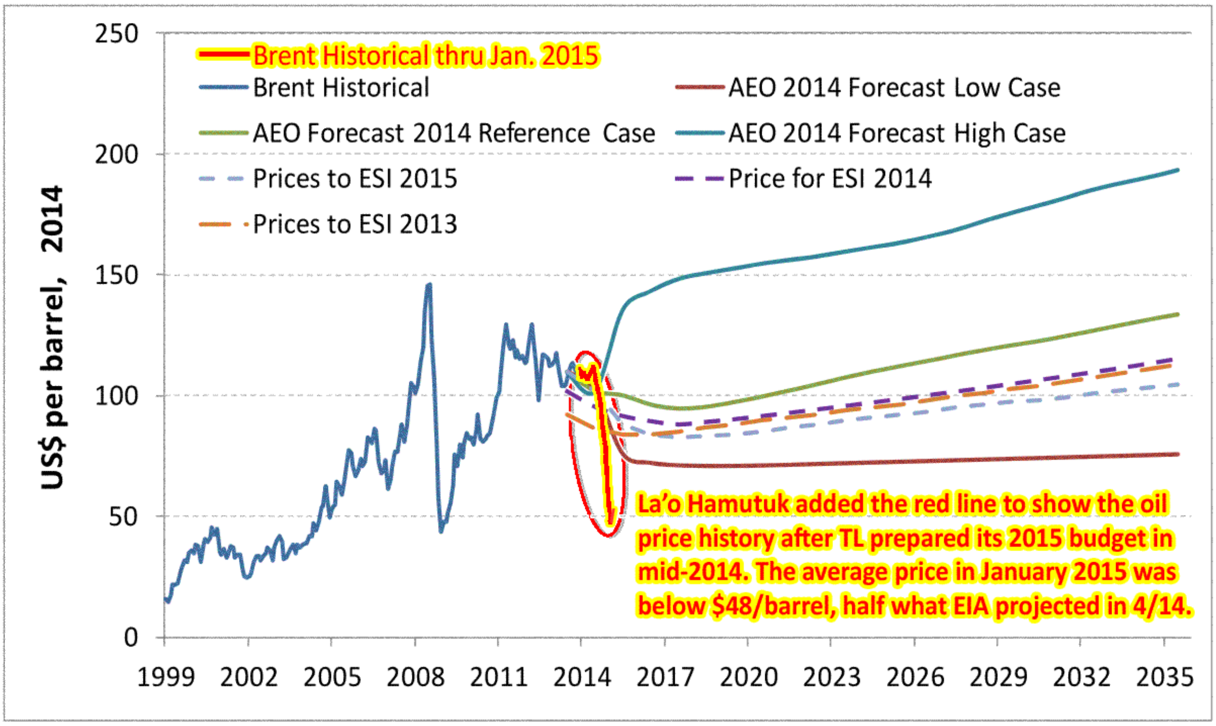
When the 2015 budget was proposed to Parliament last October, its petroleum revenue projections were based on price estimates which the U.S. Energy Information Administration had published in April 2014.[2] At that time, the world market price of a barrel of Brent crude oil was

[1] The Estimated Sustainable Income is the amount which could theoretically be withdrawn from the Petroleum Fund every year, forever, to be replaced by either petroleum revenues or investment returns. Under Timor-Leste's Petroleum Fund Law, ESI is 3% of the total of the current balance in the Fund and the expected revenues for oil and gas fields with approved development plans, corrected for Net Present Value. Bayu-Undan and Kitan are the only such fields in 2015.

[2] Annual Energy Outlook 2014, http://www.eia.gov/forecasts/aeo/index.cfm

$108. As we all know, prices unexpectedly fell sharply starting in July; the Brent price during January 2015 averaged $48/barrel. It would be foolhardy to continue to budget based on information which is clearly no longer correct.

Figure 2.6.3.1.1: Historical Changes and Future Projections in the Brent Oil Price ($ per barrel)



Source: PF Administration Unit (2015 Budget Book 1) Updated prices from U.S. Energy Information Administration

According to Book 1 of the 2015 RDTL General State Budget, the Petroleum Revenue forecasts were based on a benchmark price of $108/barrel for 2014, dropping to $90 in 2015 and $87 in 2016. At that time, these lower projections appeared prudent, but subsequent events have shown them to be too optimistic. The average Brent price during all of 2014 turned out to be $99. According to the EIA's most recent published projections, Brent prices in 2015 are expected to average $58, rising to $75 in 2016.[3] However, the EIA pointed out that there is "very high uncertainty in the price outlook." The Petroleum Fund Law requires prudence, and the ESI calculation should use lower prices than the EIA Reference Case. Although there are no official projections for the longer term, we suggest that estimating $40/barrel or lower for 2015 and $45/barrel for subsequent years would be reasonable.

According to the Ministry of Finance's Sensitivity Analysis,[4] if the Brent price drops by $10/barrel, Timor-Leste's Estimated Sustainable Income will drop by $25 million. Using our suggested updated price estimates would reduce the ESI by about $125 million.

Although oil prices fell during the second half of 2014, Timor-Leste's oil revenues during 2014 totaled $1,816 million, slightly higher than the $1,705 million that had been prudently projected when the budget books were written. This would increase ESI by $3 million.

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[3] Short-Term Energy Outlook published 15 February 2015, http://www.eia.gov/forecasts/steo/

[4] Budget Book 1, Figure 2.6.3.2.3

On the other hand, ESI should be reduced by $3m because the Government transferred $100m more from the Petroleum Fund in 2014 than the ESI calculation in the 2015 budget expected.[5]

The rising U.S. dollar and falling oil price have additional effects.

The fall in the global petroleum price, which has been accompanied by a significant rise in the U.S. dollar relative to currencies in countries Timor-Leste imports from and invests in, has other results which lead us to reduce the state budget:

- The rising dollar also means that the Petroleum Fund's investments in non-USD-denominated securities have lost value, as the value of the Fund is calculated in U.S dollars. The Central Bank of Timor-Leste reports that the balance in the Fund dropped by $426 million in 2014 due to these foreign exchange losses, reducing the return on investment earned by the Fund last year by about one-third.[6] As a result, the Fund earned a nominal return of 3.3% during 2014. After correction for U.S. inflation rates, this is a real return of about 2.5% – less than the ESI formula is based on. This amount of foreign exchange losses would reduce ESI by $13 million.
- If the oil price remains low, the amount of oil and gas which can be profitably extracted from Timor-Leste's known reserves will be less. The companies will not find it commercially justifiable to suck up the last drops (which will shorten Bayu-Undan's life and reduce its total production), and it will be impossible for Timor-Leste to find another company to continue operating the field after ConocoPhillips stops.[7] Even before the recent oil price drop, the 2014 and 2015 state budgets each projected less production from Bayu-Undan than had been projected in the previous budget, and independent auditors hired by Timor-Leste confirmed ConocoPhillips' reduced estimates of the recoverable reserve.
- Oil companies around the world are cutting back investment to explore and develop new fields. On 18 February, Woodside announced that it was suspending work on Greater Sunrise. While this could be a tactic to pressure Timor-Leste to concede on maritime boundaries and floating LNG, it also reflects an industry-wide pattern, responding to reduced income and uncertain future revenues. This will make it even harder to find new commercially-valuable oil or gas deposits in Timor-Leste's territory, and could further delay the long-promised bidding round for new Production Sharing Contracts.

However, the rising dollar and falling oil prices also brings some benefits to Timor-Leste, enabling us to save about $110 million when buying goods and services this year:

- The approved State Budget for 2015 included $115 million for vehicle and generator fuel. Since the wholesale price of diesel has dropped by nearly half since the budget was

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[5] Budget Book 1, pages 61-62 explains that the 2015 ESI calculation assumed that only the ESI ($632m) would be withdrawn from the Petroleum Fund during 2014, but by the end of 2014, $732 million had been transferred to the Treasury.

[6] The numbers are from the BCTL's Report on the Petroleum Fund for the fourth quarter of 2014, and our understanding of their significance was improved by discussions with BCTL and Ministry of Finance officials.

[7] In 2007, ConocoPhillips decided that the Elang-Kakatua field was no longer profitable and ceased operating the field. From October 2007 through March 2008, Timor-Leste tried to find another company to take it over, but was unsuccessful. In 2008, Brent Crude was selling for more than $100 per barrel, and the price went up by 31% while Timor-Leste was seeking a new operator.

prepared, this fuel will cost about $58 million less than was anticipated. The savings can be cut from the budget with no effect on state activities.

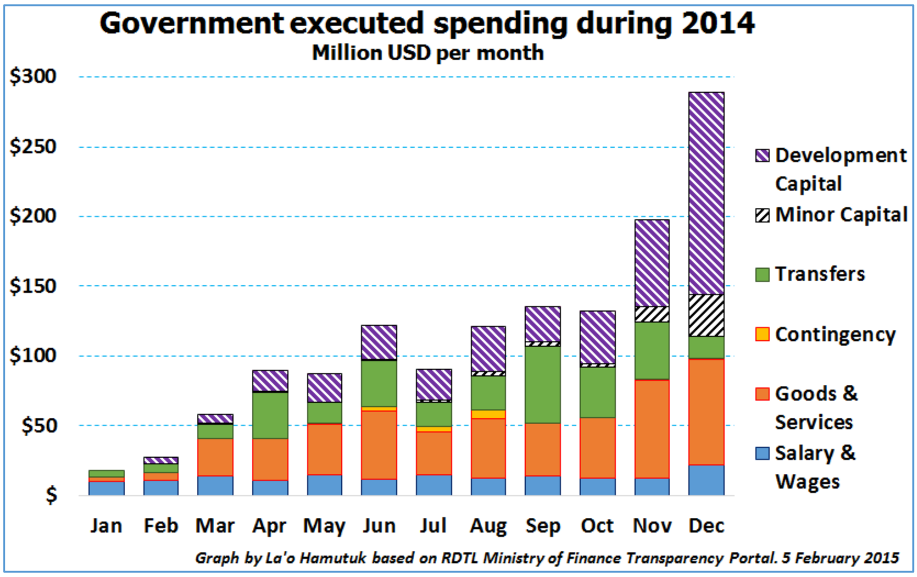
- Approximately 39% of Timor-Leste's state expenditures purchase goods imported from countries which do not use the U.S. dollar, and another 14% is for imported services. This adds up to about $497 million in non-fuel goods and $22 million in services. The USD-Rupiah exchange rate increased by 10% during the last 12 months, and there have been similar changes in the USD value relative to other countries we import from. Therefore, it will cost about USD $52 million less to purchase the same work and materials than it would have last year.

A smaller, better government should be less expensive.

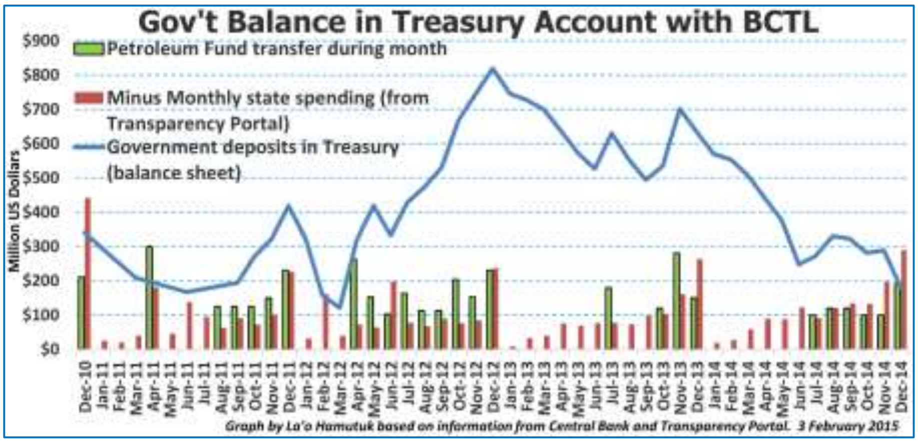
The Sixth Constitutional Government reduced the number of office-holders from 54 to 38. Although this does not mean that the entire Government is now 27% smaller (which would have reduced the budget by $420 million), it will save money, as some ministries have been combined and certain offices eliminated.

During his first speech as Prime Minister, Dr. Rui Maria Araujo said that the new Government would be more "efficient, effective and accountable." He promised that "We cannot continue allowing waste and the ineffective use of public monies" and stressed how important quality services, discipline, sustainability and integrity will be in the Sixth Constitutional Government.

Reducing waste and corruption, making the bureaucracy more efficient and requiring more productivity from public servants will enable the entire state apparatus to get more value for money, which is another reason to reduce the total budget. If appropriations are not reduced to prudent and realistic levels, the desire for good budget execution scores will encourage wasteful spending, as it has in the past.



We also encourage the new Government to take a new look at megaprojects which will cost a few million dollars in 2015 but could cost many billions in future years. Parliament and the public have yet to be told how much Timor-Leste will have to invest to build the components of the Tasi Mane project, the Oecusse Special Economic Zone, Tibar Port, Dili airport and other major public expenditures. We suggest that a thorough review be conducted of these projects, including their full life-cycle costs, benefits and economic viability. Timor-Leste should not commit its people's money through contracts, loans, or PPP agreements which could obligate the Seventh, Eighth, Ninth and Tenth Constitutional Governments to spend money that we don't have. La'o Hamutuk has suggested this to Parliament for several years, but perhaps the existence of a new Ministry with responsibility for Planning and Strategic Investment will provide the authority and expertise to carry out such studies. As the new Prime Minister said, "we must invest in a responsible and sustainable manner."



During 2013 and 2014, Government transfers from the Petroleum Fund were below the limits set by the Budget Laws. La'o Hamutuk agrees with this, as it is unnecessary (and illegal) to transfer more money from the Petroleum Fund than is required for a given year's expenditures. This was possible because in 2010-2012 the Government transferred much more from the Petroleum Fund than it was able to spend, accumulating an unreasonably large cash balance of $819 million in the Treasury by the end of 2012, which was spent down to $181 million at the end of 2014. Therefore, this cushion no longer exists. If budget execution rates stay as high as last year's 93%, new transfers from Petroleum Fund will have to pay for the great majority of state spending in 2015. Timor-Leste transferred $70 million from the Fund already in January 2015 – the first time money has ever been taken out of the Petroleum Fund during the first two months of a fiscal year.

Conclusion and recommendation

The changes to the Estimated Sustainable Income discussed above can be summarized as

	$638 million	**Estimated in the current 2015 General State Budget**
-	$125 million	Directly from lower oil prices in the future
-	$ 3 million	Overspending the 2014 ESI by $100 million
+	$ 3 million	Oil revenues in 2014 $111 million higher than prudent projections
-	$13 million	$426 million in foreign exchange losses during 2014 from Petroleum Fund investments
-	$50 million	Lower future production due to commercial considerations
	$450 million	**Revised ESI based on the above discussion.**

Therefore, the rectified 2015 General State Budget should be based on an ESI of $450 million. The original $1,570 million GSB for 2015 would require $1,372 million from the Petroleum Fund, which is $925 million above the ESI, more than three times the sustainable level and the highest excess transfer in Timor-Leste's history.

A sustainable budget would transfer only the ESI from the Petroleum Fund, which would be added to $170 million in domestic revenues and $65 million in loans received.[8] This gives a total fiscal envelope of $685 million – less than half of the enacted 2015 budget.

However, the drop in oil prices and rise in the U.S. dollar also allows some budget changes with no impact on state activities:

	$1,570 million	**Total expenditures in current 2015 General State Budget**
-	$52 million	Lower prices on goods and services imported from non-USD countries
-	$58 million	Lower prices for generator and vehicle fuel
	$1,460 million	**Revised state budget with no change in activities.**

It would be traumatic to cut the budget to $685 million this rapidly, so we suggest a less sustainable but more feasible middle ground. On 17 June 2014, the Council of Ministers approved a fiscal envelope of $1,300 million for the 2015 State Budget. Based on the discussion above, the identical amount of goods and services can be purchased today for around $110 million less, and eliminating some agencies and reducing waste should reduce the 2015 budget by at least $55 million more, so a recalculated "Yellow Road" fiscal envelope for 2015 would be under **$1,135 million.** This still requires transferring twice as much as the $450 million ESI from the Petroleum Fund, and we hope that future state budgets will be more sustainable.

Certain sectors have been consistently underfunded in recent state budgets and do not adequately serve Timor-Leste's young, impoverished and rural population. Therefore, we urge that appropriations for education, health, agriculture and rural infrastructure be maintained, even when the overall budget is reduced. Funding for these sectors is already too low, and we hope that improvements in efficiency and integrity will enable more value for the allocated money.

In closing, we appreciate that Dr. Rui Maria Araujo pointed out that "The establishment of the Petroleum Fund by the First Government enabled responsible and transparent resource management, for the benefit of current and future generations. It currently holds over $16 billion, which must be protected and invested sustainably." We hope that the entire Government and Parliament listens to these wise words, and that the revised 2015 State Budget is more consistent with economic realities and sustainable goals than recent ones have been. As always, La'o Hamutuk would like to help.

Thank you very much for your attention.

Juvinal Dias, Adilson da Costa Junior, Charles Scheiner, Pelagio Doutel, Niall Almond
La'o Hamutuk Economics and Natural Resources Team

[8] La'o Hamutuk continues to believe it is unsustainable and unadvisable to take out loans today which will have to be repaid when Timor-Leste has less money, a larger population and a greater need for state services. However, for the purposes of this discussion we assume that $65 million more will be borrowed in 2015 for projects already underway. We strongly discourage the signing of any new loan agreements.