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Timor-Leste: An Uncertain Future and an Unsettled Boundary

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Key Points

- The economy of Timor-Leste is dependent on revenues from oil and gas reserves, which are beginning to run out.
- The government will continue to over-withdraw from its petroleum revenues fund to pay for the infrastructure that is needed to grow the non-oil sector, meaning that the fund could be virtually empty by 2027.
- The Greater Sunrise area contains oil and natural gas deposits, the income from which will be essential to funding infrastructure needs of Timor-Leste, but there are concerns that the money will be wasted on unsustainable projects.
- The termination of the Certain Maritime Arrangements in the Timor Sea agreement means that Timor-Leste and Australia will have to negotiate a maritime boundary and, possibly, negotiate a new revenue split for the Greater Sunrise area.
- From a realist perspective, it is in Australia's economic interests to secure as much of the Greater Sunrise area as possible in future negotiations, but there are other important strategic factors that must also be taken into consideration.

Summary

Timor-Leste is the fourth-youngest country in the world, having achieved formal independence on 20 May 2002. The transition to independence was not smooth, as Indonesia claimed the territory for itself while suppressing the independence movement after colonial power Portugal withdrew in 1975. Since independence, the country has come a long way, creating an environment for successful development and achieving lower-middle

income status in 2011. GDP has grown strongly since 2006 from $600 million to $1.88 billion in 2015, averaging an annual growth rate of 13.5 per cent. Despite that strong growth, the country suffers from high poverty rates, poor infrastructure and fragile food security. With billions of dollars' worth of natural gas and oil on its doorstep, Timor-Leste needs to successfully utilise those resources and invest in sustainable economic growth if it is to continue development in the medium- to long-term future.

Analysis

Economic Circumstances of Timor-Leste

Timor-Leste's economy predominately runs on oil and gas. As noted by the Australian Department of Foreign Affairs and Trade (DFAT), oil and gas revenues accounted for 70 per cent of GDP and almost 90 per cent of total government revenue between 2010 and 2015. This continues to be the case, with 78 per cent of the revenue in the 2017 budget expected to be sourced from oil and gas earnings. Those earnings make up the country's Petroleum Fund, to which all petroleum income is directed. Money in the petroleum fund is saved and invested overseas, with withdrawals from the fund being guided by an Estimated Sustainable Income (ESI) benchmark; this has helped the Timorese economy to maintain growth levels despite significant declines in the oil price.

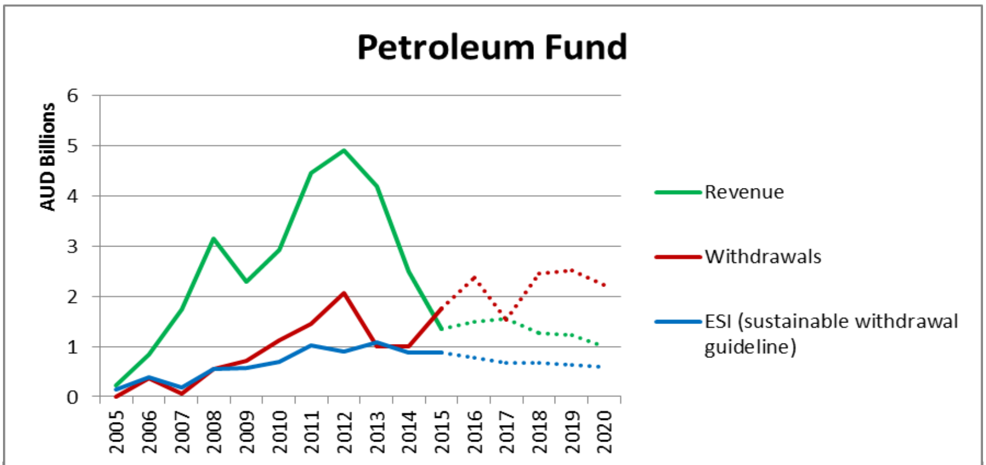

Figure 1: Based on statistics taken from the Timor-Leste 2017 State Budget and the Timor-Leste Petroleum Fund Annual Report. 2015.

While this economic model is designed to be sustainable, there is evidence that the petroleum fund could run out by 2027. Since 2012, annual revenue from the fund has significantly fallen from $4.9 billion to $1.3 billion in 2015, largely due to falling oil prices. The impact on the fund was worsened by the failure of the Timor-Leste Government to follow the ESI benchmark in its withdrawals from the fund. Consequently, 2015 saw the first decline in the fund's balance since its inception and the first instance where withdrawals exceeded revenue, as seen in Figure 1. In addition, according to government watchdog La'o Hamutuk, petroleum revenues are expected to end by 2020 due to depleted and inactive oil projects. If this were the case, the petroleum fund would become solely reliant on investment returns. The fund will become unsustainable if the government continues to exceed the three per cent withdrawal guideline. In a hypothetical situation assuming that petroleum revenues did end in 2020, Figure 2 (below) shows the severe impact that over-withdrawals could have on the petroleum balance over the following ten years (over-withdrawal figures based on the average of expected withdrawals from 2015-20).

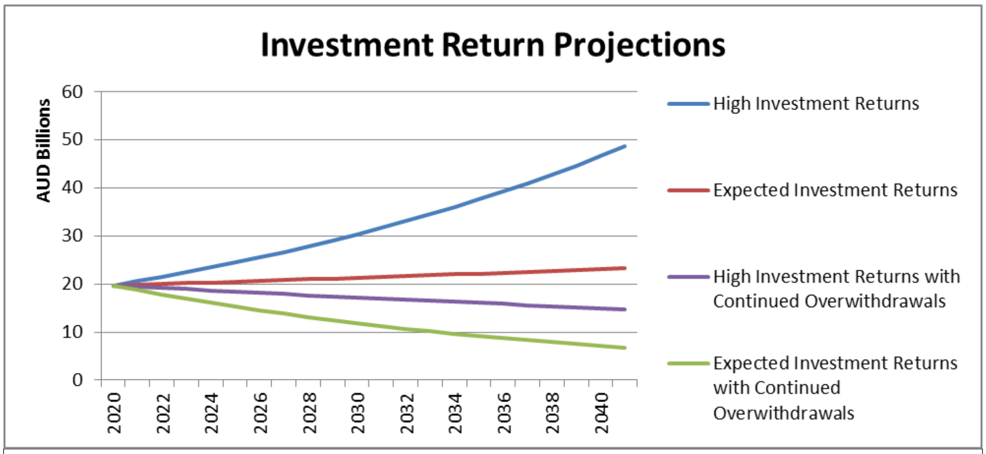

Figure 2: Based on statistics taken from the Timor-Leste Petroleum Fund Annual Report 2015.

While oil has been critical in maintaining the early stages of development in Timor-Leste, given the current situation and the possible future of the petroleum fund, there is an urgent need to diversify the economy before the oil reserves dry up.

It is concerning, therefore, that growth in the non-oil sector has been slowing in recent years. According to statistics taken from the approved 2017 budget, growth in the non-oil sector fell from fourteen per cent in 2008 to six per cent in 2014. While six per cent appears to be a strong figure for sector growth, given how small the non-oil sector is, this only equated to an additional $89 million being injected into the 2014 economy, which had a total GDP of $4.15 billion. Growth in this sector, therefore, has little impact in the short term for the economy. The non-oil sector is primarily made up of construction, retail, public

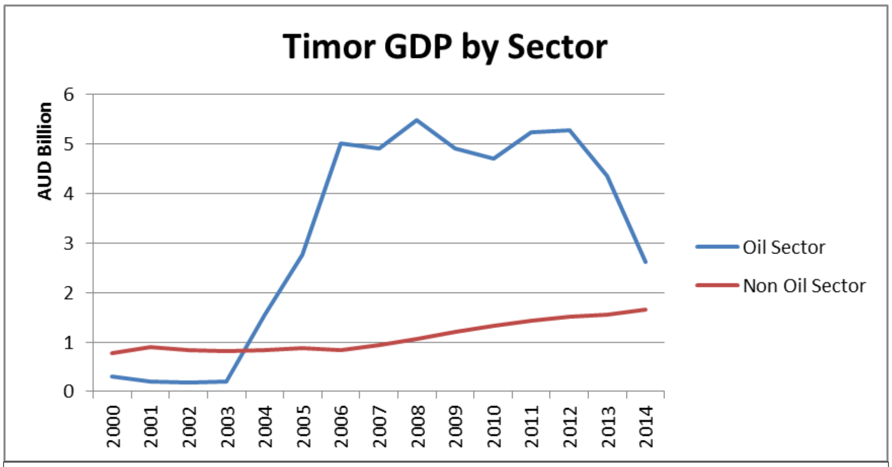

Figure 3: Based on statistics taken from the Timor-Leste 2017 State Budget.

administration and agriculture; all of these sectors individually contribute approximately $250 million to $360 million annually towards Timor-Leste's GDP.

Other than oil, the only other significant export is coffee. According to the latest available statistics, in 2014, coffee products accounted for fifteen per cent of all exports from Timor-Leste and had a value of $24.4 million. While a significant portion of total exports, the earnings from coffee still pale in comparison to the $132.2 million brought in by oil and gas exports. The trade balance in Timor-Leste is also heavily skewed towards imports, with the country exporting products worth a total of $164 million but importing $864 million worth of goods in 2014. Foodstuffs and vegetable products make up the bulk of imports at 31 per cent, followed by refined petroleum at 16 per cent. Diversifying the agricultural sector will serve to reduce the dependence of Timor-Leste on food imports, improve food security and help to increase non-oil revenue.

Strategy for Sustainable Growth

The long-term outlook for Timor-Leste's economy is problematic. As noted earlier, for the economy to become sustainable there needs to be significant growth in the non-oil sector. Growing the non-oil sector, however, will require increased government spending to improve the country's infrastructure, which will inevitably come at the expense of the petroleum fund, potentially exhausting the fund by 2030. To expand the non-oil sector without draining the petroleum fund, the government will need to strictly adhere to the ESI benchmark of three per cent and rely heavily on foreign investment, aid and domestic revenue. As noted in Figure 4, however, planned government expenditure far outweighs the combined funds received from Official Development Assistance, domestic income and the amount that can be sustainably withdrawn from the petroleum fund. Consequently, the Timor-Leste Government will be forced to over withdraw from the fund or seek to attain the additional funding through increased aid or foreign investment.

Figures in AU$ million	2015	2016	2017	2018	2019	2020
ESI Withdrawals*	$ 901	$ 712	$ 726	$ 742	$ 755	$ 762
Official Development Assistance Grants	$ 314	$ 288	$ 221	$ 153	$ 98	$ 56
Official Development Assistance Loans	$ 34	$ 151	$ 143	$ 437	$ 649	$ 448
Domestic Revenues	$ 240	$ 279	$ 291	$ 309	$ 329	$ 349
Planned Government Expenditure	$ -1,939	$ -2,037	$ -1,992	$ -2,046	$ -1,951	$ -1,911
Total	$ -451	$ -607	$ -611	$ -406	$ -120	$ -296

*Withdrawal figures from 2017 onwards assume that ESI guidelines were followed the previous years

Figure 4: Based on statistics taken from the Timor-Leste 2015 State Budget.

Adding to the concern is the amount of money that is being poured into projects that do not show much promise of long-term profitability. La'o Hamutuk expressed such concerns in November 2016 in a parliamentary submission:

> Most of Timor-Leste's non-renewable wealth will be squandered on unprofitable projects. When the money runs out about ten years from now, our economy will not yet be self-sufficient, sustainable or inclusive, but will

continue to rely on state spending and imports. When the Petroleum Fund is exhausted, the economy will collapse.[1]

The Tasi-Mane project is currently the largest infrastructure development in Timor-Leste, expected to account for 15 to 20 per cent of all infrastructure costs over the next three years. The Tasi-Mane project, which is managed by the national oil company, Timor Gap, aims to establish petroleum development in Timor-Leste through the construction of a supply base in Suai, refineries and petrochemical plants in Betano and liquefied natural gas plants in Beaço. The project has been repeatedly criticised by La'o Hamutuk, which has described it as a 'waste of money', and cited a lack of evidence that the project is commercially viable. If accurate, this assessment is concerning as, according to the International Monetary Fund, over-investment in projects with low returns will result in limited job creation and poverty reduction while depleting the petroleum fund and risking fiscal sustainability.[2] To prevent that, the IMF has recommended that projects should be subject to transparent and realistic cost-benefit assessments, which the Timor Gap company, thus far, has failed to provide.[3] It appears that the commercial viability of the Tasi-Mane project depends heavily on the amount of oil that Timor-Leste can access in the Greater Sunrise region and whether it can pipe that oil and gas to its shores.

Oil Fields and Boundary Disputes

Timor-Leste's access to the Greater Sunrise region hinges on upcoming negotiations with Australia. It was announced on 8 January 2017 that the Certain Maritime Arrangements in the Timor Sea (CMATS) agreement was terminated following allegations that Australia conducted espionage during the negotiations. Under CMATS, both countries had agreed to split the revenue from the Greater Sunrise region on a 50/50 basis and to freeze any negotiations on a permanent maritime border until 2056. Now that CMATS has been terminated, Timor-Leste is seeking to establish its border with Australia along the median line of both countries, following international convention. In maritime terms, median line refers to the line between the shores of two states which is in equal distance from either country in those cases where the Exclusive Economic Zones (EEZs) of both states overlap. A median line boundary would put the entirety of Greater Sunrise, along with gas condensate field Bayu-Undan, on the Timor-Leste side of the border.

Greater Sunrise is the main priority for the Timor-Leste Government because Bayu-Undan, which has been its primary source of oil and gas income since 2005, is predicted to run dry by 2020 with just under $200 million worth of gas condensate left in reserves. Greater Sunrise, on the other hand, is estimated to contain 5.1 trillion cubic feet of natural gas and 226 million barrels of condensate with a combined value of around $30 billion to $50 billion, depending on global commodity prices.

It is difficult to judge how the negotiations will evolve over the next year. As has been noted previously in the *Strategic Weekly Analysis*, any recommendations from the Conciliation

[1] La'o Humutuk, 'Submission to Timor-Leste National Parliament from La'o Hamutuk on the Proposed General State Budget for 2017', 7 November 2016, p. 18.
[2] International Monetary Fund, 'IMF Country Report № 16/183', June 2016, p. 32.
[3] La'o Humutuk, 'Submission to Timor-Leste National Parliament', p. 9.

Commission on a maritime border following negotiations will be non-binding. Instead, Timor-Leste and Australia will be expected to make further negotiations based upon the recommendations. If the following negotiations fail, both countries will submit the dispute to another adjudication or arbitration that will be binding. Unless Australia is lenient in negotiations, it will be some time before Timor-Leste can have access to the untapped wealth in the Greater Sunrise region. Additionally, even if all of Greater Sunrise ends up within the Timor-Leste border, it may not have access to 100 per cent of the revenues available. While CMATS has been terminated, both countries have previously agreed under the 2003 International Unitisation Agreement for Greater Sunrise (IUA) that the Greater Sunrise area would be jointly developed as a single unit. While the IUA is closely tied to CMATS, the termination of that agreement and the establishment of a maritime border does not mean necessarily that the IUA is no longer active, as noted in Article 27(3) of the IUA:

> In the event of permanent delimitation of the seabed, Timor-Leste and Australia shall reconsider the terms of this Agreement. Any new agreement shall ensure that petroleum activities entered into under the terms of this Agreement shall continue under terms equivalent to those in place under this Agreement.[4]

Further negotiations may need to take place, therefore, on either the revenue split from Greater Sunrise or on the termination of the IUA. This means that it will be some time before Timor-Leste has access to the oil and natural gas reserves and that could hold significant ramifications for the country's continued economic growth.

Australia's Rights and National Interests

Australia firmly believes that, rather than using a median line, the maritime boundary should be drawn along the continental shelf between Timor-Leste and Australia. In 2008, the Commission on the Limits of the Continental Shelf adopted recommendations confirming Australia's entitlement to a continental shelf that extends beyond the traditional 200 nautical-mile EEZ. According to Article 77 of the United Nations Convention on the Law of the Sea, Australia exercises sovereign rights over the continental shelf for the purpose of exploring it and exploiting its natural resources. If Australia and Timor-Leste were to define their borders according to Australia's continental shelf (which forms the 1972 Australia-Indonesia Seabed Boundary; the "gap" in the boundary with the former Portuguese Timor was never resolved because Portugal favoured a median line boundary), the majority of the Joint Petroleum Development Area (JPDA) and Greater Sunrise would lie on the Australian side of the boundary. From this perspective, it can be argued that Canberra has been very generous in its negotiations with Dili, in that 90 per cent of the income from the JPDA was allocated to Timor-Leste, together with numerous aid packages.

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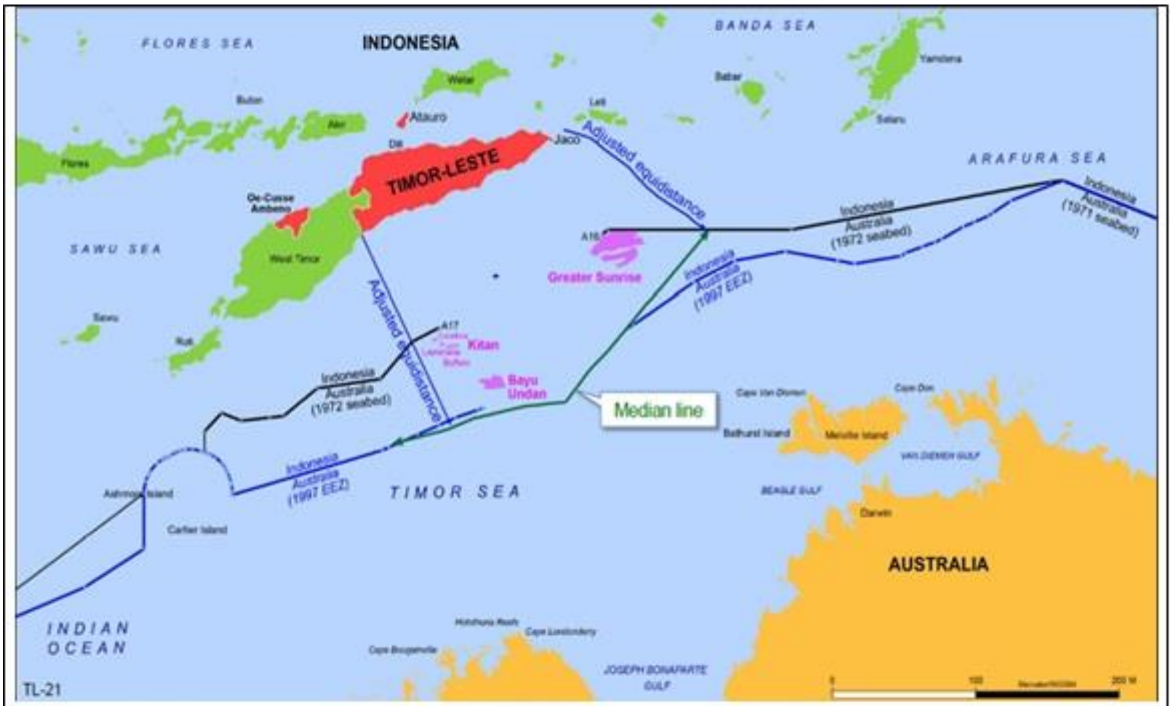
[4] Agreement between the Government of the Democratic Republic of Timor-Leste and the Government of Australia relating to the Unitisation of the Sunrise and Troubadour Fields', Timor-Leste-Australia, 6 March 2003, Article 27.



Taken from Timor-Leste's presentation at the opening session of the Conciliation Commission

From the perspective of Timor-Leste, however, the Australian claim of a continental shelf is irrelevant as both countries have overlapping EEZs as the width of the Timor Sea is less than 400 nautical miles. According to the Commission on the Limits of the Continental Shelf, any recommendations from the Commission, including the recommendation received by Australia in 2008, 'shall not prejudice matters relating to the delimitation of boundaries between States with opposite or adjacent coasts'.[5] Given the limited dimensions of the water body in question, the rights pertaining to the Timor-Leste EEZ perhaps should carry more influence in the boundary negotiations than the rights pertaining to Australia's continental shelf. On that basis, and putting aside the possible implications for the Australia-Indonesia boundary, establishing the maritime boundary along the median line between both countries would appear to be the most equitable approach.

From a realist perspective, however, it is clearly in the economic interests of Australia to advocate for a maritime boundary drawn along the continental shelf, thus putting the entirety of the Greater Sunrise area on the Australian side of the boundary. Such an outcome will obviously put Australia in a stronger position to negotiate any revenue split from the area with Timor-Leste. While an argument could be made that it is equally in Australia's national interests to ensure that Timor-Leste has maximum access to the revenue from the areas in question, thereby avoiding the possibility of an economic collapse, the earnings from the Greater Sunrise region will likely outweigh the economic consequences of a failed state on this country's doorstep.

In 2016, Australia gave approximately $100 million in aid to Timor-Leste. If this were to double to $200 million per year in response to worsening economic conditions in the

[5] United Nations Division for Ocean Affairs and the Law of the Sea, 'Commission on the Limits of the Continental Shelf (CLCS) Purpose, Functions and Sessions', n.d. http://www.un.org/depts/los/clcs_new/commission_purpose.htm#Purpose

country, it would still take one hundred years for aid payments to outweigh the economic benefits estimated to accrue from the $30-$50 billion worth of resources found in Greater Sunrise, assuming a 50/50 revenue split with Timor-Leste. Economically speaking, Australia can afford an economic collapse in Timor-Leste, but that does not take into account numerous other factors, however, such as the cost of political and social unrest in Timor-Leste, a possible surge of refugees and the reaction of the Australian public. Whether increased foreign aid in the event of economic collapse in Timor-Leste would be enough to overcome those factors would also need to be taken into consideration.

Timor-Leste is very unlikely to agree to a boundary based on the Australian continental shelf and is under no obligation to do so. Thus, the best outcome for both countries would be a maritime boundary drawn along the median line while keeping the International Unitisation Agreement for Greater Sunrise intact and re-negotiating the revenue split from it. Under the IUA, both countries agreed to develop Greater Sunrise as a single unit. CMATS, which was terminated, determined the revenue split of the Greater Sunrise. If the long-term economic future of Timor-Leste is to be secured, the revenue split will need to be shifted away from the previously agreed 50/50 arrangement and re-negotiated to allocate a higher proportion to Timor-Leste. That will be necessary as a median line boundary would put the entirety of Greater Sunrise on the Timor-Leste side of the border; a 50/50 split under those circumstances would certainly not be viewed as appropriate by the Timorese.

In negotiating a new revenue split, both countries could also take into account the potential for undiscovered oil reserves in the Timor Sea (but which do not look altogether promising), on the Timor-Leste side of the boundary. If Timor-Leste were reluctant to agree to any revenue split, and argue for the entirety of Greater Sunrise (and thus the termination of the IUA), in attempting to persuade Dili to share some amount of that revenue, Canberra may find it useful to negotiate an increase in the aid assistance that it provides to offset any financial loss to Timor-Leste in accepting a revenue split. In that way, Australia does not have to completely give into the demands from Timor-Leste and, from the Timorese perspective, any lost income can be compensated by an increase in Australian aid. On the diplomatic and public relations fronts, Australia would be seen domestically and internationally to be "doing the right thing" by agreeing to a median line boundary and increasing its development assistance funding to the struggling neighbour that it helped to bring into existence. It would also prevent the matter from going to further adjudication or arbitration, which would be binding and very likely to decide in favour of Timor-Leste at the ultimate expense of Australia.

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