

**TIMOR LESTE WATER AND SANITATION
SECTOR FINANCIAL MANAGEMENT ANALYSIS**

FINAL REPORT
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Acronyms and currency equivalents

ADB	Asian Development Bank
ADN	GoTL National Development Agency
Aldeia	‘Sub Village’ or hamlet
ANATL	Airport and Air Navigation Administration of Timor Leste
APORTIL	Port Authority of Timor Leste
AusAID	Australian Agency for International Development
BESIK	Bee, Saneamento no Igiene iha Komunidade = Community Water, Sanitation and Hygiene
BFML	Budget and Financial Management Law (of Timor Leste, 2009)
CoA	Chart of Accounts
CPV	Commitment and payment voucher
DNSAS	Direcção Nacional Serviço de Agua e Saneamento = National Directorate for Water and Sanitation
EDTL	Electricity of Timor Leste
FRA	Fiduciary Risk Assessment
FreeBalance	The GoTL/MoF financial management information system
GMF	Grupo Maneija Facilidade Be Mos Saneamento = Water Management Group
GoTL	Government of the Democratic Republic of Timor Leste
HSSP	Health Sector Support Program
IMfTL	Microfinance Institution
MDG	Millennium Development Goal
MoF	Ministry of Planning and Finance
MoH	Ministry of Health
MoI	Ministry of Infrastructure
MSATM	Ministry of State Administration and Territorial Management
O&M	Operation and maintenance
ODE	(AusAID) Office of Development Effectiveness
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
RWASH	Rural Water, Sanitation and Hygiene
RWSSP	The AusAID-funded Rural Water Supply and Sanitation Program (now designated the BESIK Program)
SAS	Serviço de Agua e Saneamento = (District) Water & Sanitation Service (within DNSAS)
SDF	Sub-District Facilitator
SDP	Strategic Development Plan 2011-2030 (draft)
SISCa	Servisu Intergradu Saude Comunidade = Integrated Community Health Service
Suco	Town or village

Currency equivalents: As at 12 May 2011 A\$1 = US\$1.0617

Executive Summary

This paper presents the findings of an initial financial management analysis of PFM systems impacting on the delivery of water and sanitation services to rural areas within Timor Leste. The overall objectives of the analysis are to:

- identify and understand the PFM related ‘bottlenecks’ to service delivery in the rural water and sanitation (RWASH) sector; and
- identify options to increase government ownership of the Australian -funded BESIK program (and any successor) which could include increasing funding through government systems in the sector.

‘Bottlenecks’ are considered from (arguably) a wider perspective than that of similar prior reviews, namely from the perspective of: *PFM-related factors serving to undermine the quality of GoTL expenditures on RWASH services*. This perspective necessarily entails review of bottlenecks stemming from government-wide and inter-agency factors as well as factors operating within individual agencies.

Section 2 of the paper, supported by Annex A, identifies PFM-related bottlenecks operating at three levels: Government-wide; inter-agency; and within individual agencies namely the Ministry of Infrastructure and Ministry of Health. The principle bottlenecks identified as operating *within* the Ministry of Infrastructure, and in particular the National Directorate for Water and Sanitation (DNSAS), are as follows.

- Despite the best efforts of the BESIK program the policy frameworks for national water supply and sanitation services have not yet been submitted to or endorsed by the GoTL.
- Earlier intentions to prepare a medium-term expenditure framework for the RWASH sector appear to have fallen by the wayside. This is a major impediment to policy dialogue regarding objectives for the RWASH sector and to closer alignment of GoTL and Australian funding inputs.
- Processes within MoI for annual allocation to individual Directorates of the Ministry-wide recurrent budget expenditure envelopes issued by the MoF merit closer examination
- Procedures for the commitment, payment and acquittal of expenditures are highly cumbersome.
- Procedures for the recording and reporting of DNSAS expenditures and their reconciliation with FreeBalance merit further examination.
- District Managers within DNSAS have virtually no control over their budgets, hence virtually no accountability for budget execution at District level.
- Logistical arrangements for the storage and delivery of equipment to the Districts appear haphazard.
- There is a range of inefficiencies associated with the management of cash advances made to District Managers.
- Sub-District Facilitators in particular appear to be substantially under-resourced to perform their functions.
- There is no internal audit function within MoI.

When viewed individually some of these weaknesses may appear relatively minor in terms of their potential impact on the quality of expenditure on water and sanitation services. In combination, however, and when compounded by weaknesses in Government-wide PFM systems, their impact on public expenditure quality is almost certainly substantial.

Section 3 considers action to address identified PFM-related bottlenecks in two main parts: threshold issues; and action priorities within MoI/DNSAS. The threshold issues considered are:

- Future delivery strategy for Australian development assistance.
- Bottlenecks and systems within which agencies?
- Which bottlenecks and related PFM systems?
- Which MoI/DNSAS services?

Recommendation 1: The following principles should guide future action to address PFM-related bottlenecks in the delivery of water and sanitation services:

- action should target systems improvements that are within the power of MoI to directly influence and implement, albeit in concert with other key GoTL agencies, especially MoF;
- within MoI, action should target PFM-related systems improvements at the District and community levels in particular;
- design of any successor to the BESIK program should place a high priority on Australian funding support for operation and maintenance of rural water supply facilities and, within this, a high priority on PFM-related actions to strengthen GoTL systems for the funding and delivery of O&M services.

Action priorities within MoI/DNSAS to address PFM-related bottlenecks are identified at three levels, the National, District and Community levels. At National level action priorities are:

- Medium-term and annual budgeting.
- Financial management information systems.
- Expenditure commitment and disbursement processes.
- Logistics.
- Clarification of O&M funding responsibilities

At District level action priorities are:

- Improved sizing and allocation of District operating budgets.
- Strengthened procurement processes at District level.
- Better management of imprest accounts.
- Trialling and cautious implementation of devolved financial management and procurement responsibilities.
- Training to support all the above.

At Community level action priorities are:

- Consolidate and extend PFM-related actions in train.
- Develop and implement action to apply an agreed policy on user charging.
- Trial alternative delivery models for O&M appropriate to a range of community circumstances.

Recommendation 2: Note and agree the above action priorities as guidance for the present BESIK program and design of any successor program.

Section 4 canvasses issues and options regarding GoTL ownership of any future program of Australian support and, in this context, the scope for greater future use of GoTL PFM systems for delivery of that support. It considers three (interrelated) approaches:

- Strengthened policy dialogue and joint decision-making in relation to the financing of rural water and sanitation services.
- Increased use of GoTL PFM systems as the conduit for future Australian funding support.
- A performance and/or output-based component for future Australian funding support for the sector based on jointly-agreed and realistic targets for improvements in delivery systems and the sustainability of outputs.

Policy dialogue can be strengthened at two key points: during the design and negotiation of any successor to the BESIK program; and during subsequent implementation through the incorporation of a performance-related component within Australia's total funding commitment.

Recommendation 3: In engaging with GoTL authorities on the design parameters for any successor to the BESIK program the AusAID Post should prepare for and be equipped to engage in substantive dialogue regarding:

- medium term GoTL and Australian funding commitments to future RWASH service delivery;
- future joint decision-making processes in relation to the budgeting for and use of GoTL and Australian funding inputs (including both MoI and MoF).

Minimum joint commitments by the partners should include:

- indicative funding commitments by both the GoTL and Australia for their funding of the RWASH sector;
- joint commitments to systems improvements and service delivery outputs (see also Recommendation 6);
- agreement and commitment to joint decision-making processes for the planning and disbursement of GoTL and Australian funding to achieve these outputs - preferably via the vehicle of a GoTL Treasury-managed account for some part of Australian funding (see also Recommendation 5).

As regards use of GoTL PFM systems, the BESIK program has taken several steps to better align its activities and their funding with DNSAS/MoH but funding of water supply and sanitation by the GoTL and the BESIK program respectively is proceeding along separate tracks.

Recommendation 4: Future fiduciary risk assessment and the design of any successor to the BESIK program should target the following areas as having the greatest potential for transitioning to greater use of GoTL PFM systems:

- Medium-term expenditure planning for future funding of water and sanitation services linking GoTL and external funding inputs.
- Related to this, development of a future budgeting system for rural water and sanitation capital expenditures enabling more orderly design, prioritisation and better linkage between budgeting for capital expenditure and operations and maintenance.
- Channelling of some significant proportion of future Australian funding through an account within the GoTL Chart of Accounts (see also Recommendation 5).
- Strengthening and subsequent use of GoTL procurement systems at the District level for operations and maintenance of water supply and sanitation facilities (to the extent not the responsibility of Water Facility Management Groups).
- Development to the point that AusAID may rely upon them of subsidiary accounting and reporting systems within MoI/DNSAS linking funding inputs as recorded in FreeBalance, funding inputs provided by Australia and program outputs.

Two options have been considered for channelling some part of future Australian funding support through ‘downstream’ components of the overall GoTL PFM system: through the GoTL Treasury Single Account (Consolidated Fund); or through a special account under joint GoTL-Australian management, within the GoTL chart of accounts but distinct from the TSA and subject to its own disbursement and acquittal procedures. Choice between these options should be guided by two main considerations: the extent to which they will best serve the underlying objective of enhancing future GoTL ownership; and the weights to be placed on ‘effectiveness’ and ‘efficiency’ as criteria by which Australia’s future funding contribution will be judged.

Recommendation 5: Subject to implementation of complementary short-term controls and ongoing support for related capacity building, AusAID consider channelling a significant proportion of funding for a successor to the BESIK program through the GoTL Treasury Single Account. However, this recommendation and the alternative option of using a special account under joint GoTL-Australian control should be the subject of further consideration and debate within AusAID in the light of a full fiduciary risk assessment. See also Recommendations 8-9.

As regards performance-based financing, funding of the BESIK program has not linked the level of Australian funding to the achievement of agreed targets for systems reform or other outcomes for the RWASH sector. Design of any successor program should aim to correct this.

Recommendation 6: Design of any successor to the BESIK program should seek to introduce a results-based financing component for future Australian funding of the RWASH sector. While the detailed design of this would need to consider many factors it should incorporate three main elements:

- GoTL (and Australian) adherence to indicative medium-term funding commitments in relation to the funding of rural water supply and sanitation services.
- Systems reform benchmarks, including but not limited to benchmarks for improvements in financial planning and management systems for RWASH service delivery.
- Output-related benchmarks, for example achievement of targets for moving individual water supply facilities at the village level to, and then keeping them at, a fully operational level.

Section 5 canvasses transitioning to a fully GoTL-led and managed program for the future O&M of rural water supply and sanitation facilities. The scale and content of any successor to the BESIK program is unknown at this stage and will be strongly influenced by AusAID decisions in relation to the future ‘architecture’ for Australia’s future development assistance funding as a whole. Section 5 assumes the continuation of a RWASH sector-specific program of some kind. It poses two main questions for any future program to support O&M of rural water and sanitation facilities: what would success look like in 5-7 years time; and how can we progress to success?

Recommendation 7: Subject to in-principle endorsement of this report’s findings and recommendations:

- its principle findings and recommendations be translated into Portuguese and form the basis of a workshop of senior MoI/DNSAS and MoF officials with a view to gaining their fuller understanding and endorsement of proposed directions and their agreement to establishment of a MoI/DNSAS/MoF reference group to progress these.
- the principle findings and recommendations also be used to steer in part a fuller fiduciary risk assessment and the team commissioned to design a successor program.

Recommendation 8: As key building blocks for dialogue in relation to future Australian funding support for any successor program the current BESIK program should aim to identify, over the next 9-12 months:

- The key GoTL agencies and decision-makers to be targeted for future policy dialogue in

relation to the RWASH sector.

- A medium-term (3 year) expenditure framework, incorporating potential funding from all sources, for the construction and maintenance of rural water supply and sanitation facilities that would enable the GoTL to achieve *and sustain achievement of*, for rural communities, the MDG water supply goal.
- Costed options for funding future O&M of rural water and sanitation services including prospective funding sources for each option and the performance targets that could realistically be set and achieved over a 5-year period for each option.
- As partial input to these options, a costed assessment of the resourcing needs of the SAS, SDFs and GMFs in order to adequately manage their O&M functions.
- Alternative models, preferably trialled, for the future delivery of MoI/DNSAS O&M services.
- Design parameters for a basic O&M financial management and performance reporting information system within MoI/DNSAS, linked but subsidiary to FreeBalance, sufficiently robust to meet both MoI/DNSAS needs and AusAID's financial and performance reporting requirements in respect of Australian funding for O&M channelled through the GoTL Treasury Single Account.

Resource availability and any supplementary requirements for these purposes would need to be considered by the BESIK program in consultation with AusAID. Without prejudice to that consideration it is unlikely that they could be fully addressed by the present short-term Budget, Planning and Finance Management Specialist alone.

Recommendation 9: Incorporation of earlier recommendations in the design of a successor to the BESIK program should address, in conjunction with the findings of a full fiduciary risk assessment, the following in particular:

- The specification of proposed funding commitments by the GoTL and Australia respectively to a 5-year program for upgrading the delivery of O&M services for rural water supply and sanitation facilities.
- As part of that, the identification of an appropriate performance-related component of any future Australian funding support, notably: (a) the proportionate amount; (b) the more detailed specification of performance-related targets and mechanisms to provide for GoTL access to the performance-related component.
- Whether other forms of future support, for example continued support for the design of new facilities and community engagement in the design process, would also enhance the sustainability of future investment in rural water supply facilities and how that could be demonstrated.
- The design of short-term controls needed to provide AusAID adequate assurance that any Australian funding provided through the GoTL Treasury Single Account was used for its intended purpose and was achieving acceptable value for money. The main focus of this design should be upon implementation of the (subsidiary to FreeBalance) financial management and reporting information system foreshadowed by Recommendation 8.
- The mechanism for annual joint GoTL-Australia decision-making in relation to performance review and budgeting of joint funding inputs to the O&M program for the GoTL fiscal year ahead.
- Targeted transition points within the life of the successor program for relaxation and cessation of short-term control measures accompanying Australian funding through the Treasury single account.
- Further review and prioritisation of other actions to address PFM-related bottlenecks in O&M service delivery, notably those pursuant to Recommendation 2.
- Resourcing of and task definition for the PFM technical specialist(s) necessary to support transition to the desired O&M program outcomes.

1. Introduction

1.1 Background

The Government of the Democratic Republic of Timor Leste (GoTL) attaches a high priority to achieving improvements in water supply, sanitation and personal hygiene including in rural areas. This has been reflected in increasing budget allocations made by the GoTL to the sector in recent years, especially budget allocations for capital expenditure. Australia provides support to the GoTL through the Ministries of Infrastructure (MoI) and Health (MoH) to strengthen the rural water supply and sanitation sector by funding the Bee, Saneamentu no Igene Komunidade (BESIK) program.

Working in partnership with the MoI and MoH the BESIK program assists the GoTL to construct water supply systems and sanitation infrastructure, promote good hygiene practices, strengthen local capacities (government, non-government organisations and the private sector) to deliver water systems and supports a community management approach to sustain water systems. Around \$40 million over five years (2007-2012) is being provided through this program.

An independent mid-term progress review of the BESIK program was undertaken in 2010.¹ It recommended the program transition from a standalone project to a program that is increasingly owned and led by government which could include greater use of government financial management and procurement systems. An understanding of Public Financial Management (PFM) systems in the sector is needed before a more comprehensive risk analysis of transitioning the program in this way can be undertaken. This paper presents the findings of an initial PFM analysis.

1.2 Objectives of the analysis

The overall objectives of this analysis are to:

- identify and understand the PFM related bottlenecks to service delivery in the rural water and sanitation (RWASH) sector; and
- identify options to increase government ownership of the program which could include increasing funding through government systems in the sector.

To these ends the analysis has:

- examined the existing PFM systems of the GoTL, MoI and MoH to identify bottlenecks in the current PFM systems that are constraining service delivery (Section 2 and [Annex A](#));
- identified possible actions to address PFM-related bottlenecks (Section 3)
- reviewed the scope and options for future use of GoTL PFM systems in delivering Australian support for the RWASH sector (Section 4); and
- identified priorities for PFM-related actions under BESIK (until mid-2012) and design of any successor program (Section 5).

The findings and recommendations of the analysis are in part intended to provide input to a more comprehensive fiduciary risk assessment and to a full design process for a successor to the BESIK program, both expected to be initiated later in 2011.

¹ BESIK Program: 'Report of the Mid-Term Independent Program Review', Final (June 2010).

1.3 Methodology

Prior reviews, including reviews in 2010 of the GoTL's PFM systems and their impacts on service delivery in the health, education and water and sanitation sectors, have already identified a range of PFM/procurement bottlenecks impeding service delivery. The present analysis has aimed to:

- update and confirm financial management bottlenecks identified by prior reviews;
- identify additional bottlenecks that have not, arguably, been sufficiently explored by prior reviews;
- identify practical options and priorities that offer realistic opportunities to deliver sustainable improvements in water and sanitation services to rural users.

The terms of reference for the analysis called for the review of PFM-related service delivery bottlenecks and possible action to address them in both MoI and MoH. Drawing largely on a prior review² the present analysis includes a summary of PFM-related bottlenecks in the MoH. However, the MoH currently plays a limited role in the delivery of water and sanitation services. It is considered that action to address PFM-related bottlenecks in that Ministry would be better designed and implemented through the HSSP support program (or any successor). Accordingly, future action priorities are focussed on the delivery of water and sanitation services by the MoI/DNSAS.

The analysis has been undertaken through a combination of documentation review ([Annex B](#)) and field study in Timor Leste. The field study occurred between 14-25 March 2011 in accordance with a program coordinated by the AusAID Post and BESIK advisers ([Attachment C](#)) including:

- discussions with GoTL officials, advisers and other stakeholders in Dili;
- visits to two Districts (Aileu, Ainaro) for discussions with GoTL officials and others at District level and to view water installations.

At the conclusion of field study an Aide Memoire outlining initial findings was prepared and presented to the AusAID Post, senior DNSAS and MoH officials, and BESIK advisers.

2. PFM bottlenecks impacting RWASH service delivery

2.1 Meaning of 'bottlenecks'

Rural water, sanitation and hygiene services in Timor Leste take three main forms: construction of water supply and sanitation facilities, their ongoing operations and maintenance, and complementary activities to promote personal and communal hygiene within communities. Numerous government and non-government organisations interact to deliver these services in ways that are complex, subject to frequent change and in some ways ill-defined (see Annex A).

Prior reviews of service delivery bottlenecks have tended to focus on PFM-related bottlenecks *within* particular agencies. For example, considerable attention has been paid to cumbersome procedures for processing requisitions and payments for goods and services and to logistical delays in the delivery of supplies to Districts and community groups.

² 'Report of Preliminary Observations on Service Delivery Bottlenecks in East Timor', report prepared by Kathy Whimp for AusAID (April 2010).

Bottlenecks of this kind are undoubtedly significant and the present analysis also addresses them in relation RWASH service delivery. However, while steps to address such bottlenecks should be pursued their alleviation or elimination would not, arguably, contribute substantially to sustainable improvements in the *quality of public expenditure*. That is determined by a far broader set of influences including Government-wide systems for budgeting and executing public expenditure and the delineation of responsibilities across agencies for the delivery of any given service.

The present analysis therefore considers ‘bottlenecks’ from the following perspective: *PFM-related factors serving to undermine the quality of GoTL expenditures on RWASH services*. This perspective necessarily entails review of bottlenecks stemming from government-wide and inter-agency factors as well as factors operating within individual agencies. The following findings are presented in summary form. More detailed descriptions of the PFM systems at the different levels that underpin these findings are documented at Annex A.

2.2 Government-wide bottlenecks

The GoTL, with support from development partners, has made significant progress in recent years in strengthening government-wide systems for financial planning and management. It has also been proactive in commissioning external reviews of the PFM system, most recently a review undertaken in 2008 of the GoTL procurement process and a further Public Expenditure and Financial Accountability assessment undertaken by IMF staff in 2010 following that funded by the European Union in 2007.

Nevertheless, recent reviews of the GoTL PFM system and associated capacity building suggest continuing weaknesses.³ Of these, the weaknesses most directly impacting on the quality of public expenditure in the RWASH sector are the following.

A robust multi-year perspective for fiscal planning is missing. Budgeted and actual public expenditure for capital development purposes in 2010 and 2011 has in broad terms reflected high-level priorities articulated in the GoTL’s (draft) Strategic Development Plan 2011-2030. But while the GoTL publishes budget estimates for the forthcoming and subsequent four fiscal years these are not linked in any explicit way to either the SDP or (where they exist) medium-term expenditure frameworks for individual sectors. Amongst the consequences of this, preparation of annual (and sometimes supplementary) budgets dominates the fiscal planning process. This in turn leads to compressed timetables for the detailed design, contracting and execution of small-scale capital works such as those typical in the RWASH sector.

The implications of capital spending for recurrent budgets are typically ignored. At the government-wide level the annual budgets for recurrent and capital expenditures are consolidated and considered through different processes, the Ministry of Finance taking the lead in setting budget envelopes for and determining routine recurrent expenditures and the Prime Minister’s Office playing a major role in determining the budget ceiling and priorities for capital expenditure. The resulting disconnects have led to what is widely regarded as under-provision

³ These recent reviews include, notably: ‘Timor-Leste Planning and Financial Management Capacity Building Program Mid-Term Review - World Bank Aide Memoire’ (May/June 2010); ‘Democratic Republic of Timor Leste: Public Financial Management - Performance Report’, Fiscal Affairs Department, IMF (August 2010); ‘Democratic Republic of Timor Leste: Report on the Observance of Standards and Codes (ROSC) Fiscal Transparency Module’, Fiscal Affairs Department IMF (November 2010); Democratic Republic of Timor-Leste: 2010 Article IV Consultation—Staff Report; Joint World Bank/IMF Debt Sustainability Analysis; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Timor-Leste, IMF Country Report 11/65 (March 2011).

for operations and maintenance of newly-constructed capital facilities including in the RWASH sector.

Budget planning and implementation capacity in line Ministries remains weak. This factor is elaborated below by reference to the Ministry of Infrastructure (Section 2.4).

Institutional responsibilities and procedures for government procurement have been in a state of flux for some time while less competitive procurement methods have become more prevalent. Procurement functions are dispersed across the Ministry of Finance (MoF), line Ministries and a proposed Procurement Commission and Procurement Technical Secretariat. Decree Law 2/2010 introduced special procedures for awarding construction work up to US\$250,000 to local companies located in the sub-districts that clearly diminish requirements for competitive tendering.

Independent internal and external audit processes are lacking. A recent review found that “Despite the presence of approximately 200 auditors and inspectors across various areas of government, outputs and value creation are low. Most internal auditors have undergone little, if any, training and because of differences in perceptions about the role of the function, their activities are provided with variable levels of guidance and oversight.”⁴ While the GoTL’s annual financial statements are audited by an external commercial auditor appointed by the GoTL a fully independent national audit institution has yet to be established. The external audit is limited to a financial audit. The external auditor does not perform performance audits and does not include financial management processes in line Ministries and agencies.

Other weaknesses include the absence of data on budgets and expenditures on a well-developed program basis, the absence of systematic reconciliations between the personnel records of line Ministries and the Treasury payroll data base, and - following a significant devolution of responsibility to line Ministries for authorisation of virements between budget line items - the potential for significant variations at line item level between budgeted amounts and actual expenditures. Amongst other considerations the absence of expenditure data on a program basis makes it difficult to readily identify overall GoTL budgets for and actual expenditures on RWASH services.

The MoF prepared in 2010 a strategic plan for public financial management intended to address key weaknesses and with support from the Public Financial Management Capacity Building Program is making continuing progress in addressing them. But so long as they persist they are a substantial negative influence on the quality of public expenditure in the RWASH sector and, in several respects, partly or wholly beyond the direct ability of the MoI to address.

2.3 Inter-agency bottlenecks

The dispersal of funding responsibility for water and sanitation facilities across GoTL agencies and decentralisation of some decision-making is, whatever their merits, blurring responsibilities and accountabilities for financial management on the one hand and service delivery on the other. In 2011 the bulk of funding for both urban and rural water and sanitation facilities and services has been formally appropriated to agencies/funds other than DNSAS:

- The Infrastructure Fund to be serviced by the National Development Agency and overseen by a Council of Administration headed by the Prime Minister is budgeted to fund US\$65.0

⁴ ‘Development options for internal audit in Timor Leste’, Colin Hall, Draft, (March 2011), page 2.

million for MDG water and sanitation and MDG housing for vulnerable groups (the latter to include a water and sanitation component).

- The Ministry of State Administration and Territorial Management is budgeted to fund by way of transfers and capital expenditure US\$26.6 million for the Decentralisation Development Program/Package (PDD1 and PDD2), a significant proportion of which will flow to water and sanitation services.
- DNSAS's *total* budget appropriation for 2011 is US\$5.0 million. However DNSAS will continue to provide design and supervision services for the delivery of capital projects funded through the other agencies while retaining ongoing funding responsibility for their maintenance.

Thus DNSAS's internal budgets for 2011 expenditure on water facilities bear no relationship to the amount formally appropriated to DNSAS. Rather, they are primarily compiled by negotiation between DNSAS and the agencies to which the greater part of funding is now formally appropriated. This substantially disconnects accountability for financial management of budget appropriations from accountability for service delivery.

A partial manifestation of this is lack of clarity at the District level in responsibilities for quality control of capital works delivered by private contractors. DNSAS District Managers have reported a range of difficulties in oversighting the quality of work being performed on water and sanitation facilities and associated progress payments and have recommended a number of improvements.⁵ However, decision-making responsibility for these matters as they arise for Local Development Program projects rests ultimately with the District Administrator funded by MSATM and DNSAS's ability influence that decision-making is problematic.

2.4 Ministry of Infrastructure bottlenecks

Any review of 'bottlenecks' must of necessity focus on areas of current weakness and potential improvements. **It is important, therefore, to preface the following outline of bottlenecks in MoI by acknowledging its undoubted commitment to strengthening its PFM systems (insofar as it can influence these).** Prior assessment has rated DNSAS as among the better performers within the GoTL in terms of its financial management. With the support of the BESIK program it has taken a number of positive steps including a more inclusive approach to annual budgeting via the establishment of a Planning and Budgeting Working Group and development of the Water Asset Information System as a tool for monitoring progress. None of the following is intended to under-rate the significance of progress already made or to question MoI's commitment to continuing improvement.

Despite the best efforts of the BESIK program the policy frameworks for national water supply and sanitation services have not yet been submitted to, much less endorsed by, the GoTL. At a broad level there is no question that the GoTL attaches a high priority to meeting rural water MDG targets and that this priority is being reflected in the Government's annual budgets. The 2011 Budget Book 1 indicated "For 2011, the Government has determined the following expenditure priorities: PN1: Infrastructure: electricity, roads and bridges, water and sanitation ...". However, national water supply and sanitation policies to underpin this Government priority by directing investment activities, clarifying financing rules and clarifying the roles and responsibilities of the various stakeholders remain in draft form. This prolongs uncertainties and scope for disputes in the delivery and financing of RWASH services.

⁵ See summary report of District Managers Workshop, February 2011, on 'Analysis of PDD process 2010'.

Earlier intentions to prepare a medium-term expenditure framework for the RWASH sector appear to have fallen by the wayside. The report of the Mid-term independent progress review noted that (page 14) “An RWSSP adviser is now working with DNSAS to strengthen public financial management tools and develop a medium term budget plan for DNSAS which includes capital and recurrent costs.” Subsequent progress reports make no mention of further work in this area. Planning and budgeting effort appears almost entirely focussed on preparation of annual budget submissions and associated Action Plans for the year ahead. There is no agreed plan articulating what it will cost to build and sustain water and sanitation facilities and services of the standard required to meet agreed objectives or how this will be financed. This is a major impediment to policy dialogue regarding objectives for the sector and to closer alignment of GoTL and Australian funding inputs.

Processes within MoI for annual allocation to individual Directorates of the Ministry-wide recurrent budget expenditure envelopes issued by the MoF merit closer examination. Budget allocations within MoI for wages and salaries are largely pre-determined by the number of permanent employees on the payroll and the scope to re-prioritise such expenditure from one year to the next appears limited. The extent to which provisions for goods and services, including in the case of DNSAS provisions for recurrent repairs and maintenance and (in 2011) the salaries of Sub-District Facilitators, are determined by reference to government priorities has not been tested. However, they appear to entail a substantial element of ‘top down’ budgeting and the exercise of considerable influence by the MoI’s National Directorate for Administration and Finance.

Procedures for the commitment, payment and acquittal of expenditures are highly cumbersome. For example, process mapping by the BESIK Program indicates that submission of a Commitment and Payment Voucher to the Ministry of Finance entails some twenty discrete steps *within* MoI *before* it is submitted to MoF, while acquittal by District Managers of expenditure from their imprest accounts entails some 10 steps within MoI. It is understood that the Minister for Infrastructure personally authorises all commitment and payment requests and that this step alone may entail delays of two weeks or more in the processing of CPVs.

Procedures for the recording and reporting of DNSAS expenditures and their reconciliation with FreeBalance merit further examination. Line Ministries have a legal responsibility to maintain accounting records that reconcile with Treasury records as recorded by FreeBalance. As at the date of this draft report there appeared to be a substantial and as yet unexplained discrepancy (approaching 20%) between DNSAS’s records of its actual expenditure in 2010 and the totals reported by the Treasury in FreeBalance. There is doubtless an explanation for this but, pending that explanation, there appears good reason to examine more closely the system and procedures employed by DNSAS to reconcile its financial records with those maintained by the Treasury.

District Managers within DNSAS have virtually no control over their budgets, hence virtually no accountability for budget execution at District level. Annex A documents this. Moreover the amount budgeted to and managed by Districts (said to be US\$500 per month in 2011) is uniform across all Districts with no regard to the differing circumstances of individual Districts (e.g. population, degree of remoteness). There is no disaggregation of recurrent budgets at the District level as between the costs of administering the District offices and the costs of supplying maintenance services to the public, or as between the urban and rural areas within Districts.

Logistical arrangements for the storage and delivery of equipment to the Districts appear haphazard. These arrangements were not examined in any depth during field study. However, a brief visit to a DNSAS supply depot in Dili detected no obvious system in place for the storage

of supplies. Discussions indicated that even if equipment is available for delivery to the Districts its delivery can be delayed by factors as trivial as the non-availability of funds to pay truck drivers' travelling allowances.

There is a range of inefficiencies associated with the management of cash advances made to District Managers. These include: substantial delays in release of the first Quarter's advance in particular pending enactment of the annual GoTL Budget and issue of Expenditure Authorisation Notices by the MoF; an apparent 'policy' that District Managers travel to Dili to receive the cash (whether or not there is a banking/micro-finance facility operating in the District); and, according to the DNSAS Administration and Finance Department, regular difficulties encountered in getting District Managers to submit their financial reports and acquittals in a timely manner (leading to further delays in replenishment of their imprest accounts).

Sub-District Facilitators in particular appear to be substantially under-resourced to perform their functions. For example discussions with SDFs during field study indicated that some did not even have notebooks and, pending receipt of the first Quarter's cash advance to the District, were using their salaries to fund some operating expenses.

There is no internal audit function within MoI. The recent review of development options for internal audit in Timor Leste noted that, along with the Ministries of Defence and Foreign Affairs, the MoI was one of the three line Ministries amongst thirteen surveyed that had no internal audit/inspectorate function. The proposed organisation structure of the MoI under its new organic law does provide for the establishment of an internal audit and inspection unit but when and how this will be established and resourced is unclear.

When viewed individually some of the above PFM-related weaknesses may appear relatively minor in terms of their potential impact on the quality of expenditure on water and sanitation services. In combination, however, their impact is almost certainly substantial.

2.5 Ministry of Health bottlenecks

Within the MoH responsibility for delivery of sanitation and hygiene services rests primarily with the Environmental Health and Health Promotion Departments and with SISCa Family Health Promoters. Aside from funding of the SISCa the MoH budget commitment to the National Directorate for Community Health (within which the Environmental Health and Health Promotion Departments reside) is relatively small - just 2% of the MoH's total budget for wages, salaries, goods and services in 2011. It is understood that most if not all development funding for sanitation environmental health and promotion has been funded by the BESIK program.

PFM-related bottlenecks in service delivery by the Ministry of Health as identified by prior review are as follows.⁶

- ***Cascading from the centre.*** Funds and supplies cascade down through several layers of bureaucracy, while accountability cascades back up. Delays are possible and even likely at each layer in both the delivery of cash and materials, and in processing acquittals that are a necessary precursor to the next release.
- ***Resources are supplied in response to demand.*** Front-line service delivery units are resourced on a "pull" basis - they must both request funding (in most cases) as well as travel to access it. It is likely that the more remote facilities receive disproportionately less because

⁶ The dot points immediately following reproduce, in abbreviated form, findings in relation to recurrent resourcing bottlenecks contained in the 'Report of Preliminary Observations on Service Delivery Bottlenecks in East Timor'.

they have to travel further to get it. They receive less, yet their costs are likely to be higher because of remoteness.

- ***Control mechanisms focus on accounting for inputs.*** There is a heavy emphasis on accounting for how money was spent, but little attention is paid to what the spending achieved by way of service delivery. Input controls are of very limited effectiveness where cash and fuel (effectively, liquid money) are concerned, since there is no ‘auditable’ paper trail.
- ***Resourcing for service delivery at the sub-district level is bundled up with resourcing for administration at the district level.*** When coupled with the lack of accountability for service delivery outputs, it is possible that administration costs that are paid for at the district level are being privileged over the needs of service delivery at sub-district level.

The prior review concluded that “It will be almost impossible to achieve good accountability around personal payments made to staff in cash, while the emphasis remains on accounting for inputs rather than outputs. Moving to a greater focus on results seems like the only logical way forward.”

The present analysis notes that these bottlenecks largely mirror a number identified in Section 2.4 for the MoI. However, in relation to three matters at least the MoH appears to have progressed further than the MoI in seeking to strengthen its budgeting and financial management:

- Funding of Timor Leste’s District Health Services is appropriated on a District-by-District basis, providing greater potential to relate funding inputs to service delivery outputs at the District level.
- The Minister for Health has delegated authority for authorisation of commitment and payment vouchers to the Director General (up to US\$50,000) and the Vice Minister (US\$50,000 to US\$250,000).
- Procedures for the replenishment of imprest accounts appear to operate more smoothly in that the accounts are ‘topped up’ before 100% of prior funding has been acquitted.

Other assessment has suggested that the Ministry of Health has been amongst the best-performing line Ministries in terms of budget formation and execution.

2.6 Implications of the decentralisation agenda

Decentralisation of functions and funding to municipal councils will, in due course, entail significant changes in the workings of current PFM systems including those impacting on delivery of water and sanitation services. However, decentralisation policy development and implementation has been deferred until after the next national elections in 2012.

The MoI and MoH have been at the forefront of line Ministries in starting to plan for decentralisation of some of their functions to the District/municipal level. However, a recent report has noted that “it will be important for MOF to lay down a framework for responsible fiscal decentralization with adequate use of central government financial management standards, systems, monitoring, and control. In many countries without such a framework being in place before decentralization starts, governments have had to reverse course on decentralization strategies.”⁷ That framework is not at present in place. Its design and implementation will have a marked but as yet unknown influence on the ability of the MoI and MoH to address PFM-related service delivery bottlenecks at the District level and below. The present analysis’s

⁷ ‘Democratic Republic of Timor Leste: Report on the Observance of Standards and Codes (ROSC) Fiscal Transparency Module’, Fiscal Affairs Department, International Monetary Fund, (November 2010), page 11.

proposed priorities for strengthening PFM within MoI have the potential to support future decentralisation of water and sanitation service delivery responsibilities by strengthening the management capacity of the SAS (see Section 3).

3. Action to address PFM-related bottlenecks

3.1 Threshold issues

3.1.1 Future delivery strategy for Australian support

Both AusAID's draft delivery strategy for future support for the RWASH sector and the terms of reference for the present analysis infer that future Australian support will continue to be delivered via a program targeting this sector. However, an alternative strategy for Australia's future bilateral support for Timor Leste's development might seek to substantially reduce the number of discrete programs funded by Australia by, for example, 'block funding' of support for (say) 2-3 key GoTL development priorities to which Australia can contribute clear value-added. A related option, namely a broader 'facility' approach to support for infrastructure, has also been canvassed. Alternative approaches of this kind would have substantial implications for whether, and how, action to address PFM-related bottlenecks in RWASH service delivery would be prioritised and supported.

This threshold issue lie well outside the terms of reference for the present analysis and no recommendation is made in relation to it. The analysis assumes as a 'given' that Australia will continue to support a RWASH sector-specific program of some description by some means.

3.1.2 Bottlenecks and systems within which agencies?

PFM-related responsibilities for the delivery of RWASH services are dispersed across multiple agencies. The PFM systems and practices of these various agencies all impact on the quality of public expenditure on RWASH services. A threshold issue for the BESIK program and any successor is the extent to which they should attempt to address PFM-related bottlenecks as they manifest themselves within all these agencies. This analysis has concluded that, while future policy dialogue will need to engage a range of key GoTL players including the MoF, future action to address PFM-related bottlenecks in service delivery should be focused on a single agency, namely MoI/DNSAS including the SAS.⁸

An attempt to address PFM-related bottlenecks within all of the agencies involved would entail a greatly expanded advisory input tending to duplicate other programs, notably the public financial management capacity building program within the Ministry of Finance and financial management technical assistance provided to the Ministry of Health through the HSSP. The link between the 'systems-wide' focus of that input and RWASH service improvements at community level would be difficult to demonstrate. The better and more pragmatic approach is to focus on the PFM-related bottlenecks to service delivery that are within the ability of the MoI, with support from other GoTL stakeholders, to address.

3.1.3 Which bottlenecks and related PFM systems?

Section 2 has identified PFM-related bottlenecks within MoI operating at national and sub-national levels. While future support to address PFM-related bottlenecks should address each level *a major focus of future support should be upon strengthening PFM and related systems at the District level and below*. Strengthening of PFM-related systems at sub-national levels is

⁸ The recent Organic Law for MoI foreshadows a split of DNSAS's present water and sanitation functions between two new Directorates: a National Directorate for Water Services and a National Directorate for Sanitation. It is unknown at this stage how this may impact on service delivery responsibilities at the District/Sub-District levels.

primarily within MoI's sole competence to address. As importantly, it is PFM-related improvements at the District level and below that will likely have the most immediate and potentially demonstrable impact on the quality of services provided to end-users. Moreover they would support the longer-term GoTL decentralisation agenda.

3.1.4 Which MoI/DNSAS services?

This analysis recommends a substantial (but not total) focus on the operations and maintenance of existing rural water facilities.

- Successive reviews have highlighted the importance of O&M as a prime determinant of the sustainability of past and current investments in extending rural water supply facilities.
- O&M functions may be least vulnerable to flux in DNSAS's functional responsibilities.
- The GoTL has budgeted for increased funding of O&M in 2011 – a future funding contribution by Australia would support and help consolidate this positive development in future years.⁹
- Expenditure on O&M has potentially big returns in terms of achieving sustainable improvements in water services and these could be demonstrated over time using the Water Information System the BESIK program has developed.
- The delivery by DNSAS/SAS of ongoing O&M needs to address a number of challenges¹⁰ but is open to a range of practical improvements in financial planning, budget execution and logistics.
- There would be scope to trial (carefully) decentralised budgeting/financial management responsibilities for O&M at District level.
- There would be scope to pilot-test various models for improved delivery and/or contracting management and supervision processes at District levels including models entailing the contracting of private sector O&M providers if/where private sector capacity exists or can be developed.
- A focus on O&M would have direct potential to demonstrate to Sub District Facilitators and water facility management groups that their engagement in rural water supply and feedback has a real impact on future priorities for O&M spending and service delivery sustainability.

Recommendation 1: The following principles should guide future action to address PFM-related bottlenecks in the delivery of water and sanitation services:

- action should target systems improvements that are within the power of MoI to directly influence and implement, albeit in concert with other key GoTL agencies, especially MoF;
- within MoI, action should target PFM-related systems improvements at the District and community levels in particular;
- design of any successor to the BESIK program should place a high priority on Australian funding support for operation and maintenance of rural water supply facilities and, within this, a high priority on PFM-related actions to strengthen GoTL systems for the funding and delivery of O&M services.

It may be argued that adoption of these principles would entail an unduly narrow focus for future action to improve the quality of expenditure on RWASH services since 'everything depends on everything else' in public financial management. There is some validity in this. But having regard to signs of some disenchantment within the GOTL regarding the value added of high-

⁹ It is noted, however, that this increased provision has been appropriated under DNSAS Capital and Development for 'Infrastructure Assets' and appears to be destined for expenditure on capital equipment. If so, this would substantially narrow its potential impact on the quality of DNSAS's ongoing O&M services.

¹⁰ See, for example, 'Rural water supplies in Timor Leste: Community Based Operation and Maintenance - An Overview', R. Reed, BESIK Program Policy and Planning Specialist (March 2011).

level technical assistance, possible reductions in the scale of technical assistance AusAID is prepared to fund in future and the need to demonstrate tangible results in terms of improved service delivery there is a strong case for this narrower focus. A ‘narrower’ focus should not, however, be interpreted as implying a sole focus on funding support for O&M if it can be demonstrated that other forms of support would also enhance the sustainability of investment in rural water supply facilities (see also Section 5).

3.2 Action priorities within MoI/DNSAS

The following outlines priority areas for action within MoI/DNSAS consistent with the above principles. Areas that can be progressed over the remaining life of the BESK program and through the design of any successor program are elaborated in Section 5.

3.2.1 Action priorities at a central level

Medium-term and annual budgeting:

- There can be no substantive enhancement of policy dialogue in relation to Australia’s future funding support for the RWASH sector unless that dialogue can debate a medium-term expenditure framework for the sector. While it may gain no official endorsement at this stage, the BESIK program and any successor should nevertheless re-introduce as an action priority, in concert with DNSAS and MoF, the development of a medium-term expenditure framework incorporating options in relation to medium-term service delivery targets for the sector and realistic estimates of the GoTL, development partner and other funding inputs necessary to achieve *and sustain* them.
- As regards annual budgeting key needs are to: clarify current processes and criteria by which the MoI’s National Directorate for Administration and Finance allocates the Ministry-wide budget envelopes set by the Ministry for Finance to individual Directorates within the Ministry (including DNSAS); and build on current support for preparation of DNSAS budget submissions including strengthening of the quality and information content of its Annual Action Plans.
- MoI/DNSAS should also be encouraged and supported to advocate more widely for a multi-year approach to the budgeting of capital expenditures on rural water supply facilities that enables a more orderly process for design and contracting of such works; and for aligned consideration of the capital costs and estimated recurrent funding requirements of investments in rural water supply facilities. This will entail dialogue with other agencies that are, increasingly, driving capital expenditure decision-making for the sector.

Financial management information systems:

- Design and implementation of a subsidiary (second-level) financial accounting and reporting system within DNSAS, taking the GoTL Chart of Accounts as its start-point but establishing a subsidiary RWASH program based structure for the recording of GoTL and external funding of inputs linked to program outputs.
- Continuing development of financing-related performance indicators (e.g. unit costs of water supply and sanitation facilities, operations and maintenance) including benchmarks for ‘reasonable’ expenditures on per-facility capital and recurrent costs and indicators of the cost-effectiveness of O&M expenditures.

Expenditure commitment and disbursement processes:

- Detailed review and, to the extent feasible, streamlining of MoI expenditure commitment and disbursement processes aimed at reducing the number of steps/signatures required for commitment and disbursement.

Logistics:

- There are significant constraints in attempting to strengthen current logistical systems including the basic constraints inherent in Timor Leste's poor road infrastructure and limited sources of supply outside of Dili.
- Nevertheless, current systems and procedures for the acquisition and distribution of supplies should be subject to substantive review and options for improvements identified, including the scope for out-sourcing of distribution functions to the (Dili-based) private sector.

Clarification of O&M funding responsibilities:

- The draft National Water Supply Policy and draft National Sanitation Policy are necessary and useful first steps in seeking to clarify funding responsibilities for recurrent operations and maintenance as between the GoTL, consumers/users and others.
- However, until these draft policies are formally endorsed by the GoTL there will continue to be no basis on which to define these responsibilities in working terms 'on the ground' (see below).
- Finalisation and endorsement of these policies (amended or otherwise) by the GoTL should be a priority over the remaining life of the BESIK program and/or the subject of policy dialogue in developing a design for a successor program.

A further desirable action would be the establishment of an MoI Internal Audit Unit. The establishment and effective operation of an Internal Audit Unit would be an important pre-requisite for any substantial devolution of financial authority to DNSAS District Managers. However, support for the establishment of such a Unit would lead Australia's support for RWASH service delivery significantly beyond its current scope.

3.2.2 Action priorities at a District level

Improved sizing and allocation of District operating budgets:

- While the 'needs' of District Managers to perform their functions more efficiently have been reviewed¹¹ that review did not address the funding implications of its recommendations.
- The funding issue should be addressed from at least four perspectives: (a) the minimum funding requirements to adequately (not lavishly) equip the offices of District Managers in terms of basics such as secure records storage facilities, adequate reliability of power supply, communications equipment and safes that work for the storage of cash; (b) the desirability of distinguishing in budget allocations between resourcing of District Management administration and resourcing of District recurrent service delivery functions; (c) resourcing of the networks required at sub-District and community levels; and (d) the need for budget allocation principles and procedures that recognise the differing circumstances of different Districts in terms of factors such as size of population to be served, remoteness and the like.

Strengthened procurement procedures at District level:

¹¹ 'Towards effective decentralized Public Financial Management (PFM) System and Service Delivery: Rapid Assessment of sub-national level PFM systems capacity', DNSAS/BESIK Program (May 2010).

- Within MoI the main focus of efforts to strengthen procurement procedures at District level should be: (a) in parallel with trialling of alternative models for future delivery of operations and maintenance (see Section 3.2.3 below), to ensure that District Managers have the requisite skills and financial delegations to implement models based on the selection and oversight of private sector or other O&M service providers; (b) continuing advocacy on the part of District Managers, with support from MoI/DNSAS nationally, to strengthen quality control procedures for the contracting of capital works funded through appropriations to other agencies.¹²

Better management of imprest accounts:

- Delays in replenishment and acquittal of SAS District Managers' imprest accounts have been a source of inefficiency and frustration at both Central and District levels.
- Notwithstanding the constraints of the 'pasta mutin' (white bag) system for the delivery of cash to District Managers for operating expenses there appears scope within this system to avoid some delays in the replenishment of imprests.
- But the better long-term approach would be to transfer funding to District Managers via the banking system as and where it develops (e.g. via District outlets of the IMfTL) rather than via transporting cash from Dili to the Districts.
- Both sources of potential improvement should be pursued.

Trialling and cautious implementation of devolved financial management and procurement responsibilities:

- Prior reviews of PFM-related bottlenecks in service delivery have highlighted the need to decentralise financial management authorities and align them with accountability for performance at the District level. There can be no in-principle argument with this.
- However, current reality within MoI/DNSAS is that: (a) there is no established culture of accountability for performance or, it appears, any reporting system that would encourage development of such a culture; (b) there would be potential financial risks in decentralising the current centralised management of procurement for items such as vehicle maintenance, other operational supplies and minor capital items so long as payment for these at District level was dependent on transactions in cash rather than by cheque or other more verifiable means.
- Nevertheless, the scope for development of reporting systems to address (a) and identify solutions to (b) should be pursued.

Training to support all the above:

- The BESIK program has delivered some training in budget management at the District Manager level and below, however the scale and content of this has not been reviewed by the present analysis.
- The PFM-related focus of training at District level should be upon the most basic competencies required by District Managers and their financial/administration support staff to better perform their PFM-related functions in an on-the-job context including maintenance of cash books, simple records management (including invoices), financial acquittal procedures and the fulfilment of routine (hopefully simple) financial and performance reporting requirements.

¹² The summary report of the District Managers Workshop, February 2011, on 'Analysis of PDD process 2010' provides an admirably pragmatic and succinct agenda for this.

3.2.3 Action priorities at a community level

Consolidate and extend PFM-related actions in train:

- Action undertaken by the BESIK program and DNSAS has included the delivery of O&M and financial training for Water Facility Management Groups for all new water supply facilities and the trialling of a payment book to improve collection and management of funds by communities. These initiatives should be consolidated and extended.
- Future training at this level should emphasise the development of a basic capacity for preventative as well as remedial maintenance.

Develop/implement action to apply agreed policy on user charging:

- The draft Water Supply Policy indicates: “Payment for persons actively involved in the management, operation and maintenance of public rural water supply systems shall depend on the terms of the service agreement between the representatives of the District Administration, SAS, the relevant GMF and Suco leaders” and that “The funds generated from tariff collection shall, as far is practical, be retained by the organisation responsible for their collection. The funds collected shall only be used for the operation and maintenance of water supply systems.”
- These principles are supported. However, if endorsed, they will require substantial additional action at community level to implement effectively, for example:
 - The design and subsequent negotiation at community level of the service agreements, including negotiation of the division of management and funding responsibilities as between each GMF and the SAS for O&M.
 - The assessment and negotiation of the tariffs (user charges) necessary to recover the ongoing costs of O&M at a level adequate to ensure the sustainability of water supplies.
 - As new supply facilities are installed, the roll-out to the communities concerned of the (simplest possible) procedures for the collection, recording, safe-keeping and disbursement of charges levied on communities.

Trial alternative delivery models for O&M appropriate to a range of community circumstances:

- There can be no ‘one size fits all’ model for future maintenance of Timor Leste’s rural water facilities. Delivery and related financing mechanisms will need to be designed with regard to a range of factors including the number of communities to be served by any given facility and the technical complexity of the facility (e.g. gravity-fed versus pump-driven facilities).
- Options include: a centrally managed tender process for national, regional or District O&M contractors; repairs carried out by District SAS offices with some or no contracting at the District level; repairs carried out and financed by local communities under the supervision of their Water Facility Management Groups.

Recommendation 2: Note and agree the above action priorities as guidance for the present BESIK program and design of any successor program.
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3.2.4 Indicative time frames

Addressing these PFM-related priorities will require substantial inputs from DNSAS supported by some re-balancing of future technical assistance. Within the current BESIK program

principal responsibility for addressing capacity building in relation to financial planning and management rests primarily with the long-term Organisational Development and Capacity Building Advisor and the short-term (periodic inputs) Budget, Planning and Financial Management Specialist. A strengthened future focus on MOI/DNSAS PFM and related systems will require a continuous (long-term) input by a PFM specialist, preferably a speaker of Portuguese and/or Tetum.

The following table presents an initial assessment of the time frames that might realistically be contemplated in seeking to implement the above action priorities to address current weaknesses in PFM-related systems *within the ability of MoI/DNSAS to influence*. This is subject to the following caveats:

- The table does not address time frames for action to address PFM bottlenecks at the Government-wide or inter-agency levels, these being largely if not wholly beyond the capacity of the BESIK program and any successor program to influence.
- Even within MoI/DNSAS, time frames will in some cases be influenced by factors beyond the direct influence of the BESIK program or any successor program.
- A future fiduciary risk assessment can be expected to provide a fuller analysis of both the scale of risks associated with current weaknesses and the time-scales needed to address them.
- The achievement of time frames assessed as realistically achievable over the remainder of the current BESIK program are contingent upon adequate resourcing of related technical assistance over this period including, perhaps, review and focussing of future inputs expected from BESIK's Budget, Planning and Financial Management Specialist.
- There is no 'end-point' for improvements in PFM or other systems, whether in a developing or developed country context. No system in any context can be declared 'best practice for all time'. The indicative time frames indicate what, in the Timor Leste context, might reasonably be expected as a time frame to deliver noticeable improvements on the status quo.

Action priority	Indicative time frames
Priorities at a central level	
Medium-term budgeting	Around 6-12 months to gather and consolidate data on past and current funding from all sources for the provision of rural water supply and sanitation facilities and services, and to develop estimates of the medium-term costs associated with options for sustainable service delivery targets for the RWASH sector. Subsequent action to link medium-term expenditure options and funding projections with annual budget provisions essentially ongoing and subject to future GoTL decision-making at a whole of government level in relation to medium-term and annual budgeting.
Annual budgeting	A maximum of 6 months to clarify current budget processes within MoI for within-Ministry allocation of annual budget ceilings and develop proposals to ensure this occurs on a transparent and rational basis. Action to improve the quality of DNSAS budget submissions and advocate for improvements to address weaknesses inherent in the present annual budgeting for capital expenditures – ongoing over the next 3-5 years.
Financial management information systems	A maximum of 24 months for design and initial implementation of a subsidiary (to FreeBalance) financial accounting and reporting system within DNSAS to establish a RWASH program-based structure linking funding inputs to program outputs. Ongoing development of financing-related performance indicators.
Expenditure commitment and	A maximum of 6 months for detailed review of current processes and options for streamlining them. Implementation timing subject to

disbursement processes	acceptance of review recommendations including, in particular, acceptance of recommendations relating to delegation of authorities for commitments and disbursements including delegations from the Minister.
Logistics	A maximum of 3 months for a full review of current logistics (storage and delivery of supplies). Time frame for implementation of review recommendations unknown but likely to be medium-term (3-5 years).
Clarification of O&M funding responsibilities	The key precondition for this is GoTL endorsement and promulgation of National Water Supply and National Sanitation Policies, whether or not amended versions of the current drafts. Delays to date in achieving this appear to reflect factors beyond the BESIK program's capacity to influence. Subject to GoTL endorsement of policy frameworks, a reasonable timeframe for translating their principles into reality at the level of service users would be 5-7 years.
Priorities at a District level	
Improved sizing and allocation of District operating budgets	A maximum of 12 months to review and identify with supporting justification adequate funding provisions for District operating budgets including allocation criteria linked to the operating needs of individual Districts. Translation of review outcomes into annual budgeting processes contingent on MoI/DNSAS agreement and subsequent implementation in annual budget processes.
Strengthened procurement procedures at District level	In principle, DNSAS's prior recommendations to this end could be actioned within 3-6 months. In practice, timing is almost entirely beyond DNSAS/BESIK control given the dispersal of management and funding responsibility for procurement relating to rural water and sanitation supply facilities. Actions to strengthen District Manager capacity to manage out-sourcing of O&M services via different models appropriate to differing rural contexts would need to be ongoing over the 5 years or so.
Better management of imprest accounts	A maximum of 6 months to identify and agree short-term steps such as partial replenishment of imprests before 100% acquittal of prior advances (as within MoH). More fundamental improvements contingent on: (a) ongoing (and repeat) training of District staff in basic record-keeping and acquittal procedures; (b) reduced reliance on imprest accounts via extension of banking facilities at District level.
Trialling of devolved financial management and procurement responsibilities	Time horizon critically dependent on timing of successful measures to reduce reliance on cash transactions plus long-term development of an 'accountability culture'. A realistic time scale for any significant devolution of these responsibilities while maintaining adequate financial accountability would be 5 years.
Training to support the above	Ongoing over the remainder of the BESIK program and beyond.
Priorities at a community level	
Consolidate/extend PFM-related actions in train	Ongoing, as water supply and sanitation facilities are rolled-out to additional rural communities.
Action to implement agreed policy on user charging	Contingent on the timing of GoTL endorsement of the user-charging principles incorporated in the draft National Water Supply and Sanitation policies. Subject to that, at least 5-7 years to translate these principles into widespread practice.
Trial alternative delivery models for O&M	Remaining life of the BESIK program (approximately 12 months)

4. Ownership and the use of the Partner Government's PFM systems

This Section considers three main potential ways of building GoTL ownership of any future program of support for RWASH service delivery in Timor Leste with reference to public financial management issues. *It does not address other possible means unrelated to PFM matters.* The three paths considered are:

- Strengthened policy dialogue and joint decision-making in relation to the financing of rural water and sanitation services.
- Increased use of GoTL PFM systems as the conduit for future Australian funding support.
- A performance and/or output-based component for future Australian funding support for the sector based on jointly-agreed and realistic targets for improvements in delivery systems and the sustainability of outputs.

Sections 4.1 to 4.3 address and make recommendations in relation to each of the three paths. While addressed in sequence the three paths are substantially interrelated, hence the recommendations of this Section should be considered in their totality, not in isolation.

4.1 Strengthening policy dialogue in relation to PFM

AusAID's Office of Development Effectiveness and the mid-term independent progress review have both advocated for strengthened policy dialogue in relation to the BESIK program, noting that this is primarily an issue to be pursued by AusAID rather than program management. What is arguably lacking to date has been convincing narrative as to *how* AusAID should and can bring the GoTL to the table for serious policy dialogue in relation to PFM-related (and other) issues. Related to this there has been little discussion to date of the GoTL agency(ies) that would best be targeted as the counterpart(s) for dialogue.

It might be assumed that the prospect of continuing Australian funding support for the RWASH sector, if nothing else, would provide an incentive for GoTL engagement. However as AusAID has noted earlier, "With more than US\$5 billion of its own money in the Petroleum Fund at the end of 2009, the government began suggesting that the international aid community was not adding sufficient value to state building—in part because the donor community is crowded and its diverse range of interests and agendas poorly-coordinated. However most donors are willing to align their activities with government priorities, *and would value clearer direction, such as a medium to long-term strategy and expenditure plan, to support this aim.* The Government's decision to develop the Strategic Development Plan is therefore promising."¹³

So the challenge is to find mechanisms for enhanced dialogue that will serve to both incentivise ongoing action to address PFM-related bottlenecks to service delivery (Section 3) and better coordinate GoTL and Australian funding of the sector. The present analysis, while recognising the GoTL's decreasing reliance on development partners for development funding, believes there will be only one serious lubricant for enhanced GoTL - Australia policy dialogue, namely money. This lubricant offers potential to strengthen dialogue at two key points:

- during the design and negotiation of any successor to the BESIK program;

¹³ AusAID 'Annual Program Performance Report 2009: Timor Leste', page 2 (italics added). Since this was written the balance of the Petroleum Fund at end-2011 is now forecast to be US\$7.8 billion, rising to US\$9 billion by end-2012. The 2011 Budget Speech delivered 12 January 2011 indicated that the Strategic Development Plan is expected to be finalised "shortly". The Draft Plan did not incorporate a medium-term expenditure framework.

- during subsequent implementation through the incorporation of a significant performance-related component within Australia's future funding commitment.

Both will entail substantial direct input by the AusAID Post. The following recommendation addresses the design and negotiation stage. Section 4.3 addresses incorporation of a performance-related component.

Recommendation 3: In engaging with GoTL authorities on the design parameters for any successor to the BESIK program the AusAID Post should prepare for and be equipped to engage in substantive dialogue regarding:

- medium term GoTL and Australian funding commitments to future RWASH service delivery;
- future joint decision-making processes in relation to the budgeting for and use of GoTL and Australian funding inputs (including both MoI and MoF).

Minimum joint commitments by the partners should include:

- indicative funding commitments by both the GoTL and Australia for their funding of the RWASH sector;
- joint commitments to systems improvements and service delivery outputs (see also Recommendation 6);
- agreement and commitment to joint decision-making processes for the planning and disbursement of GoTL and Australian funding to achieve these outputs - preferably via the vehicle of a GoTL Treasury-managed account for some part of Australian funding (see also Recommendation 5).

The AusAID Post will need to consider carefully the issue of the counterpart(s) to be targeted for this dialogue but they should certainly extend beyond MoI/DNSAS and include the MoF in particular.

4.2 Increasing use of Timor Leste PFM systems

4.2.1 Extent of current use

The BESIK program has taken a number of steps in recent times to better align its activities and their funding with DNSAS/MoH activities and funding arrangements.¹⁴ However a fair assessment would be that these steps have been essentially marginal in terms of moving the current or any successor program towards significantly increased use of the GoTL's PFM systems for delivery of program funding.

To some extent the BESIK program is constrained in its ability to move in this direction. As the ODE evaluation noted, "Although ongoing decentralisation, civil service reform and public financial management improvements are crucial to sector performance, the sector has relatively little influence on the pace of reform."¹⁵ Whatever the reasons, funding of water supply and sanitation services by the GoTL and the BESIK program respectively is basically proceeding along separate tracks with very little linkage between them. Manifestations of this include:

- Funding of the BESIK program over its life and annually appears to have been determined without obvious reference to or negotiation regarding the GoTL's funding intentions for the sector.

¹⁴ These are summarised in the BESIK program's 6-monthly progress report for the period September 2010 to March 2011 at pages 2-3.

¹⁵ ODE, page 10.

- Decision-making in relation to capital expenditure for the RWASH sector has shifted decisively away from MoI/DNSAS.
- Senior officials within MoI/DNSAS appear to feel themselves at a distance from decisions on the uses to which BESIK program funding is put.
- While the BESIK program is assisting MoI/DNSAS in the preparation of annual budget submissions the GoTL's budget decisions for the sector appear to bear little relationship to these in terms of either the recurrent or capital components of DNSAS budgets.
- The District Water and Sanitation Service (SAS) is a crucial link in the delivery of rural water and sanitation services but inadequately resourced. DNSAS and, to the extent they occur, BESIK funding inputs to the SAS do not appear to be guided by any jointly-agreed funding strategy (e.g. in relation to upgrading basic office facilities).
- While BESIK advisers have, with input from DNSAS, studied and reviewed financial management practices at a 'micro' level, for example funding arrangements and constraints impacting on the SAS, detailed understanding of the GoTL's broader PFM systems and processes appears somewhat 'patchy' and dispersed across the various advisers.

4.2.2 Initial assessment of potential for future use

Development partners seek to make increasing use of partner government systems for aid delivery not for its own sake but for the development benefits that such use may support. Assessments of the scope for increasing use of a partner government's systems need to weigh potential fiduciary risks against potential development benefits. The latter include that increased use of partner systems can serve to strengthen them, to increase the partner government's ownership of development objectives and to better align and prioritise domestic and external resources allocated to the achievement of objectives. Moreover in undertaking assessments of fiduciary risks it needs to be recognised that the adoption of more traditional means of delivering aid also carries risks.

This said, and while in no way under-rating progress made in recent years in strengthening the GoTL's PFM systems, the present analysis's initial assessment is that steps to make greater use of 'downstream' elements of the systems in delivering Australian support for RWASH services will need to be cautious, carefully targeted, extended over a period of years not months and, in the meantime, supported by both short-term control measures and further capacity building.

Considerations underpinning this initial assessment are elaborated in Annex A for each of the 'upstream' and 'downstream' components of the GoTL/MoI PFM system as a whole (On Plan, On Budget, On Parliament, On Treasury etc). Several of these initial assessments, especially those relating to 'downstream' components of the PFM system, need to be validated by a fuller fiduciary risk assessment at the RWASH sector/agency level. Subject to that the most promising areas for potentially enhanced use appear to be as outlined in the following Recommendation.

Recommendation 4: Future fiduciary risk assessment and the design of any successor to the BESIK program should target the following areas as having the greatest potential for transitioning to greater use of GoTL PFM systems:

- Medium-term expenditure planning for future funding of water and sanitation services linking GoTL and external funding inputs.¹⁶
- Related to this, development of a future budgeting system for rural water and sanitation capital expenditures enabling more orderly design, prioritisation and better linkage between budgeting for capital expenditure and operations and maintenance.

¹⁶ The draft National Water Supply Policy would, if endorsed by the GoTL, require this as a next step in any event. See draft policy dated 7 December 2010 Section 5.1.

- Channelling of some significant proportion of future Australian funding through an account within the GoTL Chart of Accounts (see also Recommendation 5).
- Strengthening and subsequent use of GoTL procurement systems at the District level for operations and maintenance of water supply and sanitation facilities (to the extent not the responsibility of Water Facility Management Groups).
- Development to the point that AusAID may rely upon them of subsidiary accounting and reporting systems within MoI/DNSAS linking funding inputs as recorded in FreeBalance, funding inputs provided by Australia and program outputs.

The BESIK program is scheduled to terminate in 2012. While preparatory steps to pursue the possibilities can be taken over the next year or so the principle vehicle for pursuing them will need to be the design, negotiation and implementation of a successor program (see also Section 5).

4.2.3 Options for channelling funds through the GoTL Treasury

There are two main options for channelling some part of future Australian funding through the GoTL Treasury:

- Option 1: Fully ‘On Treasury’ - Australian funding channelled into the GoTL Consolidated Fund (Single Treasury Account) then managed through the Treasury’s systems for disbursement and financial control. This would necessarily entail also placing the Australian funding ‘On Budget’ and ‘On Parliament’.
- Option 2: Australian funding channelled into and disbursed from a special account maintained by Treasury outside the Treasury Single Account and subject to joint GoTL-Australia decision-making in relation to the amount/timing/destination of disbursements and other matters.

How these options are assessed depends to a considerable extent on the relative weight attached to the ‘effectiveness’ and ‘efficiency’ respectively of future activities funded in part by Australia.¹⁷ Those placing greater weight on effectiveness will tend to be less concerned by current weaknesses in PFM-related processes that would impact on the delivery of Australian support were it to be delivered ‘On Treasury’, placing more weight on whether the GoTL - with Australian support - is achieving its desired outcomes. Those placing greater weight on efficiency will tend to focus on those weaknesses and their potential to undermine confidence that Australian development funding is being put to good use, while perhaps losing sight of the over-arching objectives. In practice both effectiveness and efficiency considerations need to be weighed and balanced.

Option 1 has the potential benefits of demonstrating Australia’s commitment to fully implementing the aid effectiveness agenda, of shifting the focus of dialogue away from inputs towards results, of providing potential to engage MoI, MoF and other agencies more fully in consideration of annual and medium-term budgeting for the RWASH sector, and of gaining a fuller understanding of the strengths and weaknesses of the Treasury’s systems as they operate in practice. From the GoTL perspective it would also improve the predictability of Australian funding for the program since AusAID would necessarily be required to align the timing of its annual funding commitment with the GoTL timetable for approval of the draft annual budget by the Council of Ministers and its consideration by the Parliament.¹⁸

¹⁷ ‘Effectiveness’: the relationship between program outputs and desired program outcomes (‘doing the right things’). ‘Efficiency’: the relationship between program inputs and outputs (‘doing things right’).

¹⁸ AusAID would need to consider second-order implications of this arising from the differing Financial Years used by the GoTL and Australia. For example, were Australian funding to be committed for payment into and appropriation from the GoTL Consolidated Fund in (say) 2013 then in line with the Timor Leste BFML Australia

This said, Option 1 would also entail risks.

- The main risks are that disbursement of Australian funding of the program could be subject to variations from the purposes agreed during Parliamentary consideration of the GoTL proposed budget, that its disbursement could be delayed by passage and enactment of the budget, that the cumbersome GoTL procedures for authorisation of disbursements and acquittals would unduly delay disbursements in unpredictable ways leaving budget execution below budget appropriation, and that as a result of these or other factors the ‘value for money’ of activities funded by Australia - from an efficiency perspective - might well be diminished.
- From the GoTL’s perspective there is the risk that Australia might fail to deliver on its funding commitment for the GoTL budget year ahead. The Treasury Single Account having been appropriated by the Parliament on the basis of Australia’s funding commitment, the Treasury would be under considerable pressure to release the funds appropriated whether or not Australia’s funding commitment were ‘in the bank’.

Option 2 would permit a more cautious trialling of Treasury systems since, while relying on these for disbursements and acquittals, it would retain joint decision-making by the GoTL and AusAID on the amount, timing and uses of within-year disbursements. Such decision-making would, if concerns arose, retain the means to address them as they arose rather than during negotiation of future funding commitments. The specification of procedures for authorisation of disbursements and acquittals would be less constrained by current practices and might be used to demonstrate streamlined processes. However Option 2 also entails risks/disadvantages, notably.

- The scope for leveraging enhanced policy dialogue would in all likelihood be even less than under Option 1.
- It might well be perceived as, and to some extent is, a ‘Claytons Use’ of Treasury systems - the use you have when you’re not using them.
- It would run counter to MoF efforts in recent years to reduce the number of accounts operated outside the Treasury Single Account.
- It has been contended that the use of special accounts for receipt of Australian development funding has not, in practice, proved any more effective in mitigating financial risks than use of mainstream partner government systems.
- Joint decision-making on within-year disbursements from the special account would impose additional administrative burdens on the AusAID Post.

On balance this analysis favours Option 1, *subject to implementation of complementary short-term controls and ongoing support for related capacity building.*

Recommendation 5: Subject to implementation of complementary short-term controls and ongoing support for related capacity building AusAID consider channelling a significant proportion of funding for a successor to the BESIK program through the GoTL Treasury Single Account. However, this recommendation and the alternative option of using a special account under joint GoTL-Australian control should be the subject of further consideration and debate within AusAID in the light of a full fiduciary risk assessment. See also Recommendations 8-9.

Steps needed to give effect to this recommendation are elaborated in Section 5. Whichever option (if either) is ultimately adopted it will be vital that the funding be for a clearly defined

would need to make that funding commitment by mid-October 2012 at latest. This would in turn require Australia to commit funds not only from its budget for Financial Year 2012-2013 but also in respect of its Financial Year 2013-2014.

purpose and highly desirable that its disbursement be the undivided responsibility of a single line Ministry/agency. This consideration has influenced the earlier recommendation that future Australian support incorporate a significant funding component to support rural water and sanitation operations and maintenance by DNSAS. However, other forms of future support could also meet this test, for example continued funding support for the design of new rural water supply facilities and associated engagement by communities in the design process.

4.3 Results-based financing

Funding of the BESIK program has not directly linked the level of Australian funding to the achievement of GoTL targets for systems reform or service delivery outcomes for the RWASH sector. Design of any successor program should seek to introduce a results-based financing component for future Australian funding of the sector. Such a component would, *inter alia*, provide a meaningful focus for strengthened policy dialogue with the GoTL both in finalising a design for the future program (including dialogue in relation to parallel GoTL funding commitments) and during its implementation (via joint consideration of progress towards agreed performance targets as the trigger for performance-related funding).

There are numerous ways in which a performance-based financing component could be designed and several threshold issues would need to be addressed in designing it, for example: whether the successor program is to target service delivery outcomes for the RWASH sector as a whole or only those outputs/outcomes within the direct funding and delivery responsibilities of a single agency (e.g. DNSAS); the nature and specificity of the performance targets to be set; the systems that would be used (and/or developed) to track and verify progress in achieving targets; and the mechanism for joint GoTL-Australian consideration of performance results and agreement on release of the performance-related funding component.

The present analysis has not addressed these issues in any depth, however the following illustrates the overall approach envisaged as it might apply to a performance-related component of future Australian support for the operations and maintenance of rural water and sanitation facilities by DNSAS. It would comprise three main inputs to the determination of the performance related component:

- GoTL adherence to its in-principle O&M funding commitments over time. These indicative funding commitments would be negotiated and agreed as part of the policy dialogue associated with formulating and agreeing the design of the successor program.
- Systems reform benchmarks. These would include one or more of the following: GoTL endorsement of a clear statement delineating the responsibilities of DNSAS and GMF's respectively for maintenance of rural water and sanitation facilities; improved financial planning and prioritisation systems for O&M spending; agreed processes whereby approval of any capital project is accompanied by estimates of, and preferably establishes a funding commitment to, ongoing maintenance; established procedures for defining/funding 'routine' (ongoing preventative) and 'urgent/minor' O&M spending; improved systems for contracting, contractor selection and quality control of maintenance contractors; ongoing improvements in and institutionalisation of performance reporting for O&M.
- Output-related benchmarks. Based in part on feed-back from GMFs channelled through an ongoing Sub District Facilitators network, achievement of targets for moving individual water supply facilities at the village level to, and then keeping them at, a fully operational level.

Recommendation 6: Design of any successor to the BESIK program should seek to introduce a results-based financing component for future Australian funding of the RWASH sector. While

the detailed design of this would need to consider many factors it should incorporate three main elements:

- GoTL (and Australian) adherence to indicative medium-term funding commitments in relation to the funding of rural water supply and sanitation services.
- Systems reform benchmarks, including but not limited to benchmarks for improvements in financial planning and management systems for RWASH service delivery.
- Output-related benchmarks, for example achievement of targets for moving individual water supply facilities at the village level to, and then keeping them at, a fully operational level.

In making this recommendation it is emphasised that the introduction of performance benchmarks for some component of future funding should not be seen as a ‘tick a box’ exercise but, rather, as a means of requiring both sides to ‘come to the table’ regularly for discussion of overall objectives and progress towards them. A key consideration for AusAID in the design of any performance-related component of a future program will be the capacity of the AusAID Post - with or without input from future technical advisers to the program - to monitor progress and discuss performance-related funding releases with the GoTL. The AusAID Post would need to resource this engagement with the GoTL on a well-informed and ongoing basis if the performance-related funding component were to have meaningful incentive effects.

5. Transitioning to a GoTL-led program for O&M

The scale and content of any successor to the BESIK program is unknown at this stage and, as noted, will be strongly influenced by AusAID decisions in relation to the ‘architecture’ for Australia’s future development assistance funding as a whole. Section 5 is premised on the assumption that some form of RWASH sector-specific program will continue to be supported beyond the life of the current BESIK program.

This Section is also premised on the assumption that the future program will include a significant funding commitment to support and encourage reform of GoTL systems for the operation and maintenance of rural water and sanitation services. The transitioning strategy outlined is therefore illustrated by reference to O&M. It could in principle be applied to other possible components of a future program, for example continued support for the design of new rural water supply facilities and community engagement in that process as other means of enhancing the sustainability of investments in rural water supply. However, design of any future program would need to consider in each case how use of existing GoTL systems for funding delivery would demonstrably strengthen development outcomes (see also Recommendation 9 below). Given the multiplicity of agencies now involved in capital expenditure on new investment in rural water supply, continued Australian support for such investment would be a far more complex undertaking than hitherto.

5.1 What would success look like in 5-7 years time?

Implementation of the directions suggested by this report should aim to deliver the following key results within 5-7 years:

- Achievement of a realistic GoTL target at reasonable cost for the proportion of current and new rural water facilities that achieve and sustain a classification of ‘fully operational’.
- Responsibilities for O&M of rural water and sanitation facilities and its funding clearly delineated and substantially in operation.

- Acceptance by the GoTL of forward budgeting of the O&M funding requirements to be met by the GoTL in respect of future capital expenditure on new water and sanitation services and an increasing GoTL funding contribution for that purpose.
- Related to this, adequate resourcing of the District, sub-District community networks needed to monitor O&M requirements, deliver O&M services and report results.
- Procurement systems for O&M service delivery established, delivering value for money and auditable.
- MoI/DNSAS management and delivery of the O&M program, any further requirement for technical assistance determined, selected and funded by the GoTL.
- As input to MoI/DNSAS management of the program, a basic but integrated budgeting, financial management and performance reporting system for O&M.
- At some point within the period, Australian funding support for the above delivered to and disbursed from the GoTL Treasury Single Account with no continuing supplementary controls.

5.2 How to progress to success?

This question is addressed from the perspectives of action over the next three months, over the remaining life of the BESIK program and for the design and negotiation of a successor program.

5.2.1 Next 3 months

The obvious start-point for progressing the ‘vision’ is to establish in-principle support for it within the GoTL and, especially, within the MoI/DNSAS and MoF. This will require far more than simply seeking comment on the recommendations of this report. In parallel and if endorsed, this report’s findings and recommendations should also be provided to and in part steer the future work of those commissioned to undertake a full fiduciary risk assessment and prepare the design of a successor to the BESIK program.

Recommendation 7: Subject to in-principle endorsement of this report’s findings and recommendations:

- its principle findings and recommendations be translated into Portuguese and form the basis of a workshop of senior MoI/DNSAS and MoF officials with a view to gaining their fuller understanding and endorsement of proposed directions and their agreement to establishment of a MoI/DNSAS/MoF reference group to progress these.
- the principle findings and recommendations also be used to steer in part a fuller fiduciary risk assessment and the team commissioned to design a successor program.

5.2.2 Remainder of the BESIK program

Some basic requirements for enhanced GoTL-Australia dialogue in relation to the RWASH sector are currently unmet. In relation to any future Australian support for O&M the BESIK program should aim to address these. Key requirements are as follows.

Recommendation 8: As key building blocks for dialogue in relation to future Australian funding support for any successor program the current BESIK program should aim to identify, over the next 9-12 months:

- The key GoTL agencies and decision-makers to be targeted for future policy dialogue in relation to the RWASH sector.
- A medium-term (3 year) expenditure framework, incorporating potential funding from all sources, for the construction and maintenance of rural water supply and sanitation facilities that would enable the GoTL to achieve *and sustain achievement of*, for rural communities, the

MDG water supply goal.

- Costed options for funding future O&M of rural water and sanitation services including prospective funding sources for each option and the performance targets that could realistically be set and achieved over a 5-year period for each option.
- As partial input to these options, a costed assessment of the resourcing needs of the SAS, SDFs and GMFs in order to adequately manage their O&M functions.
- Alternative models, preferably trialled, for the future delivery of MoI/DNSAS O&M services.
- Design parameters for a basic O&M financial management and performance reporting information system within MoI/DNSAS, linked but subsidiary to FreeBalance, sufficiently robust to meet both MoI/DNSAS needs and AusAID's financial and performance reporting requirements in respect of Australian funding for O&M channelled through the GoTL Treasury Single Account.

Resource availability and any supplementary requirements for these purposes would need to be considered by the BESIK program in consultation with AusAID. Without prejudice to that consideration it is unlikely that they could be fully addressed by the present short-term Budget, Planning and Finance Management Specialist alone.

5.2.3 Design of a successor program

The BESIK program will terminate in 2012 hence its scope to address and action earlier recommendations is relatively limited. Whether, how and when they should be addressed is primarily a matter for the team commissioned to design any successor program, in partnership with the GoTL and AusAID. Key matters the design team should be asked to address more fully include the following.

Recommendation 9: Incorporation of earlier recommendations in the design of a successor to the BESIK program should address, in conjunction with the findings of a full fiduciary risk assessment, the following in particular:

- The specification of proposed funding commitments by the GoTL and Australia respectively to a 5-year program for upgrading the delivery of O&M services for rural water supply and sanitation facilities.
- As part of that, the identification of an appropriate performance-related component of any future Australian funding support, notably: (a) the proportionate amount; (b) the more detailed specification of performance-related targets and mechanisms to provide for GoTL access to the performance-related component.
- Whether other forms of future support, for example continued support for the design of new facilities and community engagement in the design process, would also enhance the sustainability of future investment in rural water supply facilities and how that could be demonstrated.
- The design of short-term controls needed to provide AusAID adequate assurance that any Australian funding provided through the GoTL Treasury Single Account was used for its intended purpose and was achieving acceptable value for money. The main focus of this design should be upon implementation of the (subsidiary to FreeBalance) financial management and reporting information system foreshadowed by Recommendation 8.
- The mechanism for annual joint GoTL-Australia decision-making in relation to performance review and budgeting of joint funding inputs to the O&M program for the GoTL fiscal year ahead.
- Targeted transition points within the life of the successor program for relaxation and cessation of short-term control measures accompanying Australian funding through the Treasury single account.
- Further review and prioritisation of other actions to address PFM-related bottlenecks in O&M

service delivery, notably those pursuant to Recommendation 2.

- Resourcing of and task definition for the PFM technical specialist(s) necessary to support transition to the desired O&M program outcomes.

ANNEXES

Annex A: PFM Systems for RWASH Sector Service Delivery

A1 Introduction

This Annex presents supplementary information to underpin the principal findings and conclusions of the main report.

- Section A2 presents a summary assessment of the Government-wide financial planning and management system within which the agencies delivering RWASH facilities and services operate.
- Section A3 provides an overview of the functions and some decision-making processes of the multiple agencies involved in providing RWASH facilities and services. It notes that these are presently in a state of flux and/or are unclear in some respects.
- Section A4: elaborates the main report's summary of key features of MoI/DNSAS financial planning and management processes.
- Section A5 elaborates the main report's conclusions regarding the scope for increased use of GoTL PFM systems for future delivery of Australian support for the RWASH sector.

Section A2 draws heavily from (and in part reproduces extracts from) recent assessments undertaken by staff of the International Monetary Fund and World Bank.¹⁹ Following an outline of the legal and institutional framework Section A2 follows the PEFA structure for PFM assessments (excluding 'D. Donor Practices'). In doing so and while adding relevant background information, Section A2 reproduces the IMF's 2010 PEFA scores and explanations for public *expenditure* management in particular.²⁰

A2 Government-wide financial planning and management

Legal and institutional framework

Two main instruments provide the legal framework for government financial planning and management in Timor Leste, the Constitution and the Budget and Financial Management Law of 2009.²¹

Section 144 of the Constitution provides for the establishment of Timor Leste's tax system while Section 145 provides for a State Budget. Section 145 states:

1. The State Budget shall be prepared by the Government and approved by the National Parliament.

¹⁹ 'Timor-Leste Planning and Financial Management Capacity Building Program Mid-Term Review - World Bank Aide Memoire' (May/June 2010); 'Democratic Republic of Timor Leste: Public Financial Management - Performance Report', Fiscal Affairs Department, IMF (August 2010); 'Democratic Republic of Timor Leste: Report on the Observance of Standards and Codes (ROSC) Fiscal Transparency Module', Fiscal Affairs Department IMF (November 2010); Democratic Republic of Timor-Leste: 2010 Article IV Consultation—Staff Report; Joint World Bank/IMF Debt Sustainability Analysis; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Timor-Leste, IMF Country Report 11/65 (March 2011).

²⁰ The PEFA assessment methodology examines numerous dimensions of public financial management and incorporates a 'rating' scale of A ('best') to D for each.

²¹ Decree Law No.14/2003 regulates the creation of Public Corporations but there are presently only two of these, Radio and Television of Timor Leste and the Autonomous Service for Drugs and Health Equipment (SAMES). A series of Decrees in 2010 amended and then re-amended organisational arrangements for the oversight of procurement.

2. The Budget law shall provide, based on efficiency and effectiveness, a breakdown of the revenues and expenditures of the State, as well as preclude the existence of secret appropriations and funds.
3. The execution of the Budget shall be monitored by the High Administrative, Tax and Audit Court and by the National Parliament.²²

The Budget and Financial Management Law (BFML) enacted in 2009 regulates the preparation and execution of the State Budget. The IMF's recent assessment was: "**The framework for management of public finances is clear and comprehensive.** The BFML covers all aspects of public financial management in government including the rules and procedures for the organization, preparation, presentation, and implementation of the budget and the accounts of the state and rules and procedure for financial management. This law is applicable to the GG [General Government], and includes standard precepts of control and approval by parliament. It is comprehensive regarding its coverage of preparation of the budget, deadline for submission to the parliament, the period within which the budget should be passed, and the contents of the budget."²³

Amongst its many other provisions the BFML provides:

- for an annual state budget and the lapsing of all unspent budget appropriations at the end of each fiscal year (Article 3);
- that budget credits enabling the existence of secret funds shall be void (Article 7);
- that the budget shall identify financing to meet all State expenditures;
- that the Government will publish all documents necessary to assure the disclosure and transparency of the state budget and its execution (Article 11);
- a comprehensive definition of 'public monies' (Article 12);
- that revenues and other public monies must be deposited in official accounts on receipt (Article 13);
- that public monies can only be spent after the issue of an Expenditure Authorisation Notice by the Director of Treasury authorising expenditure of the budget appropriation specified in the Notice (Article 14);
- that the Minister for Finance is responsible for opening one or more official bank accounts for the receipt of public monies (Article 15);
- that the Ministry of Finance²⁴ is responsible for paying all Civil Service salaries (Article 19);
- for the content and structure of the annual state budget (Articles 22 to 28);
- that the draft budget law for the following financial year shall be presented to the Parliament by 15 October (Article 30);
- that, when authorised by law, the Minister for Finance may establish Special Funds that do not form part of the Consolidated Fund, the balances of which do not revert to the Consolidated Fund at the end of a financial year but remain available for their authorised uses (Article 32);
- that the Government may introduce supplementary budgets ('rectifying budgets') in the course of a financial year (Article 34);

²² The High Administrative, Tax and Audit Court is not yet established - see 'Budget Cycle - Accounting, Recording and Reporting' below.

²³ 'Democratic Republic of Timor Leste: Report on the Observance of Standards and Codes (ROSC) Fiscal Transparency Module', Fiscal Affairs Department IMF (November 2010), page 12.

²⁴ The Ministry of Finance website designates it the "Ministry for Planning and Finance". However, virtually all other documentation refers to it simply as 'Ministry of Finance' and that abbreviated designation is used here throughout.

- that the Minister for Finance may authorise transfers between services without administrative and financial autonomy of up to 20% of the appropriation concerned, but that transfers from capital development to any other budget category and from wages and salaries to any other category are not allowed (Article 38);
- that no money shall be withdrawn from the Consolidated Fund unless it is authorised by an Expenditure Authorisation Notice and such a Notice will not be valid if it authorises spending not foreseen by a budget appropriation (Article 39);
- for the establishment of budget and accounting records (Article 43);
- for three-monthly reports on budget execution to be presented to the Parliament (Article 44);
- for interim and audited final annual financial statements to be presented to the Parliament within three and nine months respective after the end of the financial year, the contents of the latter being specified in detail (Article 45);
- for the political, financial, civil and criminal accountability of public office holders and other officials in regard to their acts of commission or omission in budget execution (Article 46).

The institutions of general government in Timor Leste are as follows:

Included in the State Budget	Not included in the State Budget
The executive, legislature ²⁵ and judiciary (including Offices of the President and Prime Minister, line Ministries, Secretariats of State, public office holders such as the Prosecutor General, the National Electoral Commission and Anti-Corruption Commission)	National Petroleum Authority
	The Petroleum Fund
	Postal Services
	Communication Agency Authority
Four autonomous entities and one non-financial public corporation: Electricity of Timor Leste; Port Authority; National Authority for Aviation and Institute of Equipment Management; and Radio and Television of Timor-Leste.	Autonomous Service for Drugs and Health Equipment
	The Banking and Payment Authority
	Microfinance Institution of Timor-Leste

Excluding the Petroleum Fund institutions included in the State Budget are responsible for the vast majority of the GoTL's revenues and expenditures.

Credibility of the GoTL Budget

Background:

Government expenditure has been increasing rapidly in recent years, especially capital expenditure, financed primarily by increasing transfers from the Petroleum Fund. Transfers from the Petroleum Fund have regard to calculations of the Fund's Estimated Sustainable Income (ESI). The GoTL has undertaken no long-term borrowings to date but is understood to be considering the possibility of selective borrowing on concessional terms from multilateral development organisations.

²⁵ From 2010 the accounts of the Parliament will not be part of the Government accounts and will be audited separately.

General State Budget Expenditure (US\$ million)				
	2008 Actual	2009 Actual	2010 Budget	2011 Budget
Consolidated Fund (recurrent)	397.4	433.6	550.6	563.4
Consolidated Fund (capital)	86.5	171.7	287.3	118.3
Infrastructure Fund (capital)	-	-	-	599.3
Human Capital Development Fund	-	-	-	25.0
General State Budget Total	483.9	605.3	837.9	1,306.0

The 2011 Budget estimates that donors will fund an additional US\$194.8 million of development expenditure (i.e. an addition of around 15% to the General State Budget total for 2011).

Deviations to date between the original budgets for the Consolidated Fund and actual expenditures have reflected two main factors: substantial supplementary budgets in 2008 and 2010; and year-on-year variations in the percentage execution of approved budgets. Budget execution as a percentage of approved budget has increased over time (at least prior to 2010). Given the very rapid increase in capital expenditure budgets there must be some question as to whether increased budget execution rates for capital expenditure have impacted on the quality of that expenditure.

While actual expenditures have consistently fallen short of budgeted amounts, the composition of actual spending by line Ministries and other agencies has reflected the composition of the budget estimates to a relatively high degree. This suggests that, in broad terms at least, the GoTL's high-level capital expenditure priorities are being reflected in the composition of its expenditures.

IMF Public Financial Management Performance Report as at August 2010:

A. Credibility of the Budget		
Indicator	2010 Score	Explanation
PI-1. Aggregate expenditure out-turn compared to original approved budget	D	Actual primary expenditure deviated from budget estimates with more than 15 percent in two of the three years considered. [Fiscal Years 2007, 2008, 2009]
PI-2. Composition of expenditure out-turn compared to original approved budget	A	The variance in expenditure composition exceeded the overall deviation in primary expenditure by less than 5 percent in any of the last three years.
PI-3. Aggregate revenue out-turn compared to original approved budget	C	Actual domestic revenue collection was below 92 percent of budgeted domestic revenue estimates in one of the last three years.
PI-4. Stock and monitoring of expenditure payment arrears	D+	Anecdotal information indicate that the stock of payment arrears has generally been very low (below 2 percent of total expenditure), but no reliable data exist, nor are periodic surveys carried out.

Given the enactment of a supplementary budget in 2010 there is likely to be a further significant deviation between the original budget and actual out-turn for that year.

Comprehensiveness and transparency

Background:

The GoTL publishes its annual budgets in detail. For 2011 this was in the form of the draft budget law (with Explanatory Statement) and six budget books:

1. Budget Overview
2. Annual Action Plans of line Ministries and other on-budget agencies
 - These outline at a broad level, by major activity, objectives, expected results, ‘indicators’, costs and location of the activities.
 - However, they would need to be considerably strengthened before they could be used in any substantive way as a basis for performance monitoring and review.
3. Districts
 - This presents for each of Timor Leste’s 13 Districts details of: government personnel and services profile; recurrent spending by line Ministries (as estimated by line Ministries); total estimated capital expenditure; estimated spending by donors; the number of schools and health facilities; and individual capital development projects.
 - Given difficulties in distinguishing ‘national’ and ‘district’ expenditures and reliance on line Ministries for much of the data, some of this data should be treated with caution.
4. Budget line items
 - Presented by Ministry/agency (and National Directorates within Ministries), by economic classification (wages and salaries, goods and services, transfers, minor capital, capital and development), by line items within these classifications, for the Budget year and four following years.
5. Development Partners
 - This documents indicative funding commitments by individual development partners (including non-government organisations) by line Ministry and project/program for the current budget and three forward years.
 - Estimates for the forward years in particular are frequently ‘not available’.
6. Special Funds
 - For 2011 this documents projects to be funded by the (new) Infrastructure Special Fund and Human Capital Development Fund by ‘program’ (e.g. Transport), ‘sub-program’ (e.g. Bridges), project owner (e.g. Ministry of Infrastructure), project name, and estimated expenditures 2011 to 2016 inclusive.

As noted the General State Budget as reported in these budget books encompasses the great majority of public expenditures by the GoTL. The budget books are publicly accessible through the Ministry of Finance’s website.²⁶

IMF Public Financial Management Performance Report as at August 2010:

B. Comprehensiveness and Transparency		
Indicator	2010 Score	Explanation
PI-5. Classification of the budget	B	The chart of accounts used for budget management contains an organizational, economic, and a partial functional classification. The program classification is not well-developed and not used for budget management.
PI-6. Comprehensiveness of information included in budget documentation	A	The budget documentation does include neither information on financial assets nor explanation of budget

²⁶ As at April 2011 all six budget books were available for download in Portuguese and Books 1, 4 and 5 were available for download in English.

		implications of new policy initiatives.
PI-7. Extent of unreported government operations	D+	The level of unreported extra-budgetary expenditure appears to be low and does not exceed one percent of the budget expenditure. Few donor funded projects implemented via the line ministries' accounts in the commercial banks are neither recorded nor included in the government financial reports.
PI-8. Transparency of intergovernmental fiscal relations	NA	There is currently no subnational government in TLS. [Democratic Republic of Timor Leste]
PI-9. Oversight of aggregate fiscal risk from other public sector entities	D	Public entities which are in fact autonomously managed (SAMES, IMfTL, Lottery, ANP) are not reported in the budget documentation and there is neither annual monitoring, supervision nor consolidation of overall fiscal risks.
PI-10. Public access to key fiscal information	B	The government publishes the annual budget on the MOF website at the time of presentation to parliament. External audit reports are posted on the website as they are presented to parliament. Tender awards and resources available to primary service units are not published systematically.

Budget cycle - policy based budgeting

Background:

In 2010 the GoTL released a draft Strategic Development Plan (SDP) for the period 2011 to 2030. This included a 'Framework for Action' 2020, a Public Investment Plan to 2015 and an outline of public financing to 2015. Eight priority sectors for public investment in the period to 2015 were identified: health and nutrition; education and research; roads; power; seaports and airports; agriculture; petroleum; and tourism (note that water supply was not explicitly identified). The draft plan's discussion of public financing to 2015 outlined indicative targets for public investment in these sectors and prospective financing from the Petroleum Fund and other sources, but did not allocate target public investment to individual sectors. The 2011 Budget documents indicate that the SDP is to be finalised "shortly".

Some Ministries have prepared and released medium-term strategic plans for their sectors or parts thereof and some of these included reasonably detailed medium-term projections of financing requirements.²⁷ However, these projections do not appear to link in any systematic way to the forward estimates of expenditure contained in the annual budget documents while assumptions underlying those forward estimates are not stated. As yet, neither a policy framework nor a medium-term expenditure plan has been approved by the GoTL for the RWASH sector.

There is a well-programmed annual budget process incorporating the following main steps:

Step	Timing ²⁸
Preparation and issue of Budget timetable for the year	January
Preparation and approval of macroeconomic framework; consideration of Budget priorities by Prime Minister's Office and Council of Ministers	March
Preparation by Ministry of Finance of proposed aggregate fiscal envelope and fiscal envelopes for line Ministry recurrent expenditures, consideration/approval of same by Council of Ministers, issue of Budget Circular (including communication of recurrent budget fiscal envelopes) to line Ministries	May

²⁷ See, for example, 'Strategic Plan for Universal Primary Completion by 2015', Ministry of Education and Culture (October 2005).

²⁸ Based on 2009, 2010 Budget process. Timing appears to have slipped somewhat for the 2011 budget process.

Line Ministries prepare/submit their budget requests and Annual Action Plans to Ministry of Finance	June
Consideration of budget submissions by Ministry of Finance	First-half July
Consideration of budget submissions and Ministry of Finance recommendations by Budget Review Committee of Council of Ministers (including brief appearances by line Ministry officials)	Second-half July
Council of Ministers approves draft budget proposal	August
COM approves final draft budget documents, including final calculations of ESI	September
Budget proposal submitted to the national parliament	No later than 15 October
Budget Commission C of the parliament reviews draft Budget	October/November
Parliament approves draft Budget if/as amended	In principle, by 31 December

Prior assessments of this process have identified the following main areas that could be improved:

- Linkage between capital and recurrent budgets: the capital and recurrent budgets are developed separately; recurrent budgets and forward estimates of recurrent expenditure are not adjusted in a systematic way to reflect the recurrent expenditure impacts of capital expenditure decisions.
- Related to this, while the sectoral composition of capital expenditure decisions does reflect (broadly) the GoTL's sectoral priorities, the recurrent budgets of line Ministries do not appear to do so in any systematic way.
- Timeline for review of agency budget submissions by Ministry of Finance: the MoF is given around three weeks to review the submissions and prepare briefing material for the Budget Review Committee; this provides little opportunity for detailed analysis of expenditure priorities and options within and across Ministries.
- Line Ministries have little (if any) flexibility to re-order their recurrent expenditure priorities within a total recurrent envelope since their fiscal envelopes are determined at the level of economic expenditure categories (wages and salaries, goods and services etc).

IMF Public Financial Management Performance Report as at August 2010:

C(i) Budget Cycle - Policy-Based Budgeting		
Indicator	2010 Score	Explanation
PI-11. Orderliness and participation in the annual budget process	C+	There is a clear and widely known budget calendar and a budget circular to guide MDAs [line Ministries] in preparing budget submissions, however it does not allow a reasonable amount of time to complete the capital budget submissions and no ceilings are included for the capital budget. The budget has been approved before the start of the financial year during the two of last 3 years. [Added note: the 2011 Budget was not approved until February 2011]
PI-12. Multiyear perspective in fiscal planning, expenditure policy, and budgeting	D+	Multi-year perspective of fiscal planning is at an initial stage. A few sector strategies which are costed are not integrated into strategic plans, and are not consistent with medium-term forecasts. Investment decisions are not based on sector strategies, and there is no link between capital expenditure and medium-term recurrent estimates.

Budget cycle - predictability and control in budget execution

Background:

The great majority of GoTL revenues and expenditures flow into and from a Treasury Single Account (consolidated fund) maintained by the Treasury at the Banking and Payments Authority (central bank).²⁹ Following enactment of the annual Budget by the Parliament the main procedural steps for the expenditure of funds from the Treasury Single Account are as follows.

Steps	Responsibility	Comments
Cash flow forecast	Treasury/BPA	Treasury/BPA prepare a cash flow forecast for the year and subsequently review this quarterly. It is understood that few if any Line Ministries prepare annual cash flow forecasts for their operations.
Issue of Expenditure Authorisation Notices	Treasury	These provide authority to Line Ministries to expend funds appropriated in the Budget. Previously issued by Treasury on a quarterly basis but commencing 2010 now issued annually (typically in February) to authorise expenditure of the full annual appropriations. This has improved the within-year predictability of funds availability.
Commitment	Line Ministries	This step triggers a procurement or direct payment process. Line Ministries enter commitments against appropriations in FreeBalance. FreeBalance precludes the entering of commitments exceeding budget appropriations.
Obligation	Line Ministries	Line Ministries enter obligations in FreeBalance as they incur liabilities (e.g. signature of a contract)
Payment	Line Ministries and Treasury	Line Ministries submit a Purchase Requisition or Commitment and Payment Voucher to Treasury. Treasury checks/approves and authorises BPA to make payment by electronic transfer or cheque (which may be made out to 'cash' in the case of imprest accounts).
Acquittal of imprest accounts	Line Ministries	Line Ministries acquit expenditures from imprest accounts with a report and supporting invoices/receipts as relevant, typically when seeking a further payment to an imprest account.
Virements	Line Ministries and Treasury	Responsibility for authorising virements between budget line items within a given administrative and economic classification has been delegated to Line Ministries. Virements between administrative and/or economic classifications must be authorised by the Treasury, Minister for Finance or the Prime Minister depending on the amount involved.
Carry-over management	Line Ministries and Treasury	Payments for goods and services received by 31 December can be paid for up to 31 January from the prior year's budget (it is understood that in practice prior year's accounts may be kept open longer than a month).

Treasury maintains a central payments system for the payment of wages and salaries to government employees, accounting for some 21% of budgeted recurrent spending (wages and salaries, goods and services and transfers) in 2011. Its payroll data base and payments system form a module of FreeBalance. The majority of wage/salary payments are now deposited to employee bank accounts but some payments in cash continue to be made at the District level by Treasury officers located in the Districts (one per District).

Internal control and audit functions and resources are dispersed across the Ministry of Finance, the Office of the Inspector General and line Ministries:

²⁹ Line Ministries and other agencies have in the past operated their own accounts within the commercial banking system. However, Treasury has been engaged in the process of identifying such accounts, requiring closure of accounts no longer operative and/or unjustified, and formally authorising accounts to remain open.

- the Treasury Department within MoF has a unit comprising five internal auditors who perform ex-ante procedures on the centralised payments system;
- the Office of the Inspector General has a mandate to perform a wide range of inspections and audits across government, currently employing nine auditors to undertake financial audits;
- A number of Ministries (but not the Ministries of Defence, Infrastructure or Foreign Affairs) have established internal audit units and are said to currently employ 197 internal auditors/inspectors with plans to recruit a further 31.³⁰

Despite this resourcing successive PFM assessments have highlighted the weakness of internal audit as one of the key weaknesses of the GoTL PFM system as a whole.

IMF Public Financial Management Performance Report as at August 2010:

C(ii) Predictability and Control in Budget Execution		
Indicator	2010 Score	Explanation
<i>[Added note: Indicators PI-13 to PI-15 relating to tax obligations and collection are omitted for present purposes]</i>		
PI-16. Predictability in the availability of funds for commitment of expenditures	B+	Cash flow forecasts are made at the start of the year and reviewed every quarter. Changes are generally as a consequence of an increase in the budget outlay because of a midyear supplementary budget.
PI-17. Recording and management of cash balances, debt, and guarantees	C	Cash balances are consolidated and calculated daily. However, substantial government cash balances, both under treasury or line ministry control, are retained in bank accounts in commercial banks which do not form part of the consolidated cash balances of government.
PI-18. Effectiveness of payroll controls	D+	The treasury makes changes to its payroll database only on the basis of inputs received from MDAs or the Public Service Commission, because personnel records and payroll database is not reconciled in any systematic way. Occasionally, changes are made with a delay of up to three months. No audit of payroll has taken place for many years now.
PI-19. Competition, value for money and controls in procurement	C	While the legal framework for procurement recommends the use of competitive bidding processes, there is much leeway in practice for use of less competitive methods, and however no functioning monitoring mechanism at the center of government to track the relative use of competitive bidding. There is no external oversight body, but reasonable administrative appeals process exists.
PI-20. Effectiveness of internal controls for nonsalary expenditure	C+	Comprehensive expenditure commitment controls are in place and effectively limit commitments to actual cash availability and approved budget allocation. Staff in the MDAs are still not very conversant with rules and procedures for internal control.
PI-21. Effectiveness of internal audit	D	The internal audit capacity is weak, and reports are infrequent.

Budget cycle - accounting, recording and reporting

³⁰ See 'Development options for internal audit in Timor Leste', Colin Hall, Draft, (March 2011), pages 6-7. This draft paper is the most recent and fullest assessment undertaken to date of internal audit capacity and capacity building needs in Timor Leste. Its summary assessment included that "Despite the presence of approximately 200 auditors and inspectors across various areas of government, outputs and value creation are low. Most internal auditors have undergone little, if any, training and because of differences in perceptions about the role of the function, their activities are provided with variable levels of guidance and oversight" (page 2).

Background:

Article 43 of Budget and Financial Management Law requires the Treasury to maintain accounting records of (a) Government Revenues; (b) Appropriations; (c) Adjustments to budget appropriations; (d) Budget appropriations made available to Ministries in relation to expenses through Expenditure Authorization Notices; (e) Actual expenses made; and (f) Liabilities in arrears. The GoTL's accounts are maintained by the Treasury using the FreeBalance system, however the quality of expenditure and other data depends in part on the quality of data input by line Ministries. It is understood that while line Ministries are required to maintain separate financial records to verify the budget execution reports produced by the Treasury few in fact do so, relying heavily instead on Treasury's reports for their budget management purposes.

The FreeBalance system incorporates facilities to record budget preparation, budget execution (including commitments, payments and the generation of financial reports) and payroll. The budgeting and accounting modules of FreeBalance are fully compatible and data can be imported/exported between them. Additional modules including modules for program budgeting, procurement and asset management are at various stages of development.

For some years all transactions relating to budget execution were entered in FreeBalance by staff of the Ministry of Finance. However in 2009 authority to enter all Commitment and Payment Vouchers (CPVs) into FreeBalance was delegated to line Ministries with an associated training program. The system is now web-based. Some Ministries have remote access to the system from their offices in Dili but others must still enter their CPVs at dedicated terminals located within the Ministry of Finance. There is no capability at present for direct access to the system by either Finance or line Ministry officers at the District level or below. It is understood that connectivity issues at the District level are being examined by a current study.

In 2008 the Treasury introduced a unified Chart of Account (CoA) for recording transactions in FreeBalance. This CoA is consistent with Budget classifications. It is of particular interest from the perspective of potential use of the GoTL PFM system for future delivery of Australian (or other donor) funding assistance since the CoA has the capacity to identify financial transactions by:

- Fund (i.e. the source of funds);
- Organisation (the Ministry, Directorate and Division);
- Program, activity and function;
- Object (Account type, Appropriation category and line item); and
- Location (District, sub-District and Suco).

The classification of transactions by Program is not well-developed nor used for budget management purposes. The CoA and FreeBalance do appear to have some potential to clearly identify funds sourced from Australia and to track their recorded use to a relatively high degree of detail (should Australia wish to do that). However the present lack of meaningful classification of funding by program precludes any direct link between funding inputs and program outputs through FreeBalance.

As regards within-year reporting Article 44 of the BFML requires the Treasury to provide to the Parliament quarterly (unaudited) budget execution reports within two months of the close of each quarter.

As regards annual reporting Article 45 of the Budget and Financial Management Law provides that the Government shall present to the National Parliament:

- within three months after the end of each fiscal year, an intermediate (unaudited) budget execution report for that year;
- within nine months after the end of each fiscal year, “the set of financial balances compiled by the Treasury *audited in conformity with international accounting standards*” (italics added).

Article 45 goes on to specify in detail the required contents of the audited annual accounts which include budgeted and actual revenues and expenditures, budgeted and actual expenses disaggregated by each budget appropriation category; details of any loans to and borrowings by the government, interest payments and the number of government employees funded through budget appropriations for the year. It is understood that the annual financial statements required by Article 45 have been provided to the Parliament in a timely manner. The quarterly budget execution reports and annual financial statements are, in principle, available for downloading from the Ministry of Finance website.³¹

As regards external auditing Section 123 (1) (b) of the Constitution provides for the establishment of the High Administrative, Tax and Audit Court (HATAC). Section 129 (3) states “It is incumbent upon the High Administrative, Tax and Audit Court as a single instance to monitor the lawfulness of public expenditure *and to audit State accounts*” (italics added). In practice the HATAC has not yet been established. External audit of the GoTL’s annual financial statements³² has to date been performed by commercial auditors appointed for fixed terms (currently Deloitte and Touche Tohmatsu, appointed for three years in 2008). The external auditor does not perform performance audits and does not include financial management processes in line ministries and agencies, such as internal control, procurement, and payroll. The National Parliament receives and considers the annual audit reports but it is understood this consideration takes place alongside consideration of the next year’s draft Budget rather than as a separate exercise.

IMF Public Financial Management Performance Report as at August 2010:

C(iii) Accounting, Recording and Reporting		
Indicator	2010 Score	Explanation
PI-22. Timeliness and regularity of accounts reconciliation	B	Bank reconciliations with the TSA with the BPA take place within two weeks of the close of every month, but reconciliations and clearance of suspense accounts advances are completed within two months of the end of the financial year.
PI-23. Availability of information on resources received by service delivery units	D	Information regarding further release of funds by line ministries to service delivery units is not maintained by the MOF. The IFMIS [FreeBalance] has the capacity to monitor such details, but is not being used for this purpose at the moment.
PI-24. Quality and timeliness of in-year budget reports	C+	Budget execution reports allow direct comparison to the presentation of expenditures in the budget both on commitment and expenditure basis. Budget reports are prepared on a quarterly basis and presented to COM [Council of Ministers] and parliament within 8 weeks of the end of the quarter. MDAs, however, are not able to monitor their budget execution data on-line in user-

³¹ In practice the present Analysis encountered significant difficulties. For example, as at April 2011 the latest posted budget execution reports were for third-quarter 2010 (version in Portuguese) and first-quarter 2010 (version in English). The latter document could not be fully downloaded because a persistent error in processing a page repeatedly aborted the download.

³² The main extra-budgetary fund, the Petroleum Fund, is externally audited separately by a commercial auditor.

		friendly formats.
PI-25. Quality and timeliness of annual financial statements	C+	Financial Statements include full information on revenues and expenditures; not all financial assets are reported on and the accounting period is not fully in line with the duration of budget execution. The financial statements have been prepared in accordance with IPSASB cash basis accounting standards.
PI-26. Scope, nature, and follow-up of external audit	C+	There is no independent external auditor, but a commercial external auditor audits the government accounts. The audit performed is a financial audit of all expenditure and revenue transactions over the accounts held by the treasury. The auditor does investigate process and systems issues, and reports on these, and on compliance issues, in an annual report and through a management letter.
PI-27. Legislative scrutiny of the annual budget law	C+	The scope of the legislature's review covers fiscal policy, and aggregate and detailed estimates of the revenue and expenditure for the coming budget year, but at the concluding stage of the budget process. Procedures for legislature review are firmly defined and leave enough time (2.5 months) for parliamentary scrutiny. In-year budget amendments are clearly stated in the BFML, but they have not always been respected.
PI-28. Legislative scrutiny of external audit reports	D+	Parliament discusses the findings of the audit report only as part of the discussion on the annual budget. Only in a few cases has parliament requested action on the basis of audit findings. These request are sometimes, but not systematically acted upon.

Summary of recent assessments of the PFM system

The IMF, with the participation of the World Bank and Asian Development Bank, undertook two comprehensive assessments of the GoTL's PFM system in 2010: a public expenditure and financial accountability (PEFA) assessment; and an assessment of fiscal transparency practices. Annex 3 of the IMF Staff Report for the 2010 Article IV Consultation with Timor Leste (December 2010) summarised these assessments in the following terms.

“The 2010 fiscal ROSC and PEFA exercises evaluated the strengths and weaknesses of Timor-Leste’s public financial management (PFM) system. In response to the authorities’ request, the Fund carried out both exercises with participation of the WB and the ADB. This diagnostic work will form the basis for the IMF’s input in helping the authorities elaborate a comprehensive PFM reform strategy in close cooperation with the World Bank.

The assessments suggest that overall Timor-Leste has made solid progress in strengthening the PFM system from a low base. Key strengths in fiscal transparency include: a well-structured, basic budget process; a well-managed and supervised framework for the petroleum sector; comprehensive budget documentation and regular fiscal reporting; a modern integrated financial management information system; and an efficient Treasury Single Account. Notable gains have also been made in funding predictability, timeliness and quality of bank reconciliation and financial statements, legislative scrutiny, functionality of the treasury system, and external audit process.

However, substantial weaknesses in the PFM system remain.

- The budget is not a good predictor of actual spending, mainly reflecting large supplementary

budgets.

- Budget Review in the Ministry of Finance has very little assessment capacity, especially on the capital side.
- Budget planning and implementation capacity in line ministries are still very weak.
- Budget oversight of autonomous government agencies and public enterprises, albeit relatively few in number, is weak and associated fiscal risks are not monitored.
- Independent internal and external audit process is lacking.
- Procurement has been in a state of flux for many years, with less competitive instruments becoming more prevalent.
- The budget is only weakly linked to policy objectives and the implications of capital spending for recurrent budgets are ignored.
- The Ministry of Finance has little capacity to adequately review the rationale, costing, and impact of public investment.
- A solid multi-year perspective on fiscal planning, expenditure policy, and budgeting is missing.

Despite improved transparency in tax payer obligations, compliance and tax audit remain a major issue.”

Source: IMF Staff Report for the 2010 Article IV Consultation with Timor Leste (December 2010), page 31.

On behalf of the GoTL, the IMF Executive Director for the DRoTL responded in the following terms.

“The staff report indicates that “significant gaps remain in PFM”. The authorities have placed great emphasis on improvements in public financial management (PFM) in recent years, which has led to a substantial enhancement in the budget execution rate. A Strategic Plan for PFM was finalized in early 2010 and is being implemented in key areas related to accounting systems, procurement practices, internal audit, staff capacity building, etc. Strong anticorruption mechanisms are being put in place. Two important facts should have been highlighted: (i) it is reassuring that the Transparency International Corruption Perceptions Index of 2010 shows an improvement of 19 positions by Timor-Leste in the past 12 months; and (ii) Timor-Leste was the third country worldwide to achieve the status of full compliance with the Extractive Industry Transparency Initiative.”

Source: Statement by Mr. Arrigo Sadun, Executive Director for the Democratic Republic of Timor-Leste and Mr. José Cardoso, Advisor to the Executive Director (January 19, 2011), pages 3-4.

A3 Agency functions and funding for RWASH service delivery

Timor Leste’s administration is exercised at national and sub-national levels, the latter comprising 13 Districts and 65 Sub-Districts. While formal decentralisation of functions to the sub-national level has been deferred until after a national election in 2012 several line Ministries have representation at the District level and some (including MoI/DNSAS) at the Sub-District level. In addition, each District has an administration staffed by officers of the Ministry for State Administration and Territorial Management headed by a District Administrator.

Rural water, sanitation and hygiene services in Timor Leste take three main forms: the construction of water supply and sanitation facilities, their ongoing operations and maintenance,

and complementary activities to promote personal and communal hygiene. The following describes agency functions relevant to RWASH facilities and services (which continue to change and evolve), summarises trends in their funding and documents what is known to date regarding their decision making processes in relation to budgeting and budget execution.

Agency functions

'Agency'	Principal functions/activities relevant to RWASH facilities and services
Office of the Prime Minister	<p>The 2011 Budget has established the <u>Infrastructure Fund</u> to finance a wide range of capital projects/programs with a value exceeding US\$1 million. The 2011 budget provides for expenditure from this fund of US\$20.42 million on MDG Water and Sanitation and US\$44.58 million on the construction of housing for vulnerable groups (which will include a water supply and sanitation component) - see 'Agency funding'. The Infrastructure Fund is to be oversighted by a Board comprising the Prime Minister and 'other relevant Ministers'. However the 2011 Budget Book 1 also indicates (page 56) that "the Minister for Finance is responsible for the management and control of the Special Funds".</p> <p>A <u>National Development Agency</u> (ADN) under the Office of the Prime Minister is also being established. The 2011 Budget Book 1 indicates (page 38) "The ADN oversees implementation of projects financed by the Infrastructure Fund while the Ministries/Agencies will manage the recurrent expenditures as well as the minor capital expenditures." The ADN will report to the Parliament through the Council of Ministers. Its funding for 2011 is appropriated to the Office of the Prime Minister.</p> <p>Decree Laws 1/2010 and 3/2010 established a <u>Procurement Monitoring Commission</u> and a <u>Procurement Technical Secretariat</u>. The Commission is to be responsible for monitoring and verifying the implementation of all State procurement procedures and monitoring/verifying the execution of projects. The Secretariat is to provide technical support and advice in respect of procurements up to US\$1 million and to carry out procurement procedures for procurements over US\$1 million. Members of both the Commission and Secretariat are to be "appointed through dispatch by the Prime Minister". The Secretariat is to report to the Prime Minister "or to the person delegated by him through dispatch." The Commission's funding for 2011 is appropriated through the Office of the Prime Minister. The functional relationships between these bodies and the National Directorate of Procurement within the Ministry of Finance (see below) is currently unclear.</p>
Ministry of Finance (MoF)	<p>Within the MoF the <u>National Directorate of Budget</u> is responsible for management of the GoTL annual budget process including the review of Line Ministry budget submissions and the setting of recurrent budget expenditure envelopes for individual line Ministries. It is also responsible for the review of GoTL expenditure programs.</p> <p>The <u>National Directorate of Treasury</u> is responsible for maintaining accounts of revenues and expenditures, administering payments from the Consolidated Fund and Special Funds, and preparing within-year financial reports and the GoTL's annual financial statements. Treasury is also responsible for establishing guidelines for internal audit in line Ministries and undertaking (a limited number of) internal audits.</p> <p>The <u>National Directorate of Procurement</u> is responsible for setting GoTL</p>

	<p>standards and procedures for government procurement and for assisting line Ministries in the tendering and procurement of large projects. As noted above, the relationship between its functions and those of the Procurement Monitoring Commission and Procurement Technical Secretariat are currently unclear.</p> <p>The <u>National Directorate of Aid Effectiveness</u> is responsible for coordinating and aligning external assistance provided by development partners in accordance with GoTL development priorities. This function includes the maintenance of consolidated records of external assistance and preparation of a Budget Book summarising the indicative funding commitments made by development partners for the fiscal year(s) ahead. The <u>Major Projects Unit</u> has to date been responsible for the management and supervision of contracts valued in excess of US\$1 million. Its future role and relationship with the National Development Agency being established in 2011 within the Office of the Prime Minister has yet to be finalised.</p>
Ministry of Infrastructure (MoI)	<p>Prior to establishment of the Infrastructure Fund and National Development Agency the MoI managed the bulk of GoTL funding of civil works in the areas of roads, buildings (including housing), water and power supply. While funding for much of this infrastructure is now being channelled through the Infrastructure Fund the MoI continues to design and execute approved projects. The MoI's current structure is outlined in Section A4.</p> <p>Within the MoI the <u>National Directorate of Water Resource Management</u> has overall responsibility for the management of all water resources in Timor Leste while the <u>National Directorate of Water and Sanitation (DNSAS)</u> is responsible (along with community groups for village-level facilities) for the delivery and management of public water supplies. This function includes the identification of areas to be supplied and the application of service user charges. The Department of District Water Supply and Sanitation (SAS) within DNSAS manages the delivery of RWASH programs via staff in each District who undertake planning and project management of minor works and the maintenance of facilities. The SAS also liaises with other RWASH stakeholders at District/sub-District levels including District Administrators and the community-based Water Management Groups (GMFs), the latter liaison facilitated by a network of Sub-District Facilitators (SDFs) now employed/funded by DNSAS.</p>
Ministry of Health (MoH)	<p>Within the MoH Directorate of Community Health the <u>Environmental Health Department</u> is responsible for water quality and sanitation standard-setting and monitoring while the <u>Health Promotion Department</u> is responsible for sanitation and hygiene information and education. The Health Promotion Department is also responsible for coordinating the Family Health Promoters Program delivered through the SISCa (integrated community health service) under which community health volunteers, backed by monthly visits from the District health clinics, assist in addressing six health topics at the Suco level including environmental health and sanitation ('Table 4'). The Infrastructure Management Unit is responsible for constructing, operating and maintaining water supplies for all GoTL-funded health facilities within each facility's boundaries.</p>
Ministry of State	At the national level, the National Directorate for Local Development

Administration and Territorial Management (MSATM)	<p>and Territorial Management is MSATM's lead Directorate for the GoTL decentralisation process and coordination of local development. In 2011 its programs include the Local Development Program (PDD1) and Decentralised Development Program (PDD2) - see 'Agency funding'. A significant proportion of total funding for both programs is allocated to water and sanitation projects at the District/sub-district levels. Under Decree Law 2/2010 special procedures apply for the awarding of contracts for public works valued at up to US\$250,000 to local companies, including contracts for works funded by the PDD1, i.e. projects valued at up to US\$150,000. These procedures include provision for the selection of eligible companies and the oversight of projects (including progress payments) by joint District teams comprising the "Ministry of Infrastructure, Ministry of Finance, the Ministry responsible for the project and a District representative". It is understood that these teams are convened by the District Administrator funded by MSATM. MSATM is planning to recruit two engineers for each District and one technical officer for each sub-District (not water/sanitation specialists) along with other additional staff to strengthen management capacity at the District level.</p> <p>Responsibilities at national and District levels for contracting and oversight of projects funded by the PDD2, i.e. projects with a value of US\$150,001 to US\$500,000 are less clear pending statutory confirmation but it is understood that the National Development Agency rather than MSATM will exercise substantial quality control functions in relation to projects in this range.</p>
Other Ministries	The Ministry of Education is responsible for providing adequate water and sanitation facilities in schools and hygiene education in the classroom.
Water Management Groups (GMFs)	With the assistance of the SAS including its Sub-District Facilitators the GMFs, where they exist, are responsible for the operation and maintenance of water supply facilities at a community level, typically small-scale facilities servicing a single village or small group of villages. The GMFs are also responsible, in principle, for administering cost recovery arrangements to fund ongoing maintenance of these facilities. Pending endorsement of the (draft) National Water Supply Policy the responsibilities of the GMFs and SAS respectively for operations and maintenance are not well-defined.
Non Government Organisations	The Office of Development Effectiveness reported in 2009 that "Some 14 local NGOs have experience in water supply and sanitation construction and environmental health promotion. Some have been active in the sector since independence. In many cases, these NGOs are supported by international NGOs such as Oxfam, Triangle and WaterAid. The international bodies usually integrate water supply and sanitation as part of their broader-based community development programs. Water and sanitation improvements are often undertaken in consultation with Government but are apart from Government control." ³³

³³ AusAID: Working Paper 1 - East Timor; Independent Evaluation of Australian Aid to Water Supply and Sanitation Service Delivery in East Timor and Indonesia, Office of Development Effectiveness (December 2009), page 48.

Development partners	In 2011 the largest external assistance to water supply and sanitation services is being provided by Australia (BESIK program), the Asian Development Bank (Dili Urban Water Supply Project) and the USA (District Water Supply, Sanitation and Hygiene Project - DWASH). The BESIK and DWASH programs are essentially 'stand alone' programs operating in parallel with but distinct from GoTL systems for the delivery of water and sanitation services. UNICEF is also funding assistance to the RWASH sector (at lower level). Australia is also contributing to the Planning and Financial Management Capacity Building Program in the MoF and the Public Sector Capacity Development Program within MSATM.
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Agency funding

The GoTL does not as yet compile or publish budget or budget execution data on a program basis. There is therefore no readily available data on its aggregate budgets for or actual expenditures on RWASH facilities and services, much less any readily available data on total funding of the sector from all sources including development partners, non government organisations and Water Management Groups. However, consideration of budget documentation and appropriations in relation to the spending intentions and the agencies most directly involved point to two key conclusions:

- There has been a substantial increase since 2009 in budgeted GoTL funding of programs fully or partially used to expand water supply and sanitation facilities in both urban and rural areas such that its actual spending on rural facilities in 2011 will almost certainly exceed that by development partners.
- There has been a major shift away from the MoI/DNSAS to the Prime Minister's Office and MSATM in formal responsibility for budget appropriations directed, in whole or part, at the provision of water and sanitation facilities and services, especially budget appropriations for capital expenditure.

The following tables demonstrate both points.

GoTL Appropriations for Capital and Development 2009-2011³⁴

	US\$'000		
	2009	2010	2011
Total from Consolidated Fund of Timor Leste	205,371	252,800	89,000
Total from Infrastructure Fund	nil	nil	599,306 ³⁵
Total GoTL Capital and Development	205,371	252,800	688,306
Of which from the Consolidated Fund total:			
Office of the Prime Minister (National Development Agency) (PDD2 at District level)	nil	nil	28,811
Ministry of State Administration and Territorial Management	1,791	3,000	16,802
Ministry of Infrastructure	55,133	176,031	29,783
Of which:			
EDTL	4,818	36,300	1,200
Construction of new power station	13,209	60,000	nil
Roads Bridges and Flood Control	15,942	68,572	25,825
DNSAS	1,175	3,020	2,758
Ministry of Health	4,141	5,700	nil
From the Infrastructure Fund total 2011 of \$599 million:			
Power	nil	nil	448,742
Roads, Bridges and Airports	nil	nil	22,813
MDG Water and Sanitation	nil	nil	20,420
MDG Housing for Vulnerable Groups	nil	nil	44,580
Health projects	nil	nil	1,670

Supplementary Data: Ministry for State Administration and Territorial Management

	US\$'000		
	2009	2010	2011
Transfers:			
Public Grants Capital - Decentralisation Development Package (PDD1)	nil	31,356	11,094 ³⁶
Total Capital and Development	1,791	3,000	16,802
Of which:			
Decentralisation Development Package (PDD 1 - "village, suco and sub-district levels")	nil	nil	15,521

One consequence of the shift in formal responsibility for budget appropriations is that DNSAS's internal budgets for capital expenditure on water and sanitation facilities now bear no relationship to its formal appropriations for such expenditure. The following table illustrates this by reference to DNSAS's 2011 capital appropriations and its internal budget as at March 2011 for water and sanitation capital works to be delivered by it in 2011.

³⁴ Sources: 2010 Budget Book 1 (for 2009 aggregate capital and development data) and 2011 Budget Books 1 and 4. The Budget figures for 2010 are as reported in the 2011 Budget documentation. They differ substantially from the original 2010 Budget appropriations due to re-allocations and increases via the 2010 'Rectifying Budget'.

³⁵ Total appropriations from the Infrastructure Fund are some \$599 million. The 2011 Budget Speech indicates (Book 1 page 8) that "\$317.306 million is allocated to the Infrastructure Fund". The source of the difference is unknown but might be attributable to unspent Capital and Development balances from 2010 being credited to the Infrastructure Fund in 2011.

³⁶ There are some difficulties in linking figures provided in Budget Book 1 to the amounts formally appropriated to MSATM in particular.

DNSAS capital and development appropriations and current internal capital budget 2011

	US\$'000	
DNSAS 2011 Budget appropriation for capital and development ³⁷	2,758	
DNSAS internal budgets for capital and development as at March 2011 ³⁸		
• DNSAS appropriation	2,758	
• PDD District	5,034	
• PDD Sub-District	5,140	
• PDD Suco	1,993	
DNSAS total internal capital and development budget 2011		14,925

Inter-agency decision-making processes for water and sanitation facilities

Recurrent operation and maintenance of both urban and rural water and sanitation facilities are primarily (within the GoTL) the responsibility of DNSAS. GoTL capital expenditure on such facilities will be funded in 2011 through five main sources:

- some part of capital transfers and capital expenditure appropriated to MSATM for the 'Decentralisation Development Package';
- some part of US\$28 million appropriated to the National Development Agency for the funding of projects at District level valued in the range US\$150,001 to US\$500,000;
- the US\$20.4 million appropriated from the Infrastructure Fund for MDG water and sanitation;
- some part, possibly, of the US\$44.6 million appropriated from the Infrastructure Fund for MDG housing for vulnerable groups; and
- DNSAS's appropriation for 2011 capital and development expenditure (US\$2.8 million).

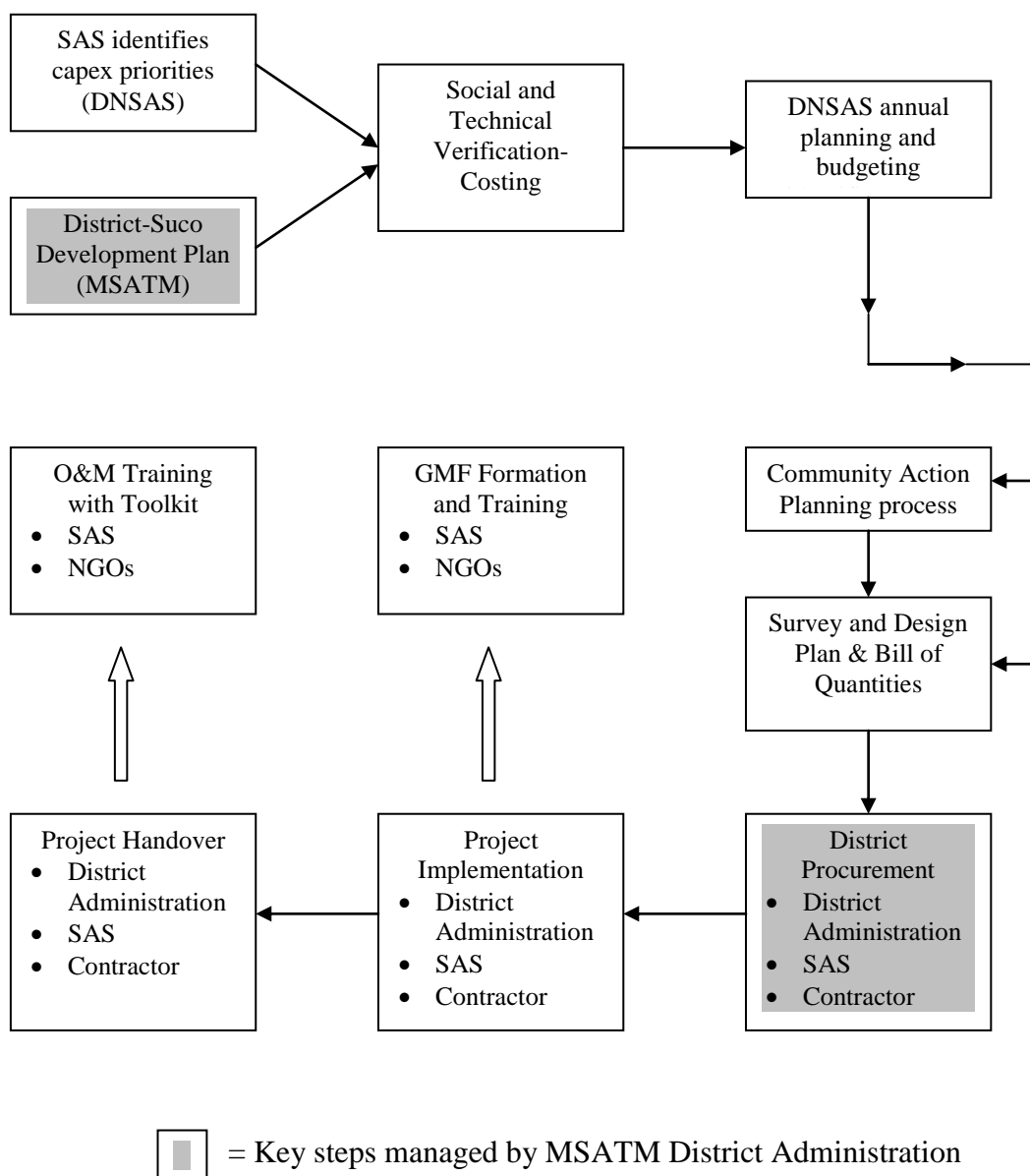
While line Ministries put forward proposals for projects to be funded from these sources the inter-agency decision-making processes prior to the 2011 Budget that led to determination of the aggregate amounts involved are unclear. They appear to have been significantly influenced by decision-making within the Office of the Prime Minister and, as noted elsewhere, to have been disconnected from decisions in relation to the funding of recurrent operation and maintenance.

As regards expenditure of the funds appropriated, inter-agency decision-making in relation to projects (including rural water and sanitation projects) valued at up to US\$150,000 for Aldeias, Sucos and Sub-Districts ('PDD1') will likely follow the procedures of previous years. These are summarised in Chart 1 following.

³⁷ Source: 2011 Budget Book 4

³⁸ Source: Data supplied by the BESIK Program. This does not as at March 2011 appear to include any budget for a DNSAS role in relation to the supply of water and sanitation facilities as part of housing for vulnerable groups to be funded from the Infrastructure Fund.

Chart 1: Rural Water Supply Planning and Project Management (PDD1)

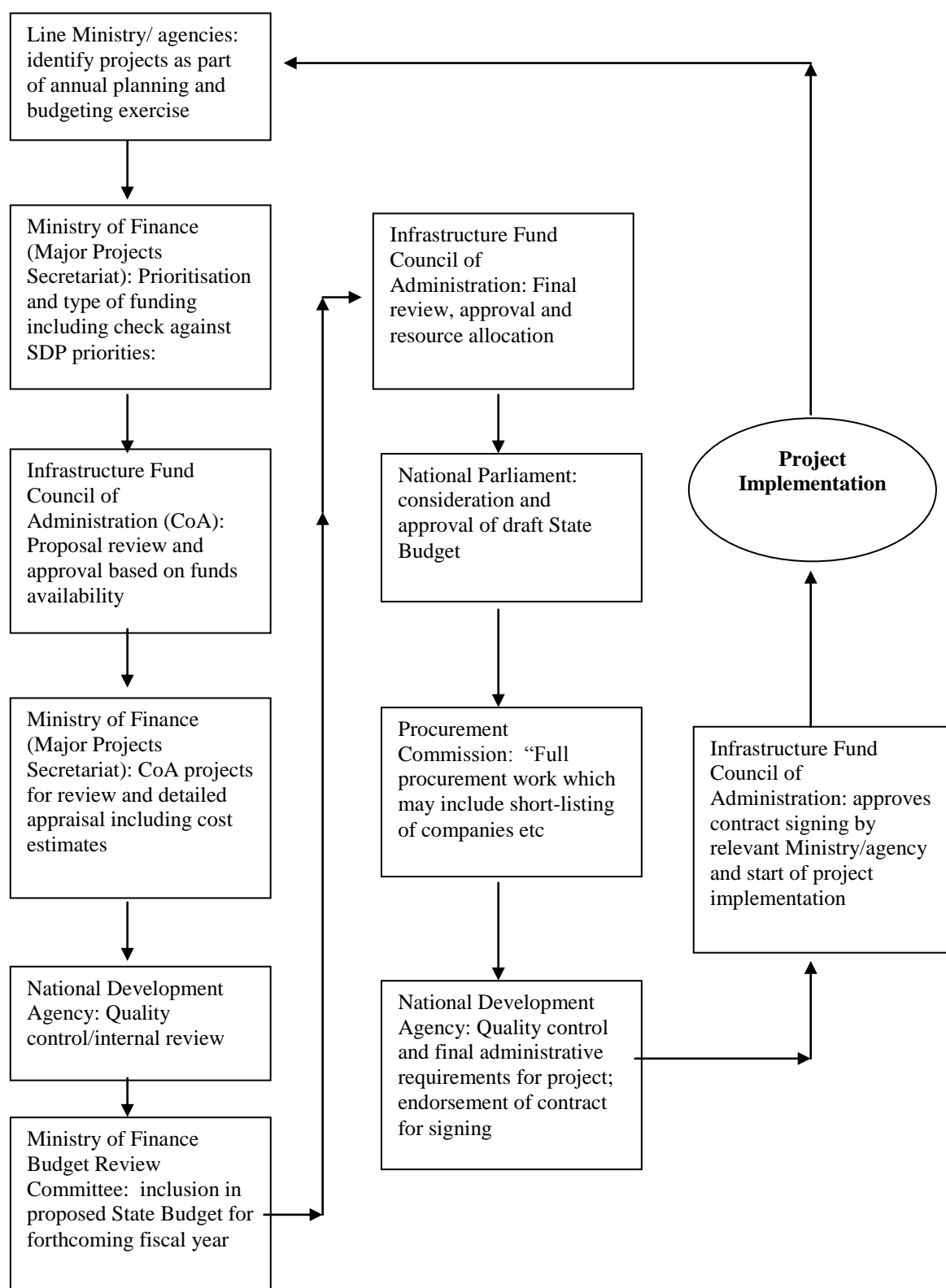


Source: BESIK Program

Responsibilities for procurement rest ultimately with the District Administration (MSATM) while responsibilities for project implementation and handover are dispersed between that District Administration, the SAS (DNSAS) and contractors. As noted elsewhere, this has given rise to quality control issues.

As regards the National Development Agency's role in delivery of PDD2 projects and its interactions with other agencies in the process these have yet to be finalised. Chart 2 outlines what is known (as at March 2011) about the process envisaged for large-scale (more than US\$1 million) projects but whether and how these would apply to ADN-administered PDD2 projects at District level is unclear.

Chart 2: Decision-making process envisaged for capital projects exceeding US\$1 million



The 2011 Budget papers indicate that the National Development Agency is to be responsible for overseeing the implementation of projects financed by the Infrastructure Fund and that this covers “multi-annual and large projects above \$1 million *and MDG*” (italics added). Given that few if any capital expenditure projects for rural water supply and sanitation facilities will exceed US\$150,000 in value it may be unlikely they would fall within the compass of the above process (notably project implementation) but that has yet to be tested.

Similarly, the roles to be played by the National Development Agency and Procurement Commission/Technical Secretariat in decision-making on the disbursement of funding for the MDG water and sanitation and MDG housing for vulnerable groups programs was (as at March 2011) unknown. The BESIK program has advised that DNSAS and the program “... have met with the MoF MDG unit regarding this program, and at this stage the proposal is that these funds [MDG water and sanitation] are partnered with [the MDG housing for vulnerable groups] budget ...”³⁹ Budget Book 6 (page 2) indicates that MoI is the “owner” of the MDG water and sanitation program while the Ministry of Social Solidarity is the designated “owner” of the MDG housing for vulnerable groups program. When combined with the stated responsibility of the National Development Agency for MDG projects this suggests that at least three, possibly more, agencies will be engaging in decision-making in relation to the two MDG programs

In summary, inter-agency responsibilities for decision-making in relation to capital expenditure on rural water and sanitation facilities valued at less than US\$150,000, while they have given rise to some problems, appear relatively clearly defined. Decision-making processes for the execution of any projects valued at above this amount are currently ill-defined. Where responsibility and accountability for their efficient execution will ultimately reside is ‘muddy’ to say the least.

A4 MoI/DNSAS budgeting and budget execution

Organisation context

In budget terms the MoI as a whole is one of the largest GoTL line Ministries. The 2011 Budget indicates that, even excluding autonomous agencies within the MoI portfolio, it ranks fifth amongst eighteen line Ministries/agencies in terms of 2011 budgeted total expenditure behind the Ministries of Social Solidarity, Education, Defence and Security, and State Administration and Territorial Management. This is notwithstanding the substantial shift in recent years away from MoI to other agencies in appropriations for capital and development.

Charts 3, 4 and 5 (following) show:

- the current organisation structure of the MoI;
- the current organisation structure of DNSAS;
- the current structure of the financial management function within DNSAS.

Within MoI the Directorate General, Corporate Services for Electricity, Water and Urbanisation plays an influential role in DNSAS budget planning and execution including through reviewing DNSAS’s budget submissions prior to their submission to MoF and (with the DNSAS Director) representing DNSAS in subsequent presentation of submissions to the GoTL Budget Review Committee.

³⁹ Email from BESIK program, 5 April 2011.

Chart 3: Ministry of Infrastructure: Organisation Structure Financial Year 2011
(ND = National Directorate)

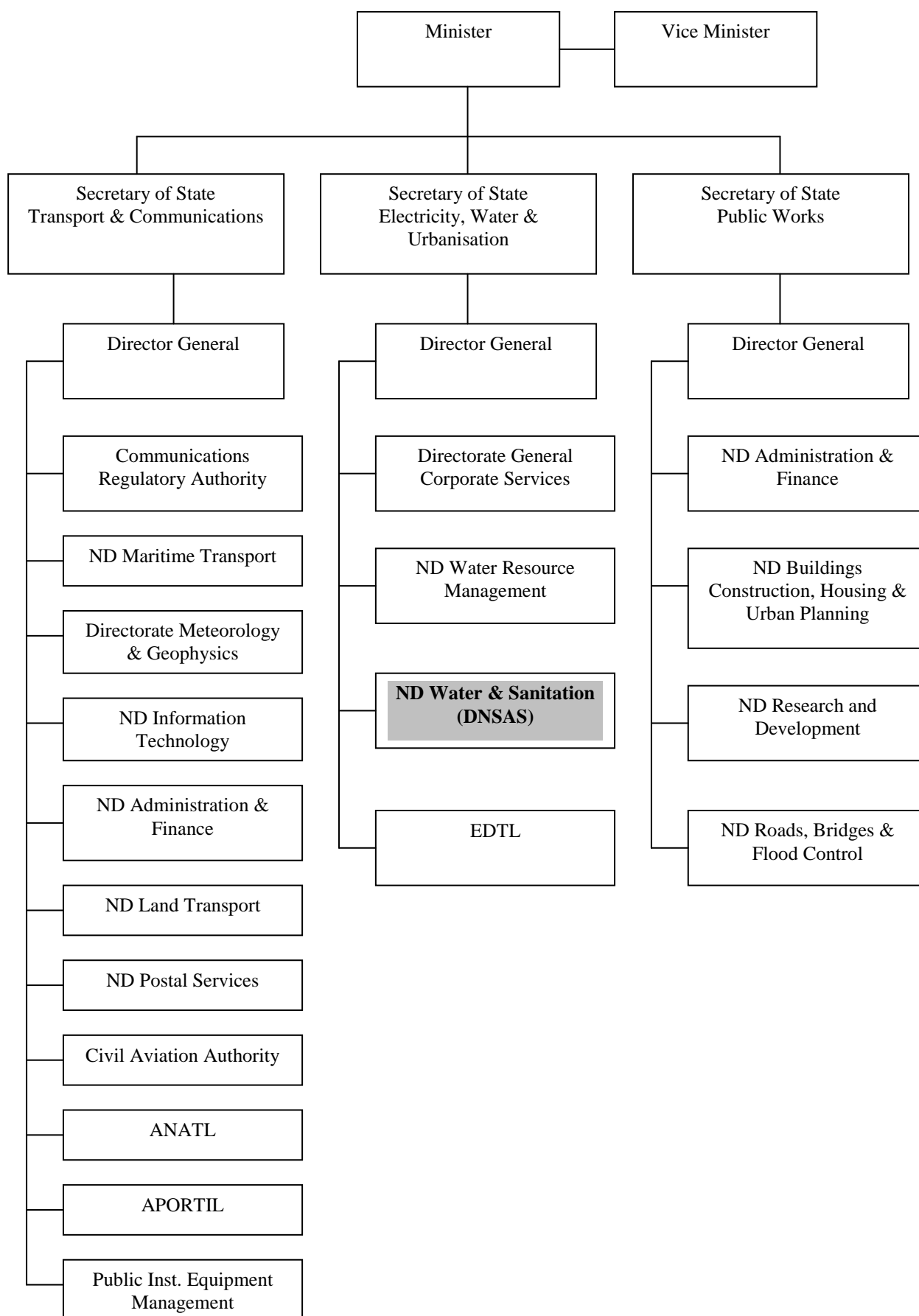


Chart 4: DNSAS Organisation structure and main functions (as at March 2011)

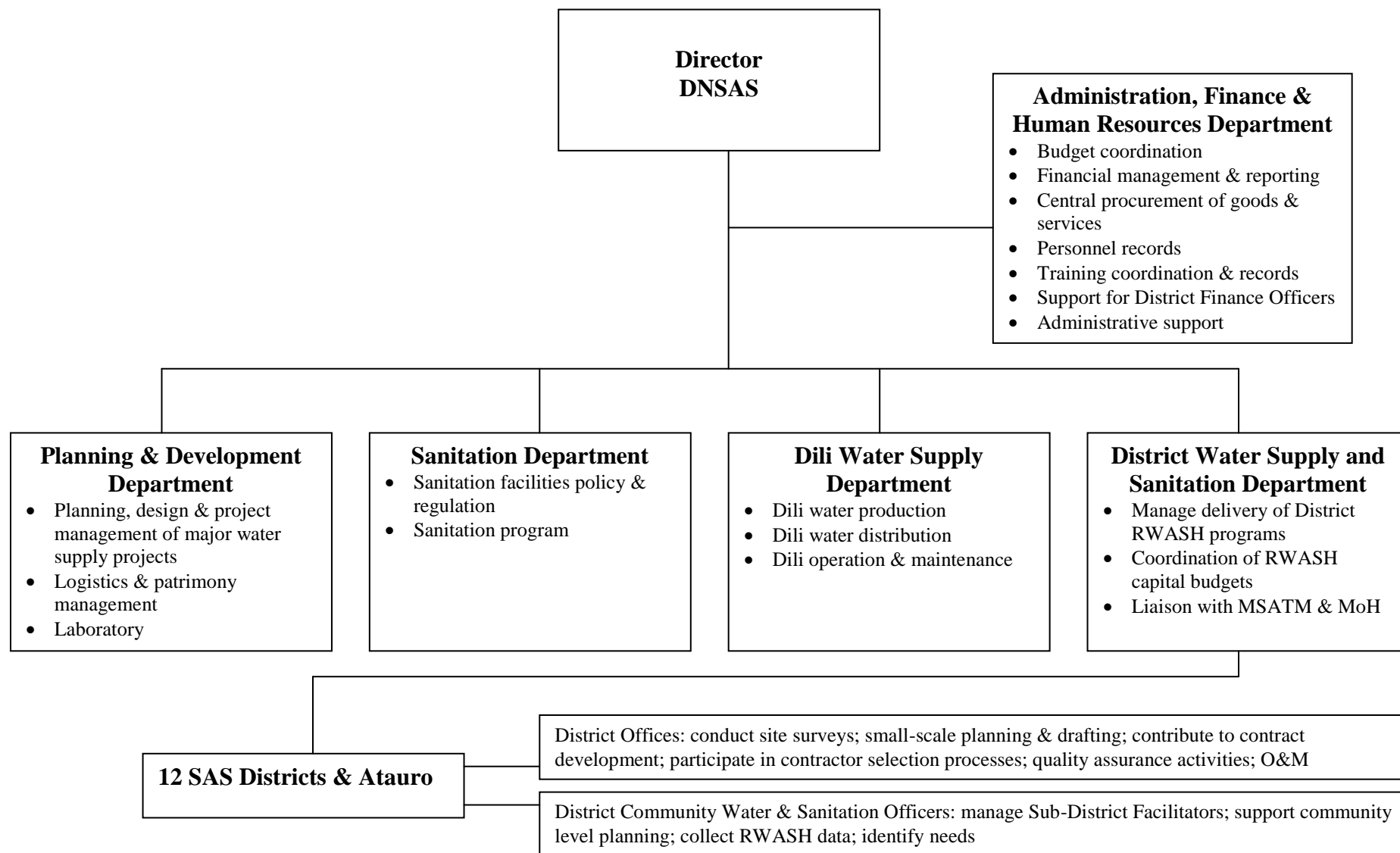
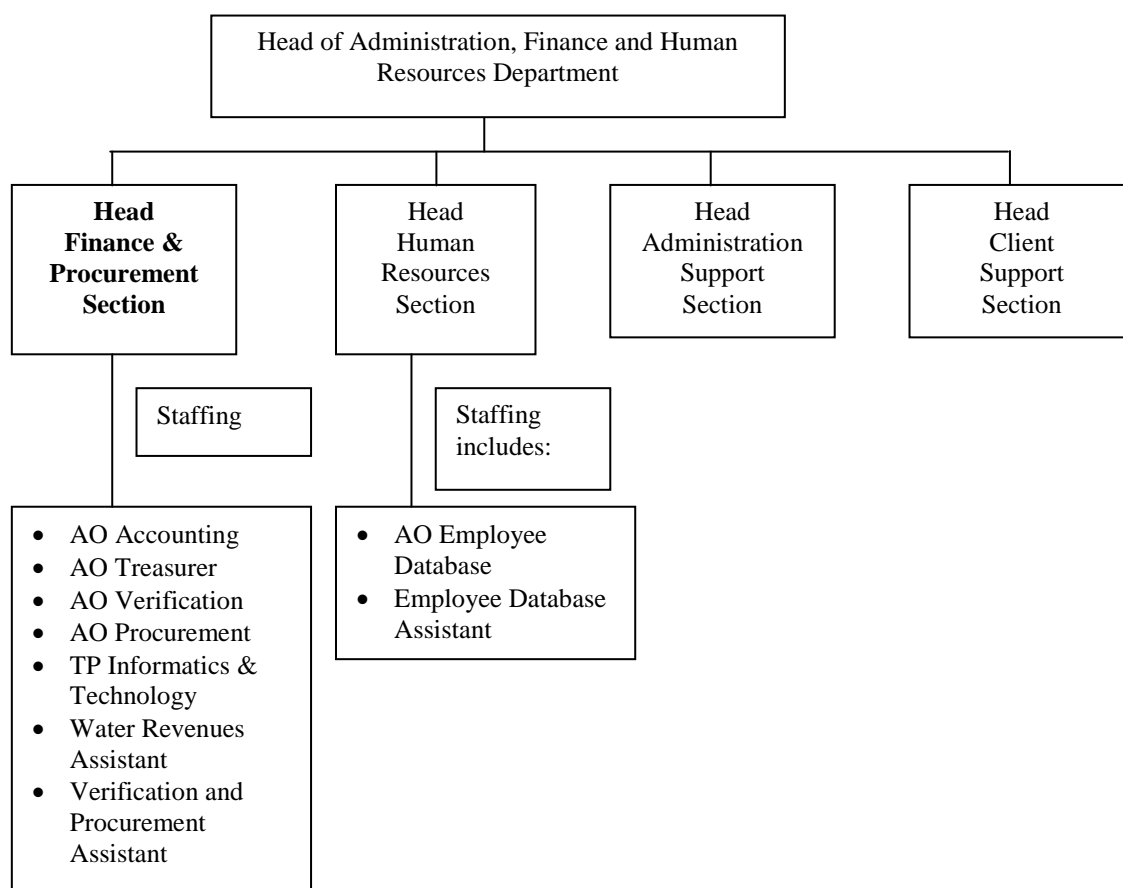
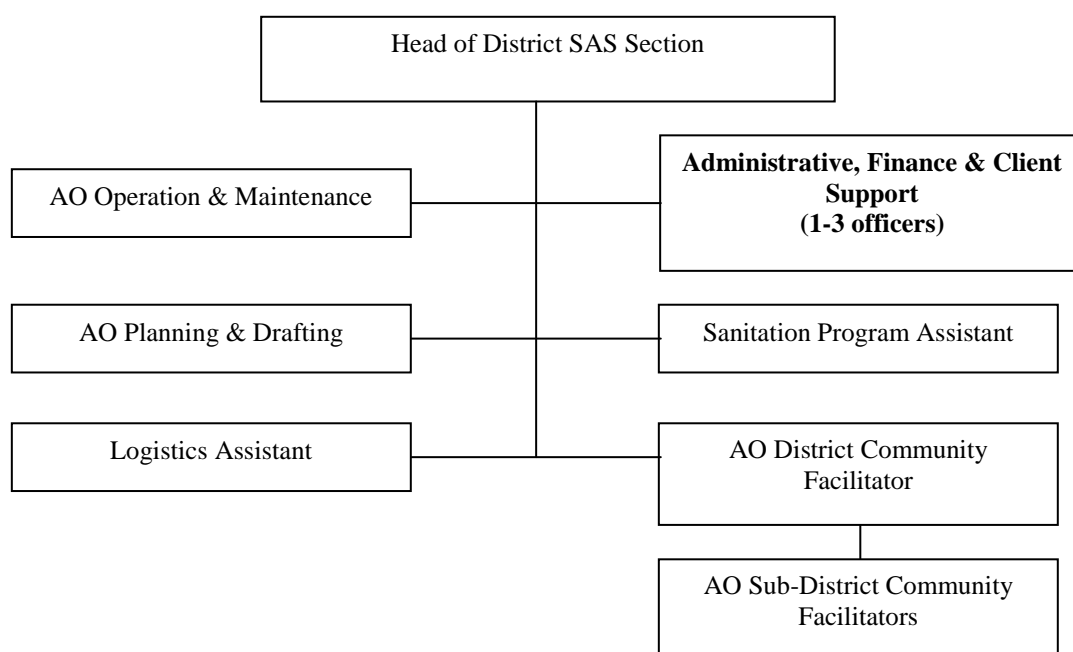


Chart 5: DNSAS organisation of the financial management function (as at March 2011)
(AO = Administrative Officer)

National Level



Typical SAS District Office Structure



The MoI portfolio includes four self-funding agencies:

- Electricity of Timor Leste (EDTL);
- Port Authority of Timor Leste (APORTIL);
- Airport and Air Navigation Administration of Timor Leste (ANATL);
- Public Institution of Equipment Management.

Excluding these autonomous agencies, the DNSAS total budget for 2011 constitutes some 12% of the MoI total budget while its recurrent budget for 2011 constitutes some 18% of the MoI recurrent total.

An MoI Organic Law of 2010 provided for a significant organisational restructuring of MoI including the creation of three water/sanitation-related National Directorates instead of the present two: a National Directorate for Water Services, National Directorate for Sanitation Services and National Directorate for Water Quality Control. However this structure was finalised too late in the year to form the basis for 2011 budget appropriations. The future relationship between the Water Services and Sanitation Services Directorates in particular has yet to be finalised, including the issue of whether each Directorate will have its own budget administration, finance and human resources department.

Within DNSAS recurrent budget coordination and financial management is undertaken by the Administration, Finance and Human Resources (AFHR) Department while proposals from the Districts for small-scale capital expenditure, including expenditure on rural water and sanitation facilities are coordinated by the Program and Community Management Section within the District Water Supply and Sanitation Department. Planning, design and project management of DNSAS capital expenditure on large water supply facilities are undertaken by the Planning and Development Department.

Some 10 officers within the AFHR Department are engaged in budget coordination, financial management and procurement activities. Financial management at the District level is essentially limited to recording expenditure from the small District imprest accounts and reporting/acquitting that expenditure (see below). This function is undertaken by the District Managers supported by, typically, a Finance assistant who may or may not combine that function with other duties. A review of four District Offices in 2010 found that the Finance Assistants had no formal qualifications in bookkeeping. The AFHR Department has, however, provided some training to the District Offices in financial reporting and acquittal procedures (the scale and depth of this has not been assessed).

DNSAS annual budget preparation

The 2010 budget preparation process for fiscal year 2011 was as follows.

Timing (2010)	Steps
First Quarter	Release of Budget Calendar by MoF
April	Preparation of DNSAS 2011 Annual Action Plan (submitted to Office of the Prime Minister end-April)
May	Formation of DNSAS Budget Working Group comprising Heads of DNSAS Departments and District Managers
May	Issue by MoF of Budget Circular including budget ceilings for recurrent expenditures
June	Initial DNSAS budget submissions prepared and forwarded to MoF via

	MoI
June/July	Review by MoF (and GoTL Budget Review Committee?) of initial budget submissions
August	Issue by MoF of approved recurrent budget ceilings
August	DNSAS Budget Working Group (BWG) meetings: <ul style="list-style-type: none"> • preparation/presentation of draft goods and services and minor capital works budgets; • consideration of Districts' proposals for the capital and development budget; • advice to DNSAS from MoI of MoI/DNSAS approved recurrent budget ceilings; • advice from MoF of revised budget timetable plus training in use of MoF standard budget preparation template; • finalisation of DNSAS entries to MoF template for 2011 Budget.
Mid-September	<ul style="list-style-type: none"> • Advice by MoI to DNSAS of GoTL-approved draft Budget for DNSAS for 2011. • Presentation to senior DNSAS management by DNSAS AFHR and Program & Community Management focal point of approved 2011 recurrent and capital budgets respectively.
End-September	Senior DNSAS management review of GoTL-approved 2011 Budget for DNSAS and budget execution strategy.
Mid-October	Presentation of GoTL proposed 2011 Budget to National Parliament

This process was apparently well-regarded within MoI, it being reportedly rated as amongst the best within MoI. However, the following features of the process merit further comment.

Annual budgeting confined to GoTL funding: As noted elsewhere DNSAS (and other agency) budget preparation focuses exclusively upon the forthcoming fiscal year. There is no medium-term expenditure framework for DNSAS's urban and rural water supply and sanitation functions, much less a medium-term expenditure framework for the RWASH sector incorporating GoTL, development partner and other funding sources. The GoTL budget documentation does include 'forward estimates' of expenditure but in no way do these form the 'start point' for the following year's budget preparations. The forward estimates appear to simply extrapolate the budget (recurrent or total) for the forthcoming fiscal year and differ substantially from one year to the next in an unexplained manner.

Forward Estimates comparisons for DNSAS: 2010 and 2011 original budgets

	Financial Year: US\$'000				
	2010	2011	2012	2013	2014
DNSAS total budget, original 2010 (2010 Budget Book 3)	12,761 (Budget year)	1,898	1,898	1,897	-
DNSAS total budget, original 2011 (2011 Budget Book 4)	(4,800)	5,019 (Budget year)	5,220	5,429	5,646

The DNSAS Annual Action Plan (and others) is not related to its overall budget submission: The DNSAS Annual Action Plan for 2011 comprised a summary table of proposed activities, expected results, performance indicators, estimated costs, and location of the activities, distinguishing between rural and urban and water and sanitation activities. While the process of

preparing this Plan served as a vehicle for discussion within DNSAS of priorities and cost estimates for the forthcoming year the latter were not related in any way to specific budget line items. In its present form, the DNSAS Annual Action Plan (and doubtless those of other GoTL agencies) cannot be used in any direct way as a tool for monitoring of subsequent budget execution.

The process for setting the budget envelopes for DNSAS recurrent expenditure merit further examination: It is understood that, initially at least, the recurrent budget envelopes set by the MoF, as approved by the Council of Ministers, are set for Ministries as a whole. The process whereby these Ministry envelopes are translated into recurrent budget envelopes for individual Directorates was not explored during field study and merits further examination since, as noted elsewhere, the DNSAS recurrent budget does not appear to be related in any systematic way to the GoTL's markedly increasing investment in water and sanitation facilities. Whether this lack of linkage arises at the GoTL/MoF level or stems from the recurrent budgeting process within MoI (or both) is presently unclear.

Recurrent expenditure is not budgeted to DNSAS programs/functions: DNSAS budgets are consolidated and presented by expenditure category for DNSAS as a whole. There is no budget (or budget execution) data disaggregated by function (e.g. water supply, provision of sanitation services) or program (e.g. urban water facilities and services, rural water facilities and services). There is no overall budget (or budget execution) data to indicate the total resources available to individual Districts. FreeBalance has the capacity, in principle, to plan and execute budgets at these levels of detail but that capacity does not appear to have been explored or used by DNSAS.

Related to this, budgeting for goods and services is almost entirely centralised: The following table illustrates this point.

Centrally managed - not allocated to specific Districts in DNSAS budgets	Allocated to individual Districts within DNSAS but procurement and payments managed centrally	Allocated to individual Districts within DNSAS and managed by Districts through cash advances (imprest accounts)
<ul style="list-style-type: none"> • IT equipment • Communications equipment • Purchase of generators • Water facilities equipment • Office equipment including furniture and fittings • Purchase of vehicles 	<ul style="list-style-type: none"> • Training and workshops • Utilities (electricity etc) • Vehicle fuel • Vehicle maintenance • Office stationary • Operational materials/supplies • Fuel for generators • Professional, translation and other services 	<ul style="list-style-type: none"> • Local travel • Repairs and maintenance of buildings, electrical, other infrastructure assets • Other maintenance services

The expression 'allocated to individual districts within DNSAS' should not be interpreted as a process of systematic budgeting for the needs of individual Districts. Thus while imprest accounts are 'allocated' to each District they are uniform across all Districts (US\$1,500 a Quarter in 2011). While some items (e.g. office supplies) are nominally allocated by reference to factors such as staff numbers in each District, others (e.g. operational materials/supplies) appear in practice to be 'allocated' wholly or partially on a 'first come, first served' basis.

District Managers are playing and increasing but still limited role in the budget process: District Managers were included in the membership of the Budget Working Group established in 2010. However, reflecting the centralisation of budgeting for goods and services and the fact that wage/salary budgets are effectively pre-determined by staff establishment they play little role in the formulation of the DNSAS recurrent budget. Their principal inputs appear to be bids for minor capital expenditure and cost estimates for rural and urban projects at District/Sub-District levels. BESIK program reports on the budget process in 2010 indicate that District budget proposals lacked prioritisation of activities and weaknesses in costing of proposals.⁴⁰

Budgeting for maintenance appears to be dominated by bids for equipment and materials: The 2011 Budget provided DNSAS with the following amounts for maintenance:

- US\$187,000 or 25% of the recurrent goods and services budget for maintenance of vehicles, buildings and equipment;
- US\$1.4 million and US\$0.75 million for materials and equipment for maintenance of urban and rural water supplies. These amounts have been appropriated within a line item under 'Capital and Development' rather than recurrent goods and services, possibly suggesting the funding is destined exclusively for the acquisition of equipment.

There is no evidence that the budget bid for maintenance reflected a fully-costed estimate of all recurrent costs associated with the expanding urban and rural networks.⁴¹

DNSAS/MoI has little opportunity to argue the case for its budget submissions: It is understood that the MoI Directorate General of Corporate Service and the DNSAS Director are invited during the budget preparation process to appear before the GoTL Budget Review Committee. However, as described during field study this appearance is both brief and in the form of 'speak when spoken to'. The review process does not entail any systematic review of expenditure options or the consequences for recurrent budgets of capital expenditure decisions.

DNSAS budget execution

DNSAS recurrent expenditures align closely with budgeted amounts. Actual capital expenditure as against budget is said to be amongst the 'best' within MoI but the data to verify this were inconsistent at the time of field study. Moreover it does not capture data for capital expenditure appropriated to other agencies but implemented by DNSAS

Budgets versus actuals for DNSAS 2008, 2009, 2010 - From Ministry of Finance

	2008 (US\$'000)		2009 (US\$'000)		2010 (US\$'000)	
	Budget	Actual	Budget	Actual	Budget	Actual
Salaries	414.0	402.9	560.0	556.7	560.0	559.0
Goods & S	1,009.0	1,403.3	993.6	965.8	849.0	835.2
Transfers	-	-	-	-	-	-
Minor cap	268.0	268.0	453.0	448.6	371.0	286.2
Cap & Dev	1,490.0	1,200.4	1,495.0	1,174.6	3,020.0	2,203.8
Total	3,181.0	3,274.6	3,501.6	3,145.6	4,800.0	3,884.3
<i>Source:</i> Ministry Finance National Directorate of Treasury - provided 24 March 2011. Amounts may not sum to totals due to rounding.						

⁴⁰ The BESIK program subsequently participated in a workshop (September 2010) for District Managers and their technical staff with special emphasis on project cost estimation.

⁴¹ An email from the BESIK Program on 6 April 2011 indicated that discussions were continuing at that stage with DNSAS as to how the provision for rural O&M would be expended.

The MoF data suggest DNSAS budget execution as a proportion of budget appropriation as follows.

	2008	2009	2010
Recurrent expenditure, actual/budget (%)	127 (?)	98	99
Minor capital expenditure, actual/budget (%)	100	99	77
Capital & Dev. expenditure, actual/budget (%)	81	79	73
Total expenditure, actual/budget (%)	103 (?)	90	81

The DNSAS data differ from the MoF data, most notably in respect of actual capital and development expenditure in 2009 and (especially) 2010. As at April 2011 no explanation had been received for these differences. A possible explanation is that the MoF data record cash expenditure whereas the DNSAS data record both cash expenditure and outstanding commitments/obligations at year-end.

Budgets versus actuals for DNSAS 2008, 2009, 2010 - From DNSAS

	2008 (US\$'000)		2009 (US\$'000)		2010 (US\$'000)	
	Budget	Actual	Budget	Actual	Budget	Actual
Salaries	391	na	560	556	560	558
Goods & S	1,009	na	993	964	849	845
Transfers	-	na	-	-	-	-
Minor cap	268	na	453	449	371	286
Cap & Dev	1,490	na	1,495	1,226	3,020	2,945
Total	3,158	na	3,501	3,195	4,800	4,634
<i>Source:</i> DNSAS Administration, Finance & Human Resources Department - provided approx. 25 March 2011						

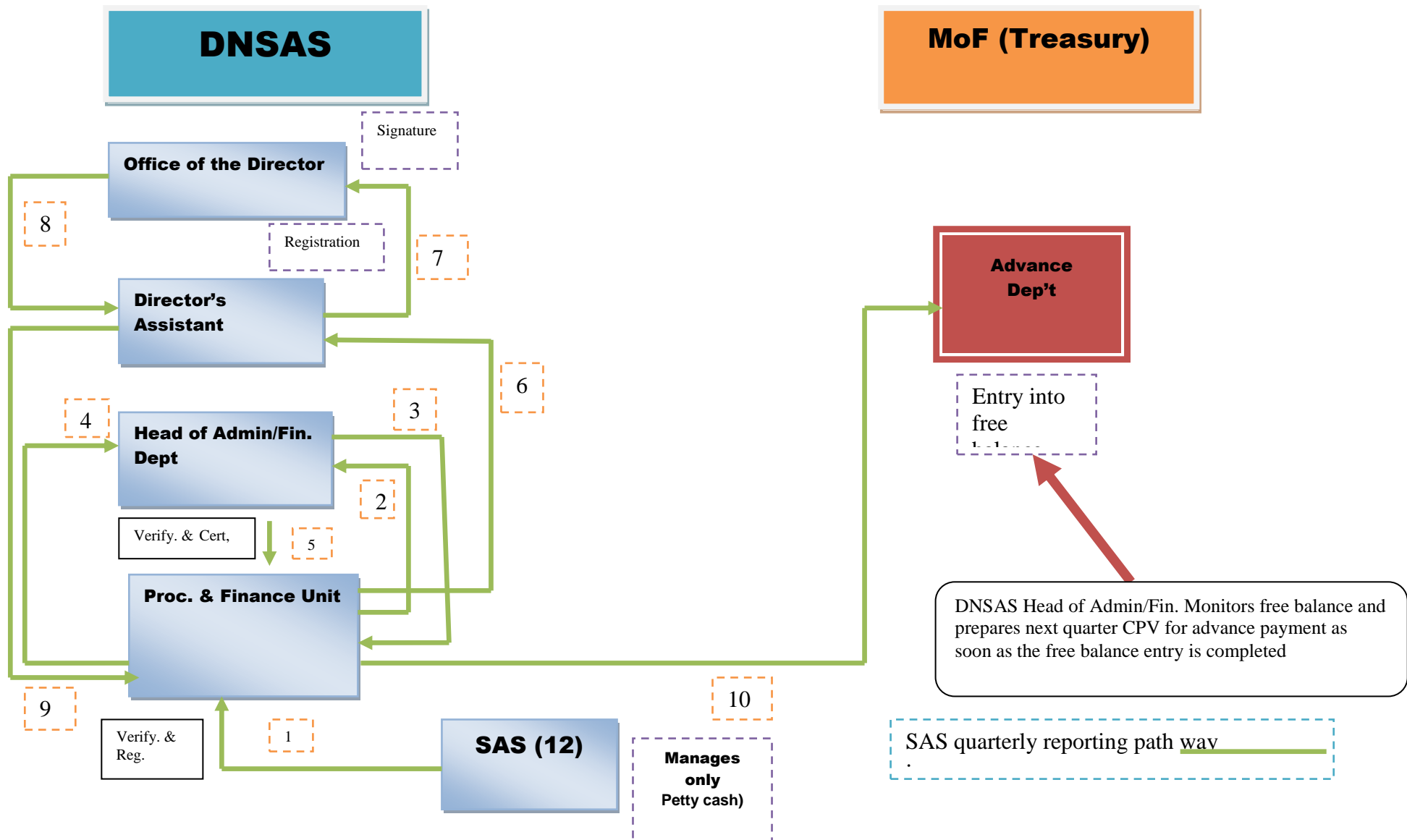
The DNSAS data suggest DNSAS budget execution as a proportion of budget appropriation as follows.

	2008	2009	2010
Recurrent expenditure, actual/budget (%)	na	98	100
Minor capital expenditure, actual/budget (%)	na	99	77
Capital & Dev. expenditure, actual/budget (%)	na	82	97
Total expenditure, actual/budget (%)	na	91	97

Notwithstanding the differences in the data they are consistent in suggesting that, if 'bottlenecks' are defined in the narrow sense of actual expenditures against budgets, such 'bottlenecks' are *not* evident in relation to DNSAS recurrent expenditure. Whatever the inefficiencies associated with accounting, reporting and acquittal procedures (see below) they do not appear to have impacted on DNSAS's ability to expend its goods and services budgets in particular. Defined in this narrow sense, 'bottlenecks' impact most noticeably on the expenditure of capital and development funds appropriated to DNSAS (and also, probably, on capital expenditure appropriated to other agencies but managed by DNSAS - not recorded above). The following charts illustrate the cumbersome nature of some routine financial management procedures operating within DNSAS (and doubtless other GoTL agencies):

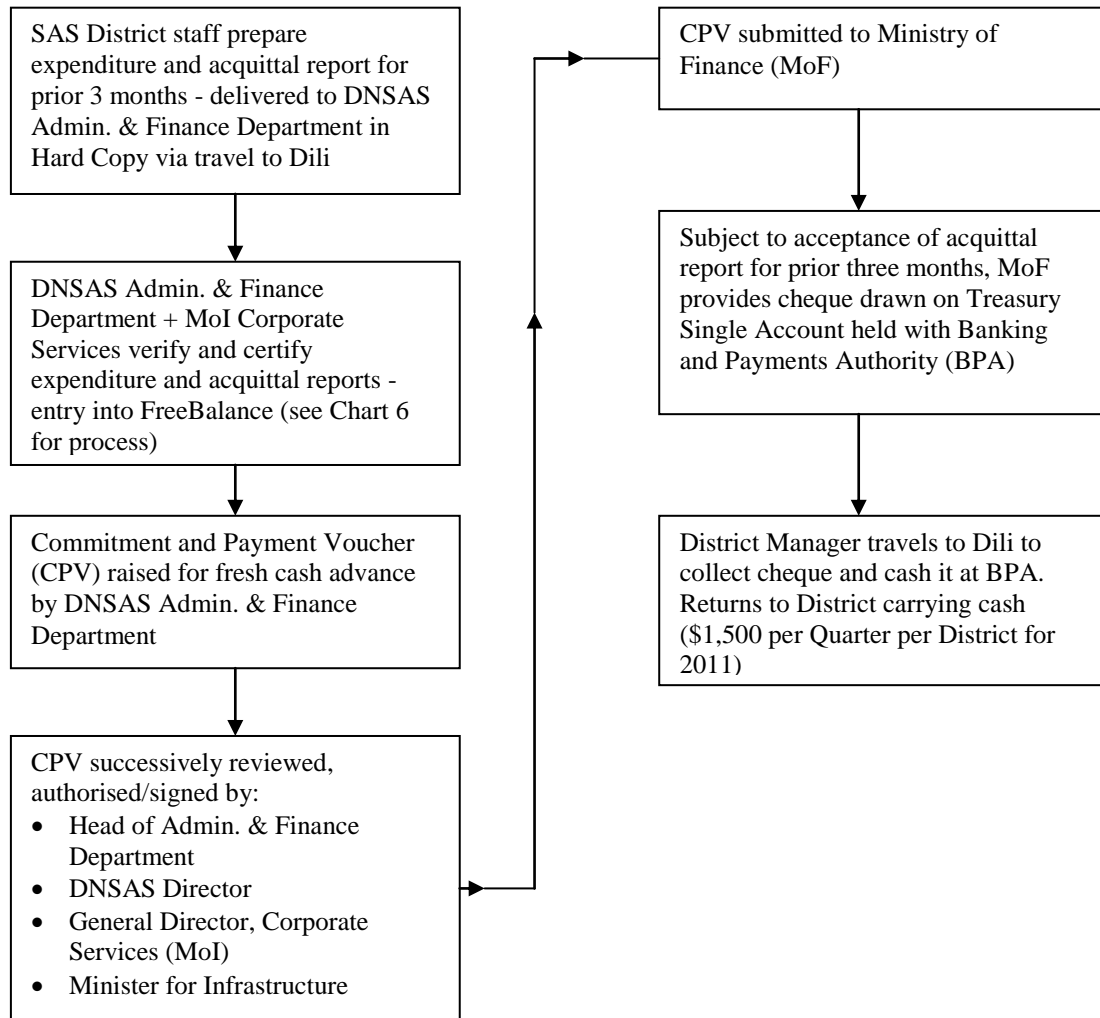
- Chart 6: District expenditure reporting process.
- Chart 7: Procedures for provision of cash advances to District Managers.
- Chart 8: Procedures for the payment of contractors undertaking works from the DNSAS capital and development budget.

Chart 6: District expenditure reporting process



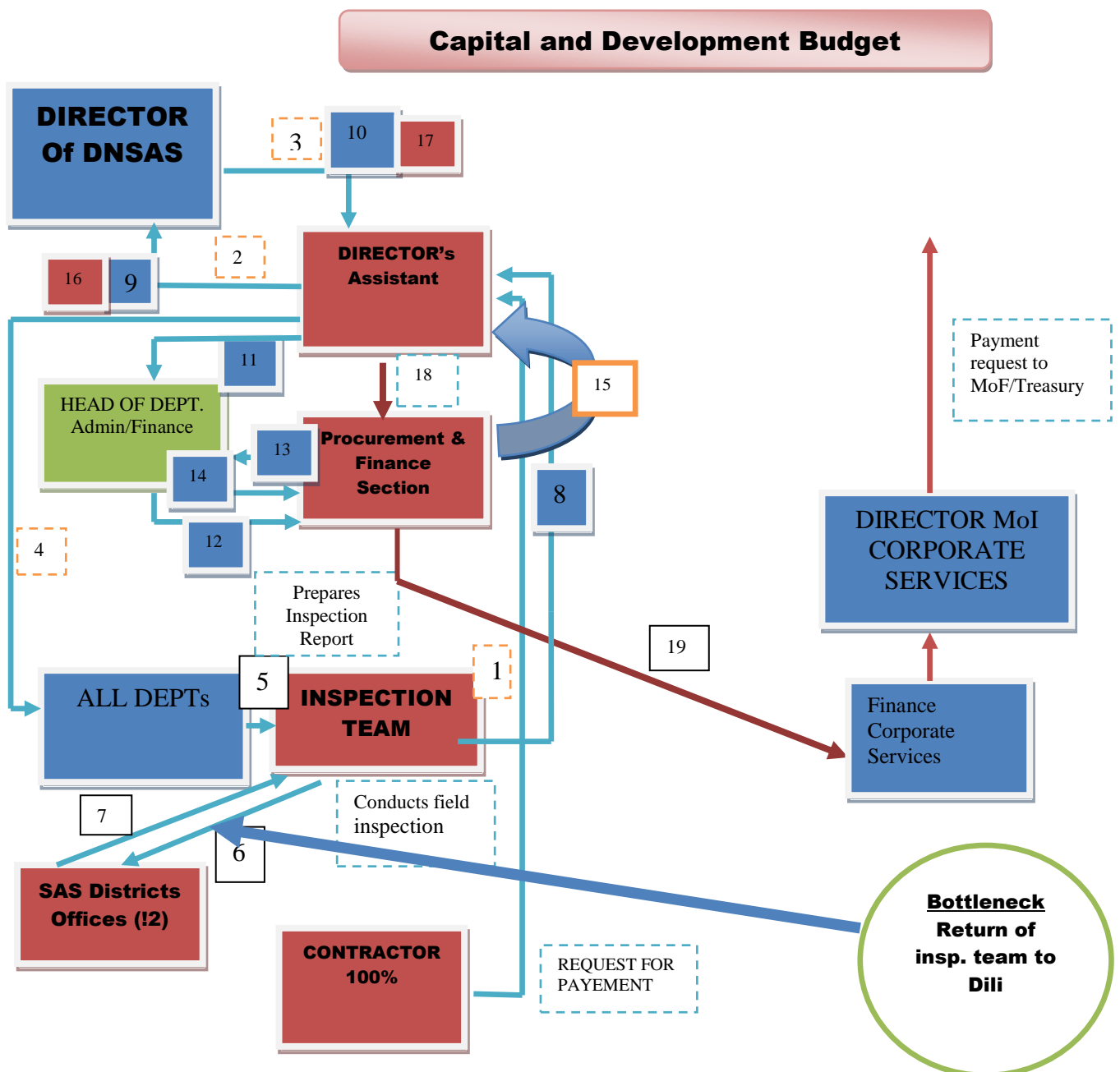
Source: BESIK Program Budget, Planning and Financial Management Specialist

Chart 7: Three-monthly provision of cash to SAS District Offices



Note: Field study indicated that at least some District Offices do not have functioning safes in which to securely store cash and that District funds are sometimes held in private bank accounts.

Chart 8: Capital and Development Budget Execution (DNSAS C&D Appropriations)



Source: BESIK Program Budget, Planning and Finance Management Specialist

Other procedural inefficiencies in budget execution by DNSAS most affecting service delivery at the District/Sub-District levels (i.e. closest to District water and sanitation ‘customers’) are the following.

Office supplies: Bulk office supplies are procured centrally in Dili and delivered to the DNSAS store in Dili (Logistics and Patrimony Management Section, Planning and Development Department). District Managers request supplies from the DNSAS AFHR Department which sends a request and approval to the Store. The Store then notifies the relevant District Manager supplies are available for collection. District staff then travel to Dili to collect them. At least some of these supplies could almost certainly be obtained directly at District level.

Vehicle repairs and maintenance: Field study indicated that repairs and maintenance of each District’s car is undertaken in Dili rather than locally. It is unclear how this occurs in practice in a situation when a car can no longer be driven.

Fuel and power: Some District offices receive no electricity during the day and have insufficient funds/vouchers/spare parts to repair broken back-up generators and/or to purchase fuel for them. Fuel vouchers for the District car and motorbikes are issued centrally and District Managers travel to Dili to collect them.

Monthly and quarterly financial reporting and acquittals: Field study indicated that, despite some training to date by DNSAS, District Manager’s financial reports and acquittals of their imprest accounts are often late and/or lack supporting documentation. This in turn creates discontinuities in the replenishment of their imprest accounts such that staff at District level routinely fund minor operating expenses from their personal salaries pending reimbursement.

Several of these inefficiencies could be alleviated if District Managers were funded to acquire a wider range of goods and services at local level. However, the scope for this will be severely limited by internal financial control considerations so long as banking facilities are either unavailable or unused at the District level.

A5 Scope for greater use of GoTL PFM systems

The Analysis has concluded that, while in no way under-rating progress made in recent years in strengthening the GoTL’s PFM systems, steps to make greater use of ‘downstream’ elements of the systems in delivering Australian support for RWASH services will need to be cautious, carefully targeted and accompanied initially by both short-term controls and further capacity building. The following provides the basis for that conclusion.

Initial assessment of potential for greater use of GoTL PFM systems
On Plan
<p>Meaning: External (donor) financing, including program and project aid spending, is integrated into spending agencies' strategic planning and supporting documentation for the policy intentions behind their budget submissions.</p> <p>Initial Assessment: There is no medium-term expenditure plan for the RWASH sector linking the GoTL’s indicative expenditure intentions and Australia’s support. However, the BESIK program has made significant progress within DNSAS in both supporting the preparation of DNSAS annual budget submissions and in influencing DNSAS thinking regarding expenditure priorities for the sector. This progress can be consolidated and extended over the remainder of the current program and by its successor. Unfortunately the impact of progress on annual expenditure planning within DNSAS/MoI is being lessened by the dispersal of budgeting and</p>

expenditure responsibilities for the RWASH sector across different line agencies, notably MoI, the Office of the Prime Minister and MSATM, and by increasing disjuncture in the GoTL processes for determining recurrent and capital expenditure priorities. Thus it is far from apparent that further improving the quality of DNSAS/MoI budgetary planning and integrating Australia's financing within it would, of itself, significantly improve outcomes. This issue is beyond the BESIK program's ability to address but will need to be addressed in the design of any future program.

On Budget

Meaning: External financing, including program and project financing, and its intended use, is reported in the budget documentation. This may be simply for information purposes, however, particularly where there is a separate development budget (see On Parliament).

Initial Assessment: The GoTL's annual budget documentation already includes (2011 Budget Book 5) a tabulation of development partners' anticipated funding contributions disaggregated by donor, implementing agency, project name and the forthcoming and three subsequent budget years. Book 5 also distinguishes activities administered with government from activities administered outside government. This is a useful first step for information purposes, however:

- The indicative external funding for individual projects/programs is frequently limited to an estimate for the forthcoming financial year only.
- There is no explicit linkage between the externally-funded projects and the GoTL programs this funding is intended to support, much less any link to the funding budgeted by the GoTL as its contribution to shared program objectives.
- The 'project name' for each project is just that. There is no explanation of even the briefest kind of project objectives or activities.

There is considerable scope to improve the information content of 'Book 5' by addressing these limitations. However this will require commitment by and inputs from both the National Directorate of Aid Effectiveness (MoF) and donors. The BESIK program and its successor can advocate for such improvements but it is more appropriately something for AusAID and (perhaps) the Public Financial Management Capacity Building Program to pursue.

On Parliament

Meaning: External financing is included in the revenue and appropriations approved by Parliament, thus requiring the Executive to account to citizens (through Parliament) for the utilisation of aid flows. Note that 'On Parliament' is not synonymous with 'On Treasury' - external funds could be appropriated by the Parliament but then disbursed to accounts held outside the Treasury system including accounts controlled exclusively by external funders.

Initial Assessment: While there is no obvious technical reason why future Australian funding could not be appropriated by Timor Leste's Parliament the implications of this would need to be clearly understood by both AusAID and the GoTL, notably that:

- It would be incumbent upon Australia to deliver the amount of funding appropriated by the Parliament (the GoTL might in fact insist that such funding be 'delivered' in advance before including provision for the appropriation in the draft Budget Law).
- It would be open to the Parliament to vary the amount to be appropriated or attach conditions to its use.
- The GoTL, not Australia, would be accountable to the Parliament for use of the funds even if they were subsequently transferred to an account under partial or sole Australian control.

Thus while technically feasible, the benefit of placing future Australian support On Parliament if it is not also to be placed On Treasury appears highly questionable.

On Treasury

Meaning: External financing is channelled into the *main revenue funds* (or accounts) of government and then managed through the government's regular systems of disbursement and financial control.

Initial Assessment: Putting aid On Treasury is a key threshold in decisions on the future use of partner systems since the partner government, through its Treasury, assumes full control of the within-year amounts/timing of the external funding and uses its own processes in tandem with those of line Ministries/agencies to regulate disbursements and acquittals. A decision to place external funds On Treasury is also a substantial influence on the scope to use other downstream components of the PFM system described below. Having regard to the most recent PEFA assessment and other findings the present analysis has reservations about placing all future Australian funding of the RWASH sector On Treasury but would support an interim step in that direction (see Main Report, Section 4).

On Accounting

Meaning: External financing is recorded and accounted for in and through the partner government's accounting system, in line with its own classification system.

Initial Assessment: The Government's Chart of Accounts and Financial Management Information System (FreeBalance) have, in principle, the capacity to track financing by:

- Fund (i.e. the source of funds, e.g. Australia);
- Organisation (the Ministry, Directorate and Division);
- Program, activity and function;
- Object (Account type, Appropriation category and line item); and
- Location (District, sub-District and Succo).

This is the case whether the funding concerned was disbursed through the Treasury Single Account or through a special account maintained by Treasury. However, the system requires further development before the potential to track funding by program can be realised. A further complication is that the system cannot currently distinguish between the 'urban' and 'rural' components of any given District, sub-District or Succo. Thus the potential to rely exclusively on the GoTL's whole-of-government accounting system for recording program expenditures funded by AusAID is limited in the near future. The possibilities for relaxing these constraints and/or for developing subsidiary accounting records to be maintained by DNSAS should be fully explored.

On Procurement

Meaning: Externally financed procurement uses the partner government's own procurement procedures, without the imposition of additional or special requirements.

Initial Assessment: Responsibilities for procurement management and procedures for the contracting of capital expenditures in particular are in a state of flux. Requirements for competitive tendering processes at the District level have been relaxed. There are uncertainties and some concerns regarding responsibilities for and the extent of quality control exercised at the District level in contracting for PDD projects. The 2010 PEFA assessment of the GoTL's systems rated 'competition, value for money and controls in procurement' as a C, a lower rating than the B given by the 2007 PEFA assessment (although that may have been generous). Staff of the BESIK has been working with DNSAS to identify and address concerns but in several respects this depends on the cooperation of District Administrators and others beyond the program's direct influence. Future Australian support could not at present rely on the GoTL's procurement procedures without continuing short-term control measures and further capacity building at the District level in particular.

On Report

Meaning: External financing is included in *ex post* reports by the partner government, without the imposition of additional or special requirements.

Initial Assessment: Given the limitations imposed by the GoTL's current chart of accounts and FreeBalance system any financial reports produced by the FreeBalance system could not be presented in a format that related funding use to RWASH program objectives. That is, such reports would be confined to program inputs rather than outputs (much less outcomes) delivered by the funding. It is unlikely that this would be seen as adequate by AusAID. However, the BESIK program is making a substantial contribution to the development of information systems within DNSAS. Subject to further development of these and DNSAS's internal financial reporting systems (notably by establishing direct linkage between the two) there is medium-term potential for performance reports on program progress to be generated by DNSAS (at least insofar as future program funds are channelled through DNSAS).

On Audit

Meaning: External financing is audited by the partner government's auditing system, without the imposition of additional or special requirements.

Initial Assessment: AusAID could not at present or in the foreseeable future place sole reliance on the current external audit system to verify that Australian funding for the RWASH sector had been used for its intended purposes, was properly accounted for and achieved value for money. The external auditor does not examine financial management processes in line ministries and agencies such as internal controls, procurement, and payroll, and does not undertake performance audits. Moreover the external auditor does not examine the uses to which funds transferred to Districts, Sub-Districts and communities are put. While consideration could be given to commissioning supplementary audits by the external auditor focussed on GoTL and Australian funding of water and sanitation services this would necessarily constitute an additional auditing requirement.

A6 Some matters for fiduciary risk assessment

The Terms of Reference for the present analysis indicated that one of its two objectives is to "identify options to increase government ownership of the program which could include increasing funding through government systems in the rural water supply and sanitation sector." The present Report has addressed this at Section 4 in particular. However, the ToR did not call for an assessment of the fiduciary risks that may be entailed in channelling some part of future Australian funding through GoTL systems. It is understood that a formal fiduciary risk assessment may be commissioned as part of the design process for a successor to the BESIK program.

AusAID's Working in Partner Systems Section has disseminated model Terms of Reference for the commissioning of fiduciary risk assessments at a sector/agency level. These provide a comprehensive framework within which both potential risks and potential benefits of using a partner government's PFM and procurement systems are to be assessed. Arising from the present analysis the following suggestions identify some specific matters that a future fiduciary risk assessment should be tasked to examine in closer detail. These suggestions are not in any way a substitute for the model ToR and do not in any way purport to represent the full range of matters that a future FRA would need to address. The suggestions are grouped under the three main dimensions of fiduciary risk associated with channelling donor funding through a partner government's PFM systems (notably their downstream components).

Donor funding is not used for its intended purpose (funds diversion)

A future FRA should consider the following *potential* sources of risk in the MoI/DNSAS context.⁴²

- Funds transferred by AusAID into the GoTL Treasury Single Account are not subsequently appropriated, along with any parallel GoTL funding commitment, to DNSAS for expenditure on the agreed purposes. This risk appears slight in practice but the FRA should examine in further detail the processes whereby annual expenditure envelopes (for goods and services in particular) are determined by the MoF, negotiated with the MoI and allocated within MoI to DNSAS and other Directorates within the Ministry.
- Funding appropriated to DNSAS for agreed purposes is subsequently ‘vired’ within the budget year to other line items for other purposes (e.g. to meet pressing payment arrears from the prior year). Responsibility for authorising virements between budget line items within a given administrative and economic classification has been delegated to line Ministries. The FRA should examine authorisation procedures within DNSAS and whether/how virements are recorded in the FreeBalance system.
- Cash advances to District Managers are not used for agreed purposes. The FRA should examine in detail the quality of acquittals submitted by the Districts for expenditure of their imprest accounts and the extent to which cash advances are ‘held’ in private bank accounts (a practice that occurs but the prevalence of which is unknown).
- Purchases of plant and equipment are not subsequently allocated to the service delivery units for which they were intended and/or are not used for their intended purpose. The FRA should examine DNSAS processes for the acquisition, storage and distribution of equipment and stores including: the procurement procedures used; the recording of acquisitions, distributions and usage; and the security of storage facilities.
- The expenditure of funds is exposed to corrupt practices. The present analysis has not addressed this risk in any way. The FRA should review the available evidence regarding the prevalence of corruption (if any) in Timor Leste as it might impact on funding channelled through the GoTL and the strength (or otherwise) of GoTL anti-corruption mechanisms.

Funds are not properly accounted for (it is not possible to determine if funds were used for intended purposes).

- DNSAS records of expenditure do not reconcile with FreeBalance records of DNSAS expenditure. The present analysis found, at the time of field study in March 2011, this to be the case in respect of 2010 DNSAS expenditure. However explanations of the discrepancy were not forthcoming. The FRA should review the extent to which DNSAS/FreeBalance records are/can be reconciled in further detail, and review also the extent to which DNSAS maintains - as required by MoF - subsidiary accounting records to substantiate and reconcile with FreeBalance totals.
- DNSAS expenditure on rural water supply and sanitation facilities cannot currently be identified in either FreeBalance or DNSAS subsidiary records. This is not a risk but a current reality. The FRA should review whether MoI/DNSAS has any plans to implement program-based recording of budgets and disbursements and, related to this, the scope to adapt use of the GoTL Chart of Accounts to create a subsidiary, program-based, financial management information system within DNSAS.
- Expenditure is not subject to either internal or external audit. It is understood that in the case of DNSAS this is not a risk but a reality. The FRA should examine whether there are any alternative internal or external controls (e.g. inspectorate activities) operating in lieu of formal internal/external audit and the current status of MoI plans to establish an internal

⁴² References here to ‘potential risk’ do not imply any judgment as to the likelihood that it would or would not constitute a risk in practice.

audit unit. It should also identify possible short-term control measures to address the current absence of auditing (see below).

Funds do not achieve value for money (they are not used efficiently and effectively).

The present Report addresses a range of bottlenecks impacting on the efficiency and effectiveness of RWASH sector expenditures (see Section 2 in particular). The following suggestions canvass the potential risk that disbursement of funds channelled through the GoTL Treasury Single Account will be subject to excessive delays.

- Delays in passage of the annual Budget and subsequent release of Expenditure Authorisation Notices (EANs) to line Ministries by MoF cause hiatus in the funding of ongoing programs. The present analysis was informed that EANs for 2011 were not issued to line Ministries until early-March 2011. However, whether this is typical and the extent to which the delay impacted in practice on service delivery by DNSAS has not been assessed. The FRA should assess this.
- Cumbersome commitment and expenditure authorisation processes within DNSAS/MoI create excessive delay in the disbursement of funds for their intended purpose. The present analysis has documented this to some extent. However, the FRA should examine in further detail the impact in practice of these processes, for example by reviewing - for a sample of transactions - the typical time lag between an initial request for commitment of expenditure and final payment.
- Procurement processes for the purchase of goods and services are subject to excessive delays. The present analysis has not reviewed MoI/DNSAS procurement processes or the extent to which they may give rise to excessive delays in the disbursement of funds. The FRA should do so.

Risk mitigation

AusAID's model ToR for fiduciary risk assessments require them to recommend both short-term control measures and longer-term capacity development measures to mitigate assessed risks in channelling funding through a partner government's PFM systems. The following suggestions for further consideration by a future FRA are confined to short-term control measures thought most likely to be relevant in the context of a successor to the BESIK program funded in whole or part through the GoTL Treasury Single Account.

- Annual agreement on spending plans and compliance with previous expenditure commitments/plans as a basis for further commitment of Australian funds.
- Design and implementation (with technical assistance as necessary) of a subsidiary financial management information system within DNSAS identifying, on a program basis, expenditure of funds on rural water supply and sanitation services.
- Related to this, 'tracking' of Australian funding through the FreeBalance system and a subsidiary DNSAS system to a level of detail to be discussed and agreed in the course of a future FRA.
- Use of 'no objection' letters for proposed procurements of goods and services (i.e. goods and services acquisitions planned, tendered and contracted through GoTL systems subject to 'no objection' by AusAID at key stages of the procurement process for significant procurement items).
- Supplementary financial audit arrangements, whether through negotiation/funding of supplementary audits by the GoTL's current external auditor or otherwise.

Annex B: Principal documents reviewed

AusAID Working in Partner Systems documentation: (a) Instruction on assessing and using partner government systems for public financial management and procurement ; (b) Guideline on assessing and using partner government systems for public financial management and procurement (date of effect 23 Feb); (c) Guideline on choosing approaches and types of aid for working in partner systems; (d) Frequently Asked Questions – Guidance on partner government systems (date of effect all 23 February 2011)

AusAID: Australian Aid to Water Supply and Sanitation Services in East Timor and Indonesia - Evaluation Report, Office of Development Effectiveness (December 2009)

AusAID: East Timor Delivery Strategy – Rural Water, Sanitation & Hygiene Behaviour Change (Draft, January 2011)

AusAID: Timor Leste Ministry of Planning and Finance Capacity Building Project - Independent Completion Report (March 2009)

AusAID: Working Paper 1 - East Timor; Independent Evaluation of Australian Aid to Water Supply and Sanitation Service Delivery in East Timor and Indonesia, Office of Development Effectiveness (December 2009)

Australia - East Timor Rural Water Supply and Sanitation Program (BESIK): Six monthly progress report #7, September 2010 to March 2011 (Draft)

Australia – Timor-Leste Rural Water Supply & Sanitation Program (Be, Saneamento no Igiene iha Komunidade), Report of the Mid-Term Independent Progress Review (Final, June 2010)

Bond, Matthew: ‘Preparation for decentralising WATSAN functions to Municipalities in East Timor’, Mission Report (April 2009)

Constitution of the Democratic Republic of Timor Leste (entry into force 20 May 2002)

Development options for internal audit in Timor Leste: Colin Hall, draft report (March 2011)

DNSAS Annual Action Plan 2011 (2010, in Portuguese)

DNSAS Budget Analysis (30 November 2010)

DNSAS Budgets and Actuals 2008-2010 (as supplied by DNSAS March 2011, incomplete)

East Timor Rural Water Supply and Sanitation Program (RWSSP) Program Concept Design: Final (November 2006)

Financial process flow diagrams (as supplied by BESIK Budget, Planning and Financial Management Specialist, March 2011)

GoTL Budget and Financial Management Law 2009 (informal translation Portuguese to English)

GoTL Budget Books 2011: Budget Books 1, 3, 4, 5 and 6 (in English or Portuguese)

GoTL Chart of Accounts Financial Year 2009 (from MoF website)

GoTL Decree Laws: 01/2010 (Changing the procurement legal regime); 02/2010 (Special procedures for awarding construction work up to USD 250,000 to local companies located in the sub-districts); 03/2010 (Organic of the Procurement Monitoring Commission and of the Procurement Technical Secretariat); 14/2010 (Temporary procurement measures).

GoTL Ministry of Finance Forms: Purchase Requisition; Commitment and Payment Voucher; Asset Register; Asset Transfer (from MoF website)

GoTL: Review of the Government of Timor Leste Procurement Process, Deloitte (January 2008)

International Monetary Fund: Democratic Republic of Timor-Leste: Public Financial Management - Performance Report, IMF Country Report 10/341 (November 2010)

International Monetary Fund: Democratic Republic of Timor-Leste: 2010 Article IV Consultation—Staff Report; Joint World Bank/IMF Debt Sustainability Analysis; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Timor-Leste (March 2011)

International Monetary Fund: Timor-Leste: Report on Observance of Standards and Codes (ROSC) - Fiscal Transparency Module, IMF Country Report 10/340 (November 2010)

Ministry of Education Review of financial management processes: Report prepared as part of the ESSP mid-term review (November 2010)

MoI Organisation Chart as authorised by MoI Organic Law 2010

Organic Law, Ministry of Infrastructure (2010, in Portuguese with limited translation into English)

Planning and Finance Management Capacity Building Program Supervision Note: National Directorate of Treasury (draft, author and date not given)

Planning and Financial Management Capacity Building Program: Support to Line Ministries – Discussion Note (author and date not given)

Process map for consideration/approval of projects to be funded through the GoTL Infrastructure Fund (undated)

Progress and other reports and Power Point presentations prepared by BESIK Program Budget, Planning and Financial Management Specialist (various dates 2010)

Report of Preliminary Observations on Service Delivery Bottlenecks in East Timor (April 2010)

Spreadsheet: Budget for 2011 capital development projects under responsibility of the Prime Minister's Office (undated)

Spreadsheets: DNSAS 2011 budget analysis and capital development projects (undated)

Timor Leste National Water Supply Policy, Third Draft (7 December 2010)

Timor Leste Strategic Development Plan 2011-2030 (Draft, 2010)

Timor-Leste National Sanitation Policy: Final Draft (22 February 2011)

Timor-Leste Public Financial Management Performance Report, Linpico (February 2007)

Towards effective decentralized Public Financial Management (PFM) System and Service Delivery: Rapid Assessment of sub-national level PFM systems capacity (May 2010)

United Nations Capital Development Fund: Mid-Term Evaluation - Local Government Support Programme (LGSP), Timor Leste, Main Report (July 2010)

World Bank: Timor Leste Planning and Financial Management Capacity Building Program Mid-Term Review Mission, May 24th to June 4th 2010 - Aide Memoire

Annex C: Field study itinerary and meetings

Date (March2011)	Activities/Meetings
14	<ul style="list-style-type: none"> • Arrival Dili from Australia • Briefing by AusAID (Jeff Prime, Pip Venning, Faviula Monteiro) • Briefing by BESIK Team Leader (Keryn Clark) and Team Advisers
15	<ul style="list-style-type: none"> • Meeting DNSAS Management Group: Sr Joao Jeronimo (Director), Sr Gustavo, Sr Joao Piadade, Sr Rui, Sr Elias, and Sr Celso • Meeting with Andrew Patching, Organisational Development and Capacity Building Adviser, BESIK • Meeting with Paul Keogh (AusAID) • Meeting with Sr. Jose Mestre (Director of Corporate Services and Finance, MoI) • Meeting with Bob Reed, Policy and Planning Specialist, BESIK • Introductory meeting with Kofi Amponsah, Budget, Planning and Financial Management Specialist, BESIK
16	Depart Dili for District visit, Aileu
17	District visit Ainaro and return to Dili
18	<ul style="list-style-type: none"> • Meeting with Keith Simpson, WS&S Engineering Adviser BESIK • Meeting with Ministry of Planning and Finance (Sr Leonardo Magno (Director, Budget Directorate, Ministry of Planning and Finance), Sr Samuel Marcal, MoF Advisers Peter Wild and Daniel Wilde, and others • Meeting with Director General of State of Administration and Territorial Management (Sr Carlito Martins)
19	Document downloading, reading, review of Week 1 notes
20	Further reading, preparation and distribution of notes on initial thinking in the light of Week 1
21	<ul style="list-style-type: none"> • Meeting with BESIK environmental health adviser (Sr Edi Styo) • Meeting with BESIK Team Leader Keryn Clark • Meeting with Rolito Rillo, ADB Procurement Adviser, and Isabella, MoI Head of Procurement • Meeting with HSSP finance adviser (Maria Sol Modesto) and former Head of MoH Finance Department
22	<ul style="list-style-type: none"> • Meeting with Sr Samuel Marcal and Sr Anicesto do Rosario (National Development Agency, Ministry of Planning and Finance) • Meeting with Pip Venning and Paul Keogh (AusAID) • Meeting with Head of Environmental Health Department, and Head of Health Promotion Department, MoH • Meeting with Sr Gustavo da Cruz, Head of DNSAS Administration and Finance Department • Meeting with Sr Joao Piadade Bars, Head of DNSAS Department of Sanitation and Alex Grumbley, Sanitation Adviser, BESIK
23	<ul style="list-style-type: none"> • Meeting with Heather Moran, Behaviour Change and Communication Adviser, BESIK • Visit to DNSAS Supplies and Equipment Store and meeting with Sr Eduardo Dias Ximenes, Facility Manager • Meeting with Sr Elias Periera Moniz, Head of DNSAS Department of District Water Supply and Sanitation

23 (continued)	<ul style="list-style-type: none"> • Meeting with Habib Rab, World Bank • Meeting with Peter Cloutier, USAID • Drafting/circulation of outline of initial findings
24	<ul style="list-style-type: none"> • Meeting with Sr Jose Alexandra, Director. Treasury Directorate, Ministry of Planning and Finance • Meeting with Manoj Nath (Community Development Adviser) and Joanna Mott (Gender Adviser) BESIK • Meeting with Sr Rui de Sousa, Head of DNSAS Department of Planning and Development • Meeting with Keryn Clark, BESIK Team Leader • Drafting of Aside Memoire
25	<ul style="list-style-type: none"> • Presentation of Aide Memoire to AusAID Post • Presentation of Aide Memoire to DNSAS Management Team • Presentation of Aide Memoire to BESIK Team Members
26	Depart Dili for Australia