

PART 2: OPERATIONS AND PERFORMANCE

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OPERATIONS AND PERFORMANCE

Introduction

The principal functions of the Australian Office of Financial Management (AOFM) are:

- the issuance of Treasury bonds to support the Treasury bond and Treasury bond futures markets;
- managing the Australian Government's cash balances; and
- minimising the cost of borrowing on the net debt portfolio, subject to acceptable risk.

This section outlines the activities undertaken in 2003-04 in relation to each of these functions and reports on their performance.

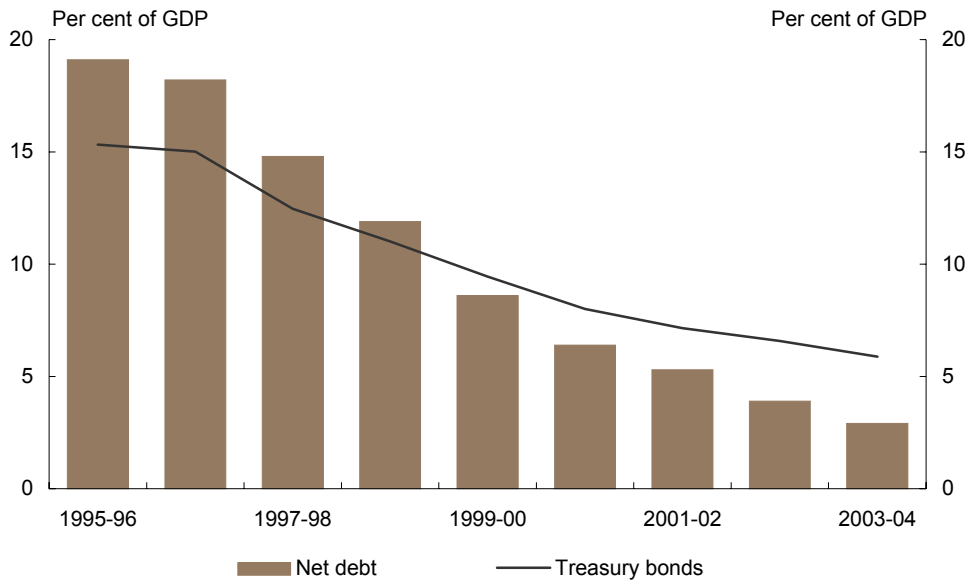
Treasury bond issuance

Objective

Treasury bonds on issue have decreased substantially over recent years, falling from around 15 per cent of gross domestic product (GDP) in 1995-96 to around 6 per cent in 2003-04. This has resulted from sustained fiscal surpluses and asset sales, whereby the Australian Government general government sector net debt has declined from a peak of around 19 per cent of GDP in 1995-96 to around 3 per cent of GDP in 2003-04 (Chart 1).¹

¹ Australian Government general government sector net debt includes Commonwealth Government securities and financial assets managed by the AOFM, together with some other financial assets and liabilities on the Government's balance sheet.

Chart 1: Australian Government general government sector net debt and Treasury bonds on issue



In view of these trends, the Government reviewed the future of the Commonwealth Government securities market and, in the 2003-04 Budget, announced its decision that in future it would issue sufficient Treasury bonds to support the Treasury bond futures market. This decision followed the review's conclusion that without a Treasury bond futures market the costs associated with managing interest rate risk across the economy would be higher.

As a result of this decision, Treasury bond issuance is now tightly targeted to support the 3- and 10-year Treasury bond futures contracts. In particular, the Government has indicated that:

- a new Treasury bond line with a term to maturity of around five years will be issued every two years;
- a new long-dated Treasury bond with a term to maturity of around 13 years will also be issued every two years;
- for each line, issuance will be brought to a total of around \$5 billion over two years; and
- no bond issuance, other than that required to support the Treasury bond futures market, is envisaged over the medium-term.

Achieving the objective

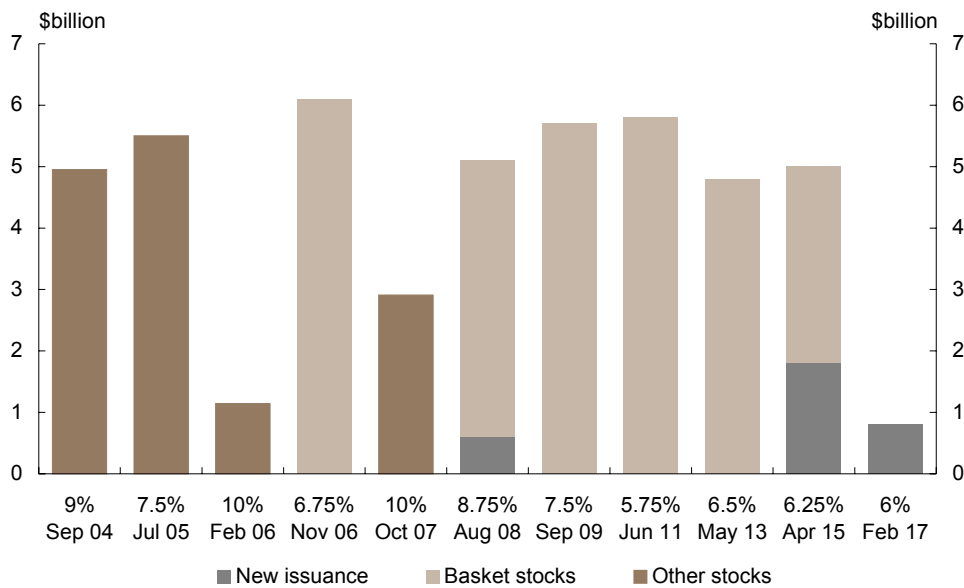
Treasury bond issuance

In 2003-04, the AOFM issued \$3.2 billion of Treasury bonds, comprising:

- \$600 million of August 2008 Treasury bonds;
- \$1.8 billion of April 2015 Treasury bonds; and
- \$800 million of a new February 2017 Treasury bond.

Chart 2 shows Treasury bond issuance over the year, as well as levels of Treasury bonds outstanding as at 30 June 2004.

Chart 2: Treasury bond issuance for 2003-04 and Treasury bonds outstanding as at 30 June 2004



Throughout 2003-04, Treasury bond issuance has been targeted to support the 3- and 10-year Treasury bond futures baskets.

To support the 3-year Treasury bond futures basket, the AOFM issued an additional \$600 million of the August 2008 bond line. This decision was taken to ensure that the outstanding level for this benchmark line provided long-term support for the 3-year Treasury bond futures basket, consistent with the review outcome that outstandings for all benchmark lines are to be around \$5 billion.

For the 10-year Treasury bond futures basket, the AOFM issued an additional \$1.8 billion of the April 2015 bond line throughout 2003-04, increasing its outstanding level to around \$5 billion. The AOFM also commenced issuance of a new February 2017 bond line towards the end of the 2003-04 year, as flagged in both the 2003-04 and 2004-05 Budgets. Upon issuance of this new bond line, the Sydney Futures Exchange announced that the February 2017 bond line will be included in the December 2004 10-year Treasury bond futures basket.

Increased transparency and communication

To improve the efficiency of its bond issuance activities the AOFM has acted to increase their transparency and expand its dialogue with financial markets. Initiatives during the year included:

- expanded contacts with financial market participants to discuss debt management activities;
- participation in meetings of the Debt Securities Committee of the Australian Financial Markets Association and at a range of financial market forums and conferences relevant to the Commonwealth Government securities market and debt management more generally; and
- development of an indicative Treasury bond issuance calendar for the coming financial year.

Conditions in the Treasury bond market

Chart 3 shows movement in yields on 3- and 10-year Treasury bonds over the course of 2003-04. Yields rose strongly in the first half of 2003-04, but eased back in the third quarter. Both the 3- and 10-year bonds ended the financial year with yields approximately 90 basis points higher than at the start of the year.

Chart 3: Australian 3- and 10-year bond yields 2003-04

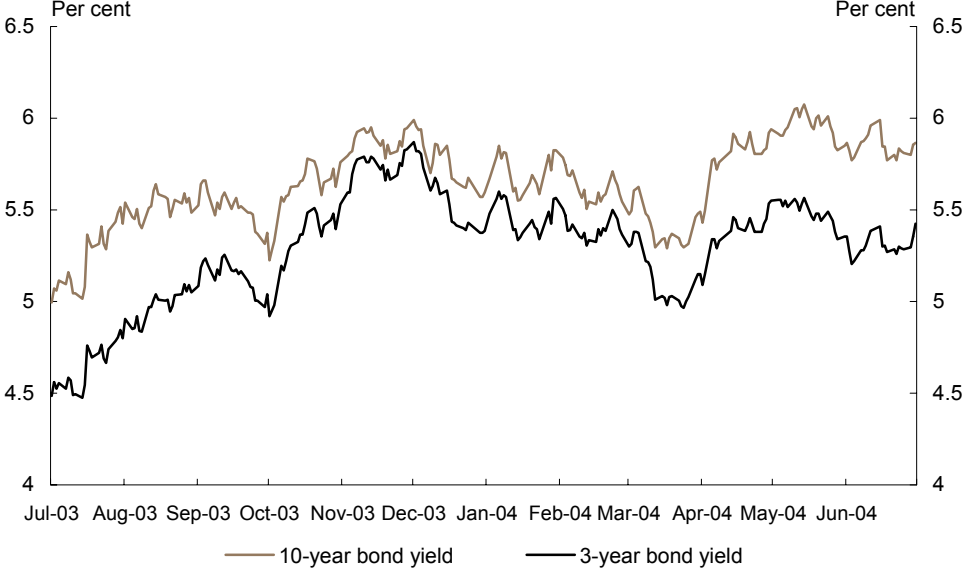
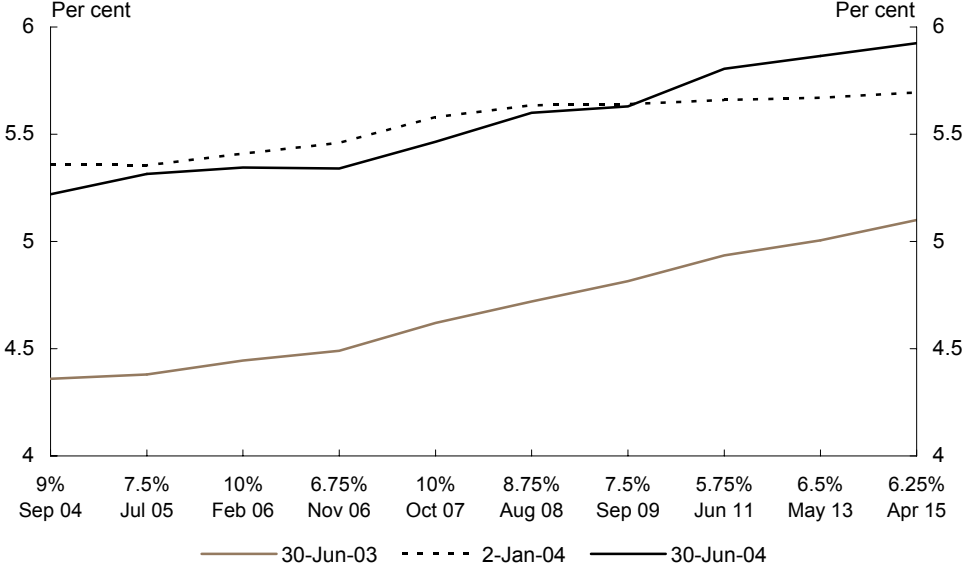


Chart 4 shows movements in the yield curve for Treasury bonds. It indicates that the increase in yields in the first half of 2003-04 was larger at the short end, but the curve steepened again in the second half of the financial year.

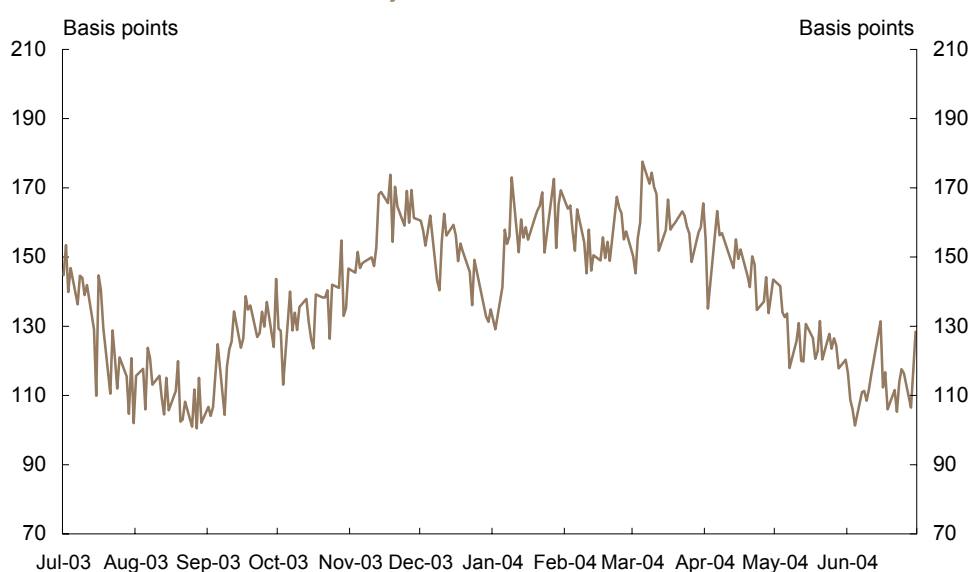
Chart 4: Commonwealth yield curves 2003-04



These changes were accompanied by upward movements in yields in global financial markets generally, as they reacted to signs of a strengthening in the world economy. However, between September 2003 and March 2004, the spread between Australian and United States (US) 10-year interest rates widened, peaking at around 180 basis points in March 2004 before falling away to just over 100 basis points in early June (Chart 5).

This widening of the Australian/US interest rate differential contributed to a marked increase in offshore investor interest in Commonwealth Government securities through 2003-04.

Chart 5: Australian/US 10-year bond interest rate differential 2003-04



Performance

Over the course of 2003-04, the level of Treasury bonds outstanding (net of Australian Government holdings) dropped by around \$2.2 billion to a level of approximately \$48 billion by year end. This reflected Treasury bond maturities (\$5.4 billion) being greater than new issuance (\$3.2 billion).

Nevertheless, turnover in secondary market outright trade of Commonwealth Government securities increased by approximately 6 per cent in 2003-04 over the previous year, from around \$1,230 billion in 2002-03 to around \$1,300 billion in 2003-04.

Total turnover of Commonwealth Government securities (that is, including secondary market outright trade, repo and intra-day activities) declined by around \$110 billion over 2003-04, caused mainly by a fall in repo market turnover activity. However, this was less than the fall of around \$740 billion that occurred in 2002-03, indicating a stabilisation in turnover after the announcement of the outcome of the review into the future of the Commonwealth Government

securities market. The ongoing trend in turnover is an important indicator for this market and the AOFM will continue to monitor it closely.

The volume of futures contracts transacted for both 3- and 10-year Treasury bonds remained healthy, with record daily volumes in March 2004. All Treasury bond futures close-outs occurred relatively smoothly over the course of the 2003-04 year.

Throughout 2003-04 the Commonwealth Government securities market experienced continuing demand for stock, particularly from overseas investors. Demand for Australian dollar denominated financial assets was particularly strong in the period from late October 2003 through to March 2004. The elevated interest rate differential between Australia and the US contributed to this demand, along with the strength of the Australian economy and the Australian dollar.

As a result, several bouts of tight trading conditions were experienced for bonds within the 3- and 10-year Treasury bond futures baskets, particularly in the repo market. The most notable occurred in late November 2003 and in late December 2003 through to early February 2004. Pressures within the repo market during these periods were focused on bonds in the 3-year Treasury bond futures baskets.

On 4 March 2004 the Reserve Bank of Australia announced that the range of securities eligible for repurchase agreements with it would be extended to include highly rated bank bills and certificates of deposit issued by banks licensed in Australia, and AAA-rated securities issued by foreign governments and government agencies that have an explicit government guarantee. The Reserve Bank of Australia also announced that the range of domestic securities that it could hold on an outright basis would be extended to include securities issued by State and Territory central borrowing authorities. These changes became effective on 15 March 2004. These announcements helped ease pressure on the Commonwealth Government securities market and were seen by bond market participants as having a positive effect on liquidity.

Overall, the Treasury bond and bond futures markets operated efficiently over the year.

Treasury bond tender results

Table 1 shows the results obtained in the nine Treasury bond tenders conducted by the AOFM in 2003-04. All tenders were well bid with the times covered ratio being above the 10-year average in all but two occasions.

Table 1: Treasury bond tender results

Tender Date	Coupon and Maturity	Face Value Amount Allocated (\$m)	Weighted Average Issue Yield (%)	Spread above Secondary Market Yield (basis points)	Range of Bids Accepted (basis points)	Times Covered
22-Jul-2003	6.25% 15-Apr-2015	299	5.54	0.66	2.00	2.82
16-Sep-2003	6.25% 15-Apr-2015	299	5.60	0.52	1.00	4.01
18-Nov-2003	6.25% 15-Apr-2015	299	5.90	0.88	0.50	4.40
20-Jan-2004	6.25% 15-Apr-2015	300	5.72	0.20	1.00	3.31
9-Mar-2004	6.25% 15-Apr-2015	299	5.51	0.39	1.50	2.72
18-May-2004	6.25% 15-Apr-2015	302	5.97	0.42	1.00	3.54
25-May-2004	8.75% 15-Aug-2008	300	5.65	0.75	1.00	5.48
1-Jun-2004	8.75% 15-Aug-2008	300	5.54	0.42	0.50	7.50
8-Jun-2004	6.00% 15-Feb-2017	800	6.04	0.00	2.00	4.64
10-year average				0.65	2.05	3.00
3-year average				0.30	1.30	3.65
1-year average				0.47	1.17	4.27

The average spread above secondary market yields was below the 10-year average, but above the average for the past three years.

Cash management

Objective

The AOFM uses term deposits with the Reserve Bank of Australia and issues Treasury notes to manage the daily cash balances of the Australian Government in the Official Public Account. The Government has access to an overdraft facility provided by the Reserve Bank of Australia, but under the terms of the overdraft agreement the overdraft is to cover only temporary shortfalls of cash, to be used infrequently and, in general, only to cover unexpected events. Holding insufficient cash balances is likely to result in inappropriate use of the overdraft facility, while persistent holdings of excess cash is to be avoided as there are alternative uses of these funds that generate a higher return.

In managing the daily cash balances of the Australian Government, the AOFM seeks to minimise cost and avoid undue use of the overdraft facility.

Achieving the objective

As in recent years, a high degree of cash-flow volatility occurred throughout 2003-04. A 'peak-to-trough' swing of around \$24 billion was managed over the course of 2003-04, compared with a swing of \$21 billion in 2002-03. On two occasions daily flow of around \$8 billion occurred, compared with only one occurrence in 2002-03.

In managing this cash-flow volatility the AOFM monitors and forecasts the daily cash balance in the Official Public Account. Forecasts of the daily cash position for the Australian Government

are used as inputs into decisions on how best to meet any short-term funding requirement, as well as best manage any resultant surplus monies.

The Official Public Account balance is the first recourse for meeting any short-term financing requirement. The AOFM's cash management activities take account of penalty interest costs associated with overdraft usage, whilst also being sensitive to opportunity costs associated with having too high an Official Public Account balance. Therefore, average cash levels in the Official Public Account are utilised to fund small within-year cash-flow mismatches and not on a protracted year-to-year basis.

Term deposits with the Reserve Bank of Australia are the main instrument used to manage the within-year financing requirement. Term deposits with the Reserve Bank of Australia are used to invest surplus Australian Government cash balances not required immediately. The term deposits are outside the Official Public Account and are undertaken for nominated periods of time. The magnitudes and terms of these term deposits are determined by the AOFM.² The maturity dates for term deposits are primarily set to finance large value outlays, particularly when these outlays fall outside peak revenue periods.³

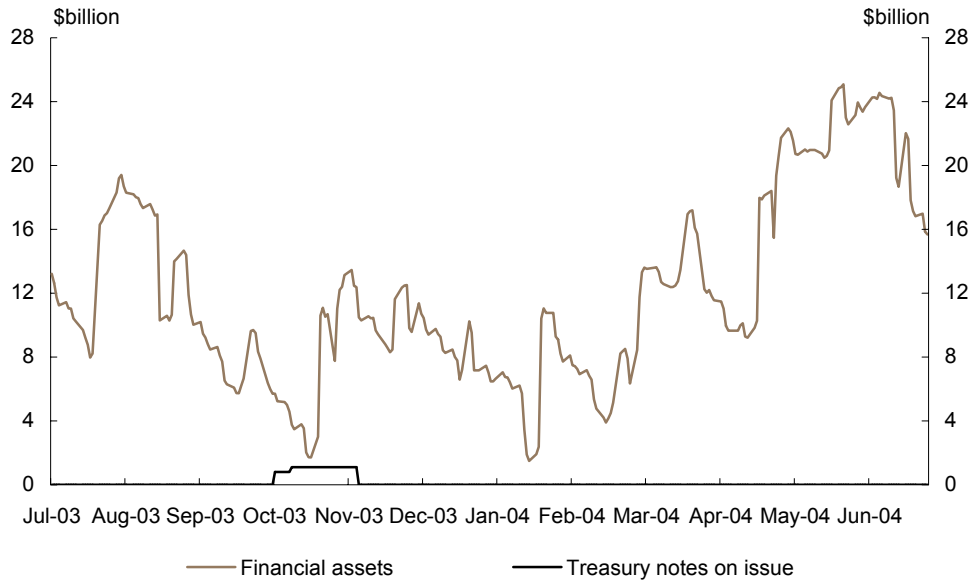
During 2003-04 the AOFM placed 288 term deposits with the Reserve Bank of Australia. The stock of term deposits fluctuated from a minimum of \$750 million in January 2004, to a maximum of \$24.1 billion in May 2004. The movement in the Australian Government's financial asset position in 2003-04, which includes term deposits with the Reserve Bank of Australia, is shown in Chart 6.

The third source of short-term funds called upon by the AOFM to help meet the within-year funding requirement over 2003-04 was the issuance of Treasury notes. Treasury notes are the Australian Government's short-term financial market funding instrument and are issued only on an as-required basis. The requirement in 2003-04 was small; only two tenders for Treasury notes were conducted, with only \$1.1 billion being issued in October 2003 (Chart 6).

2 The interest rate on term deposits is calculated by referencing the Overnight Indexed Swap rate for the same tenor as the term deposit, plus or minus a margin.

3 The shape of the yield curve and expectations concerning movements in short-term interest rates do not influence the selection of maturity dates.

Chart 6: Commonwealth financial asset holdings at the Reserve Bank of Australia and Treasury notes on issue 2003-04



Over the course of 2003-04, the AOFM reviewed assumptions underlying liquidity management and sought further improvements in liquidity risk management practices. In particular, it reviewed the required balance to be struck between unduly frequent usage of the overdraft facility with the Reserve Bank of Australia and holding persistent excess funds in the Official Public Account.

The review concluded that the AOFM would target a 91 day rolling average for the Official Public Account balance of around \$900 million, taking account of circumstances prevailing over the course of the year. To this end, operational limits of between \$700 million and \$1,100 million, based on a 91 day rolling average for the Official Public Account balance, have been established for the 2004-05 year. It is envisaged that this new approach will result in a small reduction in the average cash balances in the Official Public Account compared to 2003-04.

The review also recommended a reformulation of the Ministerial target (previously \$1.5 billion for the average balance of the Official Public Account over the financial year) as an upper limit, calculated on a rolling 91 day average balance.

The previous calculation was based on the cumulative average of the Official Public Account balance over the financial year resulted in the target being only fully binding on the last day of each financial year. The new Ministerial upper limit was agreed between the Treasurer and the Minister for Finance and Administration on 28 July 2004.

Performance

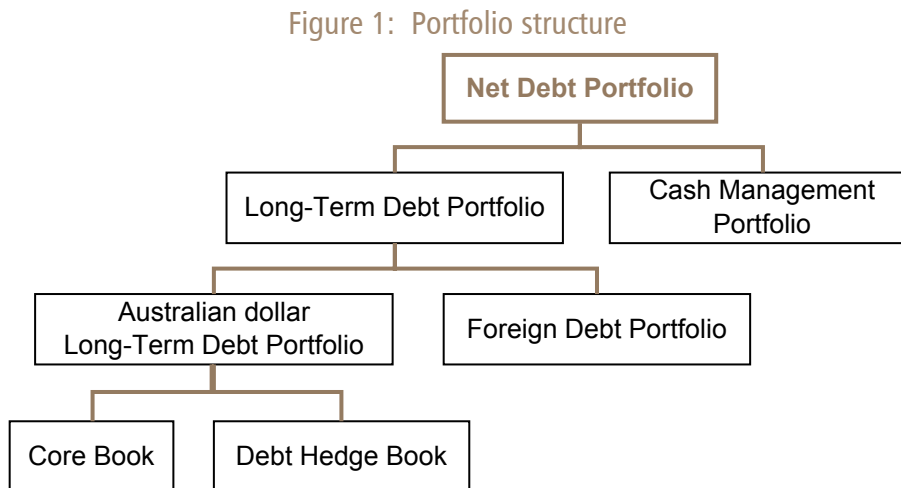
Measures of performance in managing the within-year funding task are the average balance in the Official Public Account and the frequency of resort to overdraft.

The average Official Public Account balance during 2003-04 was \$1.1 billion, compared to \$1.3 billion in 2002-03. The overdraft facility was not used during 2003-04.

Minimising debt servicing costs subject to acceptable risk

Structure of the portfolio

To facilitate the management of its several objectives, the AOFM divides its net debt portfolio into sub-portfolios and books. These are shown in Figure 1.



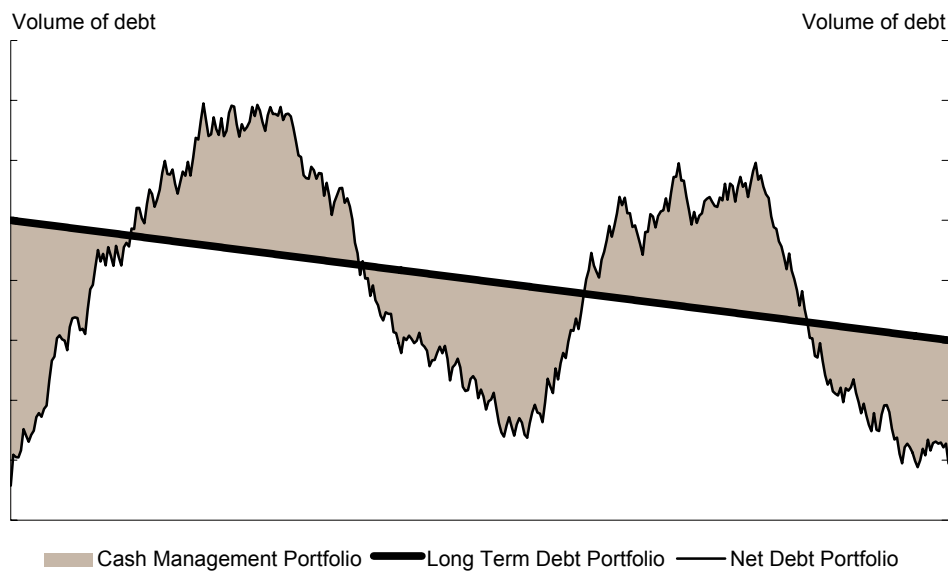
The components of the Australian Government's balance sheet managed by the AOFM are Commonwealth Government securities (Treasury bonds, Treasury Indexed bonds, Treasury notes and other securities), term deposits placed with the Reserve Bank of Australia and interest rate swaps entered into by the AOFM in the course of its portfolio management activities.⁴ Together they comprise the net debt portfolio.

The net debt portfolio is split into a Long-Term Debt Portfolio and a Cash Management Portfolio to allow continuing debt and assets to be managed separately from within-year flows. The within-year flows have become quite large relative to the overall size of the total net debt

⁴ The AOFM also administers housing loans to the States under the Commonwealth-State Housing Agreements.

portfolio⁵ and would distract from the management of continuing net debt in a single portfolio. Liabilities and assets are allocated between the two sub-portfolios so that the size of the Long-Term Debt Portfolio corresponds at any time to the estimated trend level of net debt and the Cash Management Portfolio contains the variation from the trend.⁶ This is illustrated, in a stylised manner, in Figure 2.

Figure 2: The two parts of the net debt portfolio



The allocation of liabilities and assets between the two sub-portfolios is governed by transfer rules (see box below).

Transfer rules

The separation of the net debt portfolio into the Long-Term Debt Portfolio and the Cash Management Portfolio requires rules governing the allocation of liabilities and assets between the two sub-portfolios.

-
- 5 As noted in the section on cash management, the within-year swing in the Government's funding requirement over the course of 2003-04 was around \$24 billion from peak to trough. This represented more than half the average book value of the total net debt portfolio of \$45.2 billion over the year.
- 6 That is, the Cash Management Portfolio corresponds at any time to the difference between the actual level of total net debt and the estimated trend level.

The transfer rules are designed to ensure that the volume of the Long-Term Debt Portfolio is equal to the estimated trend level of net debt at any time. This is achieved through ongoing internal loans and deposits made between the Long-Term Debt Portfolio and the Cash Management Portfolio.

The path of net debt for the financial year is estimated at the beginning of each financial year based on the published Budget estimates, and revised in the middle of the financial year based on the published Mid-Year Economic and Fiscal Outlook. The resulting adjustments are spread evenly over the financial year (or, in the case of mid-year revisions, over the remaining half of the financial year) and applied daily.

At the end of the financial year, the estimated trend is compared with the outcome and the average asset or liability balance in the Cash Management Portfolio over the course of the year is transferred to the Long-Term Debt Portfolio as a lump sum on 1 July.

Temporary transfers are also made between the Long-Term Debt Portfolio and the Cash Management Portfolio to offset the impact of lumpy volume movements such as bond issuance and maturities so that the Long-Term Debt Portfolio adheres to its trend path as determined in accordance with the rules indicated above.

The average balance in the Cash Management Portfolio in 2003-04 was \$9.2 billion. However the amount transferred to the Long-Term Debt Portfolio on 1 July 2004 was \$4.6 billion, as an adjustment was made to take account of the retirement from the Commonwealth's balance sheet of two long-term liabilities covering Commonwealth obligations relating to the Telstra and Australia Post employees' retirement benefits schemes. These obligations were paid out on 17 June 2004 and 1 July 2004 respectively. The adjustment was made because of the nature of the transactions and because their timing resulted in their having little impact on the average balance in the Cash Management Portfolio in 2003-04, whereas they will have an ongoing impact on the level of net debt and its trend level in 2004-05.

The AOFM website contains further information on the transfer rules.

The Long-Term Debt Portfolio is split into the Australian dollar Long-Term Debt Portfolio and the Foreign Debt Portfolio. The Foreign Debt Portfolio holds the foreign currency denominated component of long-term debt and was established to allow the rundown of the foreign exchange derivative exposure to be undertaken separately from the management of the domestic portfolio. Following the completion of the rundown, the Foreign Debt Portfolio now consists of small, residual amounts of US dollar Yankee loans and Sterling Bulldog loans.

Finally, the Australian dollar Long-Term Debt Portfolio is divided into the Debt Hedge Book and the Core Book.

The Debt Hedge Book holds the continuing assets that have accumulated in the net debt portfolio as a result of debt issuance in excess of funding requirements. Against these assets, the Book holds a matched set of liabilities that represent a cross-section of the Treasury bonds on issue. By placing together the ongoing assets and the liabilities they notionally offset, the Book allows their cost and risk to be managed together and compared – the net cost or benefit generated by the Book can be viewed as the cost or benefit of supporting the Treasury bond and bond futures markets rather than using the surplus assets to reduce the amount of bonds on issue.

The Debt Hedge Book's liabilities consist of internal transactions with the Core Book, and its assets are internal transactions with the Cash Management Portfolio:

- the liabilities are internal bonds from the Core Book. The coupons and maturities of the internal bonds match those of Treasury bonds on issue. In addition, internal interest rate swaps are transacted with the Core Book to effectively transform the internal bonds into floating rate liabilities with semi-annual interest rate resets.
- the assets are internal term deposits with the Cash Management Portfolio. These internal term deposits are set with terms that match the interest rate reset frequencies of the swapped liabilities.

As a result of these arrangements, the key cost and risk characteristics of the assets and liabilities in the Debt Hedge Book are closely matched and offsetting – that is to say, the liabilities are defeased.

The Core Book effectively contains the trend level of net long-term debt, as the excess of gross debt over net debt is held in the Debt Hedge Book. As long as the assets and liabilities within the Debt Hedge Book are matched, the key risk characteristics of the Core Book and the Australian dollar Long-Term Debt Portfolio will be identical. For this reason the compliance regime is focused on the Australian dollar Long-Term Debt Portfolio.

Objective

In managing the Long-Term Debt Portfolio, the AOFM seeks to minimise the expected accrual debt service cost at an acceptable level of variability around this expected outcome.

This approach gives priority to accrual debt service cost as the relevant measure of cost. Accrual debt service cost is defined as the total interest coupons associated with the portfolio's physical debt and derivatives, plus realised market value gains and losses, plus amortisation of any issuance premiums and discounts. The focus on accrual debt service cost is appropriate in circumstances where financial assets and liabilities are intended to be held or to remain on issue until maturity and there is little likelihood that unrealised market value gains and losses will be realised. In these circumstances, the inclusion of changes in unrealised market value gains and

losses would add a misleading level of volatility to debt service cost measurement. This approach is consistent with the measurement of interest costs under the AAS31 accounting standard.

Achieving the objective

In seeking to reduce debt servicing costs, the AOFM's approach is to establish a model portfolio, or *benchmark*, that encapsulates the desired trade-off between cost savings and variability in debt servicing costs. The benchmark portfolio balances the expected savings obtained from having a portfolio with a low average term to maturity with the potential for additional variability in debt service cost outcomes. Interest rate swaps are then used to bring the characteristics of the actual portfolio as close as possible to the benchmark.

The process used to select the appropriate benchmark is to project a series of debt service cost outcomes under a set of baseline interest rate assumptions for a number of alternate portfolios. Various interest rate shocks and scenarios are subsequently applied and the impacts upon debt service cost outcomes are measured. A portfolio that balances cost savings and variability in debt service costs is then put to the Treasurer for endorsement.

In September 2003 the Treasurer endorsed a new benchmark portfolio that was recommended by the AOFM and supported by the AOFM Advisory Board. The Treasurer also agreed that the existing portfolio should be brought into line with the benchmark over two to three years.

The term premium assumption

Issuing debt for long-terms with fixed interest rates ensures that future debt service costs are reasonably certain but, on average, they are likely to be higher than if the debt is issued for short terms. Long-term interest rates tend to be higher on average because investors demand a premium for holding debt for relatively long periods. Issuing debt with shorter terms would be expected to incur lower debt service costs on average, but these costs would be more variable.

The most important assumption underpinning the selection of the benchmark portfolio relates to the term premium. The term premium is the margin over the implied path of cash rates that investors in long-term debt require to compensate them for bearing the market value risk and liquidity risk associated with long-term debt as opposed to a series of short-term investments such as cash deposits.

The AOFM currently estimates that the average term premium margin for 10-year bonds over cash deposits is 0.75 per cent. Based on this assumption the average long-run savings in debt service costs that will accrue from managing the Long-Term Debt Portfolio to the benchmark are estimated to be around 0.3 percentage points per annum, compared with the cost of the portfolio that would result solely from bond issuance.

The key risk parameters used to define the debt portfolio are modified duration and short-dated exposure. These parameters explain the majority of cost and risk behaviour of portfolios. Modified duration is a market standard measure that is similar to the weighted average term to maturity. Portfolios with higher modified durations exhibit more stable, yet higher debt servicing costs than those with lower modified durations. Short-dated exposure is the proportion of the portfolio subject to immediate repricing. It can be considered to be the floating share of the portfolio. Portfolios with higher short-dated exposures exhibit a greater level of variability in short term accounting outcomes, as the interest cost of this portion of the portfolio adjusts very quickly to changes in market interest rates. Such portfolios will tend to demonstrate lower interest costs on average.

The benchmark portfolio adopted in September 2003 has a modified duration of 2.0 and a short-dated exposure of 35 per cent. This is a lower modified duration and a higher short-dated exposure than would result from bond issuance to support the 3- and 10-year futures contracts.

The benchmark portfolio is reviewed annually. A first review was completed in April 2004, following which the estimated term premium margin for 10-year bonds over the cash rate was revised from 0.90 per cent to 0.75 per cent. This downwards revision was within the range of scenarios tested when the benchmark was set and across which it was considered to be robust. Given this, the review concluded that the benchmark remains appropriate.

Policy and operational limits are set around the benchmark, the policy limits being approved by the Treasurer, while the operational limits are approved by the Secretary to the Treasury. During the transition to the benchmark these limits are adjusted annually.

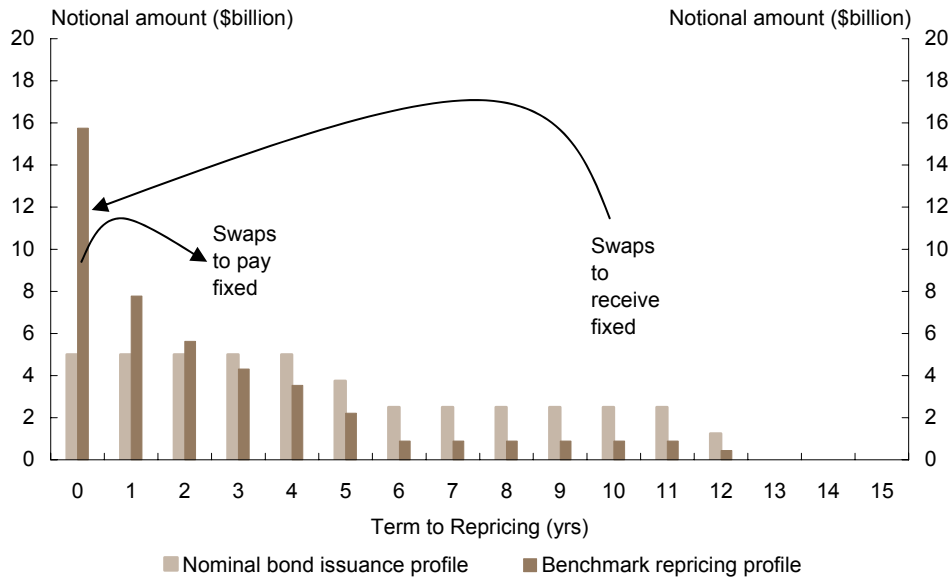
Once a benchmark has been selected and approved, the next step is to modify the Long-Term Debt Portfolio using interest rate swaps so that it more closely matches the benchmark. To reduce the differences between the maturity profile of the existing debt portfolio, as augmented by the new issuance of bonds, and the maturity profile of the benchmark, the AOFM transacts:

- long-dated interest rate swaps (of around 10 years maturity) in which it receives fixed interest rates and pays floating interest rates to match the maturity of the bonds on issue; and
- short-dated interest rate swaps (of around two to three years maturity) in which it pays fixed interest rates and receives floating interest rates to match the maturity of the desired benchmark profile.

Chart 7 illustrates how these swaps combine to change the profile of a debt portfolio towards a desired benchmark. Long-dated swaps reduce the modified duration of the portfolio, while increasing the amount of exposure to floating rates. Short-dated swaps increase the amount of one to three year exposure while reducing the floating rate exposure. Chart 7 assumes a stylised

existing portfolio that would result over time from bond issuance with maturities of five and 12 years.

Chart 7: Term profile before and after swaps



In 2003-04, the AOFM undertook a total of \$7.6 billion of interest rate swaps. This comprised \$3.3 billion in 2-year swaps where the AOFM undertook to pay a fixed interest rate and receive a floating rate and \$4.3 billion in long-dated swaps where the AOFM undertook to receive a fixed rate and pay a floating rate.

Additional statistical information on the AOFM's swap activity in 2003-04 is available on the AOFM website.

Credit management activities

The use of interest rate swaps exposes the Commonwealth to counterparty credit risk on swaps. This risk is managed by reference to a detailed Credit Policy.

In 2003-04, a broad-based increase in interest rates reduced the quantum of the credit risk exposure, while the average credit quality of the AOFM's derivative counterparties, as measured by ratings agencies Moody's and Standard and Poor's, was quite stable. Table 2 indicates the stability in average credit quality across the counterparties to which the AOFM has an exposure.

Table 2: Derivative counterparties by credit rating as at 30 June 2003 and 30 June 2004

Ratings Moody's/ Standard and Poor's	Number of AOFM counterparties with a given credit rating 30 Jun 2003	Number of AOFM counterparties with a given credit rating 30 Jun 2004
Aaa/AAA	3	3
Aa1/AA+	1	0
Aa2/AA	4	4
Aa3/AA-	9	9
A1/A+	3	3
A2/A	1	1
A3/A-	0	0

Note: Where a split rating is present, the AOFM uses the lower rating.

During 2003-04 two interest rate swaps with the A2/A rated counterparty were recouped to reduce the Commonwealth's credit risk. Under this process the existing interest rate swap contracts were replaced with swaps under which the fixed swap rate received by the AOFM was lowered to current market rates and up-front compensating payments were made by the counterparty to the AOFM.

The AOFM has commenced work on introducing collateral agreements which will enable the AOFM to reduce credit risk by requiring swap counterparties to post collateral in the event that the market value of the swaps with that counterparty move in the Commonwealth's favour by more than a predetermined threshold level. Under these arrangements, interest on the collateral will be paid at the same rate as that earned on deposits with the Reserve Bank of Australia, making collateralisation a very cost-effective arrangement. The AOFM expects to finalise these arrangements in 2004-05.

Settlement operations

In 2003-04, the AOFM settled all payment obligations in line with contractual obligations with counterparties. During the year there were four occasions where AOFM counterparties were late in making payments. As is consistent with prevailing market practice, the AOFM sought and obtained compensation in each case.

Performance

Managing the transition to the new benchmark

Over the course of 2003-04 significant progress was made in bringing the Long-Term Debt Portfolio closer to the benchmark. The modified duration of the portfolio (excluding indexed debt) started the year at 2.50 and finished the year at 2.19 (Chart 8) while short-dated exposure was reduced from 46 per cent to 41 per cent (Chart 9). The charts also indicate the transitional operational limits that applied during the year.

Chart 8: Modified duration — nominal component of Australian dollar Long-Term Debt Portfolio: 1 July 2003-30 June 2004

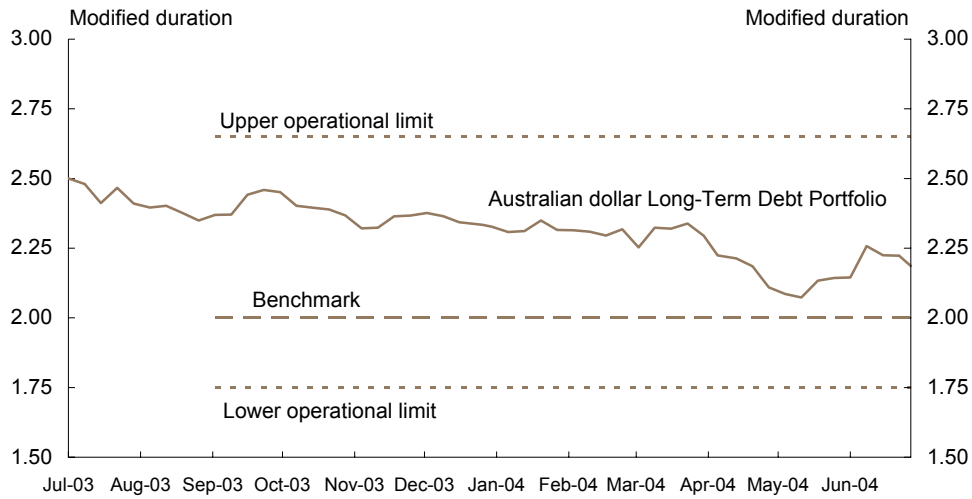
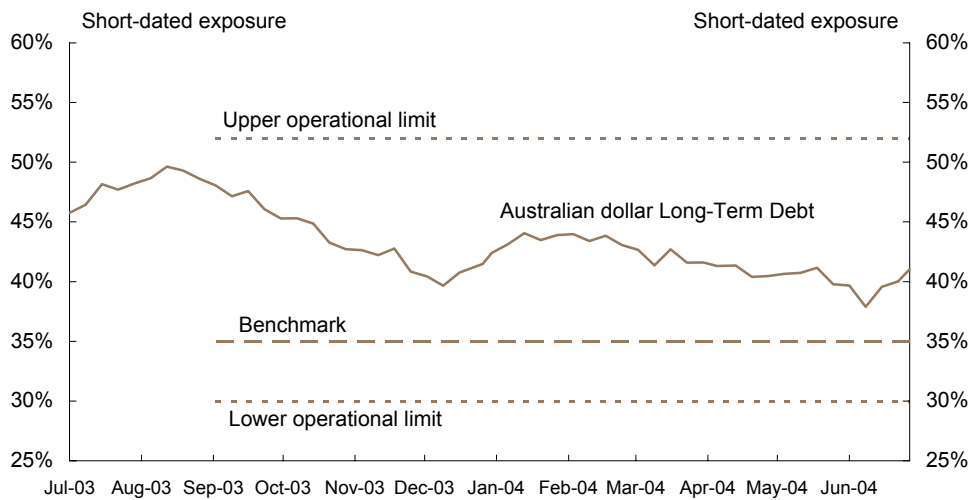


Chart 9: Short-dated exposure — nominal component of Australian dollar Long-Term Debt Portfolio: 1 July 2003-30 June 2004



Reducing debt service costs

Measured on an AAS31 accounting basis, the total debt service cost of the net debt portfolio managed by the AOFM for 2003-04 was \$2.924 billion, on an average net book value of \$45.261 billion. This represented a net cost of funds of 6.46 per cent.

This cost includes net interest savings of \$292 million on domestic interest rate swaps and \$43 million on cross-currency swaps, together with foreign exchange revaluation gains of \$163 million. Without these transactions, the debt service cost of the net debt portfolio for 2003-04 would have been \$3.422 billion and the average cost of funds would have been 7.59 per cent.

The average book value of net debt in the Long-Term Debt Portfolio in 2003-04 was \$54.413 billion, with a net debt service cost of \$3.393 billion, or 6.24 per cent.

The portfolio designed to accommodate the within-year variability of the funding requirement, the Cash Management Portfolio, experienced stronger than expected growth in asset balances during 2003-04. Over the course of 2003-04, it held an average asset balance of \$9.152 billion and earned net interest of \$469 million, which represented a weighted average return of 5.13 per cent on these balances. The role of the Cash Management Portfolio requires that funds in the portfolio be invested in short-term assets and therefore at rates close to the cash rate. The return obtained on these assets therefore acts to increase the average cost of the total net debt portfolio in percentage terms.⁷

Leaving aside the returns from foreign exchange revaluations and cross-currency swaps, which will not be repeated, and the \$47 million return on interest rate swaps which accrued against continuing assets in the Debt Hedge Book, the benefit obtained during the year from the management of the Core Book was \$246 million, or around 0.46 percentage points.

Within the Long-Term Debt Portfolio, the Debt Hedge Book held an average asset balance of \$3.9 billion in book value terms against gross debt. These assets generated revenues of \$241 million, inclusive of net receipts of \$47 million from interest rate swaps, which represents a rate of return of 6.23 per cent. The liabilities in the Book had an average book value during 2003-04 of \$3.8 billion, with an interest cost of \$228 million or 6.06 per cent. The Debt Hedge Book thus provided a small net profit of \$13 million for the year, while interest rate risks on the assets were effectively offset through the liabilities they were matched against. The average gap in modified duration between assets and liabilities in the Book over the course of the year was 0.11.

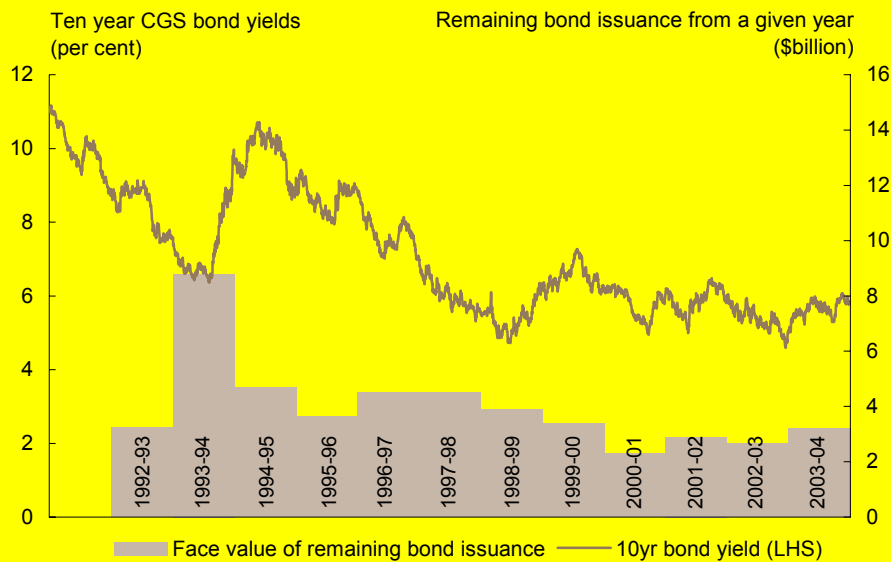
7 The cost of funds on the estimated trend level of net debt (the Long-Term Debt Portfolio) was 6.24 per cent on an average book value of \$54.413 billion. The impact of including the \$9.152 billion in average assets held within the Cash Management Portfolio, which earned 5.13 per cent, was to raise, in percentage terms, the borrowing cost on the average volume of net debt to 6.46 per cent on the lower average volume of net debt of \$45.261 billion.

What determines the Australian Government's cost of funds?

The AOFM issues nominal bonds with maturities of up to 13 years. When it does so, it raises funds at a fixed rate for the period until the bonds mature. This means that the net interest cost on the debt portfolio in a particular year will be a function of the prevailing bond yields at which issuance occurred over the preceding 13 years. For example, half of the Treasury bonds on issue to the public at 30 June 2004 had been issued in the five years up to February 1997, during which time interest rates were considerably higher than current levels.

Chart 10 demonstrates that the Treasury bonds in the market as at 30 June 2004 were issued over the course of the last 12 years. The yields on the older bonds can be seen to be higher on average than on the more recently issued bonds.

Chart 10: Bond yields and issuance



Under its portfolio management strategy the AOFM enters into interest rate swaps that have the effect of lowering the average term to repricing of the portfolio. As a result, the effective interest rate on the portfolio is reset more frequently than the average life of the underlying bonds and follows more closely general movements in interest rates. In addition, leaving aside the short-to-medium-term impacts of interest rate cycles, the use of interest rate swaps to manage the net debt portfolio in line with the benchmark is expected to lead to savings in net interest costs on average over the longer term due to the existence of a term premium (see *The term premium assumption* on page 23).

Unwind of the foreign currency exposure

Objective

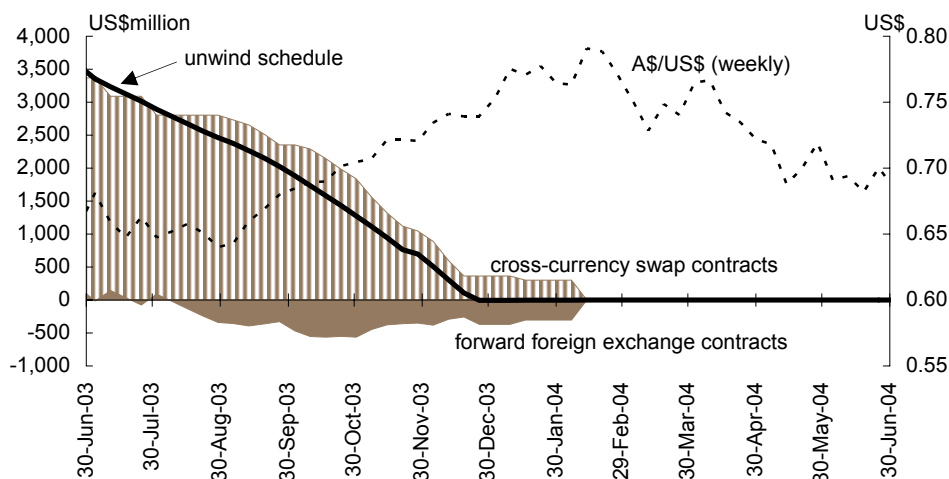
In September 2001, the Treasurer approved a recommendation by the AOFM to unwind existing cross-currency swaps. To avoid undue impact on the market, the unwind of the existing foreign currency derivative position was to be effected in an orderly manner in accordance with a schedule agreed between the AOFM, Treasury and the Reserve Bank of Australia.

Achieving the objective

As at 1 July 2003, the US dollar exposure stood at US\$3.6 billion, of which approximately US\$3.5 billion was derivative exposure and the balance was physical debt. During the course of 2003-04, the AOFM continued to reduce the exposure in line with the agreed rundown schedule. The schedule was expressed as a function of the level of the exchange rate; as the Australian dollar strengthened, the pace of the rundown accelerated. The AOFM achieved the rundown through forward foreign exchange contracts and, commencing in September 2003, the early terminations of swaps.

Chart 11 shows the rundown in net US dollar derivative exposures during 2003-04. In December 2003, the AOFM completed the rundown of the net exposure, while the last of the cross-currency swaps was terminated in February 2004.

Chart 11: Volume of US dollar derivative exposure: 1 July 2003-30 June 2004



Separate to the foreign currency derivative exposure, a small residual volume of physical foreign currency loans issued in the 1980s remained outstanding as at 30 June 2004. These loans

consisted of £39.1 million of Bulldog loans and \$US17.9 million of Yankee loans in face value terms. The AOFM is exploring means of repurchasing this debt cost-effectively.

Performance

Execution performance

The AOFM adhered to the unwind schedule agreed between the AOFM, Treasury and the Reserve Bank of Australia. The AOFM's performance in achieving the objective of eliminating the foreign exchange derivative exposure can be measured with regards to the estimated cost of terminating the exposure prior to maturity.

In all, the AOFM sought to terminate 31 cross-currency swaps in 2003-04. The AOFM set pricing benchmarks for these early terminations based on the originally-contracted term to maturity and whether the legs of each swap were on a fixed or floating interest rate basis. Negotiations on two swap contracts, with the same counterparty, did not meet the AOFM's pricing benchmarks. As a result, the AOFM novated these contracts to alternative counterparties, within the pricing benchmarks.

The budgeted execution cost versus mid-market valuation for the early terminations was \$4.4 million on the 31 contracts. The actual cost in conducting the terminations was approximately \$2.1 million versus the mid-market value of the cross-currency swaps immediately prior to their termination.

Foreign currency derivative program performance

During the course of 2003-04, the appreciation in the Australian dollar led to a foreign currency gain on Commonwealth debt of \$163 million. In addition, the remaining cross-currency swaps earned \$43 million in net interest during 2003-04.

Over the lifetime of the policy from 1988 until 2004, the foreign currency swaps, and forward exchange contracts used in their unwind, generated a total economic benefit to the Commonwealth of \$783.7 million. This figure represents:

- the total of all realised cash flows arising from the derivatives over the life of the policy (including interest receipts and payments and exchanges of principal) amounting to \$85 million; plus
- interest savings of \$698.7 million due to the reduction in debt financing required as a result of these positive cash flows over the life of the policy.

A later section of this annual report includes a review of the experience of foreign currency debt in the Australian Government debt portfolio, including cross-currency swaps.

Operational risk

Objective

The AOFM aims to minimise its exposure to operational risk, which is the risk of loss, whether direct or indirect, resulting from inadequate or failed internal processes, people, or systems, or from external events. This definition encompasses risks inherent in the Agency's operating activities which have the potential to prevent its goals and objectives being achieved. Indirect losses are qualitative impacts that do not have an immediate adverse effect on the financial performance of the Agency.

Achieving the objective

The culture and environment at AOFM are less conducive to aspects of operational risk associated with speculative trading activity than many other financial institutions, since the AOFM does not engage in such activity and does not take positions on future market movements. AOFM staff share in the ethos of the Australian Public Service and are bound by the *Public Service Act 1999* and the AOFM's Code of Conduct. Staff are not paid performance bonuses for trading activities but have their pay outcomes determined by a transparent appraisal system which is applied consistently throughout the agency.

Nevertheless, reducing operational risk is a major priority and the AOFM has made substantial progress in evaluating, assessing, measuring and monitoring it. During 2003-04:

- new audit committee arrangements were introduced with increased external membership and an independent chair;
- the task of fully documenting business critical processes was substantially completed. It will provide improved guidance for staff, help retain corporate memory and support greater business resilience if unanticipated incidents occur;
- work began on the development of a formal operational risk framework, including an operational risk charter and a more detailed and systematic approach to operational risk measurement;
- a disaster recovery site was established, business critical activities were identified and prioritised and training and rehearsal of the Disaster Recovery team undertaken;
- the annual review of the Chief Executive Instructions under the *Financial Management and Accountability Act 1997* was expanded to provide a wider assessment of relevant legislation and changed procedures for payment and processing functions; and

- additional staff were appointed in the Operational Risk and Compliance Unit to strengthen its activities.

Agency financial performance

Since its inception as a separate agency in July 1999, the AOFM has been developing its resource base and functionality. Substantial progress has been made in achieving best practice in policy, systems and methodology in the areas of financial market operations and risk management. The growth of the AOFM over the past five years has been rapid with expenditure reflecting start-up costs including significant investment in agency infrastructure (primarily information technology hardware and software), additional staffing and moving to new premises in December 2000. The 2003-04 financial year reflects a consolidation of the AOFM's operations.

Agency activities recorded an operating surplus of \$0.97 million for the 2003-04 financial year, comprising total revenues of \$8.68 million and expenses of \$7.70 million. As at 30 June 2004, the AOFM was in a sound net worth and liquidity position, reporting net assets of \$8.36 million, represented by assets of \$9.55 million (including current assets of \$0.79 million) and liabilities of \$1.19 million.

During the 2003-04 additional estimates process, the AOFM transferred administrative appropriation of \$1.53 million used to manage its debt portfolio from 'administered' to 'departmental' activities. Consequently, effective from 1 July 2003, administrative payments to suppliers (such as wire services and fiscal agent fees) were charged against agency activities.

As at 30 June 2004, the AOFM maintained cash and unspent appropriations totalling \$6.2 million. The unspent funds are held by the AOFM to settle liabilities and for future asset replacement/improvement.

During 2003-04, the AOFM did not return or establish a provision for return, by way of dividend, of unspent appropriation monies to Government.

