REVIEW BY THE CHIEF EXECUTIVE OFFICER

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Treasury Bond issuance

Over recent years debt issuance by the AOFM has been directed towards maintaining efficient Treasury Bond and Treasury Bond futures markets. These markets allow participants to better manage their interest rate risks and so contribute to a lower cost of capital in Australia.

During the year, the AOFM issued $6.2 billion of Treasury Bonds targeted to support the 3- and 10-year Treasury Bond futures contracts. Issuance was a little higher than in previous years; this allowed it to be brought into closer alignment with the timing of the futures contracts. Maturities of Treasury Bonds were also higher than in previous years, at $6.7 billion.

Overall the Treasury Bond and Treasury Bond futures markets operated efficiently in 2005-06. The turnover of Treasury Bonds in secondary market trading fell by around 20 per cent compared with 2004-05, but turnover of Treasury Bond futures contracts increased by around 20 per cent for the 3-year contract and by around 33 per cent for the 10-year contract. These trends appear to reflect, in large part, a shift in preference between the use of Bonds and derivatives based on their relative convenience in undertaking transactions. The strong demand shown by overseas investors for Treasury Bonds over recent years was maintained and does not appear to have detracted from the availability of stock or the efficient operation of the market.

The AOFM Securities Lending Facility established in September 2004 as a lender of last resort in Treasury Bonds played a useful role during the year in relieving instances of tightness in the repurchase market and so enhancing market confidence and efficiency.

The AOFM is moving to introduce a new electronic system for the conduct of tenders for the issuance of Commonwealth Government securities. During the year the Bloomberg Auction System was selected to undertake this role. The new system, which came into operation in October 2006, is expected to improve the efficiency of tenders and reduce the scope for erroneous bids.

Cash management

The volatility of the within-year cash flows in the Government's accounts has increased markedly in recent years. Daily net cash flows exceeded $10 billion on five days in 2005-06, compared with only one in 2004-05.

The AOFM manages the daily balance in the Official Public Account using term deposits with the Reserve Bank of Australia. The target balance was lowered from $900 million to $750 million on a rolling 91-day average basis for 2005-06 and the actual moving average balance was maintained around this target within operational limits throughout the year.

On 5 May 2006 the Government made an initial transfer of $18 billion to the Future Fund, which it established to offset its unfunded superannuation liabilities. These funds were previously held by the AOFM as term deposits with the Reserve Bank. Once assets are transferred to the Fund they are no longer available to the AOFM for use in its cash management activities. Depending on the size and timing of further transfers to the Future Fund, it is possible that the AOFM may need to issue Treasury Notes to support its cash management activities. However, issuance was not required in 2005-06.

Management of the portfolio

The AOFM uses interest rate swaps to manage the average term to maturity of its net debt portfolio with the objective of reducing the expected debt servicing cost over the medium term at acceptable risk. In this process a benchmark portfolio is used as a guide to the desired trade-off between savings in debt servicing costs and variability in those costs.

In 2005-06 a total of $1.6 billion of interest rate swaps were executed, significantly lower than in previous years. Three factors contributed to this reduction:

- in the annual review of the benchmark portfolio, the benchmark for 2005-06 was revised and, as a result, the actual portfolio commenced the year closer to the benchmark than in previous years;

- the transfer of short-term assets to the Future Fund reduced the average term to maturity of the net debt portfolio and consequently also reduced the need for interest rate swaps during the year; and

- during much of the year market conditions were not favourable for executing swaps to receive fixed interest rates. As a result, the volume of swaps undertaken was at the lower end of that originally planned.

In executing interest rate swaps, the AOFM exercises discretion within a prudent governance framework to avoid undertaking swaps in market conditions where the expected cost savings and risks are unattractive relative to the benchmark assumptions. Its approach is tilted towards reducing absolute risk when conditions are unfavourable, and against increasing absolute risk when conditions are favourable. Decisions are based on current conditions in the market and how they compare with benchmark assumptions, rather than forecasts of movements in market rates. Exercising discretion in this manner is likely to generate cost savings and lower risks compared with mechanically following the benchmark at all times.

Performance of the portfolio

The total debt servicing cost of the net debt portfolio managed by the AOFM for 2005-06 was $2.18 billion, or 6.90 per cent of the average book value of the portfolio. This compares with a cost of $2.92 billion, or 7.02 per cent, in 2004-05.

These figures are on an historic cost (accruals) basis and do not take account of unrealised changes in the market valuation of assets and liabilities in the portfolio. The historic cost figures are the most relevant to the AOFM's management strategy whereby debt and financial instruments are predominantly issued and held to maturity. Market valuations can fluctuate considerably from year to year and may obscure underlying trends. In 2005-06, rising interest rates led to a notional reduction in funding costs from re-measurement effects by $1.11 billion, whereas in 2004-05 falling interest rates led to a notional increase from re-measurement effects of $0.66 billion.

The performance of the portfolio during the year may be compared with the notional performance of the benchmark portfolio. The model benchmark is not constrained in the volume and tenor of the interest rate swaps that it undertakes in tracking the benchmark parameters, and is therefore not fully representative of what can be achieved in the real world where significant practical constraints apply. Nevertheless, the actual portfolio achieved historic cost savings of $136 million compared to an unswapped portfolio; this represented the major part of the savings theoretically available from adherence to the benchmark ($165 million).

Adjusting for unrealised market value gains and losses (re-measurements), the actual portfolio outperformed the model benchmark by $43 million in 2005-06, compared with underperformance by $167 million in 2004-05.

The AOFM is introducing in 2006-07 a new model benchmark that is subject to more realistic constraints on the volume of swaps notionally executed. It is anticipated that the new model will provide a more consistent and meaningful basis for analysing relative performance in the future.

Details of the factors that affected debt servicing costs during the year, and comparisons with the cost of the portfolio without swaps and with the cost of the model benchmark portfolio, are provided later in this report.

Credit management

The AOFM's use of interest rate swaps exposes the Commonwealth to counterparty credit risk. This credit exposure is managed under a detailed credit policy which includes, as a central feature, collateral agreements. These agreements require counterparties to post collateral when the Commonwealth's credit exposure rises above a predefined threshold.

By the end of 2005-06, collateral agreements had been signed with 17 counterparties and covered 87 per cent of the face value of interest rate swaps in the portfolio. The AOFM has advised counterparties that from 1 January 2007 it will require them to have a collateral agreement to be in place to be eligible to participate in tenders for new interest rate swaps.

Communications Fund investment facility

The Communications Fund was established by the Government in September 2005 to fund improvements in telecommunications services in regional, rural and remote parts of Australia. Its initial capital is $2 billion. The Minister for Communications, Information Technology and the Arts and the Minister for Finance and Administration authorised the AOFM to oversee the initial investments of the Fund in term deposits with the Reserve Bank of Australia. During the year, the AOFM placed 15 term deposits with the Bank for the Fund.

Net debt and the Australian Government balance sheet

Over recent years sustained fiscal surpluses and sales of commercial enterprises and fixed assets have brought marked changes in the Australian Government's balance sheet. In 2005-06 the net debt of the General Government Sector (GGS) fell below zero. An article in this report reviews the behaviour of GGS net debt through time, compares it with the net debt portfolio managed by the AOFM and considers the impact of the Future Fund on the portfolio.

International activities

The AOFM has actively supported sovereign debt management activities in other countries. Two staff worked in the Solomon Islands and one in Papua New Guinea to support debt management under the Australian Government's regional engagement initiatives. In each case, their work is highly appreciated by the respective governments and has facilitated substantial improvements in debt management practice.

A senior staff member conducted two seminars in Jakarta attended by Indonesian government officials. The seminars dealt with institutional and organisational arrangements for Australian Government debt management and the AOFM's experience of conducting tenders for the conversion of Treasury Bonds. An Indonesian delegation subsequently visited the AOFM under the Australia-Indonesia Partnership for Reconstruction and Development to study cash management activities. Visits were also received from debt management officials from China, the Republic of Korea and Mongolia.

A senior staff member gave a presentation at an APEC Workshop on Fiscal Risk Management in Hanoi; others participated in the annual meeting of Working Party on Debt Management of the Organisation for Economic Co-operation and Development and a meeting of experts on Stochastic Debt Strategy Simulation hosted by the United Kingdom Debt Management Office. The AOFM is currently sponsoring an OECD survey on performance measurement, the results of which will be presented at the next annual meeting of the Working Party on Debt Management in October 2006.

Operations

During the year, several major operational projects were undertaken and successfully completed. They included adjustments to our accounts for changes in international financial accounting standards, upgrading of computer hardware and software systems, and the conduct of tenders for an electronic system for collecting bids for the issue of Commonwealth Government securities and for new operational risk software. Work was also undertaken to review the business case for outsourcing registry arrangements for Commonwealth Government securities and a project commenced to update our archives and records classification system. Ongoing attention was given to improvements in fraud control, operational risk and disaster recovery.

Staff

At the end of the year Paul Power concluded his appointment to take up the position of Executive Director of the Financial Reporting Panel within Treasury. I wish him well in his new role.

The past year has been has been an active one for the Office and I thank all the staff for their continuing commitment and hard work. We have achieved a great deal together and look forward to further progress in the year ahead.

Neil Hyden
Chief Executive Officer