

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:

- issuing 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 2006-07 in relation to each of these functions and reports on their performance.

Treasury Bond issuance

Objective

Over recent years, Treasury Bond issuance has been undertaken to support the efficient operation of the Treasury Bond and Treasury Bond futures markets rather than for budget funding purposes. The Government has decided to support these markets because they contribute to a lower cost of capital in Australia as they are used by financial market participants to manage their interest rate risks. Without these markets, the financial system would be less diverse and less resilient.

The AOFM also aims to ensure that Treasury Bond issuance is undertaken efficiently. To this end, the issuance programme is conducted with a high level of transparency using competitive tenders.

Achieving the objective

In the 2003-04 Budget the Government announced that it would maintain the Treasury Bond market, with issuance targeted to support the 3- and 10-year Treasury Bond futures contracts. In particular, it indicated that:

Part 2: Operations and performance

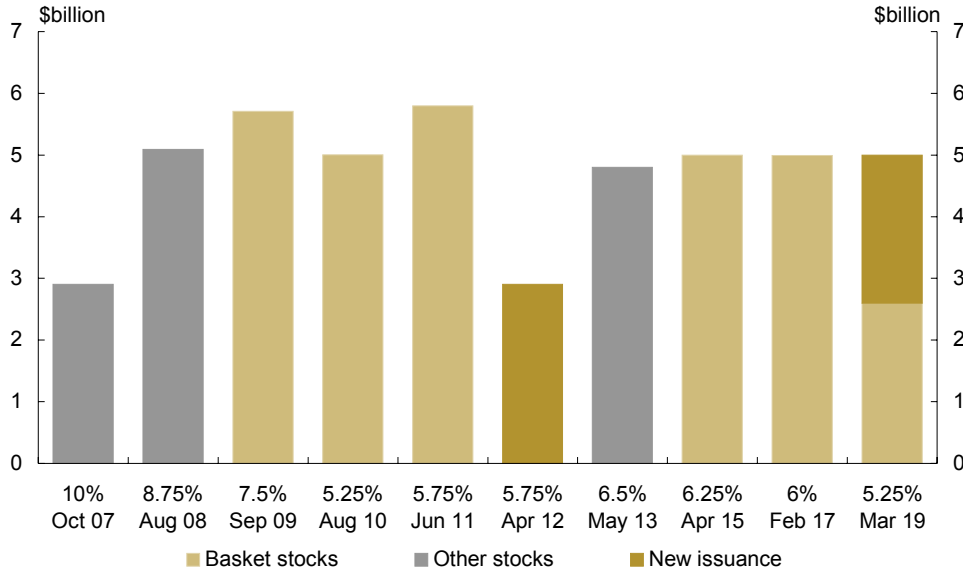
- a new Treasury Bond line with a term to maturity of around five years will be issued every two years;
- a new long-dated Treasury Bond line with a term to maturity of around 13 years will be issued every two years; and
- for each new line, issuance over the course of a two-year period will total around \$5 billion.

In 2006-07, the AOFM issued \$5.3 billion of Treasury Bonds in continuance of this pattern. It comprised:

- further issuance of \$2.4 billion of March 2019 Treasury Bonds. This completed issuance into this bond line, with the target level of \$5 billion being reached in November 2006. This bond was introduced to the basket of bonds underlying the 10-year Treasury Bond futures for the contract expiring in September 2006.
- issuance of \$2.9 billion of a new April 2012 Treasury Bond line. Issuance commenced in December 2006. This line is expected to reach the target level of \$5 billion in April 2008. This bond was introduced to the basket of bonds underlying the 3-year Treasury Bond futures for the contract expiring in December 2007.

Chart 1 shows Treasury Bonds issuance over the year, as well as levels of Treasury Bonds outstanding as at 30 June 2007.

Chart 1: Treasury Bond issuance for 2006-07 and Treasury Bonds outstanding as at 30 June 2007



The level of Treasury Bonds outstanding (net of Australian Government holdings) decreased by around \$800 million during the year, to \$47.2 billion, since bond maturities (\$6.1 billion) exceeded issuance (\$5.3 billion).

Bond tender arrangements

In October 2006 the AOFM commenced using a new electronic system for the collection and processing of CGS tender bids. The new tender system is accessed via the BLOOMBERG PROFESSIONAL® Service. Tenders had previously been conducted on the AOFM's behalf by the Reserve Bank of Australia (RBA) using its RITS system.

Feedback from bidders on the new tender arrangements has been positive, including about its ease of use and shorter turnaround time for the release of tender results. Results are now available to bidders around one and a half minutes after the close of bidding, compared with six to eight minutes under the previous system. The new system also incorporates plausibility limits which reduce the scope for erroneous bids.

The practice of releasing an indicative Treasury Bond issuance calendar for the forthcoming financial year was continued in 2006-07. The calendar is published on the AOFM's web site. It indicates the intended dates for each tender and the bond lines and amounts to be offered.

Treasury Bond tender results

Table 1 shows the results of the tenders conducted during the year.

Table 1: Treasury Bond tender results — 2006-07

Tender date	Coupon and maturity	Face value allocated (\$m)	Weighted average issue yield (%)	Spread to secondary market yield (basis points)	Range of bids accepted (basis points)	Times covered
18-Jul-06	5.25% 15-Mar-2019	400	5.9100	-0.50	0.00	3.19
15-Aug-06	5.25% 15-Mar-2019	400	5.9565	-0.23	1.00	2.30
19-Sep-06	5.25% 15-Mar-2019	399	5.7307	0.07	0.50	2.78
10-Oct-06	5.25% 15-Mar-2019	401	5.6435	0.60	0.50	2.52
24-Oct-06	5.25% 15-Mar-2019	399	5.8194	0.14	0.50	4.99
14-Nov-06	5.25% 15-Mar-2019	398	5.5780	-0.20	0.50	4.74
12-Dec-06	5.75% 15-Apr-2012	800	5.8474	na	1.00	4.11
23-Jan-07	5.75% 15-Apr-2012	600	6.0841	0.41	0.50	4.48
13-Feb-07	5.75% 15-Apr-2012	401	5.9841	-0.09	0.50	6.11
13-Mar-07	5.75% 15-Apr-2012	400	5.9049	-0.01	0.50	6.84
17-Apr-07	5.75% 15-Apr-2012	401	6.1598	-0.02	0.50	4.62
22-May-07	5.75% 15-Apr-2012	300	6.1050	0.00	0.00	5.48
Average over year to June 2007				0.02	0.50	4.35
Average over 3 years to June 2007				0.21	0.71	4.20
Average over 10 years to June 2007				0.40	1.04	3.91

The average spread of the weighted issue yield above the secondary market yield was below both the 3- and 10-year averages. For seven tenders, the weighted average issue yield was at or below the secondary market mid-rate yield. The range of bids accepted continued the narrowing trend observed over recent years and the times covered ratio was high.

The new tender system may have contributed to these results. For example, for the eight tenders conducted using the new system, the average coverage ratio was 5.17 – significantly higher than the tenders conducted earlier in the year and also higher than the 3-year and 10-year averages.

Communication with financial markets

The AOFM closely monitored the operations of the Treasury Bond and Treasury Bond futures markets throughout the year and maintained an active dialogue with price makers, the RBA and the Australian Securities Exchange. It also participated as an observer in meetings of the Australian Financial Markets Association's (AFMA's) Debt Securities Committee.

Performance

Market efficiency

The Treasury Bond and Treasury Bond futures markets functioned efficiently in 2006-07. Fine two-way prices were maintained in the outright market and participants reported that sufficient liquidity was available for large transactions. The decline in the turnover of Treasury Bonds seen over recent years appears to have levelled off, while the turnover of Treasury Bond futures contracts continued to increase. The repurchase (repo) market functioned well, with such

instances of tightness that did occur being mild. Usage of the AOFM Securities Lending Facility remained limited.

Turnover in secondary market outright trade of Treasury Bonds recorded in the Austraclear System increased marginally from around \$937 billion in 2005-06 to around \$942 billion in 2006-07. Total turnover of Treasury Bonds¹ increased by 2 per cent; intraday turnover increased by 8 per cent but repo activity declined by 2 per cent. In contrast, the volume of 3- and 10-year Treasury Bond futures contracts continued to increase, with record volumes for both contracts occurring in March and June 2007. The volume of turnover in the 3-year contract increased by around 12 per cent in 2006-07 compared to 2005-06, whereas volume in the 10-year contract increased by around 34 per cent. All Treasury Bond futures contract close-outs in 2006-07 occurred in a smooth manner.

There were relatively few occasions when tight trading conditions were experienced in the repo market in 2006-07. The May 2013 Treasury Bond traded at some 150 basis points below the target cash rate for a few days in August 2006. The April 2015 Treasury Bond traded around 100 basis points below the cash rate briefly in July 2006. The August 2010 and April 2012 Treasury Bond lines experienced a little tightness in early 2007.

The AOFM Securities Lending Facility allows bond market participants to borrow Treasury Bonds when they are not readily available from other sources in the market. This enhances the efficiency of the Treasury Bond market by improving the capacity of intermediaries to make two-way prices, particularly for bonds that become tight in the repo market. The facility was used 38 times in 2006-07 compared with 37 times in 2005-06. The face value lent was around \$1,284 million, an increase of around 10 per cent over 2005-06. The majority of transactions continued to be for one day only, although there were eight instances where counterparties sought stock for two days or more (compared to 12 occasions in 2005-06), with one transaction extending to six days. The largest amount lent on a single day was \$164.2 million and loans exceeded \$100 million on a further two occasions. Feedback from financial market participants indicates that the Facility has enhanced the efficiency of the Treasury Bond market.

The AOFM will continue actively to monitor market conditions in 2007-08. To assist it in making these assessments, it has recently sponsored academic research into indicators of Treasury Bond market efficiency. The results of this research are due later this year.

1 Includes secondary market outright trade, repo and intra-day activities.

Cash management

Objective

The AOFM manages the daily cash balances of the Australian Government in the Official Public Account (OPA).² The AOFM's primary objective in managing these balances is to ensure that the Government is able to meet its financial obligations as and when they fall due. Other objectives are to minimise the cost of funding the balances and to invest excess balances efficiently. In minimising cost the AOFM seeks to avoid undue use of the overdraft facility provided by the RBA.³

Achieving the objective

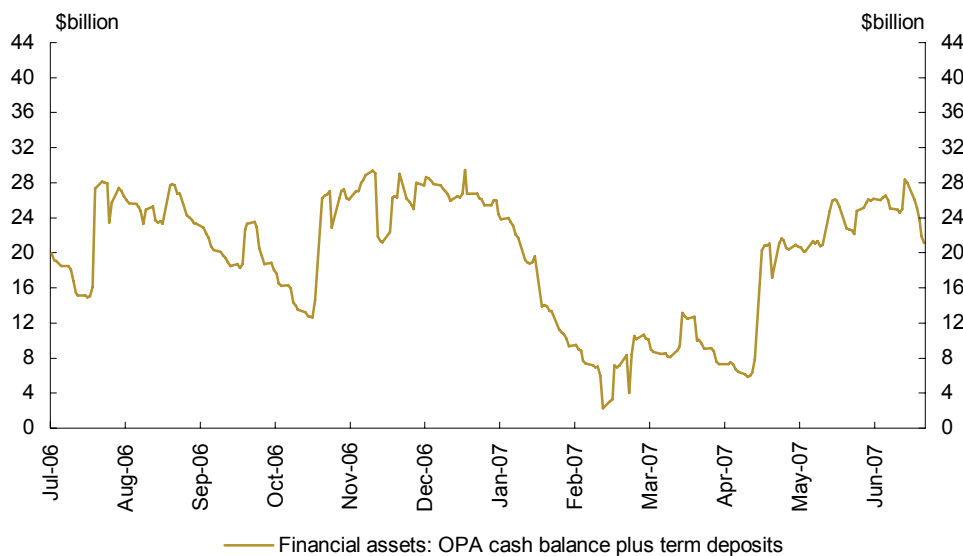
In recent years, the instrument used to manage the cash balances has been term deposits with the RBA. Balances not required immediately are invested for nominated periods, with the maturity dates set primarily to finance large future outlays. The magnitudes and tenor of the term deposits are determined by the AOFM; the interest rate is based on the Overnight Indexed Swap rate.

The daily movement in the Australian Government's financial asset position at the RBA (OPA cash balance plus term deposits) during 2006-07 is shown in Chart 2.

2 The Official Public Account (OPA) is the collective term for the Core Bank Accounts maintained at the RBA for Australian Government cash balance management.

3 The overdraft facility is more costly than equivalent short-term borrowing (for example, issuance of Treasury Notes). The terms of the facility provide that it is to cover only temporary shortfalls of cash and is to be used infrequently and, in general, only to cover unexpected events.

Chart 2: Australian Government financial asset holdings at the Reserve Bank of Australia 2006-07



Within-year cash flow volatility remained high in 2006-07, with the 'peak-to-trough' swing for financial asset holdings being around \$27 billion, compared to \$28 billion in 2005-06 and \$29 billion in 2004-05. Daily net cash flows exceeded \$10 billion on three of the quarterly tax collection days, and on one of the days when monies were transferred to the Future Fund.

In undertaking its cash management activities, the AOFM is required to maintain the 91-day rolling average of the daily OPA cash balance within operational limits around a target level. In 2006-07 these limits were the same as applied in 2005-06, with an operational target of \$750 million and upper and lower limits of \$1,000 million and \$500 million respectively. There is also a Ministerially-approved upper limit of \$1.5 billion.

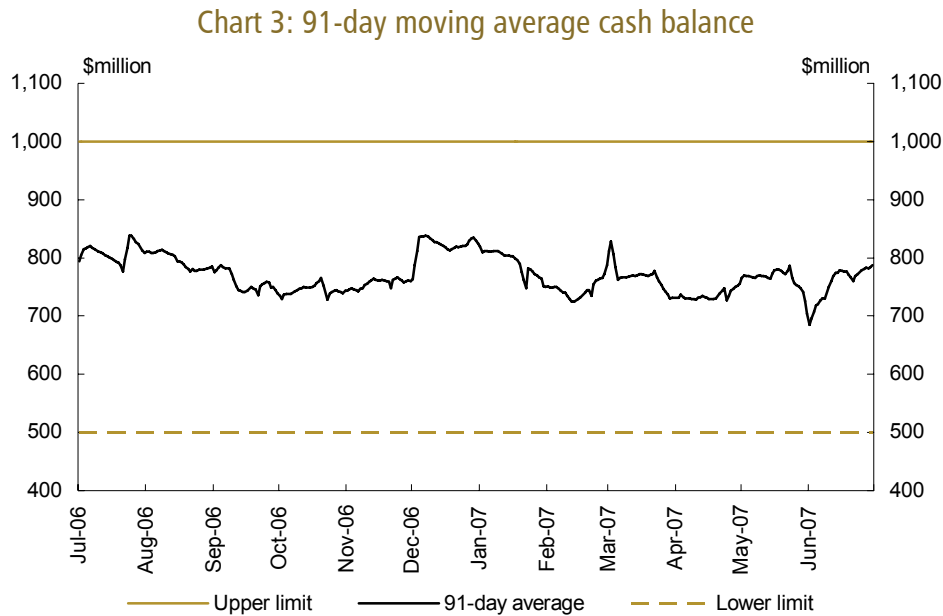
During 2006-07 the AOFM placed 462 term deposits with the RBA. The stock of term deposits fluctuated from a maximum of \$28.95 billion in November 2006 to a minimum of \$1.55 billion in February 2007.

In past years Treasury Notes have been issued to help meet the within-year funding requirement. This was not necessary in 2006-07. Treasury Notes were last issued in 2003.

Performance

The objective of meeting the Government's financial obligations when they fall due was met in 2006-07, without access to the overdraft facility. The 91-day moving average OPA cash balance was maintained within operational limits and within the Ministerial limit throughout the year.

Movements in the 91-day rolling average OPA cash balance over the year are shown in Chart 3.



Minimising debt servicing costs subject to acceptable risk

Objective

In managing its debt portfolio, the AOFM seeks to minimise debt servicing costs over the medium term at an acceptable level of risk, by which is meant an acceptable level of variability in cost outcomes.

The measure of cost used is historic accruals debt servicing cost. This includes interest on physical debt and derivatives, realised market value gains and losses, capital indexation of inflation-linked debt and the amortisation of any issuance premiums and discounts. Accrual debt servicing cost is the most appropriate measure of cost 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 market value gains and losses will be realised.

Information on unrealised market value gains and losses is useful in circumstances where it is possible that they may be realised in the future. In the AOFM's financial statements, debt servicing cost outcomes are presented on a 'fair value' basis that includes movements in the unrealised market value of physical debt, assets and interest rate derivatives. A comprehensive income format is used that allows revenues and expenses on an historic basis to be distinguished from the effects of unrealised market value fluctuations.

Achieving the objective

The physical debt in the AOFM's portfolio offers little opportunity for reducing debt servicing costs, because the volume and nature of the debt is determined by the Government's policy of issuing to support the Treasury Bond and Treasury Bond futures markets⁴. Also the volume and tenor of assets held as term deposits are largely determined by cash management requirements and Government decisions on the allocation of and the proceeds of asset sales. However, debt servicing costs can be reduced by using derivative instruments to adjust the cost and risk characteristics of the portfolio. The AOFM uses interest rate swaps⁵ to serve this objective.

Debt issued for long periods at fixed rates of interest will usually command a higher interest rate than shorter-term debt, because lenders typically demand a higher return for having their funds locked away for longer periods. Interest rate swaps can provide savings in debt service costs by swapping from longer- to shorter-term debt (or from fixed rate debt to floating rate debt). However, increasing the amount of short-term or floating rate debt in the portfolio increases the potential variability of debt service costs.

The two key parameters used to measure the risk of the portfolio are modified duration and short-dated exposure.

- Modified duration is a standard market measure that is similar to the weighted average term to maturity. Portfolios with higher modified duration exhibit more stable, yet higher, debt servicing costs in normal conditions where the yield curve is upward sloping.
- Short-dated exposure measures the proportion of the portfolio subject to immediate repricing. Portfolios with a higher level of short-dated exposure tend to exhibit a higher level of variability in debt servicing costs because the interest cost of this portion of the portfolio adjusts more quickly to changes in market interest rates. However, such portfolios have lower interest costs on average in conditions where the yield curve is upward sloping.

Setting the benchmark portfolio

In seeking to reduce debt servicing costs the AOFM uses a benchmark portfolio which identifies the desired trade-off between cost savings and variability in debt servicing costs over the medium term. The benchmark portfolio balances the savings expected to be available from having a portfolio with low modified duration against the potential for added variability in debt servicing cost outcomes. The benchmark portfolio is reviewed annually. A key assumption made

4 See the sections on Treasury Bond issuance on page 11.

5 An interest rate swap is a financial contract where one party agrees to pay another a stream of fixed interest payments on an agreed notional principal amount, in return for a stream of floating interest rate payments on the same notional principal.

in setting it is the size of the estimated term premium, which is the margin over the expected path of cash rates that investors require to compensate them for investing in long-term debt. Another important consideration is the estimated volatility of market interest rates, as this affects the expected variability in debt servicing costs of alternative portfolio structures.

In order to achieve savings in debt service costs, the benchmark portfolio is set with a lower modified duration and higher short-dated exposure than would result from debt issuance alone. Interest rate swaps are undertaken to bring the actual portfolio closer to the benchmark. In recent years swap programmes have included:

- mid- to longer-dated interest rate swaps to receive fixed rates for terms that broadly match the maturity of bonds on issue. These interest rate swaps reduce modified duration and increase the short-dated exposure of the portfolio; and/or
- shorter-dated interest rate swaps in which the AOFM pays fixed rates for terms that match the maturities of the desired benchmark profile and receives floating interest rates. These interest rate swaps reduce the short-dated exposure of the portfolio.

Decisions about executing interest rate swaps within the programme take account of current market conditions and how they compare with the assumptions underpinning the benchmark. Discretion is used so as to avoid undertaking interest rate swaps where the cost saving and risk properties are unattractive relative to the benchmark assumptions. Exercising discretion in this manner is likely to generate cost savings or lower risks (or both) compared with mechanically following the benchmark.

The benchmark is aligned to the nominal component of the Australian dollar Long-Term Debt Portfolio. However in assessing the desired balance between cost and risk in setting benchmark parameters, account is also taken of the wider portfolio's exposure to indexed debt (from the Treasury Indexed Bonds that remain on issue).

Management of the portfolio during 2006-07

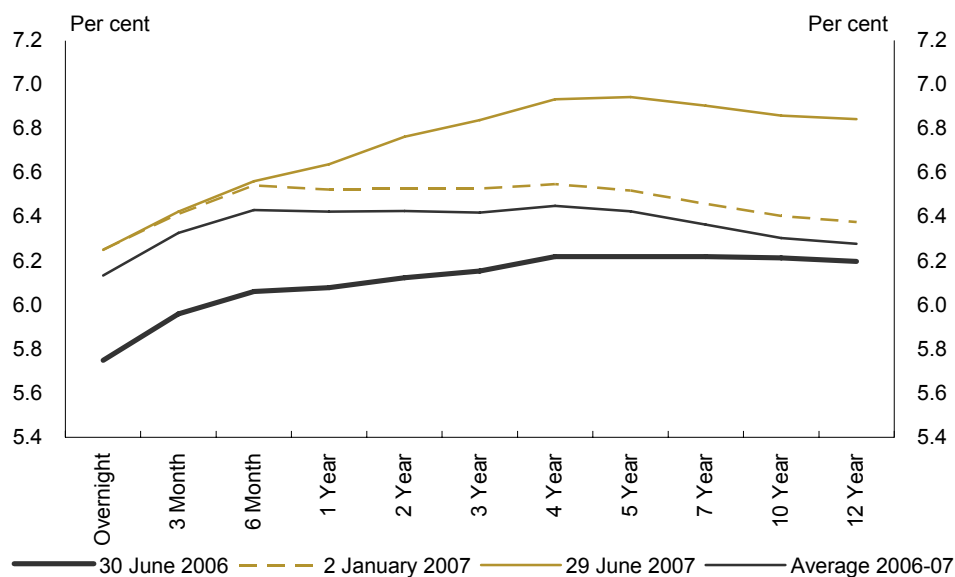
Over recent years, the slope of the yield curve has become flatter, reducing the margin between the yields on longer- and shorter-term debt. At times, the slope of the swap yield curve has been negative. The AOFM has taken these developments into account in its annual benchmark reviews and progressively reduced its estimate of the term premium. In the 2005 review of the benchmark, it increased the modified duration of the benchmark from 2 to 2.5, while keeping its short-dated exposure at 35 per cent. These targets were maintained for 2006-07.

At the start of the financial year, the modified duration of the actual portfolio was close to the benchmark, at 2.43, but short-dated exposure was higher, at 40.5 per cent. The AOFM announced an interest rate swap programme of between \$1 billion to \$3 billion in swaps to receive fixed rates and up to \$2 billion of swaps to pay fixed rates. This programme was

designed to provide scope to keep the modified duration of the portfolio close to the benchmark while allowing short-dated exposure to be reduced. The programme also provided for flexibility in the volume and timing of the execution of swaps depending on prevailing market conditions.

Movements in swap yields over the course of 2006-07 are illustrated in Chart 4. At the start of the year the curve was relatively flat at tenors beyond one year. As the year progressed, the curve flattened further and, in some segments, became inverted. Towards the end of the year it became steeper again. There was also an increase in the overall level of the curve through the year as market interest rates rose.

Chart 4: Australian swap yield curves 2006-07

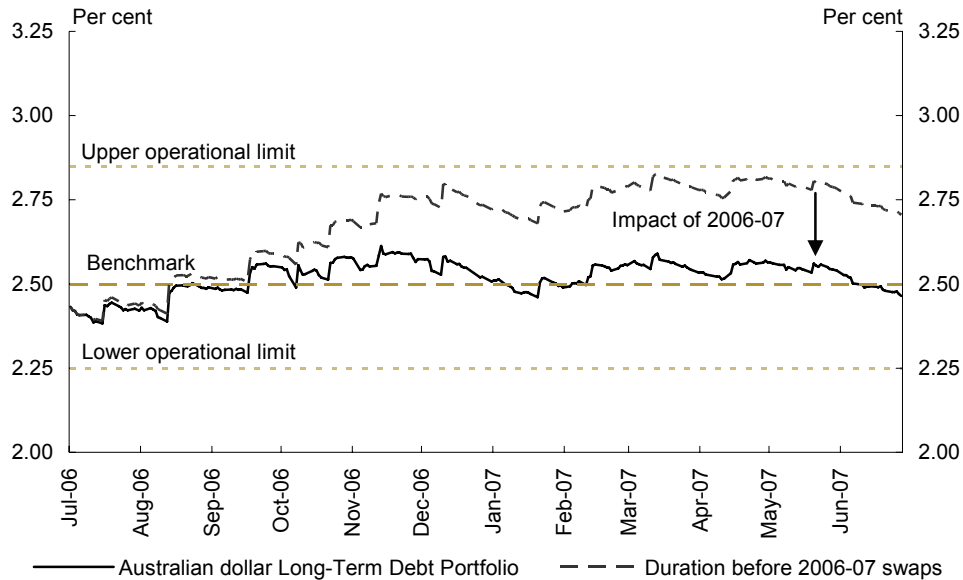


Source: Australian Financial Markets Association, Reuters.

The flatness of the curve over much of the year reduced the savings likely to be obtained in the short term from the execution of new swaps to receive fixed rates. However, given a positive term premium, the flatness of the curve also implied market expectations of subsequent adjustments in short-term rates over the five to ten year life of the swaps that would tend to enhance the savings obtained. In addition, undertaking swaps to receive fixed rates allows the AOFM to match and offset the rates being paid on the new issuance of physical bonds. The rise in the overall level of the yield curve made it more attractive to undertake such swaps.

Balancing these factors, the AOFM executed \$2.5 billion of swaps to receive fixed rates during the year, predominantly with four and five year tenors. Consequently, the modified duration of the portfolio remained very close to its benchmark target of 2.5. Modified duration over the year is shown in Chart 5.

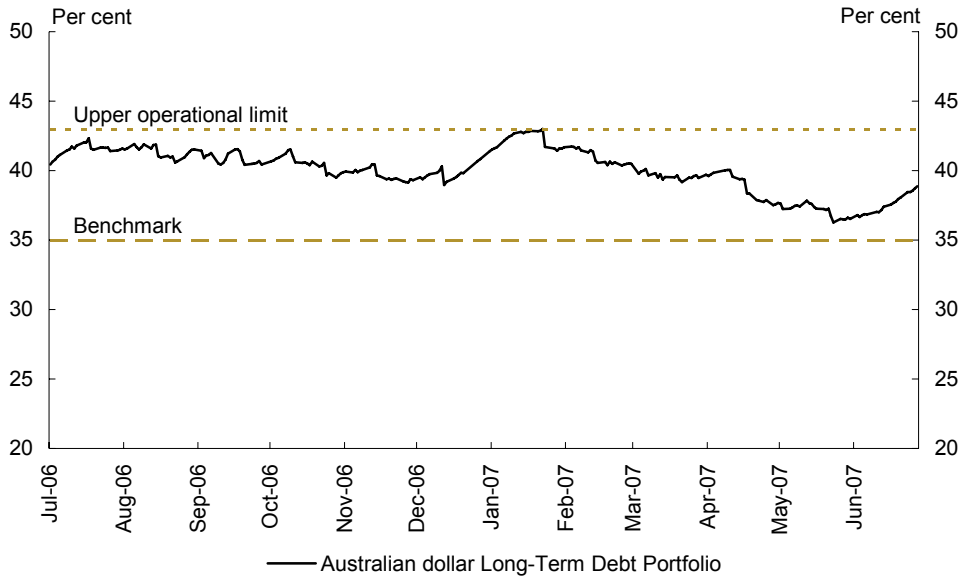
Chart 5: Modified duration — nominal component of Australian dollar Long-Term Debt Portfolio 2006-07



The AOFM did not execute any swaps to pay fixed rates during the year. It considered that, although the portfolio had a higher short-dated exposure than the benchmark, and was thus more exposed to increases in short-term rates, the reduction in this risk that would be obtained from undertaking swaps to pay fixed rates was not justified, given the prevailing fixed yields that such swaps would lock in (for terms up to three years).

Short-dated exposure therefore remained above the benchmark target during the year. However, changes in the volume and composition of the debt on issue, together with maturities of existing swaps, provided some downward movement in short-dated exposure over the course of the year. Chart 6 shows the short-dated exposure of the portfolio during 2006-07.

Chart 6: Short-dated exposure — nominal component of Australian dollar Long-Term Debt Portfolio 2006-07



Swap execution in 2006-07

Of the \$2.5 billion of interest rate swaps undertaken in 2006-07, \$1.5 billion were executed with maturities of 4 or 5 years with the remainder executed at maturities of 10 and 10½ years. The average spread from mid market was 0.25 of a basis point on the mid tenor swaps and 0.16 of a basis point on the longer-tenor swaps.

Table 2: Spreads from mid-market on interest rate swaps

	2005-06			2006-07		
	Amount (\$m)	Average bp	Range bp	Amount (\$m)	Average bp	Range bp
Short-dated swaps (pay)	1,300	0.0	-0.9 to 1.07	0		
Mid-dated swaps (receive)	200	-0.55	-1.2 to 0.1	1,500	-0.25	-0.9 to 0.3
Long-dated swaps (receive)	100	0.60	0.6	1,000	-0.16	-0.7 to 0.3

*With swaps to pay fixed rates, the AOFM expects on average to pay a margin over the mid market rate.
With swaps to receive fixed rates, the AOFM expects on average to receive a margin under the mid market rate.*

Additional statistical information on the AOFM’s interest rate swap activity in 2006-07 is available on the AOFM website.

Foreign currency exposure

As at 30 June 2007, the only foreign currency denominated debt in the portfolio was a US dollar denominated loan with a remaining face value amount of \$US5.3 million, which is scheduled to mature in March 2017. The AOFM is prepared to repurchase stock in this loan at a fair market price prior to maturity if it is offered by stockholders.

Performance

Reducing debt servicing cost

The debt servicing cost⁶ for 2006-07 of the gross debt managed by the AOFM was \$3.6 billion on an average book value of \$55.8 billion. This represented a net cost of funds of 6.42 per cent. Term deposits held with the RBA generated interest revenue of \$1.1 billion on an average book value of \$18.6 billion, giving a yield of 6.15 per cent.

Taken together, the combined portfolio of debt and assets managed by the AOFM⁷ had a net interest expense of \$2.4 billion at an effective yield of 6.56 per cent.

The interest expense of gross physical CGS debt in 2006-07 was \$3.6 billion, on a book volume of \$55.8 billion, representing a cost of funds of 6.44 per cent. This outcome reflected the mixture of securities issued at different fixed rates of interest at different times since the early 1990s. Specifically:

- debt issued prior to 1998, representing about 31 per cent of gross debt by volume in 2006-07, had an average cost of 7.88 per cent;
- debt issued between 1998 and 2006, representing about 64 per cent of gross debt, had an average cost of 5.80 per cent; and
- new securities issued in 2006-07, representing about 5 per cent of gross debt, had an average cost of 5.85 per cent.

The debt servicing cost of physical debt fell by \$37 million compared to 2005-06, as relatively expensive debt issued in the 1990s matured and was replaced with new debt issued at lower interest rates. This was partially offset by higher capital indexation charges on Treasury Indexed Bonds and a slightly higher volume of nominal debt.

6 Debt servicing cost includes net interest expenses (measured on an accruals basis) plus foreign exchange revaluation gains and losses. Unrealised changes in the market valuation of domestic debt and derivatives are not part of this measure.

7 The figures given in this section relate to net CGS debt which includes all administered assets and liabilities on the AOFM's balance sheet, apart from loans to the States arising from Commonwealth-State Housing Agreements, which are managed separately. Housing Agreement assets are included in the figures in the financial statements in Part 4.

Returns on interest rate swaps fell by \$127 million compared to 2005-06. This was due to maturities of existing swaps that had been executed in more favourable market conditions in the past, less favourable terms on new swaps and the higher level of floating rates in 2006-07. On a net basis, interest rate swaps provided cost savings of \$9 million during the year.

The interest revenue on term deposits in 2006-07 was \$1.1 billion, on a book volume of \$18.6 billion, representing a return on funds of 6.15 per cent. This yield was higher than in 2005-06 (when it was 5.55 per cent) due to higher short-term interest rates. The average volume of term deposits was lower than in 2005-06, mainly due to the transfer of assets to the Future Fund. The lower volume of deposits reduced the absolute amount of interest received on the deposits compared to 2005-06, but had a favourable effect on the net cost of funds on the combined portfolio of debt and assets.

The Long-Term Debt Portfolio had an average book volume of \$56.3 billion in 2006-07, with a cost of \$3.6 billion or 6.42 per cent. The net size of the portfolio increased, largely due to the transfer of ongoing assets from the portfolio to the Future Fund. The loss of these ongoing assets from the Long-Term Debt Portfolio increased its absolute net interest cost, although in percentage terms the cost was the same (6.42 per cent) in both years.

The Cash Management Portfolio held an average asset balance of \$19.1 billion and earned net interest of \$1.2 billion, which represented a weighted average return of 6.16 per cent on these balances (up from 5.55 per cent in 2005-06). The portfolio invests in short-dated assets and therefore benefited from higher short-term interest rates. This was partially offset by a decrease in the average volume of the portfolio.

Table 3 provides further details of the cost outcomes for the combined portfolio by instrument and portfolio for 2005-06 and 2006-07.

Table 3: Australian Government debt portfolio cost of funds analysis

	Interest expense		Book volume		Effective yield	
	2005-06	2006-07	2005-06	2006-07	2005-06	2006-07
	\$million		\$million		% per annum	
Contribution by instrument						
Treasury Fixed Coupon Bonds	(3,055)	(2,988)	(47,200)	(47,641)	6.47	6.27
Treasury Inflation Indexed Bonds	(567)	(601)	(7,991)	(8,108)	7.10	7.42
Treasury Notes	-	-	-	-		
Other miscellaneous domestic debt	(3)	(2)	(33)	(20)	10.47	9.81
Foreign loans	(2)	0	(15)	(7)	12.19	-4.88
Gross physical CGS debt	(3,627)	(3,591)	(55,240)	(55,775)	6.57	6.44
Interest rate swaps	136	9	-	-		
Gross CGS debt (after swaps)	(3,491)	(3,581)	(55,240)	(55,775)	6.32	6.42
Term deposits with the RBA	1,313	1,147	23,658	18,645	5.55	6.15
Net CGS debt	(2,179)	(2,435)	(31,582)	(37,130)	6.90	6.56
Contribution by portfolio						
Long Term Debt Portfolio	(3,161)	(3,613)	(49,262)	(56,267)	6.42	6.42
Cash Management Portfolio	982	1,178	17,680	19,137	5.55	6.16
Net CGS debt	(2,179)	(2,435)	(31,582)	(37,130)	6.90	6.56
Re-measurements (a)	1,108	1,015				
Net CGS debt (after re-measurements)	(1,071)	(1,420)	(31,582)	(37,130)		

(a) Re-measurements refers to unrealised changes in the market valuation of financial assets and liabilities

Movements in market interest rates acted to reduce the market value of the net portfolio during the year. Changes in market value are allocated in the financial statements between amortised (historic) cost and re-measurements, which represent unrealised gains and losses from price movements. In 2006-07, there were unrealised gains of \$1.0 billion in the net CGS debt portfolio. They included a reduction of \$1.6 billion in the market value of CGS debt offset by a reduction of \$555 million in the market value of interest rate swaps.

The unrealised reduction in the market value of gross CGS debt recorded in 2006-07 resulted from the overall increases in market interest rates experienced over the course of the year. It indicates that the potential cost of liquidating the debt has fallen. However, the debt in the portfolio is issued until maturity and there is no policy intention to reduce the volume of gross debt other than when maturities exceed new issuance.

The unrealised reduction in the market value of swaps also resulted from the increases in market interest rates. It indicates that the potential return from liquidating the swap portfolio has also fallen. Liquidating the entire swap portfolio in a short period of time would be impractical, but the market value figure is relevant mainly for assessing the opportunity costs and benefits of alternative portfolio management strategies. For example, if a larger volume of swaps to pay fixed rates had been executed in the preceding years, the unrealised reduction in the market value of swaps in 2006-07 could have been smaller. However, as indicated above, while this

would have brought some short-term savings, it was considered that the high cost of fixed rates made this unattractive over a longer time horizon.

Comparisons with alternative portfolios

The cost outcomes for the actual portfolio can be compared with the outcomes that might have been achieved by other possible portfolios. One such alternative portfolio is the physical debt in the portfolio without swaps. Another is a model that tracks the targeted parameters specified by the benchmark. Simulated outcomes for these portfolios are compared with the outcome for the actual portfolio in Table 4.

Table 4: Relative performance analysis: Long-Term Debt Portfolio (LTDP) vs benchmark in 2006-07

	Average modified duration (nominal \$A)	Cost of funds before re-measurements (\$million)	Cost of funds effective yield (%)	Cost of funds after re-measurements (\$million)
Actual LTDP	2.52	-3,613	6.42	-2,598
Benchmark	2.51	-3,614	6.42	-2,617
Unswapped	4.13	-3,622	6.44	-2,053

Because the actual portfolio was managed very closely to the target benchmark over the course of the year, there was very little difference in the cost of funds between it and the cost of the model benchmark in accrual historic cost terms. There was a small difference in the unrealised market value gains and losses (that is, re-measurements) between the two portfolios. Both experienced unrealised revaluation gains, with the gain for the actual portfolio being a little larger.

Both the actual portfolio and the model benchmark portfolio had similar outcomes in accrual cost terms to the unswapped portfolio due to the small savings generated by swaps during the year. However, the unrealised revaluation gains on both these portfolios were markedly lower than for the unswapped portfolio. In each case this was due to negative revaluations on interest rate swaps.

Unrealised gains and losses from changes in market value can vary considerably from year to year. The article on managing the cost of debt in this report shows the experience of the actual portfolio in this regard over recent years (Chart 6) and how unrealised gains and losses relate to overall savings in debt service costs (Chart 7). It may be observed that:

- changes in the market value of swaps due to changes in interest rates have been in the opposite direction to, and offset, changes in the market value of debt;

- the change in the market value of swaps experienced in 2006-07 is of similar order to those in preceding years; and
- although unrealised gains and losses in the market value of swaps have been substantial in individual years, they remain a good deal smaller than the cumulative realised savings from the use of interest rate swaps in the portfolio.

The model of the benchmark portfolio

The AOFM introduced a model benchmark portfolio in 2003-04. The model was based on the actual portfolio together with a set of simulated swaps to keep the model aligned with the benchmark target values for modified duration, short-dated exposure and repricing risk at various tenors. The model benchmark required a large volume of swaps to meet these targets.

In reality, executing a large volume of swaps would have been likely to have distorted the prices available in the interest rate swap market. Consequently, the model did not characterise a strategy that could be readily replicated in practice and was of limited value as a comparator.

In last year's annual report it was indicated that a new model of the benchmark would be introduced during 2006-07 that would track the benchmark parameters closely within rules that would limit the volume of simulated swaps. By using transactions that the actual portfolio could replicate in practice, the new model was expected to provide a more realistic and meaningful basis for comparisons of outcomes. The operation of the two models was reviewed during the year. The review endorsed the superiority of the new model and use of the old model was discontinued from 1 July 2007.

In 2006-07, the funding costs of the actual portfolio were 0.01 per cent higher than the original model benchmark (before re-measurements). After re-measurements, the actual portfolio underperformed the original model benchmark by \$10.1 million.

Credit management

The Australian Government's exposure to counterparty credit risk arises through the use of interest rate swaps and is managed by reference to a Credit Policy. Due to the general rise in interest rates during the financial year and the greater volume of swaps to receive fixed rates than swaps to pay fixed rates in the portfolio, the value of the portfolio fell over the course of 2006-07. Consequently, the Australian Government's exposure to credit risk at 30 June 2007 was lower than at the beginning of the financial year.

Table 5: Derivative counterparties by credit rating as at 30 June 2006 and 30 June 2007

Credit rating: Moody's/ Standard & Poors (a)	Number of AOFM counterparties by credit rating as at 30 June 2006	Number of AOFM counterparties by credit rating as at 30 June 2007
Aaa/AAA	1	1
Aa1/AA+	0	2
Aa2/AA	6	12
Aa3/AA-	9	6
A1/A+	4	3
Total number of counterparties	20	24

(a) Where a counterparty has a split rating between the two ratings agencies it is allocated to the lower of the two ratings levels.

Collateral agreements, which require counterparties to post collateral when the Australian Government's credit exposure rises above a predefined threshold, remained the focus of credit risk management for 2006-07. Over the course of the financial year, the AOFM executed two new Credit Support Annexes to provide for collateral agreements, bringing the total number to 19. One was with an existing AOFM counterparty while the other was with a new counterparty with whom no swap transactions have yet been executed.

On 30 June 2007, 90 per cent of the total nominal face value of the interest rate swap portfolio was covered by collateral agreements.

Communications Fund

The Communications Fund was established by the Australian Government in September 2005 with an initial cash amount of \$2 billion. The purpose of the Fund is to provide an income stream to fund the Government's response to any recommendations proposed by the Regional Telecommunications Independent Review Committee in reports reviewing the adequacy of telecommunication services in regional, rural and remote parts of Australia.

The AOFM was authorised by the Minister for Communications, Information Technology and the Arts and the Minister for Finance and Administration (the responsible Ministers) to oversee the initial investments of the Fund as term deposits with the RBA until longer-term arrangements were decided.

Following a review by a consultant engaged by the Department of Communications, Information Technology and the Arts, the responsible Ministers approved a longer-term investment strategy for the Fund and agreed that the AOFM would continue to manage the Fund's investments.

The Investment Authorisation for the longer-term investment strategy was signed by the responsible Ministers on 22 January 2007. Under the approved investment strategy and guidelines:

- The Fund is to have a relatively high level of liquidity whereby all the seed funding and accumulated earnings are to be available within three months with minimal risk of capital loss over that period.
- The Fund is to invest in a portfolio of basic low risk Australian denominated debt instruments and deposits. Acceptable debt instruments and deposits include bank accepted bills, negotiable certificates of deposit and commercial paper.
- The Fund is to maintain a portfolio credit rating standard of AAAf as set by the Standard & Poor's ratings agency.
- On full transition to the approved longer-term investment strategy, the before fees portfolio performance benchmark is the UBS Australian Bank Bill Index. The after expenses performance benchmark for the Fund is the UBS Australian Bank Bill Index less 2 to 3 basis points.

Following its appointment to manage the Fund longer-term, the AOFM established an investment facility to manage Communications Fund monies and an investment dealing panel for the facility. Panel members are required to be Authorised Deposit-Taking Institutions regulated by the Australian Prudential Regulation Authority and have a significant presence in the Australian short-term money market. At end-June 2007, there were 19 dealing panel members.

The AOFM commenced the investment of monies under the longer-term investment strategy in late-June 2007. All Communications Fund investments in term deposits with the RBA had been replaced by investments consistent with the longer-term investment strategy by the beginning of August 2007.

Financial information concerning the operation of the Communications Fund is reported in the financial statements of the Department of Communications, Information Technology and the Arts.

Operational risk

Objective

The AOFM manages its exposure to operational risk, which is the risk of loss, whether direct or indirect, resulting from internal processes, people, or systems, or from external events. It encompasses risks inherent in the agency's operating activities such as fraud risk, settlement

risk, accounting risk, personnel risk and reputation risk. Operational risk involves both an operational failure occurring and there being a resultant loss.

Achieving the objective

The AOFM maintains a culture of prudence and does not engage in speculative trading activity. Staff share in the ethos of the Australian Public Service and are bound by its Code of Conduct and the AFMA Code of Conduct. This foundation is accompanied by an extensive system of controls which is overseen by the Audit Committee and Operational Risk Committee. The Compliance and Operational Risk Unit monitors compliance with its Balance Sheet, Interest Rate Risk and Credit policies and procedures on a daily basis.

In 2006-07, the AOFM undertook a number of activities to enhance the operational risk framework including:

- an enterprise risk assessment and assurance project to identify, at a high level, the operational and financial risks affecting the agency and review the controls in place to mitigate these risks;
- a project to address the Certificate of Compliance requirements for Chief Executives of agencies governed by the *Financial Management and Accountability Act 1997* to report on compliance with the financial management framework annually from 2006-07 onwards;
- development of a compliance regime for the AOFM's Communications Fund investment activities;
- scoping work to assess the impact on the AOFM of the Australian Government's new Anti-Money Laundering and Counter-Terrorism Financing legislation which places on prescribed reporting entities obligations in relation to, among other things, customer identification, transaction reporting and record-keeping; and
- internal audits covering activities such as business continuity and disaster recovery planning, contract management and regulatory risk management.

Settlement operations

In 2006-07, the AOFM settled all payment obligations in line with contractual obligations with counterparties. During the year there was one occasion when an AOFM counterparty was late making a payment.

International activities

Over the 2006-07 financial year, the AOFM continued to provide support for debt management activities in Papua New Guinea and the Solomon islands. Two staff were seconded to the Solomon Islands and one to Papua New Guinea under the auspices of the Regional Assistance Mission Solomon Islands and the Enhanced Cooperation Programme respectively. These deployments aim to develop cash and debt management capabilities through training and mentoring, as well as the development of systems and procedures. This year a workshop was conducted by the AOFM in Canberra attended by officials of the two countries together with seconded AOFM staff. The workshop identified options and priorities for developing cooperation on debt management between the three countries.

The AOFM hosted visits from debt management officials from China, Chile, Indonesia and Thailand. A senior staff member conducted seminars in Bangkok on bond issuance and conversion techniques at the invitation of the Bank of Thailand. The AOFM also participated in the annual meeting of Australian and New Zealand Chief Finance Officers of government debt management agencies held in Wellington.

The AOFM participated in the annual Working Party on Debt Management of the Organisation for Economic Co-operation and Development (OECD) meeting in Paris and the third OECD-China forum on Public Debt Management and Government Securities Markets in Beijing. At the request of the World Bank, the CEO addressed a forum for sovereign debt managers in emerging market economies in Cairo. A senior staff member gave a presentation on off-balance sheet risks to the APEC Future Economic Leaders' Think Tank forum in Sydney. This annual forum is an initiative of the APEC finance Ministers. Other officials presented papers at a government cash management workshop in India arranged by the World Bank and at a debt strategy modelling workshop hosted by the Bank of Canada in Ottawa.

Agency financial performance

Agency activities recorded an operating surplus of \$1.67 million for the 2006-07 financial year, comprising total revenues of \$10.05 million and expenses of \$8.38 million. As at 30 June 2007, the AOFM was in a sound net worth and liquidity position, reporting net assets of \$11.69 million, represented by assets of \$13.05 million (including current assets of \$0.58 million) and liabilities of \$1.36 million.

As at 30 June 2007, the AOFM maintained cash and unspent appropriations totalling \$11.39 million. These funds are held to settle liabilities as and when they fall due and for future asset replacements and improvements.

During 2006-07, the AOFM did not return or establish a provision for return, by way of dividend, of unspent appropriation monies to Government.